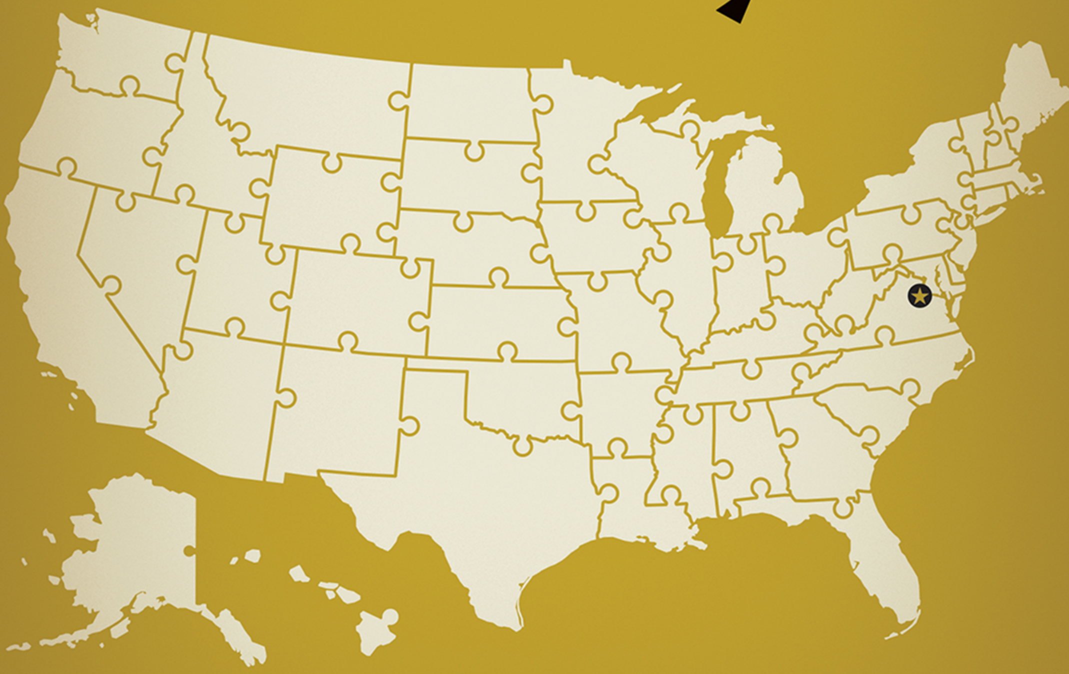
Perspectives on Political and Economic Governance

American Federalism Today



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Is the United States Still a Competitive Federal System?

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In democratic societies, competitive federalism exists when elected officials at lower tiers of government have independent authority to determine a broad range of tax, expenditure, and regulatory policies (Feld et al. 2004). Within such a system, the higher and lower tiers each have a specific domestic policy function to perform (Peterson 1995). The central government executes the redistributive function, the reallocation of resources from the productive to the dependent segments of society.[1] The lower tiers of government carry out the developmental function by establishing a regulatory framework and providing services that foster community prosperity and growth. Their focus on development is a byproduct of constraints imposed by their structural position within a competitive federal system. States, provinces, municipalities, and special districts compete with one another for human, material, and financial capital. To enjoy prosperity, states and municipalities need to offer services and establish regulatory frameworks that attract productive residents and business without imposing overly burdensome taxes (Peterson 1981, 1995; Tiebout 1956). Winners typically enjoy higher property values, increased economic activity, population growth, and enhanced fiscal strength. Losers struggle with property devaluation, capital flight, out-migration, and fiscal stress. If losses are extreme, the state or municipality risks bankruptcy.

Competitive federalism is an unusual form of government. Although 40 percent of the world's population is said to live within a federal system (Forum of Federations 2021), it is the large countries that select this form of government. Only 23 to 25 of the world's 193 countries have any form of federalism, competitive or not (Rodden 2006, 23; Forum of Federations 2021). In noncompetitive federal systems, the national government places sharp limits on lower tiers of government, either by appointing its officers or by financing and closely regulating their expenditure. Only in the United States, Canada, and Switzerland do independently elected officials exercise broad authority over tax, expenditure, and regulatory policies (Feld et al. 2004; Lauden and Smith 2000, 634, 636, 653–54; Rodden 2006; see also Olowu 2002, 19; Republic of India 2006, 8).[2] Among these three, the United States seems to provide the clearest contemporary example of competitive federalism, as in the other two countries the number of lower-tier governments is fewer, making it easier for them to coordinate action.

Tocqueville noticed the exceptional aspects of federalism in the United States as early as 1835 when he wrote "Americans love their towns for much the same reasons that highlanders love their mountains. In both cases the native land has emphatic and peculiar features; it has a more pronounced physiognomy than is found elsewhere" (quoted in Winthrop 1976, 96). He regarded its federal institutions as foundational for both political liberty and economic prosperity (Hancock 1990; Winthrop 1976).

Developmental vs. Redistributive Functions

Differences between higher and lower tiers of government are propensities, not inevitabilities. Political struggles within a democratic society may generate outcomes inconsistent with the broad propositions outlined above. The national government can and does undertake developmental projects, especially large-scale ones (space exploration, basic scientific research) beyond the capacity of lower-tier governments. State and local tiers of government experiment in redistribution. They are more likely to do so if they enjoy a monopoly over valued resources or are well situated in a highly desirable location, in a scenic setting or adjacent to a harbor, waterway, or transportation hub. For example, the politics and policies of San Francisco differ from those in most other cities in part because its setting is unparalleled (DeLeon 1992).

Despite these exceptions, throughout the twentieth century, national and subnational tiers of government usually focused on their distinctive functions (Peterson 1995). However, recent changes in US politics have had the potential to alter those foci. To see whether the structure of federalism in the United States has shifted in response to political developments, we look at types of public expenditures and sources of revenue by central and local governments between fiscal years 1993 and 2021.

To describe recent political changes, following V. O. Key (1949), we divide society into two broad categories, the "haves" and "have-nots." The group of haves consists of households who are self-sufficient enough that their outputs spill over to the benefit of others. The have-nots are those who are not productive enough to be self-sufficient, but who remain partially or wholly dependent on charity or government assistance.

The relative power of the haves and have-nots has shifted back and forth over the three-quarters of a century since the end of World War II. The close balance of forces is evident from the shifting back and forth in partisan control of the presidency and the regularity with which the party controlling the executive lacks control of one or both houses of the legislative branch. Only in a few instances has one party been so dominant that it controls both branches, the most recent cases in point being short periods within the Johnson, Obama, Trump, and Biden administrations. Still, in the postwar era, the "arc of history," to borrow a phrase from President Obama, bends toward the have-nots (Obama 2016). As this segment has gained greater political weight and become more politically sophisticated, it has enlarged the size of the public sector, broadened the range of services provided to have-nots, and tightened regulations on the productive segment of society, or the haves.

