United States Country Report: Second Draft
September 26, 2021
Fiscal Federalism Second Intermediate Workshop, Salzburg

From its inception as a military alliance among colonies, the American system of federalism has been an exercise in compromise. Although he mounted a spirited defense in *The Federalist*, Alexander Hamilton viewed the United States Constitution as far too decentralized, and he was deeply concerned about the notion of independent spending and borrowing by the states. But he saw a loose, uncoordinated group of sovereign states as a far worse alternative. His opponents from Virginia were equally concerned about the prospects that a centralized system would come to be dominated by Northern commercial interests and undermine the system of slavery and plantation agriculture. But given the common perception of existential external threat, they were able to forge a compromise in which sovereignty was to be divided between the states and the federal government. In the language of the Constitution and institutions like the electoral college, the system of bicameralism, and the judiciary, they crafted a variety of safeguards meant to prevent either from overwhelming the other. And they avoided writing down an exhaustive enumeration of the fiscal and policy responsibilities of the federal government, states, and municipalities, leaving future generations with a lot to fight about.

Like other multi-layered political systems, the United States has experienced moments of intense pressure for fiscal and political centralization, including wars, depressions, and fiscal crises. And indeed, the U.S. has experienced significant centralization of both taxation and expenditures over the last two centuries, and the activities of each layer of government have become increasingly intertwined. But the system of constitutional safeguards from the 18th century, and the lingering inter-regional discord that gave birth to it, have preserved a significant

measure of autonomy and independence for the state governments that is somewhat unique among the federations of the world.

After tracing out the origins and evolution of the U.S. system of fiscal federalism, with an eye toward lessons for the European Union, this essay attempts to summarize the system's strengths and weaknesses, all of which have been on stark display during the COVID-19 crisis. First, the safeguards and redundancies built into the U.S. system have been celebrated for their ability to prevent the federal government from overreaching or shirking (Bednar 2012), and for their ability to preserve democracy and protect minorities (Ostrom and Allen 2008). Given the federal government's disengagement during the early days of the COVID crisis, many residents of cities with severe outbreaks gained a newfound appreciation for multi-layered authority, as state and county officials took the lead in establishing COVID mitigation policies. On the other hand, shirking and blame-shifting might be especially attractive political strategies in the intertwined American system, especially in the context of contemporary political polarization. As COVID mitigation policies have become politicized in the United States, age-old battles about the jurisdiction of federal, state, and local authority have been rekindled, often with a negative impact on COVID mitigation.

Second, perhaps one of the most admired features of U.S. federalism is the fact that state governments approach credit markets and voters as miniature sovereigns, and they do not anticipate easy or automatic gap-filling transfers from the federal government to help them service their debts, pay their workers, or provide services during downturns. This forces state governments to make difficult decisions, and prevents them from externalizing their burdens onto one another. But in recent decades, it has also generated exceptionally pro-cyclical patterns of state and local public finance that can prolong recessions—especially in the areas that have

been hardest hit by globalization and the decline of manufacturing. Architects of European integration have much to learn from the successes, failures, and trade-offs illuminated by the American experience with federalism.

Origin and Evolution of the U.S. System of Fiscal Federalism

Origin and goals of the system

The U.S. federal system originated as a defense pact among a group of newly independent colonies (Riker 1964). Their common cause started as a revolt against new taxes (Rabushka 2008), but eventually they declared their independence from Great Britain by asserting a series of loftier fundamental rights, including "life, liberty, and the pursuit of happiness." This union was formed from a group of colonies of very different size, military strength, organization, and economic structure. One of the most central cleavages pitted states where elites derived significant income from slave labor against those that did not. They were only able to reach a constitutional consensus by crafting a series of institutional safeguards that would prevent one faction from imposing its will on the others by capturing the federal government.

Some of these safeguards are now viewed by many as hallmark characteristics of federalism. Some of the language of the Constitution protects the interests of states and places limits on the federal government, and the Senate gives equal representation to all states, regardless of population. Another crucial safeguard only emerged over time. The Federal Judiciary, above all the Supreme Court of the United States, slowly grew in importance over decades, and gained a veto over the policies of the legislature, in large part due to the need for a "referee" between states and the federal government. Many important questions about the fiscal, legal, and policy authority of the federal government, states, and municipalities have been

decided by the Supreme Court. This has led to a situation where many public policy debates that might be determined by legislatures in other countries— for example, early 20th century debates about taxation or the regulation of child labor, or contemporary debates about abortion or gay marriage— are cast in the United States as debates about the authority of the federal government vis-à-vis the states. As a result, the U.S. Supreme Court plays an important role in the United States. On many occasions, the Court has thwarted the aspirations of those who wished to expand the central government's economic authority. But on some occasions, for instance with civil rights or abortion rights, the Court has acted to limit the policy autonomy of states and municipalities in fundamental ways.

The original purpose of the U.S. federation was to provide a limited set of collective goods that were under-provided by the colonies acting individually: above all, collective defense. Alexander Hamilton's aspirations notwithstanding, the design of the U.S. federation reflects the desire of some of its architects to limit the authority of the central government. An explicit goal was to avoid significant inter-regional redistribution and risk-sharing. One of the most distinctive features of the United States political system is that, unlike most advanced industrial democracies, it is still based on an elite bargain from the 18th century. Through industrialization, globalization, depressions, international conflict, and even the Civil War and Reconstruction, the American approach has been to amend rather than renegotiate the original bargain. Remarkably, the basic structure of the 18th century bargain remains in place—celebrated in schools and popular culture and protected by courts.

Evolution of the system

Given that the U.S. federation was born of a tax revolt, it is not surprising that the fiscal authority of the federal government was extremely limited for over a century. Governments were

only able to levy indirect taxes, and well into the mid 19th century, state and local governments funded themselves through land sales and other forms of "taxless finance" (Wallis 2005). From the beginning, Alexander Hamilton viewed the federal government's powers as hopelessly weak, and worked tirelessly to expand the central government's fiscal authority. His famous maneuvers included the assumption of the debts of the states from the Revolutionary War, the establishment of a mint, and the establishment of the First Bank of the United States.

The debate about the establishment of the Bank has cast a long shadow. Thomas Jefferson, James Madison, and other Southerners viewed it as an unconstitutional power grab by Northern commercial interests. They argued that the Constitution did not explicitly mention the establishment of a bank or issuance of bills of credit. Hamilton convinced Washington of the constitutionality of the Bank with an expansive interpretation of the clause giving Congress the power to enact laws that were "necessary and proper" in order to carry out its more explicitly enumerated functions. Hamilton argued the Bank was necessary because the new republic could not carry out basic functions without expanding the money supply, extending credit, collecting taxes, handling foreign exchange, and storing money. This notion has become known as "implied powers," and it allowed Hamilton and the Federalists to lay the foundation for expansion of federal fiscal powers in years to come. Hamilton's doctrine was eventually formalized by the Supreme Court in 1819 in *McCulloch versus Maryland*.

