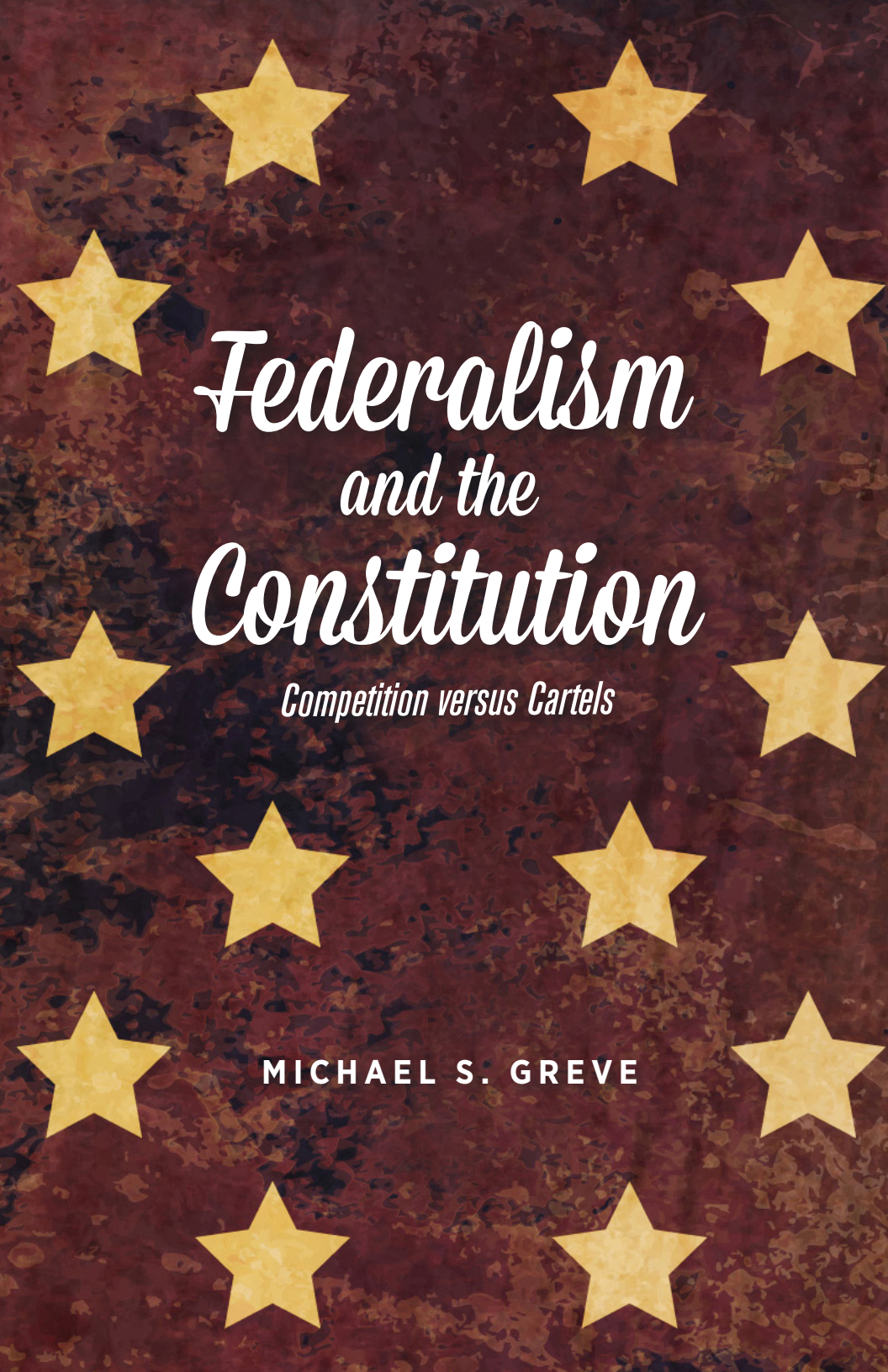
Federalism
and the
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Competition versus Cartels
MICHAEL S. GREVE

FEDERALISM AND THE CONSTITUTION

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MERCATUS CENTER
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AUTHOR'S NOTE

This essay explores the constitutional dimensions and the political economy of contemporary American federalism. It draws on themes and arguments developed at much greater length in my book *The Upside-Down Constitution* (Harvard University Press, 2012). I thank the Mercatus Center for the opportunity to present parts of the analysis—and the case for reform—in a more digestible form. James Conde, Christopher C. DeMuth, Robert R. Gasaway, Erica Peterson, and Todd Zywicki supplied helpful comments on earlier drafts. The Mercatus Center's editorial guidance and assistance have been terrific.

Michael S. Greve
Alexandria, Virginia, April 2015

Among the Constitution's structural principles, federalism is the Founders' most original contribution to the science of government. The "compound republic," as James Madison called it, unites partially autonomous states under a single sovereign government. Thus, federalism differs from a mere league or alliance among states. But it also differs from mere administrative decentralization. States are not mere subdivisions of the central government, to be ordered about at whim. The Constitution guarantees their existence and their territorial and political integrity.

Beyond that, though, the Constitution does not say very much about federalism. Within broad contours, it leaves much of the federal architecture to political struggle and ideological combat. For that reason, federalism has played a central role at every turn of our history and perennially given constitutional substance to the political issues of the day. So now: from "Obamacare" to immigration, from gay marriage to drug policy, from labor law and pensions to environmental protection, our domestic policy debates have a prominent federalism dimension.

Alongside those engagements, the federal structure itself has re-emerged as a subject of public debate. At times, "more federalism" is held out as a cure for an overbearing, divided, faction-ridden central government. In many cases, that may well be the right prescription. Manifestly, however, not all is well with our federalism. In numerous policy arenas, from education to disaster

relief to health care and insurance, federal arrangements have ceased to work. Bloated intergovernmental bureaucracies appear to defy any serious reform effort. Governments at all levels suffer from high levels of debt. These debilities, former Senator James L. Buckley (among others) has observed in a recent book, are *federalism* problems.[1] They command urgent attention: persistent policy failures that may have seemed tolerable in more prosperous, confident times take on a more menacing coloration in times of economic stress, public indebtedness, and widespread public disaffection. To a distressing extent, however, the contemporary federalism debate misses both the perils and perhaps the potential of our federalism.

The usual first question in that debate is, "how much federalism?" (meaning: how much decentralization and state authority?). For reasons I hope to elucidate, that is the wrong question. Federalism in its current configuration is deeply pathological; more of it would likely make matters worse. We need a different *kind* of federalism—a federalism for citizens, not governments; a federalism that disentangles intergovernmental bureaucracies and disciplines government at all levels.

That form of federalism—*competitive* federalism—would require very substantial structural reforms, and any effort in that direction would encounter fierce resistance from entrenched interests and bureaucracies. Still, there is no cause for despair. In fact, there are reasons to think that prospects for a more sensible federalism are better than they have been in quite some time. The first step, though, is a clear-eyed appraisal of our federalism predicament. That, in a nutshell, is the program of this essay. The remainder of this introduction provides a brief overview.

Federalism, the prevailing view has it, requires a healthy "balance" between Washington and the states. Conservatives and libertarians believe that the balance has been lost. The New

1. James L. Buckley, *Saving Congress from Itself: Emancipating the States and Empowering Their People* (New York: Encounter Books, 2014).

Deal threw it out of whack, and we have been on a relentless march toward centralization ever since. An overbearing, distant government in Washington, DC, has aggrandized itself and trampled state and local governments underfoot. To restore fiscal sanity and a more democratic government, the thinking goes, we should return power to the states and bring government closer to the people.

This conventional view has considerable plausibility—what with a national government that regulates local mud puddles, grade schools, and office jokes. However, the account misses important pieces of the federalism picture. Prominently, it overlooks powerful evidence of progressive *de*-centralization over the past decades. And to say the least, those trends have not been unambiguously beneficial. For example:

- From the end of the Korean War to 2008, federal taxes in relation to GDP hovered between 18 and 20 percent. Over that same time frame, state and local own-source revenues tripled, from about 5 to 18 percent. In fiscal terms, the growth of government in the United States is largely attributable to the growth of state and local government.
- A few decades ago, few national business enterprises worried about state law, state regulators, attorneys general, or trial lawyers. Now, companies operate amid a horde of regulatory trolls, any one of whom can unleash a regulatory firestorm any day of the week. *Never* in our history have states exercised more power over the commerce of the United States than they do now.
- Our federalism suffers from an alarming fiscal imbalance: state and federal governments spend federal dollars in excess of $600 billion per year. In well over half of all states, federal transfers account for over 30 percent of

revenues.[2] Perhaps the federal government is simply paying states to dance to its tune, but, if so, the price has increased substantially.

In short, excessive centralization has gone hand-in-hand with excessive decentralization. Both trends have produced bigger, more sprawling government. Both are federalism problems.

In this light, it is a mistake to view federalism and its problems as a question of federal-state "balance." Rather, it is a question of *structure*. Federalism comes in different forms—some conducive to fiscal discipline and economic growth; others to government bloat, systemic policy failure, and fiscal irresponsibility. Good and bad effects can occur at almost any level of decentralization.[3] To repeat, then, the central question is not, *how much* federalism? Rather, it is, *what kind* of federalism?

The starting point is a simple distinction, developed at greater length in section 1, between competitive federalism and cartel federalism. *Competitive* federalism compels states to compete for the talents, assets, and affections of a mobile citizenry. It thereby disciplines government at all levels, and it enhances political accountability and transparency. Competitive federalism was the federalism of the nineteenth and early twentieth century. By all accounts, it fostered the stupendous growth of the US economy over that long time.

Cartel federalism, in diametrical contrast, allows states—that is, their institutions and political elites—to *suppress* economic and political competition among states, with the active assistance of the central government. Cartel federalism promotes the growth of

2. Joe Luppino-Esposito and Shannan Younger, "New data reveals amount of federal aid to states in 2012," blog post, State Budget Solutions, January 28, 2014, http://www.statebudgetsolutions.org/publications/detail/new-data-reveals-amount-of-federal-aid-to-states-in-2012.

3. Book-length contributions in this vein include Daniel Treisman, *The Architecture of Government: Rethinking Political Decentralization* (New York: Cambridge University Press, 2007), and Jenna Bednar, *The Robust Federation: Principles of Design* (New York: Cambridge University Press, 2009).

government at all levels, creates impenetrable intergovernmental bureaucracies and a torrent of transfer payments, and destroys political accountability. Cartel federalism is not simply less good than competitive federalism. It is deeply dysfunctional and, in its more extreme forms, spells the ruin of nations. To a dismaying extent, this has become our federalism. We do not have a "balance" problem. We have a serious structural problem.