But has politics altered the structure of the federal system? Has political change shifted the focus of lower-tier governments? To address that question we trace trends at both the national and lower governmental tiers in (1) the share of expenditures allocated for developmental and redistributive purposes; and (2) the progressivity of revenue streams received by each level of government. If the structure of competitive federalism has remained essentially intact, we expect to see little change in the percentage of state and local expenditures paid from their own fiscal resources that is allocated to developmental rather than redistributive purposes. We also expect to observe little change in sources of revenue. But if political trends have been powerful enough to alter the structure of the federal system, we expect to see an increasing share of state and local expenditure allocated for redistributive purposes and an increasing use of progressive taxes by state and local governments.

Lower Tiers of Government in a Federal System

The traditional role of the lower tiers of government is to provide a set of services that sustain the community's economic development. As James Bryce (1921, 132) phrased it a century ago:

> It is the business of a local authority to mend the roads, to clean out the village well or provide a new pump, to see that there is a place where straying beasts may be kept till the owner reclaims them, to fix the number of cattle each villager may turn out on the common pasture, to give each his share of timber cut in the common woodland.

The role played by lower tiers of government remains no less significant today than when Bryce penned these words. Admittedly, the size of government has risen steeply in the intervening period. Between 1962 and 1993, outlays for redistributive and developmental purposes by the central government rose from 5 percent to 11 percent of the GDP (table 11.1; Peterson 1995, 54, table 3-1). Outlays by state and local governments rose nearly as rapidly. In 1962, they were at 7 percent of GDP (Peterson 1995, 54, table 3-1), higher than the outlays by the central government. By 2018, they had increased steeply to 10.3 percent of GDP, a somewhat lower rate of increase than that of the central government (table 11.2). Yet state and local tiers of government still accounted for nearly half of US government domestic spending allocated toward redistributive and developmental purposes.[3]

Table 11.1 National expenditure, 1993–2021 (2018 US $billions)

Items	1993	*Share*	2018	*Share*	2021	*Share*	*Annual growth rate 1993–2018*	*Annual growth rate 2018–2021*
Developmental								
Transportation	56	*0.05*	93	*0.04*	154	*0.03*	*2.0%*	*18.5%*
Utilities	7	*0.01*	2	*0.00*	6	*0.00*	*-4.5%*	*40.2%*
Safety	24	*0.02*	60	*0.02*	71	*0.01*	*3.7%*	*5.7%*
Education	76	*0.06*	96	*0.04*	298	*0.05*	*0.9%*	*46.2%*
Natural resources	69	*0.06*	76	*0.03*	443	*0.08*	*0.4%*	*79.8%*
Science and tech	27	*0.02*	32	*0.01*	36	*0.01*	*0.6%*	*4.1%*
Post office	3	*0.00*	-1	*0.00*	-3			*23.9%*
Subtotal Developmental	**262**	***0.22***	**357**	***0.15***	**1,006**	***0.18***	***1.2%***	***41.2%***
GDP share	*2.4%*		*1.8%*		*4.7%*			
Redistributive								
Welfare	743	*0.61*	1,466	*0.60*	2764	*0.49*	*2.8%*	*23.6%*
Health and hospitals	159	*0.13*	551	*0.22*	796	*0.14*	*5.1%*	*13.1%*
Housing and development	52	*0.04*	84	*0.03*	103	*0.02*	*2.0%*	*6.8%*
Subtotal Redistributive	**954**	***0.78***	**2,101**	***0.85***	**4,670**	***0.82***	***3.2%***	***30.5%***
GDP share	*8.8%*		*10.3%*		*21.6%*			
Total Developmental and Redistributive	**1,216**	***1.00***	**2,458**	***1.00***	**5,675**	***1.00***	***2.9%***	***32.2%***
GDP share	*11.2%*		*12.1%*		*26.3%*			
Other expenditure								
Pensions/medical insurance	103		147		162		*1.4%*	*3.4%*
Administration	21		24		274		*0.6%*	*125.5%*
Defense	466		631		754		*1.2%*	*6.1%*
International affairs	28		49		47		*2.3%*	*-1.4%*
Interest	318		325		352		*0.1%*	*2.7%*
Subtotal Other expenditure	**935**		**1,176**		**1,590**		***0.9%***	***10.6%***
GDP share	*8.6%*		*5.8%*		*7.4%*			
Total National expenditure	**2,151**		**3,634**		**7,265**		***2.1%***	***26.0%***

Note: Share is over total developmental and redistributive expenditure.

Source: Budget of the United States (2021), Table 3.2, Outlays by Function and Subfunction: 1962–2025.

Table 11.2 State and local direct expenditure, 1993–2021 (2018 US $billions)

Items	1993	*Share*	2018	*Share*	2021	*Share*	*Annual growth rate 1993–2018*	*Annual growth rate 2018–2021*
Developmental								
Transportation	94	*0.08*	159	*0.08*	154	*0.06*	*2.1%*	*-1.0%*
Natural resources	41	*0.03*	72	*0.03*	74	*0.03*	*2.3%*	*1.0%*
Safety	140	*0.12*	27	*0.01*	286	*0.12*	*-6.4%*	*120.4%*
Education	511	*0.42*	986	*0.47*	1,003	*0.42*	*2.7%*	*0.6%*
Utilities	187	*0.15*	323	*0.15*	337	*0.14*	*2.2%*	*1.4%*
Miscellaneous	(1)	*0.00*	7	*0.00*	15	*0.01*		*28.8%*
Subtotal Developmental	**972**	***0.80***	**1,574**	***0.75***	**1,870**	***0.78***	***1.9%***	***5.9%***
GDP share	*9.0%*		*7.7%*		*8.7%*			
Redistributive								
Welfare	194	*0.16*	607	*0.29*	650	*0.27*	*4.7%*	*2.3%*
Health and hospitals	24	*0.02*	(120)	*-0.06*	(186)	*-0.08*		*15.7%*
Housing	21	*0.02*	33	*0.02*	62	*0.03*	*1.8%*	*23.4%*
Subtotal Redistributive	**239**	***0.20***	**520**	***0.25***	**526**	***0.22***	***3.2%***	***0.4%***
GDP share	*2.2%*		*2.6%*		*2.4%*			
Total Developmental and Redistributive	**1,211**	***1.00***	**2,093**	***1.00***	**2,397**	***1.00***	***2.2%***	***4.6%***
GDP share	*11.2%*		*10.3%*		*11.1%*			
Other expenditure								
Pensions/medical insurance	158		365		530		*3.4%*	*13.3%*
Administration	148		293		106		*2.8%*	*-28.8%*
Interest on debt	88		111		107		*0.9%*	*-1.2%*
Subtotal Other expenditure	**394**		**769**		**743**		**2.7%**	**-1.1%**
GDP share	*3.6%*		*3.8%*		*3.4%*			
Total State and local expenditure	**1,605**		**2,862**		**3,140**		**2.3%**	**3.1%**

Note: Share is over total developmental and redistributive expenditure.