However, the federal government's fiscal powers remained quite limited, and the vast majority of expenditures took place at the state and municipal levels. As in other countries, the history of the expansion of centralized fiscal authority is closely linked with war. After all, the initial move from the Articles of Confederation to the Constitution was driven by the need for stronger common defense, and Hamilton's initial centralizing maneuvers were facilitated by

existence of debts from the Revolutionary War.[1] Faced with a need for revenue during the Civil War, Congress passed the Revenue Act of 1861, which included a tax on personal income. This tax was eventually repealed, but again in 1894, Congress enacted another federal income tax. The Supreme Court ruled that the tax was unconstitutional, since Article I, Section 2, Clause 3 of the U.S. Constitution requires that direct taxes imposed by the federal government be apportioned among the states on the basis of population. The Court's determination of what constituted a "direct" tax made it difficult for the federal government to raise revenue without immediately apportioning it to the states. Writing for the majority, Chief Justice Melville Fuller wrote that the founders intended "to restrain the exercise of the power of direct taxation to extraordinary emergencies, and to prevent an attack upon accumulated property by mere force of numbers" (*Pollock v. Farmers Loan Trust Co.*). Throughout the 19th century, the federal government relied primarily on tariffs and excise taxes on particular goods. Only by amending the Constitution was it possible to expand the federal government's power to tax. Congress passed the 16th amendment in 1909, allowing the federal government to raise direct taxes without apportionment, and it achieved support of the final state needed for approval in 1913. Herein lies a noteworthy observation for Europe: in spite of the desires of elites, centralized direct taxes were not possible in the United States for over 100 years, and did not become available until obtaining the support of voters in two thirds of the states via constitutional amendment.

This expanded federal tax authority came in quite handy a few years later when the United States entered World War I. Figure 1 displays total federal government expenditures as a share of total—that is, federal, state, and municipal—expenditures from 1900 to the present.

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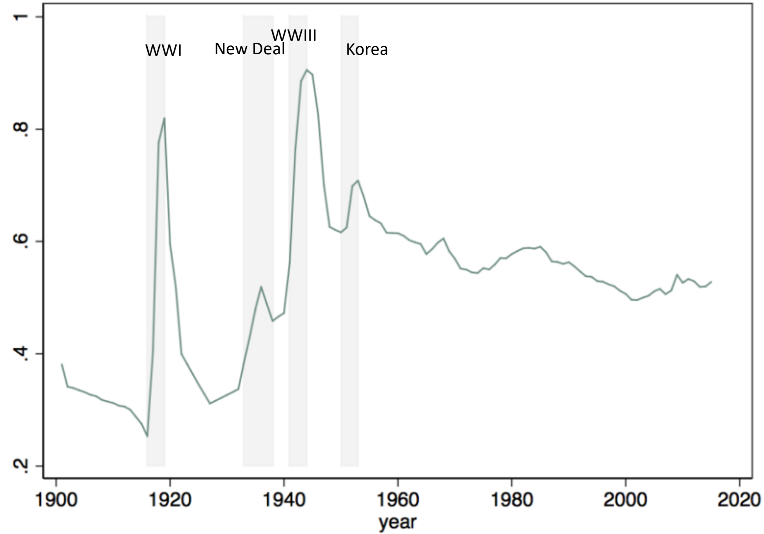
[1] Going back even further, the taxes against which the colonists revolted were collected to pay British troops stationed in the colonies after the French and Indian War.

Figure 1: Federal expenditures as a share of total (federal, state, municipal) expenditures in the United States, 1900 to present



World War I led to a sudden and dramatic increase in the federal government's ability to raise and spend money. This was achieved largely by the War Revenue Act of 1917, which greatly increased progressive income tax rates and reduced exemptions. While the central government accounted for less than a quarter of the public sector on the eve of World War I, it quickly surpassed 80 percent. The federal government's role quickly retreated after the war, but not all the way to its pre-war level.

World War I was the first of three major ratchet-like events leading to spikes in federal taxes and expenditures that led to a higher equilibrium thereafter. The second event was the Great Depression and the policies eventually adopted to combat it. The New Deal was perhaps the single most important turning point in the history of U.S. federalism. The federal government became involved in a wide range of activities that had previously been considered off limits. Franklin Delano Roosevelt's various new federal programs aimed at combating the Great

Depression, generating employment, and facilitating greater income security were extremely popular, and they brought the federal government into activities that had previously been viewed as constitutionally and politically off limits.

Once again, the Supreme Court's interpretation of the 18th century bargain took center stage. Even though FDR won a resounding victory in 1936, and his party had a massive majority in Congress, a series of cases headed to the Supreme Court, in which the entire basis of almost every major New Deal program was threatened. Much of the federal government's authority over the economy came not from any enumerated powers in the Constitution, nor from the "necessary and proper" clause, but rather, from a clause in the Constitution empowering Congress to regulate commerce between the states. But a narrow Supreme Court majority interpreted the interstate commerce clause as only giving the federal government very narrow powers, ruling against the constitutionality of many popular New Deal programs.

In a moment with considerable contemporary relevance, FDR proposed to alter the composition of the Court, expanding it to include additional justices appointed by him to support his agenda. Perhaps in part because of the threat of FDR's court-packing scheme and a desire to protect the autonomy of the Court, the decisive justice, Owen Roberts, switched his position on the interpretation of the Commerce Clause and joined the majority in a series of decisions that upheld the constitutionality of several crucial New Deal programs. Facing growing criticism of his proposal, FDR eventually retreated and withdrew his plan to restructure the Court.