To understand that problem, one has to go back to the beginning—the Founding. As shown in section 2, the contest between "balance" and "structure" is as old as the Republic, and it has a prominent constitutional dimension. The "balance" perspective was the Anti-Federalists', who insisted on protecting state prerogatives. The Federalists, in contrast, resolutely rejected that position. They insisted that federalism—the "compound republic"—had to serve the interests of *citizens*, not the states' political institutions and elites.[4] That objective, to the Founders' minds, required federalism arrangements that, in keeping with the Constitution's overall structure, would establish effective government institutions and, at the same time, discipline those institutions. The Founders had no full-blown theory of *competitive* federalism, as we now understand it. However, they did have a well-developed theory of the federal structure; and remarkably,

4. In Federalist No. 45, James Madison inveighed vehemently against opponents of the proposed Constitution who protested that the instrument would leave too little power to state governments:

> [If] the union be essential to the happiness of the people of America, is it not preposterous, to urge as an objection to a government, without which the objects of the union cannot be attained, that such a government may derogate from the importance of the governments of the individual states? Was then the American revolution effected, was the American confederacy formed, was the precious blood of thousands spilt, and the hard earned substance of millions lavished, not that the people of America should enjoy peace, liberty, and safety; but that the governments of the individual states, that particular municipal establishments, might enjoy a certain extent of power, and be arrayed with certain dignities and attributes of sovereignty?
>
> James Madison, Federalist No. 45, in *The Federalist*, ed. George Carey (Indianapolis, IN: Liberty Fund, 2001), 237–38.

each piece of that structure is a vital component of what we now call "competitive federalism."

The structure lasted for well over a century. In the course of the twentieth century, it was largely lost—not, as the conventional view has it, as a result of centralization but, in the wake of the New Deal, in an inversion of competitive federalism into cartel federalism. Section 3 describes the contours of that transformation. Section 4 discusses its fiscal implications and consequences—in particular, its tendencies to produce overspending, public debt, and state gambles on federal bailouts.

In the immediate post–New Deal decades and well into the 1970s, economists and political scientists took a very benign view of cartel federalism. However, a grimmer view has since taken hold. For reasons discussed in section 5, many experts view cartel federalism as an engine of government failure and fiscal irresponsibility. Alas, cartel federalism has powerful self-reinforcing tendencies. Barring very severe shocks, it will resist any reform effort and instead lurch to ever-higher levels of bureaucratic entrenchment, systemic policy failure, and overspending. Its most extreme embodiment is the Patient Protection and Affordable Care Act, discussed in section 6.

American federalism has come very far down the cartelization road and may be beyond reform. Against that demoralizing prospect, however, stands the recognition—the Founders' recognition, no less—that moments of great danger may also be moments of great opportunity. The concluding section describes the present conditions that may permit a reconstruction of a more sensible, constitutional, competitive federalism. Cartel federalism is approaching the outer limits of affordability and political plausibility; its proudest accomplishment, the Affordable Care Act, is crumbling at all ends. Increasingly sharp political divisions among states have created political constituencies for meaningful, structural federalism reform. And the Constitution continues to exert a powerful gravitational pull toward a more competitive federal order. In short, threats as well as opportunities loom larger now

than they do in the course of ordinary politics. Seizing the opportunities requires a recognition of the moment and a hard-headed analysis of the problem. This essay aims to make a start.

I. FEDERALISM FOR CITIZENS AND STATES

We associate federalism with cherished values and virtues: government discipline and accountability; protection against the ravages of factional politics; civic engagement; choice and innovation. Federalism *in a certain form* can in fact serve those purposes. In other forms, however, federalism can produce a sprawling, wasteful, unaccountable government; facilitate political and economic exploitation; and exacerbate financial and political instability.[5] For example, a combination of centralized tax authority and decentralized spending authority (a common arrangement in many federal systems, including the United States) is conducive to chronic overspending and, in some cases, fiscal ruin.[6] Similarly, federal systems can suffer excessive centralization and, *at the same time*, excessive decentralization—a proliferation of virtually autonomous power centers that impose multiple compounding or conflicting burdens on a nation's economy. (Think of Internet or catalogue sellers with tax collection and remittance obligations in potentially thousands of jurisdictions.) Overlaps of public authority may produce thickets of intergovernmental bureaucracies that are impervious to public accountability, let alone political reform. Which federalism is it to be?

In most federal systems (including ours), federalism's benefits and pathologies occur in some combination. To some extent, they go together. For example, granting states substantial autonomy

5. For an overview of the literature, see Jonathan Rodden, "The Political Economy of Federalism," *Oxford Handbook of Political Economy*, eds. Barry Weingast and Donald Wittman *(Oxford:* Oxford University Press, 2006).

6. A particularly informative contribution to this grim literature is Jonathan Rodden, *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism* (Cambridge: Cambridge University Press, 2006). A prime example of ruinous fiscal federalism practices is Argentina. See 43–44 below.

will produce frictions and coordination costs that a wholly centralized system will not have to bear. That said, there are better and worse ways of organizing a federal system. It helps to start with a simple, binary distinction between two highly stylized types of federalism: competitive federalism and cartel federalism.

In a brilliant exposition, Geoffrey Brennan and Nobel laureate James Buchanan derived this distinction from a calculus that might inform a federalism choice *before* a constitution is in place.[7] In that preconstitutional context, one can think of federalism as the choice of individual prospective citizens—a sovereign "We the People." If those individuals opt for federalism (as opposed to a unitary government), they will choose federalism *of a certain form* and for a certain purpose—to discipline government at all levels. The conventional term for that form of federalism is *competitive* federalism. Alternatively, one can think of federalism as a bargain among state governments or local elites.[8] That perspective will generate a very different federalism. The junior governments will yield to central authority only if that strategy promises to enhance their own power and rewards—in particular, their ability to tax citizens in excess of the cost of providing public services.[9] This form of federalism I call *cartel* federalism.

The Citizens' Choice: Competitive Federalism. "The great difficulty" in forming "a government which is to be administered

7. Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Indianapolis, IN: Liberty Fund, 2000).

8. The leading exponent of this view—which is eminently plausible, especially in the formative stage of federal unions—is William H. Riker, *Federalism: Origin, Operation, Significance* (Boston: Little, Brown, 1964). For sophisticated reformulations of Riker's perspective, see Mikhail Filippov, Peter C. Ordeshook, and Olga Shvetsova, *Designing Federalism: A Theory of Self-Sustainable Federal Institutions* (Cambridge: Cambridge University Press, 2004), and David McKay, "William Riker on Federalism: Sometimes Wrong but More Right Than Anyone Else?," *Regional and Federal Studies* 14, no. 2 (2004): 167–86.

9. For the formal specification of this "Leviathan" hypothesis, see Brennan and Buchanan, *The Power to Tax,* 33–35, 162.

by men over men," James Madison wrote in *The Federalist*, is that "you must first enable the government to control the governed; and in the next place oblige it to control itself."[10] This calculus applies to federalism as to all institutional choices. For the purpose of controlling the governed, a single central government will do. Thus, from the prospective citizens' vantage, the point of entrusting a second set of junior governments with authority over the same citizens and territory is to oblige government to control itself. Federalism can serve that purpose in two ways:

- Federalism limits the central government to procuring public goods that can be provided only at that level, such as national defense. Local public goods (such as parks or libraries) are to be provided locally. That arrangement helps to reduce central decision costs, which is worthwhile even if politicians at every level are perfectly benevolent.[11] On any set of less charitable assumptions, the central provision of local public goods will result in a level of spending and taxing in excess of *any* jurisdiction's preference, or the level of spending that would obtain if jurisdictions had to tax themselves for the benefit.[12] (Bridges to nowhere, all across the country.) Thus, to the extent that the central government's taxing and spending authority can be limited to goods that are national in scale, federalism can serve as a protection against government error and exploitation.

10. James Madison, Federalist No. 51., in *The Federalist*, 269.

11. The calculus is not entirely straightforward. "Local" and "national" public goods are clearly distinct only in economists' blackboard models. In the real world, the determinations are endlessly contestable and contested. Moreover, decentralization entails friction and conflicts among local jurisdictions, which in turn produce decision costs that would not accrue under a centralized system. Still, so long as federalism yields a *net* reduction in decision costs, it is worth having—all else being equal.

12. James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor: University of Michigan Press, 1962), 135–40. The prediction hangs on the assumption that local jurisdictions are represented at the national level (as they are in practically all federal systems).

- If citizens and firms are mobile, federalism will enable citizens to choose among varying bundles of public services, and it will force states and local governments to compete for productive citizens and firms. Competition in this sense has many potential advantages. It may allow citizens with varying preferences to sort themselves

COMPETITION AMONG STATES

Competition among the states is often called "Tiebout competition," after the eponymous author of a famous article published in 1956.* The moniker has stuck, but it is a bit misleading. Tiebout models seek to show that competition among governments can be "efficient" in the technical sense in which economists use that term. However, that result is only obtained under exceedingly unrealistic assumptions (for example, cost-free exit from each jurisdiction). Moreover, Tiebout's model is not really a *federalism* model: it features no central government at all.

In the real world, of course, competition among states is very imperfect. The cost of "voting with one's feet" may be quite high. Government services and taxes come in bundles, none of which may be entirely to your liking. Governments often fail to change policies that cause massive out-migration, and they may "compete" in destructive ways (for example, by erecting protectionist barriers). The case for competitive federalism, then, rests not on some efficiency theorem but rather on the expectation that *on the whole* state competition will beat the alternative of wholesale centralization. In that institutional perspective, competitive federalism is comparable to checks and balances at the federal level. We *know* that bicameralism and the separation of powers will block a few public-regarding laws. But they will also block a ton of special-interest legislation. The institutional devices are imperfect, but they exert a salutary discipline. That advantage would be lost under a monopolistic system (such as a one-house national parliament). The case for competitive federalism rests on an analogous reasoned intuition.

* Charles M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64, no. 5 (1956): 416–24.

into jurisdictions that offer different bundles of public services and accompanying tax payments. It may help to disclose information both about what policies work and about citizens' preferences, and it may foster policy innovation. Its principal advantage, however, is to discipline governments. Citizens will be willing to pay for public services at levels that will vary among jurisdictions. In contrast, states' attempts to exploit citizens will induce them to exit—to "vote with their feet." This "Tiebout competition" (see sidebar, opposite) will discipline state governments in the same way in which market competition disciplines private producers.