Source: US Census Bureau, Annual Surveys of State and Local Government Finances (multiple years).

When the lower tiers of government play such a major role in the provision of public services, they can adapt services to local needs and tastes. They can learn desired levels of service provision and estimate price levels by observing choices made by neighbors (Berry and Berry 1990; Walker 1969). Local governments can also explore new policy options without forcing wholesale change nationwide. As Justice Louis Brandeis observed: “A single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country” (New State Ice Co. v. Liebmann 1932, 262; but see Tarr 2001). If the experiment seems successful, others will try it out; if it fails or proves controversial, others will modify or ignore it.

Within a competitive system, state and local governments resist taking responsibility for large-scale redistributive programs. If states and localities attempt to tax the rich unduly and give generously to the poor, they become perverse magnets that attract dependent households but repel productive ones. For example, states that pay high welfare benefits to needy families are more likely to attract dependent households (Peterson and Rom 1990). More generally, residents of local communities "vote with their feet" by choosing to live in a locality where government services and regulatory practices suit their preferences and needs (Hirschman 1970; Hoxby 2000; Tiebout 1956). Between 2015 and 2020, about 13 percent of the population moved to a new place of residence annually (Frost 2020). If the prosperous are taxed unduly, they will search for alternative residences (Rauh and Shyu 2021). Locational responsiveness of high-income residents to state and local tax differentials increased with the passage of federal tax legislation in 2017 limiting federal income tax deductions for taxes paid to lower tiers of government. Population shifts from high-tax states (California, New York, and Illinois) to low-tax states (Florida, Texas, Montana, and Colorado) have been so substantial that the former lost seats in the House of Representatives as part of the reapportionment that followed the 2020 population census (Ax 2021). Other shifts from large central cities to suburbs, towns, exurbs, and more remote locations have accelerated since the onset of the COVID pandemic (Roberts 2020; Whyte 2020). All such moves affect property values at both the departure and destination points. Local policymakers have strong incentives to choose options likely to benefit a community's economic and social development. Perhaps that is why Bryce thought local officials exhibited a "narrowness of mind and the spirit of parsimony." If it were otherwise, Bryce added, "there would be less of that shrewdness which the practice of local government forms" (Bryce 1921, 132–33).

Throughout the twentieth century, the "spirit of parsimony" at the state and local levels remained well entrenched. Local expenditure focused on activities designed to enhance local prosperity, not interfere with it. Admittedly, state and local governments in the United States were not immune from the growth-in-government syndrome characteristic of the postwar era. However, the level of redistributive expenditure of state and local governments from own fiscal sources continued at a relatively modest level even after political changes in the aftermath of the Vietnam War. Self-financed expenditure for redistributive purposes by local governments budged upward from only 0.76 percent of GNP in 1962 to just 0.94 percent of GNP in 1990. Self-financed state redistributive expenditures expanded from 1.4 percent to only 2.5 percent of GNP during this period (Peterson 1995, 54, tables 3-2, 3-3).

In sum, the tiers of government in the United States in 1990 continued to fulfill their historic functions. Government expanded in size, but lower tiers remained faithful to modern versions of traditional responsibilities: to repair trails, upgrade wells, mend fences, police streets, and school the community's children. They executed government's development function.

Political Pressures for Redistribution

Political changes in the late twentieth century nonetheless threatened to alter the developmental focus of lower tiers of the federal system. Congress added free medical services, free and subsidized food services, housing subsidies, enlarged welfare benefits, compensatory education, and other programs for low-income households to its redistributive portfolio. To implement these policies, it provided intergovernmental grants to state and local governments. To administer these programs, state and local governments hired many more employees and recruited policy specialists whose perspectives were not always consistent with the traditional role of the lower tiers of government. As the number of employees increased, they became a fertile field for union organizers.

Intergovernmental Programs

Federal grants for redistributive programs (largely for payments to individuals) increased fiftyfold from $11.4 billion to $630.3 billion in constant 2012 dollars between 1955 and 2021, a shift from 0.4 percent to 3.3 percent of GDP over the period (figure 11.1). The grants generally came at little cost to lower tiers of government. Yet the clear redistributive purposes of these activities carried an implicit message that state and local governments can—and should—execute redistributive policy.

Policy Professionals

Federal grants initially generated intergovernmental conflict between national and lower tiers of government (Pressman and Wildavsky 1973). Housing for the poor was resisted locally by those who insisted it not be placed in "my backyard." When it was built, it was concentrated in dangerous high-rise silos or designed to serve an elderly, middle-class clientele. Grants directed toward the education of children from low-income households ended up funding traditional school operations. However, policy professionals

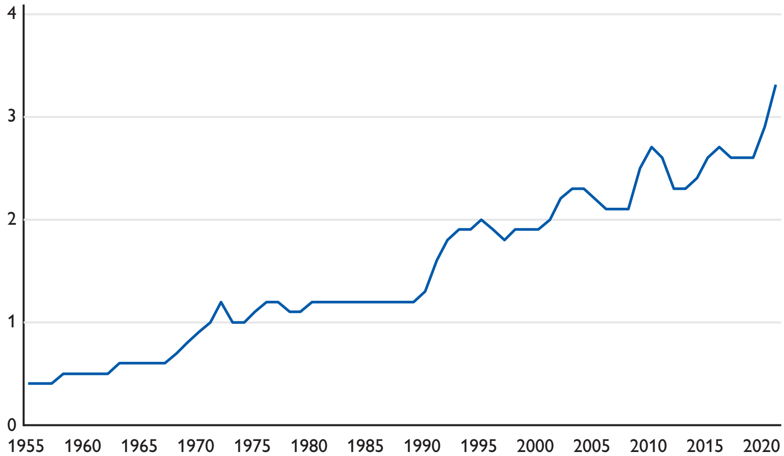

Figure 11.1 Transfers from national to state and local governments as a share of GDP, 1955–2021

Source: Budget of the United States (2021), Table 6.1, Composition of Outlays: 1955–2028.

sympathetic to the needs of program recipients were eventually hired to grease the intergovernmental machinery. They proved more loyal to their programs and their professional mission than to any tier of government for which they worked (Grodzins 1966). Gradually, they acquired the power to shape the broad range of public services (public health, mental health, special education, compensatory education, low-income housing, and welfare) in ways that adapted to nationally designed programs (Peterson, Rabe, and Wong 1986).[4] The new system acquired the moniker "cooperative federalism" (Grodzins 1966).