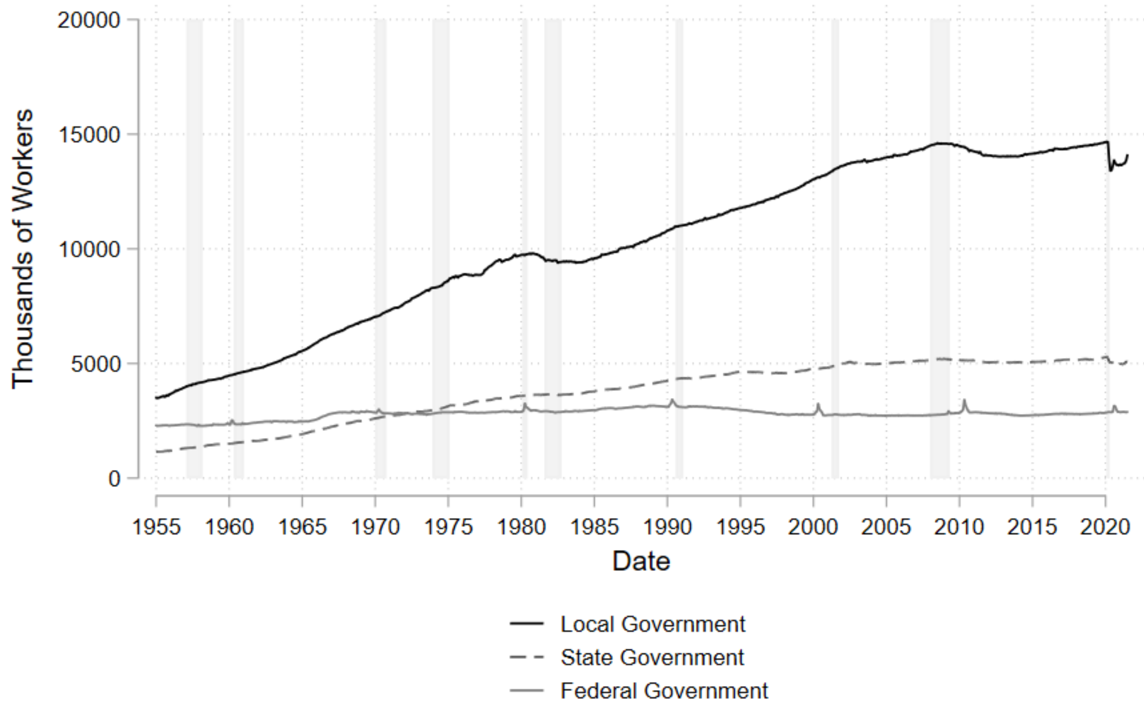
It is easy to look at Figure 1 and interpret the New Deal era as primarily an expansion of the authority of the federal government vis-à-vis the states. However, as pointed out by John Wallis and Wallace Oates (1998), the New Deal led to the growth in expenditures of *both* the federal and state governments, and ushered in the increased interdependence of the two. Many

New Deal programs were funded with intergovernmental grants, which grew dramatically during this period. The New Deal can be seen as the moment when the U.S. federal system transitioned away from what is often called the period of "dual" federalism, when the spheres of authority of the federal and state governments were relatively distinct, even if highly contentious. After the New Deal, the states became much more involved in implementing federal grant-funded programs, and in a variety of policy areas, both layers of government became intertwined in a complex web of activity. Since the 1930s, it has become increasingly difficult to identify policy areas of exclusive competence for one layer of government or the other.

The next major expansion of the federal government was to fund World War II. The spike in the federal government's share of expenditures associated with World War II was one of the largest, and perhaps in part because it was followed by the Cold War, the arms race with the Soviet Union, and another spike associated with the Korean War, it was also a lasting one. It is worth noting that aside from small spikes associated with the Viet Nam War and a period of modest fiscal centralization associated with the last years of the Cold War, the expenditures of the U.S. federal government have steadily declined relative to the states and municipalities.

It is important to note that in terms of public employment, the expansion of the public sector in the United States has happened primarily at the local level. Figure 2 plots total public employment at the federal, state, and local levels since 1955. In spite of overall population growth, federal employment has been relatively flat—with small temporary spikes every ten years when census employment ramps up—and has even fallen since 1990. The growth in overall employment at the state level has been quite modest. Employment growth has been concentrated among local governments, where much of the employment growth has occurred in the education sector.

Figure 2: Public Employment in the United States: Federal, State, and Local Governments



Local expenditures on employee compensation are funded by a mix of local taxes, especially property taxes, and transfers from state governments. Figure 2 also includes indicators (vertical gray bars) for recessions. Federal and state employment is not very responsive to the business cycle. However, note that local employment growth sometimes slows or reverses during lengthy recessions, such as in the early 1980s, and especially after the Great Recession—a point to which I will return below.

The Relationship Between Federalism and Democracy in the United States

A long tradition of scholarship builds on the insights of Madison, Hamilton, and Jay in *The Federalist*, celebrating the role of the safeguards and limitations on majorities that emerged from the American constitutional bargain as a well-crafted structure for generating democratic self-government while protecting rights and preventing tyranny (Ostrom 1994). As Barry

Weingast (1997) has pointed out, elections are perhaps the most important safeguard of all in maintaining balance between the federal government and states. Admirers of the American system appreciate its status quo bias, gridlock, and gradualism as safeguards of minority rights and the assets of long-term investors. The system rarely bestows unchecked authority on one individual or group, and thus requires forbearance and compromise.

As a system for protecting minorities, however, federalism can fall short if the boundaries of subnational jurisdictions do not line up with the geography of those minorities. The very nature of American federalism was shaped by the desire to protect slave-owners from a possible future anti-slavery majority, and for much of American history, "states' rights" were used by white majorities in Southern states to prevent African Americans from experiencing full citizenship. William Riker (1964) went so far as to characterize American federalism as an institution whose primary purpose was the perpetuation of racism. Only through centralized intervention was it possible to extend rights to local minorities.

In the current moment of intense political polarization, decentralized federalism can seem like a solution if local majorities with different preferences, for instance over gun regulation or abortion policies, can have their way within their territories. However, since the geographic arrangement of the American political divide is largely urban-rural rather than regional, state boundaries do not correspond to the relevant political groups. Enhanced powers for state governments are of little value to urban progressives in states like Texas or Idaho, where rural interests are dominant, or to rural voters in Illinois or California, who feel oppressed by urban-dominated state governments.

It is impossible to understand the functioning of American democracy without understanding the 18th century federal bargain. Above all, it created the U.S. Senate, which gives

two senators to each state regardless of population, making it one of the most counter-majoritarian institutions among modern democracies. American Senate malapportionment emerged not only from the original colonies, but from the process through which sparsely populated territories achieved statehood. For instance, the Dakota Territory was divided in two in order to provide a very sparsely populated frontier area with four senators. Yet another counter-majoritarian institution, the Electoral College, also features a (much smaller) advantage for rural states.[2]

Although the founders hoped to avoid political parties altogether, the winner-take-all presidency and winner-take-all electoral rules for the Senate and U.S. House districts has created the world's strictest two-party system. For reasons explained in Rodden (2019), this two-party system has come to be arranged around an urban-rural divide, such that supporters of the party of cities—the Democratic Party—are highly concentrated in space. Thus, the Senate creates obvious and dramatic over-representation of the Republican Party, and as demonstrated in Rodden (2019), even the more evenly-apportioned House of Representatives favors the Republican Party due to its more efficient geography of support. As a result of this, although the Democratic Party routinely wins more votes than the Republican Party in U.S. Senate elections, it cannot win Senate majorities without winning extremely large majorities of votes. The same is true on a smaller scale in the House of Representatives.