State Choice: Cartels. Now invert the perspective, and think of federalism as a bargain among states—that is to say, state officials or political elites. What is *their* constitutional choice? Prospective citizens, as just seen, will embrace competitive federalism because it promises to reduce government abuse and exploitation all levels. States, in diametrical contrast, will embrace union only if, and to the extent that, it promises to enhance the "power, emolument and consequence of the[ir] offices," in Alexander Hamilton's words.[13] Much like private producers in economic markets, states "as states" will seek to obtain more revenue for their product—government services—than they could generate under competitive conditions. (Brennan and Buchanan call this difference the states' "surplus.") That requires various cartelizing noncompete agreements, and the enforcement of those agreements against free-riding states in turn requires a central government. At the same time, a central government that is sufficiently strong to protect the states' surplus may also be sufficiently strong to confiscate it, and states will want to guard against that eventuality.

13. Alexander Hamilton, Federalist No. 1, in *The Federalist*, 2; Brennan and Buchanan, *Power to Tax*, 33.

Many federal constitutions enshrine this federalism-as-cartel model. For example, some grant the central government a tax monopoly (thus suppressing tax competition among states) and guarantee the junior governments a share of the proceeds.[14] The Constitution, we shall see in section 2, contemplates no such thing and, when properly enforced, blocks or impedes state cartels. By most measures, American federalism is still among the most competitive in the world; for example, it tolerates a high level of state tax competition.[15] However, it has lurched a long, long way toward the cartel model. For example, hundreds of federal "conditional funding" programs support, from general taxes, services that states would decline to provide under competitive conditions for fear that taxed citizens or firms might head for the exits. Countless federal workplace, employment, and safety standards suppress state competition for mobile labor and capital. It is a fateful mistake to view those programs as federal regimentation or impositions on states; for the most part, they respond to a genuine state demand.

Depressingly, the Brennan-Buchanan model *predicts* federalism's migration from competition to cartel. States that must operate under a competitive constitution will seek to procure through ordinary politics the anticompetitive regime that eluded them at the founding; and over time, they will figure out a way to accomplish that end.[16] From this vantage, the question is not why American federalism became cartelized. The question is why it took well over a century to accomplish that result. Much of the answer has to do with our ingenious Constitution.

14. The German Constitution, for example, operates on this principle. F.R.G. Const. art. 104 (a), 106–7.

15. Rodden, *Hamilton's Paradox*, 27–31.

16. Virtually all federalism scholars agree that competitive federalism can protect itself, if at all, only under very unusual circumstances. See, for example, Jonathan Rodden and Susan Rose-Ackerman, "Does Federalism Preserve Markets?," *Virginia Law Review* 83, no. 7 (1997): 1521.

II. CONSTITUTIONAL FORMS

At one level, the choice between competition and cartel is a question of policy. For example, the federal tax deduction for state income taxes dampens tax competition among states. (We could and probably should restore full competition by repealing the deduction.[17]) At a deeper level, however, the choice is constitutional. First, some anticompetitive policies are so destructive that no institution or political majority should be permitted to choose them. For this reason, the Constitution prohibits states from taxing imports without the consent of Congress and prohibits states (as well as the national government) from taxing exports.[18] Second, institutions matter. Depending on their configuration, they will tend to produce competitive or cartelizing policies—not in each case but over the general run. Federalism's basic institutions, in turn, are established by and under constitutions. What, then, would a "pure" competitive federal constitution look like?

The Founders, as noted previously, did not have a worked-out theory of competitive federalism. Even so, the US Constitution is the prototype of a profoundly competitive federalism order. Stanford political economist Barry R. Weingast and others have explicated competitive (or "market-preserving") federalism's basic formal elements.[19] Competitive federalism, according to the authors' widely accepted formulation, requires subordinate governments (states) underneath a central government with sufficient institutional integrity to engage in political and

17. Jeremy Horpedahl and Harrison Searles, "The Deduction of State and Local Taxes from Federal Income Taxes" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, March 2014), http://mercatus.org/sites/default/files/Horpedahl_State-Deductions_MOP_030614.pdf.

18. US Constitution, Article I, Section 10, Clause 2, and Article I, Section 9.

19. Barry R. Weingast, "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development," *Journal of Law, Economics & Organization* 11, no. 1 (1995). For a very similar exposition, see Jenna Bednar, *The Robust Federation: Principles of Design* (New York: Cambridge University Press, 2009), 17–20, 43.

economic competition over some range. The authors add two further conditions:

1. Competitive federalism requires a rough division of authority between the central and subordinate governments. States should have autonomy over conduct within their jurisdiction, provided (a) they permit free entry and exit and (b) their activities do not cause excessive externalities (that is, social costs not borne by the producer). Enforcement of these conditions is entrusted to the central government.
2. Competitive federalism requires that federal transfer payments to subordinate governments remain limited.

Note that these formal elements say nothing about a federal "balance." Condition 1 may seem to imply a very limited role for the national government. However, depending on the states' propensity to erect protectionist barriers, the structure of the economy, and other factors, policing the competitive rules of the game may require a very muscular central government.

Closer examination shows that the Constitution incorporates competitive federalism's conditions. It grants Congress limited and enumerated powers, leaving all else to the states. It forbids state protectionism and discrimination, and it entrusts the enforcement of those prohibitions to the national government (foremost, the judiciary).[20] And while the Constitution does not prohibit federal transfers, it contains important structural mechanisms to limit them.

20. Congress could prohibit state violations of those rules even under a very restrictive understanding of the power to regulate commerce among the states. The point of the constitutional prohibitions (contained in Article I, Section 10, and Article IV, Section 2) is to render them *judicially* enforceable, even in the absence of any congressional action.

Condition 1: The Breadth and Depth of Federal Powers. Federalism, I noted at the outset, differs both from an alliance among states and from mere administrative decentralization (which even a centralized system such as France will pursue to some extent). It is tempting to understand federalism as a happy "balance" between those extremes. Crucially, however, James Madison's canonical account of the "compound republic" in Federalist No. 39 rejects any attempt to collapse it into a simple national-state dichotomy or federal-state "balance." Rather, Madison describes the constitutional order as a hybrid of "national" and "federal" elements. Not every hybrid is a mutt, though. The Constitution combines those elements *in a particular, coherent way*: the general government's powers are *federal* "in extent" but *national* "in operation."[21] What does this mean?

The government is "federal in extent" because it is a government of limited and enumerated powers. (On the not entirely reliable authority of Federalist No. 51, those powers are "few and defined."[22]) All else is left to the states. The nineteenth century had an almost physical understanding of separate state and federal "spheres," roughly corresponding to a distinction between the states' "internal" affairs and "national" matters committed to the central government. On account of this division of federal and state authority, the federalism of the nineteenth century is often called "dual" federalism. But dualism has a profoundly competitive dimension: in all the domains that are beyond the national government's reach, states will have to compete for mobile citizens and firms.

The "national in operation" part of Madison's compound republic is less familiar but no less crucial. It encapsulates three interlocking principles: federal *supremacy* over state law, the *exclusivity* of federal law, and the *direct* operation of federal law.

21. James Madison, Federalist No. 39, in *The Federalist*, 199.

22. Article I Section 8 of the Constitution alone contains 18 grants of power—not exactly "few." Moreover, the powers are *more or less* defined, and some, such as the power to tax, are amazingly broad.

Supremacy means an ironclad choice of law rule, contained in Article VI, Section 2, of the Constitution: validly enacted federal law breaks any and all state law. States may not exempt themselves or their citizens from federal law, and judges (including state judges) must give full force and effect to federal law. At first impression, supremacy looks like a brutally nationalist principle. However, it is also a competitive principle. It attaches only to treaties, the Constitution, and laws enacted "in Pursuance thereof"—that is, in accordance with established procedures and within the limits of the enumerated powers. Within those bounds, supremacy ensures the federal government's ability to enforce competitive ground rules among states (for example, by prohibiting interferences with free interstate commerce).

Exclusivity means that private conduct is subject to state *or* federal authority, not both at the same time. That general rule is not unbroken. Foremost, the power to tax is (with a few exceptions) a concurrent power: states and the federal government may tax the same base, at any rate they see fit. Moreover, we shall see that the exclusivity principle was effectively abandoned over the course of the twentieth century. It is all the more important to recognize that exclusivity *was* the general rule and a background principle[23]—and that it, too, is a procompetitive principle. To illustrate: a federal statute (the Airline Deregulation Act) provides the national government with exclusive power to regulate the rates, routes, and services of airline carriers. If states had concurrent power, they would impose conflicting regulations with a pronounced tendency to transfer wealth from interstate carriers to instate constituencies. And because the carriers must obey federal

23. The canonical exposition is Alexander Hamilton's Federalist No. 32. In some cases, Hamilton writes, the Constitution explicitly makes federal powers exclusive; in others, it specifically prohibits state regulation; and in a third set of cases, exclusivity is implied in the terms of a power. Hamilton's example is the power of Congress to establish a "uniform rule of naturalization": if states had concurrent power, he says, the rule would no longer be "uniform." Read the Constitution: with the exception of the power to tax, virtually every enumerated power—including the power to *regulate* commerce among the states—is at least arguably exclusive.

law in any event, state regulation can cut in only one direction: more, stricter regulation. Exclusive federal authority blocks that one-way ratchet.

The *direct* operation of federal law means that the central government is authorized to tax and regulate citizens without assistance or intermediation of the states. This feature marks the key difference between the Constitution and the Articles of Confederation. Under the Articles, Congress taxed states rather than individuals, with predictably depressing results: states often failed to pay Congress's requisitions, and the national government had no practical way of making them pay. The Constitution remedied that disabling flaw.

By *empowering* the national government to act directly on citizens, the Constitution (according to the prevailing but not undisputed understanding) also *prohibits* it from governing indirectly, through the states. Unlike the Articles of Confederation (or, for that matter, the European Union), the Constitution establishes a government over individuals, not governments.[24] Thus, Congress may within the compass of its powers *preempt* the states—that is, prohibit them from interfering with federal powers. However, Congress may not affirmatively *command* states to do anything at all.[25] Section 6 will provide a powerful illustration of this constitutional "anticommandeering" principle and its salutary force.

Condition 2: Transfers and Bargains. Competitive federalism, according to Weingast et al., requires that federal-to-state transfer payments must be limited. (Later sections discuss the reasons and the dire consequences of large transfers.) However,

24. The European Union is a modern-day version of the failed Articles of Confederation: it lacks a general power to tax, and it depends on member states' governments and courts to implement its regulations and directives. Alexander Hamilton's brilliant Federalist No. 15 identified this "great and radical vice" as the central defect of the Articles.