Collective Bargaining

As state and local government took on more responsibilities, the number of local government employees jumped upward—from 3.6 million in 1955 to 13.9 million in 2020 (figure 11.2). The number of those working for state governments shifted upward from about 1.2 million in 1955 to 5.2 million in 2020.[5] With a tripling of the size of the public-sector workforce, trade unions perceived an opportunity to broaden their constituency at a time when the manufacturing sector was in decline and trade unions in the private sector were suffering steady enrollment losses. But to capitalize on the opportunity, public-sector unions needed to overturn long-standing laws prohibiting collective bargaining and union strikes in the public sector.[6]

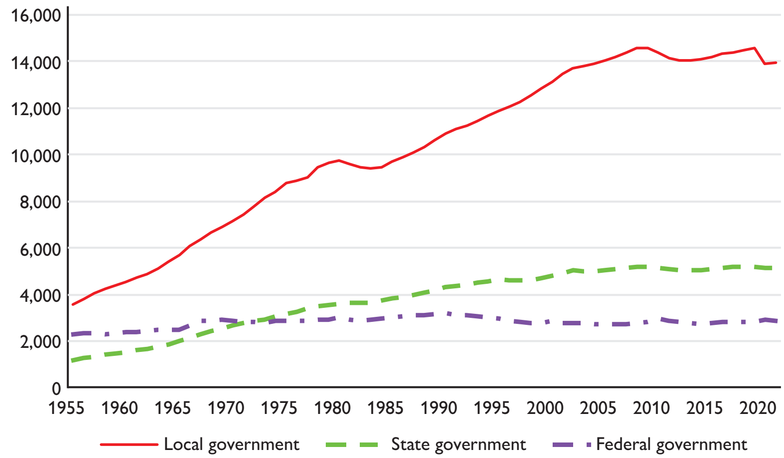

Figure 11.2 Number of public-sector employees, 1955–2021 (thousands)

Source: US Bureau of Labor Statistics, All Employees, Federal (CES9091000001), retrieved from FRED, Federal Reserve Bank of St. Louis.

In the 1950s, northern Democrats introduced bills in Congress that would allow federal employees to select unions to bargain collectively on their behalf. A stout Republican–Southern Democratic coalition blocked their passage, but in 1963, President John F. Kennedy issued an executive order granting federal employees the right to bargain on matters related to their working conditions, though not on wages and benefits that have direct impacts on governmental expenditure.

The presidential order opened the floodgates at state and local tiers of government. Over the next decade and a half, thirty-three states passed laws that imposed upon municipalities, school boards, and other lower tiers of government the duty-to-bargain collectively with their employees (Lovenheim and Willén 2019). The topics subject to bargaining included salaries, benefits, working conditions, and general school policy, such as the number of charter schools that could open within a district (Sowell 2020) and school openings during the COVID pandemic (Hartney and Finger 2022).

These changes in the intergovernmental system—enlarged grant programs, recruitment of policy professionals sympathetic to have-nots, and public-sector collective bargaining—posed a challenge to the structure of competitive federalism. It is plausible that together they were potent enough to alter the propensity of state and local tiers of government to concentrate their focus on development policy.

Data

To explore this topic, we track changes in domestic expenditure as well as changes in sources of revenue for both the national tier and the lower tiers of government between 1993 and 2021, the latest year for which relevant information is available.

Domestic Expenditure

We present domestic expenditure at selected intervals for this twenty-eight-year period as reported by the *Annual Survey of State and Local Government Finances* (hereinafter *AS*) issued yearly by the US Census Bureau.[7] We classify most expenditure as either developmental or redistributive.[8] We classify as developmental the following categories of domestic expenditure: transportation, natural resources (parks and recreation), safety (police and fire), education, utilities, and miscellaneous. We assume that the primary purpose of these expenditures is to sustain the well-being of the community as a whole, though some redistribution may occur. For example, there may be lower utility rates for low-income groups and more intensive safety protection in communities with high concentrations of poverty. We classify education as a developmental expenditure, because a primary purpose of educational institutions is to enhance human capital. It may also contribute to equal educational opportunity, but most research suggests that disparities in student performance between those from higher and lower socioeconomic backgrounds increase as students age and move to higher grades in school (Jencks and Phillips 1998; Shakeel and Peterson 2022). We classify the welfare, housing, and health and hospital categories in the *AS* data set as redistributive expenditure.

We place employee pensions and medical insurance in a separate category because it is part of the compensation package offered to public-sector employees. We are unable to distinguish between benefits received by employees whose activities are developmental from those whose activities are redistributive.[9]

We allocate expenditure to the tier of government that is the source of revenue used to cover its cost. For example, medical services paid out of grants from the national government are identified as expenditures by the highest tier but medical services paid from state and local sources of revenue are classified as expenditures by the lower tiers.[10] Classification error may occur when placing government-reported data into these analytical categories. Any government program may be in service of both developmental and redistributive purposes, and the function of a program may vary with the setting in which it is provided.

Sources of Revenue

The way in which a government obtains its revenues also fosters either developmental or redistributive objectives. If residents generally receive benefits from services commensurate with the amount of taxes paid, then revenue policy fosters a developmental objective. If have-nots receive more benefits from services than taxes paid, and haves do not, the tax system fosters a redistributive objective. Consistent with these propositions, we assume that the greater the progressivity with which governments access revenue, the greater the redistribution. Conversely, the less progressive the system of revenue collection, the more government is pursuing developmental objectives. We rank order tax sources by conventional notions of progressivity.

Our rank order from most to least progressive is as follows:

1. Individual income tax. The federal individual income tax and most state income taxes levy higher rates on households of higher income.
2. Corporate income tax. Corporate taxes are at least in part a tax on earnings of stockholders who are usually members of households of higher income.
3. Property tax. Taxes on property are generally proportional to property values.
4. Excise and sales taxes. Sales and excise taxes are consumption taxes that fall on households roughly in proportion with their expenditures except they generally fall more heavily on luxury items than necessities.
5. Federal payroll tax (social insurance trust). The tax is set at a constant level on wages and then it is capped; it falls more heavily on lower-income to middle-income workers than on higher-income ones.
6. Utility and liquor store revenue; charges, fees, and miscellaneous taxes. These sources of revenue usually capture a larger share of the income of lower-income households.

We exclude from own local revenues any amounts received from the central government through intergovernmental grants. We also exclude revenues received from state and local insurance trusts to cover pension and medical insurance costs, as state and local governments withdraw those sums from funds they have invested for this purpose.