As described above, largely because of federalism, the U.S. Supreme Court has become an important veto player in the American policy process, to the point that some voters condition their votes in Senate and presidential elections on the promises of the candidates about Supreme

[2] The apportionment formula for electoral votes includes a "floor" for small states, which slightly over-represents them. Note that pro-Republican bias in the electoral college is quite tenuous, however, and could easily reverse if Georgia or Texas, due to in-migration and urbanization, begin to produce Democratic majorities.

Court appointments. In recent years, in addition to a singular focus on tax cuts, the Republican Party in the Senate has focused much of its attention on judicial appointments. The appointment process, which involves the president and counter-majoritarian Senate, has become exceptionally politicized. Due to lifetime tenure, battles over judicial nominations only raise the stakes in a polarized winner-take-all system with pronounced anti-majoritarian features rooted in federalism. A remarkable feature of American federalism in the 21st century is that a firm majority of justices with an "originalist" framework of constitutional interpretation rooted in the 18th century was placed in office by a President and Senate that were both elected with less than half the vote.

The comparison with the New Deal is difficult to avoid. Once again, a conservative court with a narrow interpretation of constitutional provisions will be tempted to overturn progressive legislation. And again, progressives will be tempted to expand the size of the court and undermine its legitimacy. And again, in order to forestall this, the Court might take care to protect its institutional prerogatives by acting more cautiously than its most ardent supporters and detractors anticipate. This dance between elected officials and courts is a recurring leitmotiv of American federalism.

It is difficult to understand the relationship between federalism and democracy in the United States over the last three decades without considering the rise of extreme partisan polarization. As new cleavages emerge over time—including civil rights, abortion, globalization—the parties take distinct positions on the new issues, and some voters with strong preferences on these new issues sort themselves into a different party. This makes the parties more internally heterogeneous in the short run, and provides party leaders and their media allies with incentives to manage that internal party heterogeneity by portraying the out-party as

ideologically extreme. Elites in the two parties, along with their media allies, invest a great deal of effort into portraying the out-party as ideologically extreme and distasteful. Parties have become increasingly focused on mobilizing base voters with such "demonizing" appeals rather than attempting to demonstrate their competence to moderates.

This type of politics led to the quick politicization of COVID-19 response in the United States. The virus emerged first in densely populated, overwhelmingly Democratic areas. Given the combination of political polarization and federalism in the United States, the federal executive branch, then controlled by a Republican president, initially faced weak incentives to implement policies called for by Democratic officials in urban states and counties. Thus, in the early days of the pandemic, Democratic public officials became supportive of shutdowns and an expanded role for government expenditures and regulations. For many Republican officials, whose base-mobilization strategy requires sharp ideological contrast with Democrats, the response was to characterize most COVID response as a cynical power-grab by the left. Once COVID response had been politicized in this way, it eventually expanded beyond the realm of shutdowns and expensive relief packages—policies with a clearer mapping onto preexisting ideological conflicts—to ostensibly orthogonal mitigation strategies like masks, vaccines, and drugs.

All of this has had important implications for battles about federalism and local authority. In many states controlled by Republicans, grudging acceptance of mitigation strategies implemented by Democratic mayors and county public officials has given way to intergovernmental conflict. Several Republican governors have jettisoned the party's traditional support for local authority, and attempted to preempt local officials' efforts to regulate bars and restaurants and require masks and vaccines in various settings. In some instances, governors

have threatened to withhold funding for schools and local governments if they required masks to be worn indoors. In contrast, in states controlled by Democrats, rural Republican officials have bridled at COVID regulations ordered by state-level officials, largely ignoring them or refusing to implement them. In short, like many other controversial policy issues, from abortion to gay marriage, guns, or immigration, battles about COVID mitigation have quickly transformed into battles about federalism and decentralized authority.

The Distribution of Resources and Substantive Competences

As mentioned above, by specifying that direct taxes must be apportioned to the states, the original American system was explicitly designed to avoid inter-state redistribution. The 16th Amendment made it possible, however, for the central government to pursue forms of inter-personal and place-based redistribution that would have the effect of generating inter-regional redistribution. And as described above, the creation of an array of intergovernmental grant programs in the New Deal era have led to the creation of a complex intertwined system of finance for many programs. Yet unlike some other federations, the United States has avoided the creation of "shared" taxes. Moreover, unlike almost every major federation, it has not developed a system of broad general-purpose grants aimed at achieving some type of inter-regional redistribution from wealthy to poor states, or guaranteeing some minimal level of service provision in poor states. An exception was the short-lived program of so-called "general revenue sharing" in the 1970s and early 1980s. For the most part, beginning with the New Deal, the federal government has engaged in various earmarked, program-specific grants to the states. At the current moment, two thirds of federal grants to states are for Medicaid. Thirteen percent are for income security programs, 8 percent are for transportation, and 6 percent are for education.

In comparison with other federations, the United States is quite exceptional in its lack of a formal system of fiscal equalization. Beland and Lecours (2014) argue that in part, equalization payments emerged in federations like Canada and Australia in the middle of the 20th century as efforts to forestall secessionist movements and generate national unity, whereas the United States, after the Civil War and Reconstruction, did not face any similar threats to its territorial integrity. They also point to differences in cultural notions of citizenship, and the ease with which states that stood to be "payers" in any system of equalization in the United States might be able to block any proposals that they feared would make them into long-term losers.

To be sure, some of the grants in the United States are distributed via formulas that are broadly progressive. However, many of the grants, e.g. for highway funds, are distributed via formulas that have little to do with income. In the distribution of federal funds, the counter-majoritarian and highly malapportioned Senate is of crucial importance. Small states are able to bargain for far more than their per-capita share of resources. The standard operating procedure for many grant programs—especially ad hoc responses to events like recessions or the pandemic—is to release grants on a per-capita basis, with a minimum floor that is of great benefit to small states. In practice, states like the Dakotas, Vermont, and Wyoming are showered with federal largesse that is funded by taxpayers in larger states. The result of all this is a system of intergovernmental grants that is only very weakly progressive, in that the correlation between per capita income and per capita grants is only weakly negative, with a large standard error.