25. See *New York v. United States*, 505 U.S. 144 (1992); *Printz v. United States*, 521 U.S. 898 (1997).

the Constitution does not prohibit such transfers. Article I grants Congress an explicit power to tax, which implies a power to spend. Congress may purchase or subsidize the states' services, much as it purchases or subsidizes the services of Catholic Charities or Boeing (provided only that the spending must be in "the general welfare"). The dangers are palpable: Congress may "spend its way around" the enumerated powers, thus eviscerating the federal structure. States, for their part, will be tempted to borrow and spend on the federal government's implied credit. Why would constitution-writers with a commitment to limited government and (competitive) federalism countenance such an arrangement?

The basic answer is that some national public endeavors—say, the construction of military facilities in a given state, or the management of large-scale water resources—require federal-state cooperation. Of necessity, then, a workable federal order must permit the levels of government to bargain around the constitutional entitlements, and those bargains will often involve a transfer of federal funds. The dangers, however, remain. What are the safeguards?

- The Constitution contains budget constraints on the federal government. But they operate on the *tax* side, not the *spending* side. The Founders envisioned a system of hard money and limited federal borrowing. The notion that the system might print a fiat currency or debt-finance routine non-wartime expenditures for a burgeoning transfer state would have horrified them.
- The Constitution contains structural mechanisms that are calculated to impede federal spending for anticompetitive purposes. A single state or a few states cannot easily obtain a bicameral majority and presidential approval for special spending on their behalf. Thus, barring unusual circumstances (such as natural disasters), federal spending programs must be made available to *all* states willing

to accept the funds. Even a universal state agreement to procure federal funding, however, may well founder on disagreement about the distribution. Unlike most federal constitutions, ours contains no distributional formula—in other words, no baseline that would facilitate state bargains.[26] States must construct such bargains on an open field, and in a fragmented political system that requires considerably more than a simple majority in a single legislative chamber, that will often prove impossible.

- Federal transfers are subject to constraints. As the Supreme Court has put it, federal conditional grant programs are "in the nature of a contract."[27] The legal force of Medicaid or No Child Left Behind in any given state comes not from the Supremacy Clause but from the state's acceptance of federal funds, which Congress may invite but, on account of the anticommandeering rule, never compel.

Sections 5 and 6 discuss the force and limitations of these constitutional arrangements.

Enforcing and Preserving Competitive Federalism. As suggested earlier, specifying competitive federalism's initial conditions is tolerably straightforward; protecting the arrangement against cartelizing pressures is fiendishly difficult. Supreme federal powers are necessary to protect competition. Once granted, however, those powers may also be used to destroy competition.[28]

26. For a lucid discussion and an instructive comparison between the US Constitution and Germany's Basic Law, see Kenneth W. Dam, "The American Fiscal Constitution," *University of Chicago Law Review* 44, no. 2 (1977).

27. The origin of this oft-quoted phrase is *Pennhurst State Sch. v. Halderman*, 451 U.S. 1, 17 (1981).

28. See also Richard E. Wagner, "American Federalism: How Well Does It Support Liberty?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, March 6, 2014), http://mercatus.org/sites/default/files/Wagner_Federalism_v2.pdf.

No constitution can escape the dilemma. The US Constitution does all that can be done: it biases the exercise of federal powers in a procompetitive direction.

Bicameralism and the separation of powers make it difficult to produce federal legislation, especially including cartelizing or centralizing legislation. That is an implicit protection for federalism. The institutional impediments, however, will also tend to block federal interventions that are needed to order state relations and to protect competition. The Constitution contains an ingenious solution to this dilemma: it commits the ordering of interstate relations principally *to the federal courts*, not to Congress.

Federalism in any configuration will pose conflicts and coordination problems among states. The required coordination can be supplied on "positive" terms, through affirmative standards ("Food in interstate commerce must carry nutritional labels"), or on "negative" terms, through prohibitions against state interferences ("No state may tax imports"). Legislative coordination can be positive or negative: Congress may liberate commerce, "harmonize" it, or destroy it. Judicially supplied coordination, in contrast, will almost inevitably proceed on competitive terms. Federal courts cannot compel transfer payments among states, harmonize their laws, or pay them money to implement a federal standard. Under a suitably designed Constitution, however, federal courts *can* forbid states from discriminating against outsiders, taxing or regulating sister-states' citizens, or blocking entry to and exit from their jurisdictions. All these coordination rules compel members of the union to compete in a domestic free-trade order.

If competitive federalism is your cup of tea, then you will want to entrust the federal structure principally to the courts, armed with federal jurisdiction and competition-protective constitutional clauses, while cluttering the federal legislature with obstacles. That, in essence, is the constitutional arrangement.

The arrangement is not failsafe. It worked very well during the nineteenth century, when the judiciary understood that the ordering of interstate relations and the protection of the commerce of

the United States were its foremost tasks and when Congress remained relatively quiescent. In the wake of the New Deal, however, the Supreme Court largely abandoned its federalism responsibilities, and Congress has been anything but quiescent. Most fatefully, Congress managed to find spending formulas to gather states under a federal cartel umbrella. Federal funding, the following sections will show, is competitive federalism's Achilles' heel and cartel federalism's lifeblood.

III. FEDERALISM'S TRANSFORMATION

For well over a century, the Constitution's competitive logic prevailed. Congressional interventions remained sporadic, and the Supreme Court aggressively policed the Constitution's competitive, open-market rules. While a few federal transfer programs did exist, they were pork barrel programs that had more to do with party politics than with federalism, and they remained limited.

The "dual" competitive federalism of the nineteenth century is dead and gone. What has taken its place is a cartel federalism that turns competitive federalism's constitutional logic and institutional arrangements upside-down.

- Recall competitive federalism's constitutive features of *federal* (limited) powers, *national* in operation: the order has been very nearly inverted. Federal powers have become effectively unlimited—"national," in Madison's parlance. The powers remain "supreme" in a technical but not in a practical sense: over a vast range of activities, state regulation runs concurrent with and on top of federal regulation. And, far from being "national" in operation, most federal programs are administered by state and local officials.
- As noted earlier, federal transfers are anything but limited: they now clock in at over $600 billion per year.

- Hard federal budget constraints have been replaced with routine peacetime debt finance and a central bank that lends freely.
- The Supreme Court has largely abandoned any serious effort to protect interstate commerce against state interferences. It has surrendered that task to the Congress, whose idea of "protection" is harmonization rather than competition.

These changes encapsulate federalism's transformation during the Progressive Era and the New Deal. "Competition versus cartels" is a helpful way of understanding that oft-told, endlessly fascinating story.

Competitive federalism, we have seen, disciplines state taxing, spending, and regulation. State politicians do not like this one bit. Thus, they will do what producers in private markets will often attempt: they will seek to form cartels and to suppress competition. That demand is a constant in all federal systems. Its *intensity*, however, depends on economic and social conditions: the fiercer the competition, the higher the demand to suppress it (all else being equal). At the end of the nineteenth century, industrialization and its concomitants—the emergence of vertically integrated corporations on a national scale, nationwide financial intermediation, sharply reduced transportation costs—dramatically increased state competition and, therefore, the demand for central interventions. Many of those interventions, from labor and workplace regulations to the first federal conditional grant programs, were explicitly designed to curb state competition. For several decades these adjustments remained piecemeal and halting, both on account of constitutional scruples and because deep divisions among states blocked cartelizing measures. However, under the unusual conditions of the New Deal period (a horrendous economic and social crisis and an extraordinary degree of partisan consensus), political actors found a cooperative solution—a federal constitution that creates and entrenches state cartels over a

STATES TO CONGRESS: COME GOVERN US

Had the New Deal been a "nationalist" revolution, state governments should have resisted it. The pattern was just the opposite: states *demanded* federal intervention. The famous Supreme Court cases that first blocked and then routinely sustained the nationalist innovations of the New Deal were all brought not by states but by (mostly small) business owners. In each case, states supported the federal laws. It was left to private enterprises, Justice Robert Jackson observed at the end of the period, to carry "the states' rights plea against the states themselves."*

* Robert H. Jackson, *The Struggle for Judicial Supremacy: A Study of a Crisis in American Power Politics* (New York: Knopf, 1941), 160.

vast swath of activity.[29] Federal grant programs, tax credits, labor laws, and statutes regulating pricing and entry in private industries exploded in number and size. Many of these measures cartelized private industries, and virtually all eroded state competition.

The "competition versus cartel" lens shows the New Deal transformation in a new light and so helps to guard against widespread misperceptions that afflict the federalism debate to this day. One such misperception is the notion of a "nationalist" and centralizing New Deal; the other, the misunderstanding of the New Deal's federalism as "cooperative." (See side bar, above.)

A Revolution in Favor of Government. The New Dealers greatly expanded the functions of the national government and made way for that expansion through a dramatic reinterpretation of the Constitution. But New Deal architects never made the mistake of thinking that federalism must be a zero-sum game, such that the national government can gain power only at the states' expense.

29. For a similar account, see Jenna Bednar, William N. Eskridge Jr., and John Ferejohn, "A Political Theory of Federalism," *Constitutional Culture and Democratic Rule*, ed. John Ferejohn, Jack N. Rakove, and Jonathan Riley (New York: Cambridge University Press, 2001), 223.

Rather, they recognized that federalism could serve to empower both the federal government *and the states*, instead of disciplining either. The New Deal, then, was not a revolution in favor of central government but a revolution in favor of government at *all* levels. At times, states actively demanded federal interventions; at other times, Congress solicited the support of state political elites to enact federal measures. Consequently, federal interventions took on distinctly state-friendly contours.

- *Revenue figures* tell a familiar story of government growth under the New Deal—and a less-familiar story about centralization. Although federal revenues rose considerably with the onset of the New Deal, an increasingly large share found its way into state and local budgets. Between 1932 and 1940, federal outlays for "cooperative" fiscal programs exploded from $250 million to almost $4 billion, accounting for fully 75 percent of the growth in the federal government's nonmilitary expenditures.[30] Newly enacted grant programs involved the national government in many activities that up to that point had remained beyond its purview, but they also enabled the states to procure federal funds for activities that previously had to be financed from own-source revenues. Expanded federal tax credits further enhanced state capacity.
- *Regulatory and social policies* reflect a state-protective pattern. Not a single New Deal regulatory regime unambiguously trumped or displaced the states. For example, the Securities Act of 1933 and the Securities Exchange Act of 1934, which established a federal regime to govern corporate disclosure and the stock exchanges, explicitly declined to preempt state regulators and instead layered the newly created Securities Exchange Commission

30. John Joseph Wallis, "The Birth of the Old Federalism: Financing the New Deal, 1932–1940," *Journal of Economic History* 44, no. 1 (1984): 144.