Trends in Domestic Expenditure, Revenue Sources, and Debt

In this section, we trace trends in expenditure and revenue sources over the twenty-eight years 1993–2021. All calculations are percentages of GDP or in constant dollars.

Domestic Expenditure

Redistributive expenditure by the national government grew almost fivefold, from $0.95 trillion in 1993 to $4.7 trillion in 2021 (table 11.1 and figure 11.3). Up until 2018, the average annual rate of increase was 3.2 percent, though the rate of increase fluctuated within that period. Redistributive expenditure declined from 8.8 percent to 7.8 percent of GDP between 1993 and 2000, but Congress then added prescription drug benefits to Medicare and Medicaid during the Bush administration and passed the Affordable Care Act during the first years of the Obama administration. Redistributive spending rose to 11.7 percent of GDP by 2010, with most of the increase driven by expenditures for hospitals and healthcare. Between 2010 and 2018, economic growth and reduced expenditure for housing and community development facilitated a decline in redistributive spending to 10.3 percent of GDP, but this was followed by a sharp increase to 21.5 percent of GDP in 2020 and 21.6 percent of GDP in 2021. This was fueled by increases in welfare payments, which almost doubled after 2018, and health spending, which went up by 44 percent.

Developmental expenditure by the central government increased from $262 billion in 1992 to $357 billion in 2018, a 1.2 percent annual rate of increase (table 11.1). That increase was concentrated in the safety budget, perhaps as a function of increased concern about terrorists and illegal immigration. National development expenditure as a share of GDP declined from 2.4 percent to 1.8 percent. In the period between 2018 and 2021, developmental expenditure grew sharply, at an annual rate of 41 percent, driven by natural resources and education. However, the developmental share of total expenditures by the national government declined from 85 percent in 2018 to 82 percent in 2021, as redistributive expenditures grew at a much faster rate.

At the state and local level, expenditure from own sources climbed from $1.6 trillion in 1993 to $2.9 trillion in 2018, an annual rate of increase of

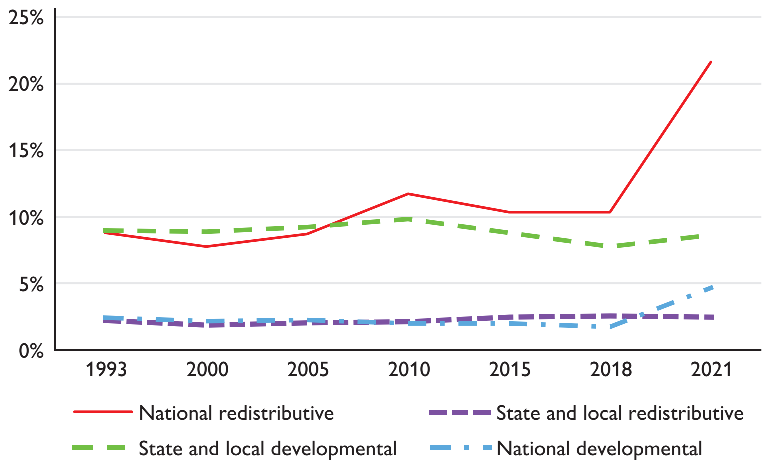

Figure 11.3 Expenditure by level of government and type as a share of GDP, 1993–2021

Note: We exclude pensions and medical insurance, administration, defense, international affairs, and debt interest.

Sources: US Census Bureau, Annual Surveys of State and Local Government Finances (multiple years); Budget of the United States (2022), Table 3.2, Outlays by Function and Subfunction, 1993–2028.

2.5 percent (table 11.2 and figure 11.3).[11] The amount spent for redistributive purposes rose from $239 billion to $520 billion in 2018, an annual growth rate of 3.2 percent. As a percentage of GDP, redistributive expenditure went from 2.2 in 1993 to 2.6 in 2018 but then slipped to 2.4 in 2021.

Welfare (public assistance and other cash transfer programs) constitutes the largest item within state and local redistributive spending category. It also is the one that grew the most, at an annualized 4.7 percent between 1993 and 2018 and by 2.3 percent annually between 2018 and 2021. Offsetting these increases, the category defined as "health and hospitals" paid for from state and local sources shows a decline in expenditure in the period before 2018 (when expenditures from federal grants are excluded), while housing expenditure grew modestly at 1.8 percent between 1993 and 2018.

Developmental expenditure by state and local governments shows a broadly similar pattern. It rose from about $1.0 trillion in 1993 to $1.7 trillion in 2010, or from 9.0 percent to 9.8 percent of GDP, probably due in part to a contracting economy. It then retreated to 7.7 percent by 2018, as expenditures plateaued and the economy expanded. By 2021, it was $1.9 trillion, or again 8.7 percent of GDP. Overall, the increase in 1993–2021 was 2.4 percent annually, rather less than the 2.9 percent increase for redistributive expenditure. As of 2021, education, the largest single category, constitutes the largest of development expenditures, with about $1 trillion (and 42 percent of total developmental and redistributive expenditure). This compares to the $650 billion in welfare, the largest redistributive expenditure.

As mentioned, the amount spent by state and local governments on pensions and medical insurance for government employees is not classified as either redistributive or developmental. These expenditures climbed steadily from $158 billion in 1993 to $365 billion in 2018, a steep annual rate of increase of 3.4 percent. The introduction of collective bargaining seems to have encouraged state and local governments to greatly increase employee benefits (Biggs and Richwine 2014; Costrell and Dean 2013; Koedel, Ni, and Podgursky 2014; Koedel and Podgursky 2016).

Between 2018 and 2021, welfare expenditures jumped to $530 billion. This increase was driven by increases in unemployment compensation, which increased by 511 percent between 2018 and 2021 due to rapid expansion of unemployment benefits during the COVID pandemic.

In sum, both redistributive and developmental expenditures had increased steeply over the twenty-five-year period 1993–2018. But redistributive expenditure as a share of total expenditure by the lower tiers of government did not change materially between 1993 and 2018. In 2021, redistribution is 22 percent of state and local redistributive and developmental spending, as compared to 20 percent in 2018 and 22 percent in 1993. Although shifts occur within this period, no secular trend is evident. The structure of competitive federalism appears to have remained substantially unchanged. However, expenditures devoted to pensions and health insurance increased by an annual rate of 3.4 percent, the largest rate of increase for any large category of expenditure. Collective bargaining is driving up employee costs. It is the most dynamic element in state and local finance.