The federal government has little direct formal involvement in the states' ability to raise revenue, but as a practical matter, state and federal governments are attempting to tax the same individuals and firms, and the efforts of each level create important externalities for the other. The revenue structure of the states is quite varied. Some states, like California, raise substantial

revenues through state income taxes, while others, like Texas, have no income tax at all. States without income taxes rely mostly on sales and corporate taxes. The states have full autonomy over the designation of the base and rates for their various taxes. However, the states are very much affected by federal government's decisions about things like the deductibility of state and local taxes as well as mortgage interest on federal tax returns. For many decades, Americans were able to reduce their federal tax burden by deducting taxes paid to state and local governments. Recent tax reforms placed a $10,000 limit on this deduction, which had the impact of raising taxes significantly for high earners in states that rely heavily on income taxes.

In order to understand the impact of this type of reform, it is important to understand the geography of prosperity and the knowledge economy in the United States. As explained by Moretti (2012), investment in the knowledge economy, and the high-paying jobs that go with it, are highly concentrated in a small number of counties in the United States. A poorly understood aspect of this concentration is the history of massive federal government investments in sophisticated national defense programs in places like Silicon Valley and Boston. Another important factor is the broad withdrawal of the federal government from antitrust enforcement. This geographic concentration of prosperity appears to be growing more quickly in the United States than in many other federations. Another feature of American decentralization is strong control for local jurisdictions over zoning, and as a small number of cities (e.g. Boston, Seattle, and San Francisco) have seen extraordinary investment in the knowledge economy, self-interested local majorities have prevented an increase in the housing supply. This leads to extremely high home prices and higher cost of living in these dynamic cities. The U.S. dollar is a rather different unit of currency in wealthy coastal cities than in much of the rest of the country. Yet the federal tax system treats them exactly the same. Thus, a middle-class individual in the

San Francisco Bay area makes a substantially higher salary, and pays substantially more for housing and utilities, than a middle-class person in Ohio. The San Francisco resident is also taxed by the federal government at a much higher rate. A very high share of federal taxes in the United States are collected in a very small number of counties in the most productive parts of the country on the two coasts. Someone in the top decile of the income distribution in Alabama would be in the middle of the distribution in the San Francisco Bay Area. Thus, the federal tax burden of the middle and upper part of the *local* income distribution is far greater in knowledge economy cities, which effectively subsidize the rest of the country.

By reducing the state and local income tax deduction, along with the amount of mortgage interest that can be deducted, while also lowering top rates, recent tax reform had the impact of increasing even further the tax burden in productive, wealthy knowledge-economy areas and reducing it for the wealthy in less productive parts of the country. This also has an important implication for state governments in states like Massachusetts and California, since the increasing federal tax burden makes it increasingly difficult for state governments to raise additional revenue.

On the expenditures side as well, state governments have full autonomy in theory, but practice is much more complex. A very large share of the expenditures of the states is conducted in policy areas, above all health care, where the federal government plays an extremely important role in funding via grants. For the implementation of its policies, the federal government has a rather limited presence around the country. Two major social programs are administered directly by the federal government: Social Security and Medicare (a health-care program for senior citizens). The federal government also runs an extensive health system for veterans. Otherwise,

the federal government must attempt to achieve its goals via conditional grants to states and in some instances, local governments.

It is tempting for the federal government to issue so-called “unfunded mandates,” where it simply commands states to achieve certain goals without providing resources, or more frequently, it offers inter-governmental grants that are insufficient to achieve the specified outcomes. A frequently-cited example is the Americans with Disabilities Act. City and county governments also complain about unfunded mandates from states. Debates about unfunded mandates and conditions associated with grant programs are a ubiquitous and ongoing feature of American federalism. Like every other aspect of American federalism, they frequently involve the courts.

One of the most controversial aspects of federal-state relations is Medicaid—a joint federal-state program to provide health care for low-income residents. The key feature of Medicaid is its open-ended federal matching component. The federal government guarantees matching funds—at least dollar for dollar— to states for all qualifying Medicaid expenditures undertaken by states. This provides states with relatively strong incentives to spend money on Medicaid versus other programs that receive no matching funds. In some instances, the federal government provides a higher matching rate. For instance, as part of the Affordable Care Act (“Obamacare”), the federal government offered to pay 100 percent of Medicaid costs for newly eligible individual added to the program, tapering to 90 percent after an introductory period.

Like so many other policy areas, Medicaid expansion, and the Affordable Care Act more generally, have become part of the highly polarized American two-party conflict. Again, incumbents and challengers have adopted a system of base mobilization driven by the maximization of the perceived ideological distance of the out-party rather than competence-

based politics aimed at moderates. This has led some state officials to leave surprisingly large amounts of federal money on the table. Because they are opposed to the expanded federal role in Medicaid and the ACA more generally, some Republican-led states have refused to expand Medicaid enrollments that would have, at least for a period of time, been completely funded by the federal government.

The system of unemployment insurance in the United States is also a complex area of joint federal and state involvement. Each state administers its own unemployment insurance system. These systems are funded by payroll taxes levied on employers, but in some states, employees make direct contributions as well. Benefit levels and eligibility requirements vary by state. States with under-funded programs have been able to borrow from the federal government to keep unemployment benefits flowing. This provision was used by a number of states during the Great Recession and during the COVID pandemic. The states whose unemployment trusts have built up the largest debts to the federal government include California, New York, Texas, and Illinois.[3] Moreover, beyond these loans, the federal government has stepped in to provide direct subsidies to bolster state unemployment systems, in particular with the goal of expanding the duration of coverage, during severe recessions. In response to the Great Recession, the federal government provided additional unemployment insurance to cover 100 percent of the cost of a program that extended benefits for an additional 13 weeks. In response to the COVID pandemic, the federal government not only backstopped state programs, but it also provided addition supplementary unemployment payments that were completely funded by the federal government.

[3] https://calmatters.org/economy/2021/03/california-unemployment-crisis-reform/

The framers of the U.S. Constitution did not envision programs like Medicaid or unemployment insurance. The assignment of tasks was oriented toward an 18th century notion of how to govern what was essentially a mutual defense pact. As the demands on the federal government grew, the path of least resistance was often the creation of redundancies and complex, intertwined programs involving the federal government, states, and local governments. One clear disadvantage of this style of federalism, especially when combined with the current level of political polarization, is the extent to which it encourages credit-claiming and blame-avoidance.

This disadvantage was on clear display during the COVID crisis. The federal government presides over an impressive national public health apparatus, including the Centers for Disease Control and the National Institute of Health. Yet as described above, the virus first emerged in Democratic cities, most of which were in Democratic states, providing the Republican president with weak incentives to act. The president called upon state and county governments to act alone—even encouraging them to compete against one another to obtain protective equipment and ventilators. Likewise, governors sometimes avoided making difficult and potentially unpopular decisions about closing bars, canceling sporting events, or requiring masks, leaving those decisions instead to county public health officials, who then ended up facing protests in front of their homes and death threats from irate local citizens.