CARTELS AT EVERY LEVEL

A pair of cases, argued on the same day in 1942 and decided in 1943, illustrates the ways in which the Supreme Court bent constitutional doctrine to accommodate New Deal aspirations.*

In *Wickard v. Filburn*, the court unanimously sustained a federal law that limited the amount of wheat farmers were permitted to grow, including wheat that never entered interstate commerce but was instead consumed on the farm (chiefly, as livestock feed). The court explicitly rejected the distinctions—for example, between agricultural and manufacturing "production" and "commerce" in those products—that had previously limited the reach of the Commerce Clause. That clause, *Wickard* held, allows Congress to regulate any activity that in the aggregate "affects" interstate commerce.

In *Parker v. Brown*, the court unanimously upheld a producer cartel for raisins, established by the state of California for the explicit purpose of limiting output and raising prices. At the time, California supplied virtually all of the nation's raisins. The monopoly costs were paid by consumers across the country. The Supreme Court held that state-sponsored cartels are immune from federal antitrust laws. (This so-called "*Parker* immunity" lives to this day.) Moreover, the Court rejected the contention that California's exploitative cartel imposed impermissible "extra-territorial" costs on interstate commerce. California, the court said, regulated only the local production of raisins, not their sale in interstate commerce.

Precisely that distinction, of course, had been rejected in *Wickard*. The point of that holding was to facilitate the *federal*, *congressional* cartelization of private production. The point of adhering to the supposedly discredited production-commerce distinction in *Parker* was to immunize *state*-sponsored cartels against *judicial* checks. Only one constitutional "principle" harmonizes these holdings: cartels at every level.

* The cases discussed in this side bar are *Wickard v. Filburn*, 317 US 111 (1942), and *Parker v. Brown*, 317 US 341 (1943).

(SEC) on top of the states' laws. Most New Deal regulation, from telecommunications to agriculture policy, transportation industries, and deceptive business conduct has the same structure. Similarly, virtually all New Deal social legislation, from unemployment insurance to

welfare benefits, afforded the states an important administrative and political role. Only one important program, the old-age insurance title of the 1935 Social Security Act (what we now call Social Security), was structured as a wholly national program.

- *Constitutional doctrine* assumed a distinctly state-friendly trajectory. Conventional wisdom has it that in 1937 or thereabouts, the Supreme Court surrendered a judicially enforceable federalism principle of limited, enumerated powers. The power to regulate commerce among the states, for example, became the power to regulate any economic conduct that "substantially affects" interstate commerce. However, New Deal jurisprudence coupled the demise of restraints on the national government with doctrines that unshackled *the states* from constitutional constraints. The Supreme Court greatly expanded the states' power to tax and regulate the nation's commerce, fifty times over (see side bar, page 25). State and federal power became concurrent over virtually the entire range of private (economic) conduct.[31]

"Cooperative" Federalism and the "Race to the Bottom." Federalism poses coordination problems at the best of times, and the greatly increased economic scale and integration of the industrial age posed them with increased frequency and severity. Federalism, the Progressives and New Dealers insisted, had to become "cooperative."[32] Because history is written by the

31. In a path-breaking article, Stephen Gardbaum inventoried the New Deal's state-liberating doctrines: the demise of "substantive due process," a state-protective reformulation of the dormant Commerce Clause and of federal preemption, and doctrines that greatly expanded the jurisdiction of state courts. Stephen Gardbaum, "New Deal Constitutionalism and the Unshackling of the States," *University of Chicago Law Review* 64, no. 2 (1997).

32. Invention of the term is generally credited to Edward S. Corwin. See Edward S. Corwin, *The Twilight of the Supreme Court* (New Haven, CT: Yale University Press, 1934); Edward Corwin, "The Passing of Dual Federalism," *Virginia Law Review* 36 (1950).

winners, that term has stuck. In truth, however, the only coordination "problem" that troubled the Progressives and New Dealers was competition among states. The genius of the New Deal was to define competition *itself* as an interstate harm.

The New Deal's "cooperative" programs illustrate the point: they rarely coordinated anything, while consistently establishing intergovernmental or industrial cartels. Federal minimum standards for labor practices coordinated nothing because states remained free to legislate on top of those standards. The New Dealers' strategy of granting states a concurrent role in industry regulation—a consistent practice even where wholly national regulation would have made a lot more sense—did not solve coordination problems but rather created them.[33] So, too, with fiscal programs. Coordination-wise, it would make eminent sense to monopolize redistributive programs at the federal level. (The federal government has a comparative advantage at redistribution because it can tax on a nationwide basis and knows how to move gobs of money.) Running the programs through state bureaucracies involves high administrative costs, fiscal distortions, policy slippage, political gamesmanship, and the risk of outright theft. The New Dealers were well aware of those problems but, evidently, not terribly impressed by them.[34] Their "cooperative" innovations, though touted as solutions to federalism's coordination problems, instead created such problems in abundance.

What the programs did accomplish was to curb state competition—in the Progressives' and New Dealers' telling, a destructive "race to the bottom." One notorious example was corporate law,

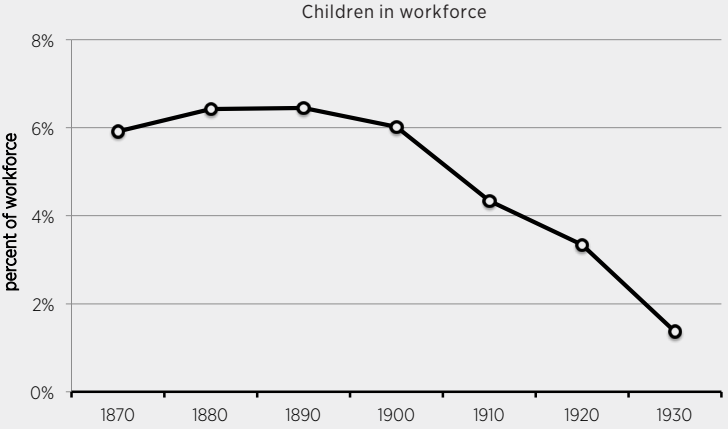
33. Wholly national responses to increased complexity and novel social demands presented themselves at the time. For example, the recognition that states are poorly equipped to regulate interstate power or telecommunication networks might have suggested that monopolistic, central administration was the appropriate remedy. Regulated industries often pressed the point but to little avail. See, for example, Joel Seligman, "The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation," *Michigan Law Review* 93, no. 4 (1995): 649, 652.

34. The best account is still James T. Patterson, *The New Deal and the States: Federalism in Transition* (Princeton, NJ: Princeton University Press, 1969).

A "RACE TO THE BOTTOM," OR SOCIAL PROGRESS?

In *Hammer v. Dagenhart* (1918), the Supreme Court invalidated, as exceeding Congress's powers under the Commerce Clause, a federal statute prohibiting the interstate shipment of goods from any factory employing children under the age of fourteen. Four years later, in *Bailey v. Drexel Furniture Co.*, the Court invalidated a federal tax designed to accomplish the end already found unconstitutional in *Hammer*.* Efforts to prohibit child labor by means of constitutional amendment remained unavailing, and child labor remained unregulated at the federal level until 1938.

What happened in the real world? The figure below shows the percentage of the labor force comprised of children (ages 10–15) between 1880 and 1930:



Source: "Percentage of workforce comprised by children," *Historical Statistics of the United States*, Bicentennial Edition, Series 75 and 80.

All states had already adopted child labor laws by the time of *Hammer*, albeit of varying stringency. Those differences reflected a deep divide between the poor South and the wealthier states especially in the Northeast, where high-wage industries (such as the Massachusetts textile industry) demanded federal intervention. Even so, state-level prohibitions toughened over time, and one observes a sustained improvement in economic and social conditions. Child labor had already been cut almost in half at the time of *Hammer* and effectively disappeared (except on farms) by 1930.

* *Hammer v. Dagenhart*, 247 US 251 (1918); *Bailey v. Drexel Furniture Co.*, 259 US 20 (1922).

where state charters allowed corporations to escape into (allegedly) irresponsibly lax jurisdictions, notably Delaware. A second "race" frustrated state efforts to tax wealthy and, as it turned out, highly mobile individuals. (Florida's emergence as a tax-free retirement haven dates to this period.) A third "race" was the states' reluctance to enact protective labor legislation and to provide social services to the indigent, disabled, and elderly. Fear of interstate competition, it was said, prevented enlightened states from responding to urgent social problems and demands.

On the whole, contemporary scholars are very skeptical of "race to the bottom" predictions that competition will induce local governments to under-produce public goods (such as environmental protection).[35] The concern seems more plausible with respect to redistributive programs: a state that enacts stringent labor protections or expensive benefit programs must fear an exit by mobile taxpayers as well as an unwanted "welfare magnet" effect. Even here, though, it is surprisingly hard to find evidence of a destructive "race" during the pre–New Deal decades: by virtually all measures, social well-being improved substantially (see side bar, opposite). Still, the "race to the bottom" flourished as an all-purpose rationale for federal intervention.

35. A prominent example: the state "race" for corporate charters that troubled the Progressives is now widely viewed as a potent vehicle for maximizing shareholder value. Among the leading contributions to the voluminous literature are Ralph K. Winter Jr., "State Law, Shareholder Protection, and the Theory of the Corporation," *Journal of Legal Studies* 6, no. 2 (1977), and Roberta Romano, *The Genius of American Corporate Law* (Washington, D.C.: AEI Press, 1993). But see William L. Cary, "Federalism and Corporate Law: Reflections upon Delaware," Yale Law Journal 83, no. 4 (1974), which argues that state competition results in a race to the bottom. Similarly, many modern economists doubt that jurisdictional competition systematically induces jurisdictions to undersupply public goods, such as environmental amenities. Under most reasonable assumptions, the level of such goods will reflect the local demand, which may be quite high even when the tax price is substantial. See Richard L. Revesz, "Rehabilitating Interstate Competition: Rethinking the 'Race to the Bottom' Rationale for Federal Environmental Regulation," *New York University Law Review* 67, no. 6 (1992). Revesz's path-breaking article produced a flurry of criticism. The references can be found in his rejoinder, Richard L. Revesz, "The Race to the Bottom and Federal Environmental Regulation: A Response to Critics," *Minnesota Law Review* 82, no. 2 (1997). In my estimation, Revesz has long won the argument, even though the debate continues.