Revenues

In 1993, the individual income tax levied by the central government generated 70 percent of the revenue received by the national government (table 11.3 and figure 11.4). That percentage ebbed and flowed over the next twenty-five years, becoming 78 percent of total national government revenue in 2018. By 2021, it slipped to 75 percent. As a source of revenue for the national government, the corporate income tax reached a high of 20 percent in 2005 but fell to 9 percent in 2018, very likely due both to changes in tax law and to

Table 11.3 National revenue, 1993–2021 (2018 US $billions)

Items		1993	*Share*	2018	*Share*	2021	*Share*	*Annual growth rate 1993–2018*	*Annual growth rate 2018–2021*
Individual income tax		816	*0.70*	1,684	*0.78*	1,947	*0.75*	*2.9%*	*5.0%*
Corporate income tax		188	*0.16*	205	*0.09*	354	*0.14*	*0.3%*	*20.0%*
Subtotal income taxes		**1,004**	***0.86***	**1,888**	***0.87***	**2,302**	***0.88***	***2.6%***	***6.8%***
	GDP share	*9.3%*		*9.3%*		*10.7%*			
Insurance (Social Security and other)		186	*0.16*	316	*0.15*	345	*0.13*	*2.1%*	*2.9%*
Excise taxes		77	*0.07*	95	*0.04*	72	*0.03*	*0.8%*	*-8.9%*
Charges, fees, and other		81	*0.07*	176	*0.08*	230	*0.09*	*3.1%*	*9.4%*
Subtotal consumption, payroll taxes, and other		**158**	***0.14***	**271**	***0.13***	**302**	***0.12***	***2.2%***	***3.7%***
	GDP share	*1.5%*		*1.3%*		*1.4%*			
Total National revenue		**1,162**	***1.00***	**2,159**	***1.00***	**2,603**	***1.00***	***2.5%***	***6.4%***

Source: Budget of the United States (2021), Table 2.1, Receipts by Source.

international shifts in capital. By 2021, it was 14 percent. Revenue from the payroll tax fluctuated between 12 percent and 15 percent between 1993 and 2021 but no strong secular trend takes place. Revenue from the excise tax plunged from 7 percent in 1993 to 4 percent of the total in 2018, and it slipped further to 3 percent by 2021, as government tariffs were lowered as part of efforts to enhance international trade. With 87 percent of revenue coming from individual and corporate income taxes in 2018, it seems clear the US national government tax system remains decidedly progressive.

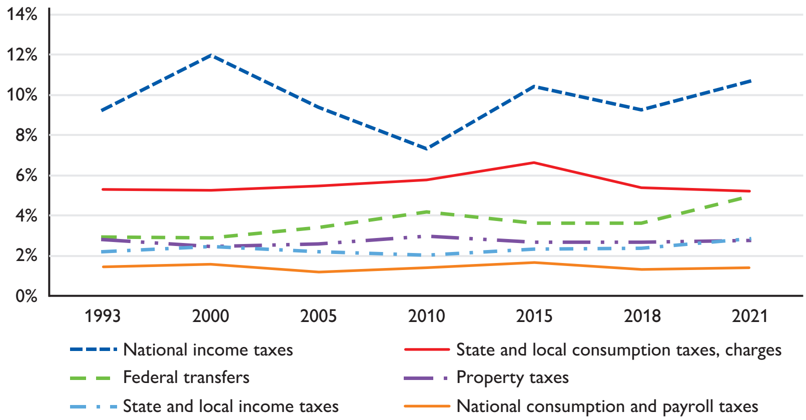

Figure 11.4 Government revenue source breakdown, as a share of GDP, 1993–2021

Sources: US Census Bureau, Annual Surveys of State and Local Government Finances (multiple years); Budget of the United States (2021), Table 2.1, Receipts by Source, 1934–2028.

Redistributive forms of taxation account for a much smaller share of all revenue received by state and local governments from their own sources (table 11.4 and figure 11.4). The amount generated by the individual and corporate income taxes as a portion of total revenues varies between 16 percent and 19 percent during the twenty-five years, but it is only slightly greater in 2018 than in 1993, at 18 percent. In 2021, it is, at 20 percent, only a bit higher. The share generated by the property tax slips modestly from 21 percent in 1993 to 18 percent in 2018, rising to 20 percent in 2021. The trend for the sales tax drifts downward from 23 percent to 20 percent in 2018 and then turns upward to 22 percent in 2021. Meanwhile, the share of revenue from the most regressive sources—utility and liquor store sales, charges, and miscellaneous items—increases from 39 percent to 45 percent, but then subsides to 38 percent in 2021. Altogether, the share of revenues from taxes on consumption (sales and other consumption-based revenues) imposed at the state and local level increases from 63 percent in 1993 to 65 percent in 2018. It then falls to 60 percent in 2021. We may add to that figure the revenue from the

Table 11.4 State and local revenue, 1993–2021 (2018 US $billions)

Items		1993	*Share*	2018	*Share*	2021	*Share*	*Annual growth rate 1993–2018*	*Annual growth rate 2018–2021*
Individual and corporate income tax		239	*0.16*	482	*0.18*	613	*0.20*	*2.8%*	*8.4%*
	GDP share	*2.2%*		*2.4%*		*2.8%*			
Property taxes		304	*0.21*	547	*0.20*	600	*0.20*	*2.4%*	*3.1%*
	GDP share	*2.8%*		*2.7%*		*2.8%*			
Sales taxes		335	*0.23*	611	*0.22*	657	*0.22*	*2.4%*	*2.4%*
	GDP share	*3.1%*		*3.0%*		*3.0%*			
Subtotal taxes		**879**	***0.60***	**1,640**	***0.60***	**1,871**	***0.62***	***2.5%***	***4.5%***
Utility and liquor store revenue		104	*0.07*	184	*0.07*	181	*0.06*	*2.3%*	*-0.6%*
Charges		239	*0.16*	548	*0.20*	543	*0.18*	*3.4%*	*-0.3%*
Other taxes		72	*0.05*	121	*0.04*	133	*0.04*	*2.1%*	*3.1%*
Miscellaneous		159	*0.11*	241	*0.09*	270	*0.09*	*1.7%*	*3.8%*
Subtotal other consumption-based revenues		**575**	***0.40***	**1,094**	***0.40***	**1,126**	***0.38***	***2.6%***	***1.0%***
	GDP share	*5.3%*		*5.4%*		*5.2%*			
Intergovernmental revenue		318		740		1,067		*3.4%*	*13.0%*
	GDP share	*2.9%*		*3.6%*		*4.9%*			
Total State and local revenue		1,771		**3,474**		**4,064**		***2.7%***	***5.4%***

Note: Share is over taxes and other consumption-based revenues.

Source: US Census Bureau, Annual Surveys of State and Local Government Finances (multiple years).

property tax if it is assumed that benefits from expenditures are commensurate with property taxes paid. Once that assumption is made, the share of taxes from less redistributive sources rises to 80 percent. The more redistributive sources—individual and corporate income taxes—account for no more than 20 percent of total revenues in 2021. In other words, there is little sign that sources of revenue upon which state and local governments depend became substantially more redistributive over the entire period.