Even the administration of elections is an area of complex joint responsibility. The Elections Clause of the Constitution directs the states to determine the “times, places, and manner” of elections to the federal legislature. State legislatures also have the power to choose presidential electors—a power that they have delegated to their voters, but one that they could

take back. Actual election administration, including the printing of ballots and counting of votes, is carried out by counties, who often operate by rather different norms and procedures, for instance about rejection of absentee ballots, even within the same state. Popularly elected and openly partisan Secretaries of State make determinations about where to send voting equipment. As with so many other aspects of U.S. politics, federalism and overlapping authority generate intense judicialization. Most close elections end up being litigated, and election law is a booming field. Federal and state laws, above all those meant to facilitate minority representation, lead to constant lawsuits not only about the conduct of state and federal elections, but also elections for city councils and school boards. All of this only adds to the centrality of judicial appointments as focal points in American political battles.

A current area of concern is with efforts by strong partisans to take over what were traditionally non-partisan election administration jobs at the local level. Likewise, state governments have attempted to wrestle power over election administration away from local officials when it suits their partisan interests. As with so many policy areas, highly polarized battles about election administration are wrapped up in battles about federalism and decentralized authority.

Financial Stability

Perhaps one of the most admired features of the U.S. system of federalism is the lack of federal involvement in the borrowing decisions of the states, and the emergence of the states as subnational "sovereigns." A multi-layered fiscal system can be understood as a dynamic game of incomplete information, where lower-level governments must respond to negative revenue shocks, but they are uncertain about whether, in the event of a debt servicing crisis, the central

government would rescue them with bailouts (Rodden 2006). If the perceived probability of an eventual bailout is sufficiently high, lower-level governments face incentives to avoid hard decisions and wait for bailouts. If the perceived probability is sufficiently low, the lower-level governments are like miniature sovereigns. They understand that they are responsible for their own fiscal obligations, and as a result, they will take politically painful measures to cut expenditures or raise revenues in reaction to a negative shock, perceiving that they have little to gain from allowing a full-blown debt-servicing crisis to emerge.

The latter type of system requires that the higher-level government make a credible "no bailout" commitment. This commitment was first established in the United States in the 1840s, when a number of states defaulted on their debts. They and their creditors lobbied the federal government for a new round of federal debt relief along the lines of Hamilton's initial debt assumption. They were rebuffed, in large part because it was not possible to put together a legislative majority in favor of bailouts. This is reminiscent of the argument of Beland and Lecours (2014) about the veto power of wealthy states as a reason why the United States did not adopt a formal system of equalization. The defaulting states were frozen out of credit markets. In order to approach credit markets again, states were then forced to move beyond financing themselves with things like charters and land deals and develop a tax base, and they devised a set of self-imposed formal borrowing restrictions. These borrowing restrictions eventually spread through a process of policy diffusion, and are now in place in almost all states.

The 1840s scenario was an important moment in the emergence of the central government's credible "no bailout" commitment. Whether the federal government's commitment is still credible after two world wars and the emergence of complex, intertwined federalism during the New Deal is the subject of some debate in the United States. In each U.S. recession,

after considerable indecision, debate, and lobbying, some system of ad hoc special grants to the states is eventually allocated by Congress. However, these grants have never been earmarked for debt servicing, or distributed according to indebtedness or even income. In fact, they are typically distributed on a per-capita basis with a generous floor for small states, or on some other criteria that reflect last-minute bargaining in the legislature. Homeland Security grants after September 11 went disproportionately to rural fire departments rather than cities facing terrorist threats, and the recent grants to states in the initial package of relief after the outbreak of COVID showered substantial resources on South Dakota, which had very few cases at the time, and left New York with relatively little, even though it had one of the largest outbreaks in the world. Some observers refer to these ad hoc grants as "bailouts," but this seems to be a definition of bailouts that would include virtually any federal transfers.

In short, perhaps in large part because the United States does not have a system of redistributive and/or counter-cyclical general-purpose grants, and since delayed, ad hoc formulaic grants in the wake of crises are of little comfort, state governments do not appear to make fiscal decisions in the wake of downturns as if they expect to eventually receive federal bailouts. On the contrary, they abide by their self-imposed borrowing restrictions and make dramatic and immediate cuts to their expenditures. It took ten years for expenditure levels in the U.S. states to return to their pre-2008 levels.

Recall from Figure 2 above that state and federal employment do not typically fall during recessions. Job losses take place primarily at the local level, where borrowing during recessions while revenue is falling in order to avoid firing teachers and social workers is especially difficult. Note that in recent recessions, the ad hoc scramble for additional federal support has been directed almost exclusively at state governments. In fact, state governments have been able to

stabilize their direct expenditures as a result of these additional grants. However, in spite of this extra support from the federal government, state governments typically cut their transfers to local governments during recessions (Rodden 2021). As a result, local governments are hit with simultaneous reductions in tax revenues and intergovernmental funds. This can be especially difficult for relatively poor, rural municipalities and school districts, where budgets are often more dependent on transfers funded by more affluent suburban taxpayers.

In urban and suburban areas with diversified economies and many sources of private sector employment, it is often possible to absorb these cuts and return to growth relatively quickly. However, in much of rural America, public sector employment is a very important part of the labor market, and as a result, cuts during recessions leave a lasting legacy. Employment in large swaths of rural America has still not recovered from the public sector cuts in the wake of the Great Recession. In some rural places, the local public sector was the biggest single category of long-term job losses in the decade after the Great Recession.

It should be noted that federal COVID relief efforts have made some important changes from the typical post-recession playbook. In particular, rather than routing resources exclusively through state governments, the American Rescue Plan has made funds directly available to local governments, and those resources that still pass through the state government must be dispersed to local governments on a rapid time-table or forfeited. Moreover, the funds provided to state and local governments by the American Rescue Plan are not earmarked for COVID-related programs, and state and local governments are allowed to use additional federal transfers to fill gaps in budgets, bolster social expenditures, or invest in infrastructure. Governments are explicitly forbidden, however, from using the funds to enact tax reductions. This provision has

been extremely controversial and difficult to enforce, and like many other aspects of COVID policy, it is currently being challenged in court.

The federal government's COVID response also has potential to change the basic structure of American federalism in other ways. U.S. state governments do not have a tradition of running up large debts to the federal government, as in, for example, the Brazilian federation. However, as mentioned above, several states have run up large debts to the federal government via their unemployment insurance programs during COVID. Forgiveness of such debts, if carried out, might create moral hazard problems going forward.