Nor did the New Deal merely compromise competitive federalism's logic; it inverted it. Even as competition turned into an "externality," *politically* generated externalities *ceased* to count as harms. Congress as well as the Court affirmatively encouraged states to tax and regulate their neighbors and interstate commerce, several times over.[36] Mutual state aggression of this sort will rarely meet with organized resistance: the benefits for each state and its clientele are concentrated, while the costs are shared by consumers across the country and therefore unnoticeable. Nor would it matter if the exploited consumers did notice: they can neither escape the imposition nor vote the bums out of office. Consider the raisin cartel of *Parker* fame (described in the side bar on page 25): not one state protested California's imposition. They all had their own cartels to defend.[37]

Does it Matter? The New Deal transformation is a *fait accompli*. Nonetheless, it remains crucial to understand it as a transition from one form of federalism to another. Both the notion of a "nationalist" New Deal and the New Dealer's artfully constructed mythology of a "cooperative" federalism impede a realistic assessment of federalism's current predicament. Unless corrected, those misapprehensions will help to frustrate and misdirect any attempts to tackle cartel federalism's destructive tendencies. Section 4 describes those tendencies.

36. For a brilliant overview, see Gardbaum, "New Deal Constitutionalism."

37. For a good discussion of *Parker* and its federalism implications, see Frank H. Easterbrook, "Antitrust and the Economics of Federalism," *Journal of Law and Economics* 26, no. 1 (1983).

IV. CARTEL FEDERALISM IN ACTION

Cartel federalism has played out in a *regulatory* and in a *fiscal* dimension. This section and the remainder of this essay are largely limited to the fiscal dimension—not because the regulatory problems are secondary but because a full discussion of that subject would carry far into arcane legal doctrines and expand this essay beyond all reason. A few brief observations illustrate the common themes between regulatory and fiscal cartel federalism.

The enormous expansion of the federal government's powers permitted Congress to wipe out state competition on practically any margin. To many minds, this is the cardinal sin of the New Deal's Constitution. That view has a great deal of plausibility, but it is not the whole story. In a modern economy, *most* business will cross state lines. Private actors will often demand federal intervention—sometimes to gain special favors but often to obtain relief from protectionist or exploitative state regulation. Their problem is not so much that the federal government regulates them; it is that such regulation usually fails to make commerce regular, by allowing states to regulate *on top of* the federal rules. National enterprises then find themselves beleaguered by legislatures, courts, attorneys general, regulators, and trial lawyers from fifty state fiefdoms—all with their own conflicting, cascading demands but united in their desire to have a piece of the action.

The picture is familiar to every newspaper reader. California, among other states, has contrived to tax corporations on profits earned in foreign jurisdictions, to impose sales tax collection obligations on internet sellers domiciled elsewhere, and to impose its idiosyncratic notions of responsible animal feeding and global warming policy on jurisdictions from Arkansas to Ohio and from Canada to Brazil—with nary a peep, and often encouragement,

from Congress and the federal courts.[38] State attorneys general have reorganized entire industries through settle-or-else prosecutions.[39] And day in, day out, products and profits disappear in state hellhole jurisdictions.

These practices exact an enormous price. For present purposes, two features bear note. The first is the systematic overgrazing of the economic commons: fifty states and the federal government "compete" by heaping burdens on the commerce of the United States. The second is the system's self-reinforcing dynamic: the toughest regulator or state court jury sets the rules of the game, and there is no stopping point. Those same deleterious features characterize cartel federalism in the fiscal domain.

Fiscal Federalism: A Brief History. The Constitution, we saw in section 2, erects structural impediments to large-scale federal transfer programs. However, the Constitution does not *prohibit* such programs, and under unusual conditions (crises, high levels of partisan consensus), the political system will produce them. In venues from poverty relief to unemployment insurance to infrastructure, the New Deal found funding formulas and institutional techniques (such as highly discretionary administrative programs) to overcome obstacles to "cooperative" transfer

38. Most recently, the Supreme Court has declined to hear challenges to California's extraterritorial regulation of energy production and animal feed practices in other states and countries. See, respectively, *Rocky Mountain Farmers Union v. Corey*, 730 F.3d 1070 (9th Cir. 2013), cert. denied, 134 S. Ct. 2884 (2014), and *Ass'n des Éleveurs de Canards et d'Oies du Québec v. Harris*, 729 F.3d 937 (9th Cir. 2013), cert. denied, 2014 US LEXIS 6979 (2014).

39. The most thorough account is Paul Nolette, *Federalism on Trial: State Attorneys General and National Policymaking in Contemporary America* (Lawrence, KS: University Press of Kansas, 2015).

programs.[40] The New Dealers failed to obtain transfer programs in policy domains (especially education) where federal involvement would have posed a direct threat to the racial caste structure in the South. Those obstacles, though, were eventually overcome in the 1960s, with the advent of the civil rights revolution and the Great Society. Federal education funding accomplished what *Brown v. Board* had promised—an end to state-enforced segregation. Needless to say, no one laments the demise of Jim Crow. However, "cooperative" fiscal federalism exploded well beyond such limited and compelling purposes. In 1960, the count of federal aid programs stood at 132. In 1970, scholars counted 530 such programs; by 2006, more than 800; today, more than 1,100.

Figure 1 illustrates the stupendous growth of federal grant programs over the past half-century. Transfers remained relatively modest until the early 1960s (the first years shown in the graph), and a large portion was devoted to the national highway program and other infrastructure investments. With the onset of the Great Society, transfer payments exploded. Overwhelmingly, the new programs funded not infrastructure but services, from education to medical benefits to poverty relief.

Well into the 1970s, economists and political scientists took a very favorable view of federal transfer and grant programs. Such programs, experts argued, can help to combat collective action problems and externalities among states; compensate for undeserved state advantages (think California beaches) or inequalities; produce national public goods (such as a road system) efficiently and with sensitivity to local conditions; and smooth out business

40. Richard Franklin Bensel, *Sectionalism and American Political Development, 1880–1980* (Madison: University of Wisconsin Press, 1984), 275–355. Bensel emphasizes two institutional factors that stabilized the system: (1) a congressional committee system that was able (until the 1960s) to bottle up legislation that might have broken the New Deal coalition and (2) an administrative apparatus with discretionary means and budgetary resources to negotiate sectional—and thus political intraparty—conflicts.

cycles.[41] Increasingly, however, the recognition set in that fiscal federalism programs rarely if ever conformed to the economists' models. In 1981, the congressionally funded Advisory Commission on Intergovernmental Relations (ACIR) summarized its comprehensive review of grant programs as follows:

> [T]he record indicates that federal grant-in-aid programs have never reflected any consistent or coherent interpretation of national needs. . . . Regarding fiscal equity, the record indicates that federal aid programs have never consistently transferred income to the poorest jurisdictions or individuals. Neither do most existing grants accord with the prescription of "externality" theory. . . . Regarding economic efficiency and administrative effectiveness, the record indicates . . . serious obstacles to the successful implementation of intergovernmental programs.[42]

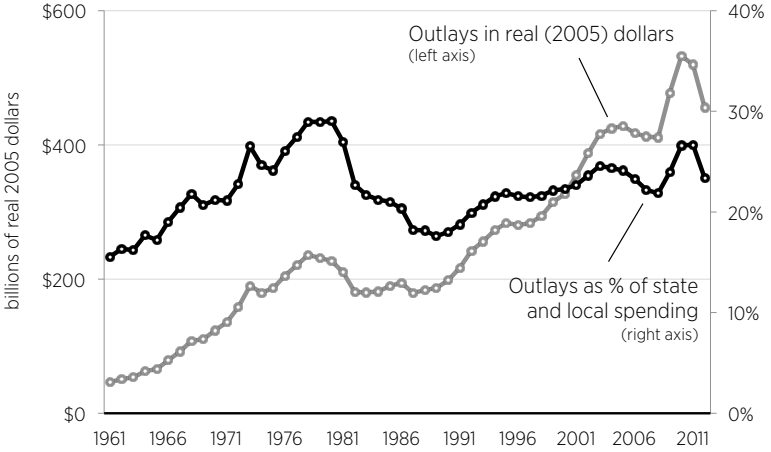
Such discontents prompted an ambitious "New Federalism" initiative by the newly elected Reagan Administration, which sought to disentangle federal-state relations.[43] At the same time, the Federal Reserve Board's decision to wring inflation out of the economy ended the political strategy of redeeming promises to state and local governments in cheaper dollars. For a few years, state and local governments suffered an unprecedented net reduction in fiscal transfers. However, transfer payments soon resumed their upward climb. The recent sharp rise (and subsequent drop)

41. A very useful summary and discussion is Wallace E. Oates, "An Essay on Fiscal Federalism," *Journal of Economic Literature* 37, no. 3 (1999).

42. Advisory Commission on Intergovernmental Relations, *The Federal Role in the Federal System: Dynamics of Growth* (Washington, DC: Advisory Commission on Intergovernmental Relations, 1981), 94.

43. For a good discussion, see Timothy Conlan, *From New Federalism to Devolution: Twenty-Five Years of Intergovernmental Reform* (Washington, DC: Brookings Institution Press, 1998), 191–211.

Figure 1: Federal Outlays to State and Local Governments



Sources: GDP: Bureau of Economic Analysis, National Income and Product Accounts Table 1.1.5;
federal outlays to state and local governments: Office of Management and Budget, Historical Table 12.1.

reflects the 2009 "Stimulus Bill" and other responses to the 2008 financial crisis. Though touted as an "investment" policy, it was actually a debt-financed bailout. The troubling lessons are discussed in section 5.

The Wages of Fiscal Cartel Federalism. Fiscal cartel federalism's upward trajectory is propelled by powerful dynamics. Foremost, federal transfer programs create potent fiscal illusions: they inflate the demand for government by reducing its perceived cost. No state would devote 25 percent of its budget to Medicaid if it had to tax its own citizens for the entire cost. But states are evidently willing to tax themselves for half the cost: one dollar of own-source revenue buys two or more dollars worth of services, and that looks like a bargain. At the same time, the fact that the federal government pays less than the full cost again makes its programs look much cheaper than their actual costs. Thus, the

joint costs of the programs are obscured, and federal funding drives up the demand for taxing and spending at all levels.

Political calculations reinforce the fiscal illusions. Congress cannot terminate funding without incurring the wrath of all states and of the (incidental) beneficiaries of its programs. And no individual state can opt out without leaving its own taxpayers' proportional contribution to the federally financed program on the table. Thus, the states and the feds perennially fight over the distribution of funds and obligations within "cooperative" programs—but hardly ever about the programs as such. When the programs fail (as they usually do), the unanimous demand among the institutional actors is to pump more money into the system.[44]

These nasty dynamics will dominate—and have dominated to date—even in the face of persistent policy failure, colossal waste, and acute fiscal distress.