Debt

The structure of competitive federalism can be threatened by steep increases in liabilities incurred by lower-tier governments. If the debts of lower-tier governments expand rapidly, they can reach a point at which they become unsustainable (Boskin 2020). In the case of state and local governments, excessive debt at the lower tiers could force bailouts by the central government, putting the equilibrium of competitive federalism at risk. We find, however, that in aggregate, the ratio of state and local government debt to revenue did not expand between 1993 and 2021 (figure 11.5).[12] The cost of servicing state and local debt had also not increased as of 2021, as interest rates remained low. However, this is likely to change with the subsequent steep increase in interest rates.

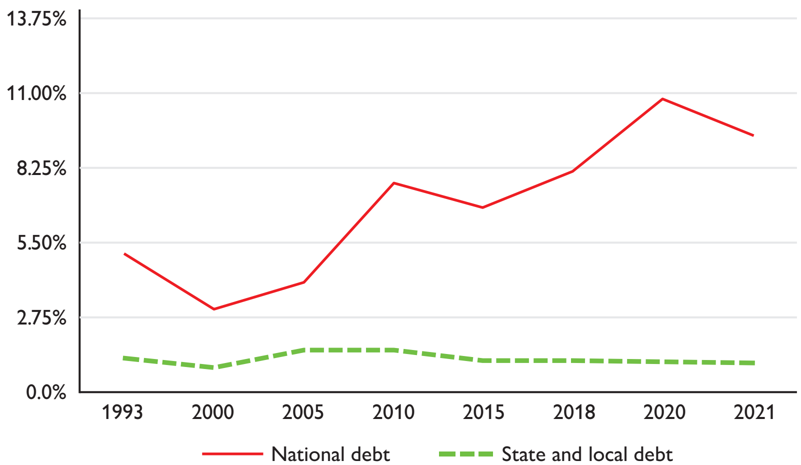

Figure 11.5 Debt levels over total own source yearly revenues (percent), 1993–2021

Source: Board of Governors of the Federal Reserve System (US), Federal Government and State and Local Governments, Debt Securities and Loans, Liabilities Level (FGSDODNS and SLGSDODNS), retrieved from FRED, Federal Reserve Bank of St. Louis.

Equally worrisome, state and local governments may be asked to address imbalances in pension assets and liabilities in the coming decades. Between 1993 and 2021, pension expenses rose by 3.4 percent annually, faster than state and local expenditures classified as either developmental or redistributive (table 11.2).[13] The rapid expansion of pension liabilities is viewed as posing "the threat of default" for numerous state and local governments, which are thought to be burdened by liabilities that are becoming "unaffordable" (Biggs 2014; Farrell and Shoag 2017). The increase in these obligations is a direct consequence of past increases in the responsibilities and, consequently, the employment levels of state and local governments. Though currently a matter of growing concern, the challenges would be mitigated if current inflationary trends continue, as inflation reduces the value of the obligations state and local governments have incurred.

Discussion

The structure of competitive federalism in the United States has remained essentially intact over the past thirty years, despite strong redistributive pressures amid a fluctuating political climate. Revenue and expenditure trends have not decisively shifted the responsibilities or the resources of the lower tiers in government. Although total state and local expenditure shifted upward throughout this period, little secular change in the portion allocated to redistributive purposes took place. Nor has the tax system become more progressive. The major fiscal change has been the share of GDP allocated for employee pensions and medical insurance and the increasing risks from increased liability-to-asset ratios in pension funds. Collective bargaining appears to have had a detectable effect on the way employees are being compensated and on the risks facing pension funds, though this could change if inflation reduces the value of current state and local obligations. Overall, the resources of the lower tiers of government remain directed toward development purposes.

That does not mean that this system of competitive federalism in the United States will remain unaltered in coming decades. The threat of public-sector bankruptcies, especially if pension and medical insurance liabilities escalate, together with an increasing tendency on the part of the national government to relieve institutions in distress, could alter competitive federalism if debts of state and local tiers are routinely covered by the central government. Several municipal governments have declared bankruptcy in recent years—Bridgeport, CO; Harrisburg and Westfall, PA; Central Falls, RI; Moffett, OK; and in California, Stockton, Vallejo, Desert Hot Springs, and San Bernardino. The Detroit school district also declared bankruptcy, with assets divided between pension recipients and bond holders. A new debt-free district was formed. The state of Illinois has teetered on the verge of bankruptcy for much of the twenty-first century (Peterson and Nadler 2014).

Bankruptcy does not by itself alter the structure of a federal system. Eight states defaulted on their debt during an economic crisis between 1841 and 1843, and only half ever compensated investors in full (Peterson and Nadler 2014, 26). Bankruptcies occurred during the deep depression of the 1930s, and the State of New York bailed out New York City when it veered out of fiscal control during the 1960s (Peterson 1981). Although these distressed municipalities and states asked for assistance from the national government, Congress refused to bail them out.[14] Senators and representatives from states and districts that were not facing similar levels of distress saw little reason to pay the debt of jurisdictions they viewed as less prudent. State and local governments cannot be sure the national government will provide substantial assistance in times of fiscal challenge. Nonetheless, calls for federal intervention have become ever more insistent. The dean of the law school at the University of California (Berkeley) urged federal loans to states troubled during the 2008–9 recession, and the famed investor Warren Buffett said it would be hard for the federal government to deny help to states when it had rescued large corporations such as General Motors (Peterson and Nadler 2014, 32).

When the COVID-19 pandemic swept across the country, the federal government did, indeed, respond to similar calls for fiscal relief. In addition to providing moneys to individuals and businesses, Congress enacted four fiscal relief measures that funded state and local governments at levels not previously reached: Families First Coronavirus Response Act (FFCRA); Coronavirus Aid, Relief, and Economic Security (CARES) Act; Consolidated Appropriations Act (CAA); and American Rescue Plan Act (ARPA).

The four pieces of legislation together authorized more than $1.3 trillion in federal grants to state and local governments (table 11.5). The grants were spread out over a multi-year period, but the expected distribution of funds was heavily concentrated on the first three fiscal years, with $125 billion expended in 2020, $738 billion in 2021, and $291 billion in 2022.

Table 11.5 Distribution of federal stimulus funds for state and local governments, by type of expenditure (2020 US $billions)

Type	Act	Total package
Developmental	CAA	69
	CARES	44
	ARPA	284
	Total	*397*
Redistributive	CAA	38
	CARES	26
	FFCRA	1
	ARPA	107
	Total	*172*
General purpose	CARES	340
	ARPA	402
	Total	*742*
	Grand total	**1,319**

Note: Funds appropriated by state and local governments, including the State and Local Fiscal Recovery Funds of the American Rescue Plan Act (ARPA); Families First Coronavirus Response Act (FFCRA); Coronavirus Aid, Relief, and Economic Security (CARES) Act; and Consolidated Appropriations Act (CAA).