Perhaps the most important innovation for fiscal federalism in the policy reaction to COVID was the decision by the Federal Reserve to introduce a program for purchasing newly issued state and local government bonds via the Municipal Liquidity Facility (MLF). This program was supported by Treasury via the CARES act, which indemnified the Fed against losses from default. The program was hurriedly introduced as bond yields were rapidly increasing in March of 2020, and some governments were unable to issue debt. It was clear that these government would begin to shed public employees very quickly. Soon after the introduction of the program, bond yields stabilized, ultimately declining throughout the summer after a very large spike in March.[4] It should be emphasized that actual take-up of the program was very low. Only the state of Illinois and the New York Transportation Authority ended up participating before the program was wound down. The rapid reduction in bond yields in late March and April 2020 indicates a powerful backstop effect, not unlike Draghi's famous "whatever it takes" speech. According to analysis of Bordo and Duca (2021), this indicates that

[4] https://www.brookings.edu/blog/up-front/2021/08/31/how-well-did-the-feds-intervention-in-the-municipal-bond-market-work/

there was systemic risk in the municipal bond market, and without the Federal Reserve's action, yields would have continued to rise and many governments would have been frozen out.

Recent research by Haughwout, Hyman, and Shachar (2021) exploits a discontinuity in MLF eligibility to study the impact of the program. They find that not only did the Federal Reserve serve as a liquidity-provider of last resort, but it may have also created the perception of credit-risk sharing. Specifically, they find that the lowest-rated issuers were some of the biggest beneficiaries. Haughwout and collaborators also examined the impact of this program, along with inter-governmental grants associated with the CARES act, on state and local employment. They find that both programs had an immediate impact on employment. Similar to Scheiner (2021), they also find evidence consistent with the view that government furloughs of public-sector workers in response to the pandemic were surprisingly large relative to the size of revenue losses, suggesting that local officials may have over-reacted based on past experience.

The MLF is no longer functioning, but the episode may have set an important precedent. Market actors might now begin to view the Federal Reserve and Treasury as a natural backstop in the event of another systemic state/municipal crisis. An important question for future analysis is whether this might be the beginning of the end for the traditional "no-bailout" commitment of the federal government.

In sum, another legacy of the original American federal bargain is that the federal government has been rather uniquely disengaged from regulating the borrowing of the states, and since it is also disengaged from guaranteeing minimal levels of service provision or income, it has also been credibly disengaged from guaranteeing their debts. With the federal response to each recent recession, this disengagement has been increasingly called into question. Over recent decades, this disengagement has been a double-edged sword. It works well as a mechanism for

avoiding burden-shifting from imprudent lower-level governments to the center, but it also creates highly pro-cyclical public expenditures. State and especially local fiscal contraction and job losses can easily undermine the efforts of the federal government and central bank to stimulate the economy during recessions.

Inequality and Solidarity

The United States has come a long way since Jefferson, in his *Notes on Virginia*, referred to Virginia as “my country.” While the governor of California in 2020 pointedly refers to it as a “nation state,” the primary allegiance of most Americans is with the nation rather than their individual state. Nevertheless, solidarity is, quite literally, a foreign concept in the U.S. federal system. This word has no place in the lexicon of American federalism akin to its use in Germany. While formulaic grant programs in the United States often have a minimum floor, these act merely as subsidies to small states. As a legacy of its founding, the U.S. Constitution contains no hint of an indication that the federal government has an obligation to guarantee some minimum level of service provision or, in the parlance of the German Basic Law, living conditions, throughout the country.

In spite of wars, recessions, and the growth of the federal government, little has changed in this aspect of U.S. federalism. Public expenditures vary dramatically from one part of the country to another. The provision of education, for instance, varies greatly from one state to another, and more importantly, from one school district to another within states. After a long period of income convergence associated with the movement of manufacturing to the South and the rise of the Mountain West, incomes are rapidly diverging across states, as well as within states, and economic prosperity is increasingly concentrated. Rates at which people have health

insurance are quite varied cross states. Even life expectancy is diverging across states and counties, and is actually declining in some of the poorest rural counties.

As described above, however, there are some federal programs that provide the same benefits to individuals regardless of their geographic location. These programs are limited, for the most part, to senior citizens (Social Security and Medicare), disabled individuals (also funded through the Social Security Administration), and veterans who have access to the nationwide system of health care offered through the Veterans Administration. Payments associated with other programs, such as Medicaid or food assistance programs, are ultimately determined by decisions of states. In European policy debates, the claim is sometimes made that the U.S. system of fiscal federalism provides a system of insurance against asymmetric shocks. This is true, but research has shown that this insurance comes exclusively from the nature of the income tax. Asymmetric negative income shocks are associated with lower federal tax payments, but they are not associated with increased federal expenditures.

Viewed from Europe, Americans' tolerance for growing inter-regional inequality might seem puzzling. It may seem surprising that political entrepreneurs do not latch onto the issue and mobilize poor regions to push for increased inter-regional transfers from the wealthy regions. The explanation is largely beyond the scope of this essay, but one possibility is provided by Alberto Alesina and his collaborators, who point out that compared with Europeans, Americans have rather distinctive beliefs about the impact of effort versus luck in the determination of income (Alesina and Angeletos 2005).

Another possibility has to do with the odd way in which the American party system has evolved in the era of the knowledge economy and globalization. The party of the "left," which traditionally advocates for greater levels of redistribution, by virtue of its geographic legacy in

cities, has become closely associated with the elites of the knowledge economy. In 2016, two thirds of federal tax payments originated in majority-Democratic counties, and this has likely increased since the most recent tax reform. And the Republican Party, which advocates for smaller government and lower levels of redistribution, has become the dominant party in the parts of the country where economic opportunities are most rapidly disappearing and voters are most dependent on federal transfers. Voters in Republican-dominated areas have the most to gain from the introduction of a system of general-purpose transfers focused on the equalization of fiscal capacity or living conditions, but the party's elites have invested for decades in calling for market-based solutions to economic decline rather than government intervention. As a result, neither party currently has incentives to advocate for an enhanced system of inter-regional redistribution.

Monetary Policy

The Federal Reserve system has a regional structure, and its decisionmakers have at their disposal an array of region-specific data. But they must make "one size fits all" decisions about monetary policy. Relative to the European Monetary Union, this has not been especially controversial in the United States. According to Malkin and Nechio (2012), if one applies the Taylor rule to four different U.S. regions, the predicted interest rate policies of the regions are consistently different, but they are in a relatively narrow band around the actual, observed rate. Furthermore, there is no obvious pattern of advantage or disadvantage in the observed policy for any particular region in the long run. When they conduct the same exercise for the Euro area, contrasting the countries of the "core" and "periphery" of the union, however, they find a much

large difference between the Taylor rule predictions of the core and periphery, and a persistent similarity of the observed policy to the optimal policy for the core.