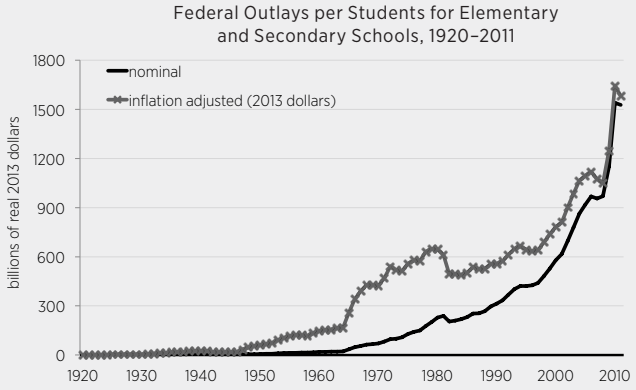
- *"Cooperative" fiscal program have consistently produced appalling results.* K-12 education has been a perennial poster child (see side bar), but it merely illustrates the ACIR's damning assessment over three decades ago. The 1996 welfare reform, which curbed welfare rights litigation and gave states more latitude to implement welfare-to-work requirements, is routinely (and with some justice) cited as an example of a successful cooperative federalism policy.[45] Even that enactment, however, reformed a failed cooperative program. Moreover, welfare reform owes its prominent status to its singular nature: it has not served as a model for any other reform.

44. The single best article on the dynamics is Aaron Wildavsky, "Fruitcake Federalism or Birthday Cake Federalism," *Federalism and Political Culture*, eds. David Schleicher and Brendon Swedlow (New Brunswick, NJ: Transaction, 1998), 55–64.

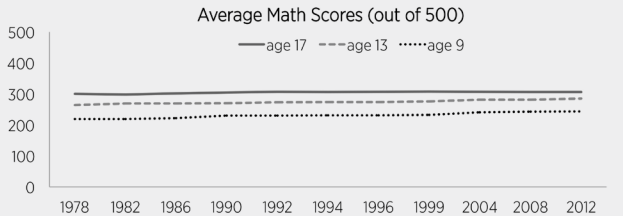
45. See, for example, Peter H. Schuck, *Why Government Fails So Often: And How It Can Do Better* (Princeton: Princeton University Press, 2014), 356–59.

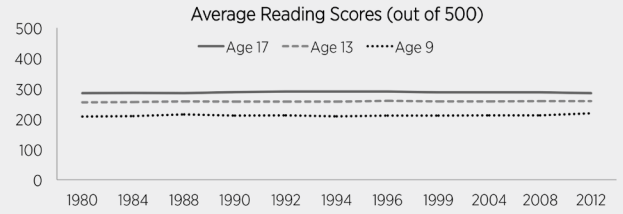
THE RISING COST OF MEDIOCRITY

Since the enactment of the Elementary and Secondary Education Act (ESEA) in 1965, K-12 education has been among the largest federal conditional grants programs. (Federal funds constitute about 10 percent of local school budgets.) The programs have been the target of energetic reform efforts by Democratic and Republican presidents and Congresses, and grant conditions have swung from very lenient to highly categorical (as under the No Child Left Behind Act). Measured outcomes are shown below: student achievements have flatlined, while costs (in inflation-adjusted dollars) have tripled.



Source: Digest of Education Statistics 2013, National Center for Education Statistics, US Department of Education.





Source: National Center for Education Statistics, "NAEP Long-Term Trend Assessments."

- *Fiscal cartel programs entrench parasitic bureaucracies and political constituencies*. Education programs support educators, and children only secondarily; Medicaid supports providers; highway grants support the concrete lobby and construction unions; and so on. Economists estimate the ratio of this diversion or "flypaper effect" (the money sticks where it hits) at somewhere between 0.3 and 1.0.[46] The *intended* effect of federal transfer programs is to feed a vast intergovernmental bureaucracy and its nominally private clientele. Those constituencies, in turn, provide political support for the programs and lobby for their expansion.
- *Federal transfers produce moral hazard*, meaning the recipients' tendency to engage in risky behavior in the hope and expectation that they will be bailed out in a crisis.[47] In relatively flush times, expanding federally funded programs looks relatively cheap for state officials. In recessions, when fiscal constraints force budget cutbacks, demand for many federally funded services tends to rise and cuts in those services look prohibitively expensive. (The more generous the program, the more expensive the cuts.) Thus, the programs will expand in good times and bad. While state officials may often recognize the dire long-term consequences of federal funding, they have a constricted time horizon: officeholders aggressively seek federal funding—a benefit that accrues during their expected tenure in office—even if the long-

46. Robert P. Inman, "The Flypaper Effect" (working paper 14579, National Bureau of Economic Research, Cambridge, MA, 2008).

47. See also Matthew Mitchell, "The Pathology of Privilege: The Economic Consequences of Government Favoritism" (Mercatus Research, Mercatus Center at George Mason University, July 8, 2012), http://mercatus.org/sites/default/files/Mitchell_PathologyofPrivilege_v3_1.pdf.; Russell Roberts, "Gambling with Other People's Money" (Mercatus Special Study, Mercatus Center at George Mason University, April 28, 2010), http://mercatus.org/sites/default/files/publication/RUSS-final.pdf.

> term fiscal consequences are known to be ruinous. This conduct is backed, in a manner of speaking, by the expectation that the federal government will provide added funding in times of distress.

The fiscal cartel federalism that we have inherited from the New Deal and the Great Society is enormously resilient—far more so than competitive federalism. Even so, it is not invulnerable. The experience of the first Reagan administration suggests that under some conditions, meaningful—albeit, in that instance, transient—reforms are possible. A necessary (though hardly sufficient) condition is a recognition—not just among experts but among politicians, pundits, and above all the public—of fiscal cartel federalism's high price. Section 5 discusses an increasingly salient aspect: the danger of moral hazard and federal bailouts.

V. BAILOUT NATION?

The risk that state and local governments will overspend in anticipation of a federal bailout afflicts any system that couples centralized monetary and tax authority with decentralized borrowing and spending authority.[48] The United States is no exception. For many decades, cartel federalism's destructive fiscal dynamics have been masked—at the federal level, by inflation and, in the 1990s, the dissipation of the "peace dividend"; at the state level, by increased tax effort and relatively hard budget constraints. With only one exception (Vermont), states operate under balanced budget requirements. While state budgets have been subject to much gimmickry and manipulation and balanced budget rules have been enforced with varying degrees of

48. Large parts of the chapter are based on Michael S. Greve, "Our Federalism Is Not Europe's. It's Becoming Argentina's.," *Duke Journal of Constitutional Law & Public Policy* 7 (2012).

stringency,[49] the requirements have prevented massive annual deficits that would alarm the public and the bond markets.

In recent years, however, fiscal federalism's deleterious effects have become graver and more visible. At the federal level, expansions of the transfer system have been largely debt-financed. At the state level, balanced budget requirements have exacerbated a shifting of excess spending into off-budget accounts—bond obligations and, above all, pension systems.[50] Unfunded pension obligations are estimated to amount to more than $4 *trillion*. In addition, state and local governments owe other post-employment benefits ("OPEB"), mostly in the form of health benefits, to retirees. These obligations run close to a trillion dollars and are almost entirely unfunded.[51]

For the time being, the debts seem manageable. Bond debt can be rolled over, and with the exception of a few states such as Illinois, underfunded pension systems will not require backbreaking budget infusions for some years.[52] In the interim, state and local governments can and do pay contractors in scrip, shorten school years, close prisons and parks, and leave roads unrepaired. Eventually, however, the debts will come due. There are good reasons to fear that they cannot and therefore will not be

49. Henning Bohn and Robert P. Inman, "Balanced Budget Rules and Public Deficits: Evidence from the U.S. States" (working paper 5533, National Bureau of Economic Research, Cambridge, MA, 1996).

50. Eileen Norcross, "Getting an Accurate Picture of State Pension Liabilities" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, December 13, 2010), http://mercatus.org/sites/default/files/Getting-an-Accurate-Picture-of-State-Pension-Liablilities.Norcross.12.13.10.pdf.

51. See Robert Novy-Marx and Joshua Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23, no. 4 (2009); Robert Novy-Marx and Joshua Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?," *Journal of Finance* 66, no. 4 (2011); US Government Accountability Office, *Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs*, GAO-10-899 (Washington, DC: US Government Accountability Office, 2010).

52. See Eileen Norcross and Benjamin VanMetre, "Illinois's Fiscal Breaking Points" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, October 2011), http://mercatus.org/sites/default/files/Illinois-Fiscal-Breaking-Points.pdf.

paid in full. And there are reasons to fear that in that event, we will bail out the states in one form or another. A realistic assessment of that threat requires an appraisal of the considerable strengths of our system of federal finance—and of the looming dangers.

Strengths: Commitment, Debt Markets, and Constitutional Structure. Only two principal safeguards can protect against moral hazard and bailout risks: (1) "hierarchical" controls, meaning central controls on, and timely interventions in, local governments' spending and borrowing authority; or (2) "market" controls, meaning the enforcement of fiscal discipline through private debt markets. Central, hierarchical interventions in junior governments' fiscal affairs have been common in many federal systems. The European Union, for example, imposes mandatory "fiscal stability" criteria on member states, monitors their performance, and extends loan guarantees to insolvent member states in exchange for a commitment to fiscal austerity.[53] However, that option is not available to the United States. As explained, our system is not a "government over governments." Instead, it operates on a principle of (circumscribed) state autonomy and especially fiscal autonomy. Thus, state fiscal discipline must be enforced through the bond markets. Market controls, in turn, require a credible federal commitment against central bailouts. Without it, state governments will borrow—and creditors will lend—on the central authority's implied credit.

Just that commitment has been a distinctive and salutary feature of American federalism. While states have occasionally defaulted on their debts (Arkansas accomplished the feat three

53. A concise discussion, contrasting the US experience with the EU's arrangements, is C. Randall Henning and Martin Kessler, "Fiscal Federalism: US History for Architects of Europe's Fiscal Union" (Brussels: Bruegel, 2012): 10–13, http://www.bruegel.org/publications/publication-detail/publication/669-fiscal-federalism-us-history-for-architects-of-europes-fiscal-union/.

times[54]), such occurrences have been rare. And the United States has *never* bailed out individual states. It is not obvious why that should be so, especially in a nation that started with a bailout—to wit, the assumption of the states' Revolutionary War debts. Two factors help to explain the long-running success story: the structure of the capital markets and the structure of the Constitution.