Sources: Congressional Budget Office (CBO), "Estimated Budgetary Effects of H.R. 1319, American Rescue Plan Act of 2021," March 10, 2021; CBO, "H.R. 6201, Families First Coronavirus Response Act," April 2, 2020; White House, "President Biden Announces American Rescue Plan," January 20, 2021.

With the enactment of these fiscally expansionary pieces of legislation, the recent subsidization of lower-tier governments by the central government rose to an unprecedented level. The share of state and local revenues coming from federal transfers climbed to over 26 percent in 2021 (figure 11.6), raising concern that the delicate balance may have been permanently altered. Such a shift could undermine the self-reliance of state and local governments that is necessary to preserve a system of competitive federalism. Two-thirds of the authorized relief funds are designated for general purposes, giving lower tiers of government wide latitude in their use of the funds. California used it to give rebates of $1,100 to households with one dependent and $600 to other taxpayers. Illinois, the country's most fiscally distressed state, anticipated a budget deficit of nearly $4 billion in November 2020, but with large, mostly unrestricted grants from the federal government, it was able to balance its budget without a tax increase. The

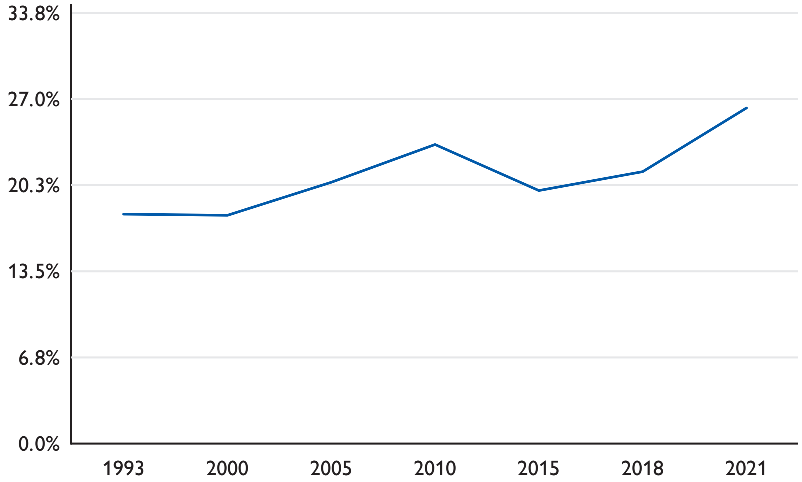

Figure 11.6 Federal transfers over total state and local revenues (percent), 1993–2021

Sources: US Census Bureau, Annual Surveys of State and Local Government Finances (multiple years); Budget of the United States (2021), Table 2.1, Receipts by Source: 1993–2028; authors' estimation.

national government may be setting new expectations for lower-tier governments in fiscal distress. If Congress can be expected to react to economic downturns with sufficient fiscal revenues to cover state and local deficits, then states and localities can be expected to take greater fiscal risks in more prosperous times. To preclude reckless behavior, the central government will begin to impose tighter controls. The autonomy that has been at the heart of competitive federalism will erode.

The structure of competitive federalism in the United States stands as one of the least understood pillars undergirding centuries of economic prosperity. Further, it sustains the liberties of those who may who lack access to power at the national level. Like our republic, it shall endure, as Benjamin Franklin said to Elizabeth Willing Powel, "if you can keep it."[15]

Notes

1. To avoid confusion, we refer to the highest tier of government in the United States as the "central" or "national" government, not the "federal" government. We save "federal" for references to systems of government.

2. The European Community may have been a system of competitive federalism until recently, but the peaceful departure of the United Kingdom from the Community suggests that it is more accurately classified as a confederation of autonomous states, much like the United States under the Articles of Confederation.

3. The figures discussed in this paragraph exclude interest on debt and general administrative expenses but include pensions and medical insurance.

4. In response to the COVID pandemic, for example, public health professionals at all tiers of government exercised extensive influence over economic and social policy.

5. By contrast, the number of employees working for the national government did not change significantly throughout this period. The size of the military sector declined substantially after the end of the Vietnam War. The number of nonmilitary federal employees remained relatively constant at about two million throughout the postwar period. Only 2.8 million people worked for the federal government in 2020, but more than the 2.2 million in 1955.

6. Even pro-union political figures opposed the practice. In 1935, Franklin Delano Roosevelt signed the National Labor Relations Act (NLRA), which established the legal framework that gave a union the authority to negotiate on behalf of private-sector employees when selected as the agent by a majority of them. Yet Roosevelt said similar arrangements within the public sector were unconstitutional because only a democratically elected legislature could commit the public purse. As late as 1960, New York City mayor Robert Wagner Jr., son of the Senator who had sponsored the NLRA in Congress, expressed the view that public-sector bargaining was unconstitutional in the State of New York, though he subsequently altered his position when teachers went on strike (Peterson 2010, 110–15).

7. Peterson (1995) used the decennial *Compendium of Government Finances*, but the Census Bureau no longer releases that document. The two sources use similar if not identical principles of classification.

8. General administration and the interest paid to service general governmental debt are excluded from this analysis.

9. We do not assume that the share of employees is roughly the same as the share of expenditure for each category, because some activities (education) require more personnel than others (welfare). Nor do we assume that employee pensions and medical insurance expenditure may be classified as redistributive on the grounds that benefits are considerably more generous in the public than the private sector (Biggs and Richwine 2014; Costrell and Dean 2013; Koedel, Ni, and Podgursky 2014; Koedel and Podgursky 2016), suggesting they have become an inefficient form of compensation. Benefits substitute for salary, even if they do so inefficiently. The category by itself is of interest, as it shows substantial secular change over the period.

10. We are unable to distinguish between state and local expenditures, because the *Annual Survey of State and Local Government Finances* does not separate federal grants given to local governments from those given to states.

11. We consider state and local expenditures from own sources only. In calculating them, they are therefore netted of federal transfers.

12. The trajectory of state and local debt is similarly flat in this period when we compare it with GDP levels.

13. This is not the case for the national government's pension expenditures (table 11.1), which have been growing less (1.4 percent) than total national development expenditure (2.9 percent), and about the same as national redistributive expenditure (1.2 percent).

14. The national government assumed the debts of states incurred during the Revolutionary War. It was argued that state indebtedness was on behalf of a national cause.

15. The quote was related by James McHenry, Maryland delegate to the Constitutional Convention, in a journal entry dated September 18, 1787.

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