The narrower range of predicted interest rates for the U.S. regions might have several explanations. First of all, the United States has a system of net fiscal transfers that, because of the role of the federal income tax, helps smooth out asymmetric shocks. Second, in the past, labor market mobility has been more pronounced as a response to economic shocks in the United States than in Europe. However, Europe and the United States are converging on this dimension as labor market mobility declines in the United States and increases in Europe (Beyer and Smets 2015). An important reason for the decline in labor market mobility in the United States is that as knowledge-economy cities have become more expensive, and as middle-skill jobs have disappeared, there are fewer incentives for unskilled workers in struggling regions to move (Autor 2019). In fact, the most prosperous parts of the United States are *losing* population, in large part because of housing prices. Moreover, growing inequality and divergence in prices between knowledge-economy cities and the rest of the country might also be generating differences in optimal monetary policy. It is possible that as inter-regional inequality grows, the United States will become more like Europe in the strain created by its "one-size-fits-all" monetary policy.

As described above, the role of the Federal Reserve vis-à-vis state and local governments changed with the introduction of the Municipal Liquidity Facility in 2020. In this regard, the United States has followed the lead of the ECB by announcing its willingness to intervene and provide a backstop in the event of a systemic crisis.

Costs, Benefits, and Lessons for Europe

In order to extract lessons from the U.S. experience, it is important to understand the U.S. Constitution not as the product of masterful design that might be copied, but as a compromise among elites who wanted very different things—a compromise that was viewed with some distaste by all who ultimately supported it. In many respects, this tradition has continued to the present day. On the right side of the political spectrum, it is common to argue that all of federalism's potential to restrain the growth of government and facilitate efficiency was lost with the New Deal and the rise of intertwined federalism (Greve 1999). And on the left, all of federalism's safeguards and counter-majoritarian features are viewed as among the most important impediments to the pursuit of progessive policy goals. Criticized from all sides, American federalism is still very much an exercise in compromise.

It is remarkable that this ancient constitutional bargain is still largely in place, and that a pact among jealous elites evolved into a stable and relatively democratic system of governance. But the institutional and social legacies of that bargain have created serious tensions that led once to a bloody civil war, and that are again creating a dangerous level of polarization, hostility, and threats to democracy. The ability of the American system to diffuse conflict and promote compromise via democracy is probably more threatened now than at any time since the Civil War.

The United States is often viewed as a blueprint for those in the European Union who, like Alexander Hamilton in the late 18th century, perceive the center's powers as too limited for the tasks at hand, and would like to find a way to overcome obstacles to centralization. But Hamilton's machinations notwithstanding, the most important centralizing constitutional moments in the United States have not been carried out by elites in smoke-filled rooms or by imperious courts, but by large democratic majorities during periods of something like broad

consensus around a common purpose, as with the 16th amendment, the New Deal, and wartime military buildups.

However, when there is no war or common enemy, the U.S. federal system comes under strain. This is especially true in the current era of urban-rural sectionalism. The majoritarian, two-party nature of American democracy has, in the era of the globalized knowledge economy, created intense conflict between a party of cities, the global knowledge economy, and associated services on one side, and a party of exurban and rural communities characterized by more traditional economic activities on the other. The institutions of federalism over-represent the latter in a way that creates antagonism. The counter-majoritarian aspect of American federalism is increasingly frustrating to urban interests, while much like Jefferson and the Virginians, rural America feels threatened by the notion of unbridled majority rule. Rather than articulating and defending policy positions or claiming credit for effective management, candidates for federal office increasingly advertise themselves to their core supporters as effective warriors in inter-group conflicts. Europe would do well to avoid this type of polarization.

Ever since Jefferson bridled at Hamilton's notion that the "Necessary and Proper" Clause allowed for the formation of a national bank, it was clear that the practical implementation of the pact would require the frequent intervention of a referee. Over the years, this has led to increasingly important courts and a judicialization of politics in the United States. The story of growing power of the judiciary in the American democracy is one of the central stories of American federalism. Whether a woman can obtain an abortion in the South, or whether the federal government is allowed to play a central role in health care, are determined not only by elections and legislative decisions, but also very much by philosophical musings about how to interpret an 18th century compromise among a group of nine appointees with lifetime tenure.

For their part, members of the court attempt to protect their institutional prerogatives and legitimacy by attempting not to stray too far, or for too long, from public opinion, and by making (increasingly strained) claims of non-partisanship. Courts are constrained because the threat of court-packing or non-implementation of judicial decisions is always lurking. This aspect of American federalism deserves careful consideration in Europe. The American path from a loose confederation to a more centralized and intertwined federation involved a judicialization of some aspects of politics, and rancorous partisan fights about judicial appointments, that Europeans may wish to eschew.

Another crucial feature of American federalism, as it has developed over the last 250 years, is the increasing overlap and intermingling of the functions of the central government, states, and municipalities. Accountability has suffered as a result. Blame-shifting is ubiquitous. Overlapping and redundant authority may be especially problematic in the presence of intense geographic polarization. The American response to the COVID-19 pandemic is an example. The pandemic also revealed some of the advantages of American federalism, however, in that it allowed for innovation and policies that matched local conditions. While the costs of blame-shifting and the benefits of local innovation were on display in other federations as well, the U.S. was perhaps unique in the extent to which the multi-layered system of authority mapped onto political polarization.

The American system of fiscal management is perhaps one of the areas of greatest interest for Europe. In spite of the rise of a strong central government and a complex system of intergovernmental grants and intertwined responsibilities, the states have retained significant revenue and policy autonomy without falling prey to soft budget constraints. Key components of this system are self-imposed borrowing limits at the state level, federal disengagement from

regulating subnational borrowing, the lack of a pre-existing bailout mechanism, the difficulty of assembling a political coalition in favor of bailouts, and the lack of any national consensus or expectations about solidarity or minimum service provision. In the wake of the debt crisis, Brexit, and COVID Europe has moved in a rather different direction on some of these dimensions than the United States.

The U.S. system of market-imposed discipline, with its lack of inter-regional solidarity, has some costs that might not be palatable in Europe. Above all, local public expenditures and public employment are pro-cyclical, and without major reform, there is little scope for counter-cyclical policy in the states. Recessions are associated with large and lasting cuts in expenditures and public employment in the poorest localities. Federal assistance during recessions is typically ad hoc, delayed, politicized, and poorly targeted. Americans are quite accustomed to this type of federalism and the inequality it produces, but it would be quite foreign to Europeans.

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