When sovereign debts are owed to and leveraged by big, "systemically important" financial institutions, no central government can credibly precommit to a no-bailout policy. In the European Union, banks hold and leverage large amounts of state debt, thus eroding any credible commitment against bailouts. (The EU, led by Germany, never really bailed out Greece. It bailed out its creditors, prominently including large German banks.) In other federal systems (such as Brazil), state or provincial banks that serve as a source of cheap credit for their governments likewise have been a chronic problem; and if there were a State Bank of Illinois or California, loaded up with leveraged state debt, those states—or rather the counterparty banks—would surely have been bailed out in 2008–9, alongside commercial and investment banks. Mercifully, however, the US has not had state banks since the antebellum era. (North Dakota's state bank is the lone exception, and it is not a menace to the economy.) Overwhelmingly, state and municipal obligations are owed to individual bondholders. If those debts go bad, bondholders and funds with big bets on the wrong side of the market will have to absorb the loss. That would be unfortunate, but it would not threaten the financial system. Thus, the central government can keep creditors and would-be lenders guessing.[55]

54. Louella Moore, "Bond Financing and Economic Development: The Arkansas Legacy of Default," *Midsouth Political Science Review* 8 (2006).

55. The behavior of the bond markets through the financial crisis suggests that creditors harbor no illusions that the federal government would rush to their rescue. Andrew Ang and Francis A. Longstaff, "Systemic Sovereign Credit Risk: Lessons from the U.S. and Europe" (working paper 16982, National Bureau of Economic Research, Cambridge, MA, 2011), http://www.nber.org/papers/w16982.pdf?new_window=1.

WASHINGTON TO STATES: DROP DEAD

The force of structural constitutional impediments to state bailouts is powerfully illustrated by the federal government's "drop dead" stance in the first serious test between 1837 and 1843. In the antebellum era, states competed aggressively in providing roads and especially canals, often through tax-free finance: state-chartered banks and internal improvement corporations sold debt instruments, very often to European investors. Those schemes sailed into trouble after a sharp deflation beginning in 1837. By 1840, banks collapsed and the bottom dropped out of the speculative land market that had supported the borrowing spree. In 1841–42, several states defaulted. British and Dutch investors pressured the United States government for intervention, arguing (probably with some justice) that they had extended funds in reliance on the credit of the United States. In 1842, the United States was entirely cut off from international credit. Plans for a federal bailout surfaced as early as 1839, and the federal government possessed ample tariff revenues to bankroll the states. Still, no bailout materialized. A committee proposal for federal debt assumption was never even put to a vote in Congress. The assumption debate was not about what distribution would be "fair" relative to a known baseline; it was about what the appropriate distribution baseline ought to be in the first place. Especially under the conditions of antebellum America, no agreement on such a baseline was possible. The Constitution's silence "clearly bolstered the credibility of the [federal government's] commitment to stay out of the states' budget difficulties."*

* Rodden, *Hamilton's Paradox*, 66. This side bar summarizes Rodden's excellent account of the crisis, ibid., 57–71.

What of the Constitution? At first impression, the document seems horridly deficient in stemming the bailout peril. Nothing in the Constitution bars states from borrowing themselves into ruin (although they must pay their debts in real money); nothing authorizes the U.S. government to restrict the fiscal autonomy of even the most reckless state government; and nothing bars the federal government from paying the states' debts *sua sponte* or upon the states' request. Thus, the stage seems set for irresponsible state bets on federal assistance. Even so, the Constitution's structural features have helped to prevent that nightmare scenario.

Foremost, in the absence of any hierarchical federal control over state governments, it is exceedingly difficult to recapitalize a state in exchange for a promise of future fiscal discipline: no institutional framework exists to enforce such a bargain. For this reason, a bailout of a single state (or a few states) remains a very remote prospect. Any bailout would have to benefit *all* state governments, in accordance with some agreed-upon formula.

That undertaking, in turn, is made difficult by a second constitutional feature, noted earlier. In contrast to most modern federal constitutions, ours contains no "fiscal constitution"—that is, no mandate for the distribution of federal tax receipts to subordinate governments and no distributive baseline. Thus, a state bailout would have to be negotiated and engineered on an open field and in a bicameral, separation-of-powers system that demands considerably more consensus than a simple majority in a single body. Throughout American history, bailout demands have foundered on those obstacles (see side bar, page 43).

Recent trends and events, however, raise considerable doubts whether the historical commitment against bailouts is still credible.

Dangers: Are We Becoming Argentina? In the wake of the 2008–9 financial crisis and in view of Europe's sovereign debt crisis, there were widespread fears that California or Illinois might become "the next Greece"—that state and local governments' fiscal distress might prompt federal bailouts. The threat seemed sufficiently acute to prompt legal scholars to propose a bankruptcy process for states, akin to the process that Chapter 9 of the Bankruptcy Code provides for municipalities.[56] For reasons just discussed, a direct bailout remains unlikely. That does not mean,

56. For extensive discussion, see Peter Conti-Brown and David Skeel, eds., *When States Go Broke: The Origin, Context, and Solutions for the American States in Fiscal Crisis* (Cambridge: Cambridge University Press, 2012). For my own view, see Michael S. Greve, "Bailouts or Bankruptcy: Are States Too Big to Fail?," *Legal Outlook* 1 (American Enterprise Institute, Washington, DC, 2011), https://www.aei.org/publication/bailouts-or-bankruptcy-are-states-too-big-to-fail/.

however, that our federalism poses no bailout risks. It means that the risk takes a different form: a series of undercover bailouts for *all* states. That form of debt relief is endemic to institutionalized transfer systems with sizeable fiscal imbalances (such as ours), for three reasons:

- fiscal transfers weaken fiscal discipline at the state level;
- large-scale transfers signal the central government's willingness to ameliorate the states' fiscal conditions; and
- "cooperative" fiscal programs provide mechanisms and pathways through which additional aid to the states may be supplied. They provide what the Constitution lacks—a distributional baseline and intergovernmental networks to administer *de facto* bailouts.

The prime example of these destructive tendencies is Argentina—like the United States, a presidential, federal, and bicameral system.[57] Argentina features a large number of states (provinces) and a powerful, poorly apportioned upper house (the Senate). Its nineteenth-century constitution is modeled on the US Constitution and, prior to 1994 amendments, resembled ours in striking detail. Argentina's federalism was profoundly "dual" until it succumbed, as did our federalism, to a "cooperative" model and massive federal transfer payments. Argentina now suffers an extreme vertical fiscal imbalance—a highly centralized system of tax collection, coupled with highly decentralized spending (and borrowing) authority and an extravagant system of federal transfers, which account for more than 60 percent of provincial budgets. As a result, Argentina has come to exemplify fiscal federalism's perils. Provinces overspend and gamble on federal bailouts; go bust; are recapitalized; and, following a brief

57. For this paragraph, see Mariano Tommasi, Sebastian Saiegh, and Pablo Sanguinetti, "Fiscal Federalism in Argentina: Policies, Politics, and Institutional Reform," *Economía* 1, no. 2 (2001).

interregnum, promptly revert to their exploitative form. This dynamic has contributed greatly to Argentina's century-long economic decline (broken by hectic and inflationary growth spurts), periodic defaults, and political instability and lurches into authoritarian government.

The United States is not about to succumb to autocracy. However, our fiscal federalism has begun to display Argentina-style pathologies. Foremost among those tendencies is a recurrent resort to across-the-board debt relief for state and local governments in the form of new or more generous funding programs. (Paradoxically, the relief is often tied to an expansion of the programs that prompted the distress in the first place.) Such undercover debt relief has been a common response to state and local fiscal distress for quite some time. The creation of large-scale transfer programs under the New Deal was already a form of debt relief for near-insolvent state and local governments. Similarly, the creation of large-scale transfer programs in the 1960s served in part to redress perceived structural imbalances between Washington and state and local governments.[58]

In recent years, undercover bailouts seem to have accelerated. For example, in response to the financial crisis that began in 2008, the federal government created Build America Bonds, effectively subsidizing some $115 billion in newly issued municipal bonds. The American Recovery and Reinvestment Act ("ARRA"), better known as the 2009 "Stimulus" bill, provided some $223 billion to state and local governments. Roughly half of the amount was dedicated to program- and project-specific transfers, principally for the purpose of closing state budget gaps

58. A widely held theory at the time noted that the federal government can tax income more easily than can state and local governments. In times of rising incomes, the "whiplash of prosperity" produces ample federal revenues and chronic state and local shortfalls. Walter W. Heller, *New Dimensions of Political Economy* (Cambridge, MA: Harvard University Press, 1966), 118. Proposals for federal revenue transfers often rested on this theory.

and of propping up the government employment market.[59] These measures were accompanied by several expansions of Medicaid, discussed in section 6.

Argentinean tendencies have developed not only at a fiscal level but also at an institutional level. Argentina presents an advanced form of "executive federalism": it combines a weak legislature with a powerful, poorly constrained presidency. Under that system, federal transfer payments and conditions are largely determined through "fiscal pacts" between provincial governments and the national executive. Naturally, those pacts are driven not by substantive economic rationality but by political needs and forces, such as the executive's protection of its power base and the provinces' bargaining strength.[60]

It is tempting to think Congress is far more ornery and assertive vis-à-vis the executive than Argentina's legislature. However, potent tendencies toward executive government and executive federalism are hard to miss. For example, with respect to Medicaid and its expansion under the Affordable Care Act (discussed in the next section), Congress has effectively committed to writing a check for whatever federal expenditures the states' experiments may entail. Moreover, most major federal transfer programs—Medicaid, No Child Left Behind, and welfare among them—conform fully to the "executive federalism" description. While the statutes are exceptionally detailed and prescriptive, they grant federal administrative agencies broad authority to waive or suspend statutory requirements. Thus, the actual programs are shaped in negotiations between federal agencies and political leaders and bureaucrats in each state. In practical

59. Robert P. Inman, "States in Fiscal Distress," Federal Reserve Bank of St. Louis, *Regional Economic Development* 6, no.1 (2010): 65, 66, http://research.stlouisfed.org/publications/red/2010/01/Inman.pdf.

60. Tommasi, Saiegh, and Sanguinetti, "Fiscal Federalism in Argentina," 175–85.

operation, many programs have lost any resemblance to the statutory framework.[61] No law in any meaningful sense governs this federalism. It is government by waiver and strategic bargain.[62]

Looming Threats. Undercover debt relief is like fighting a hangover with booze: you can hide the consequences for only so long. The places where they are hidden for now are the states' pension and OPEB accounts; and as previously noted, the size of the obligations suggests that some states are one serious economic downturn away from becoming rehab candidates. How would the federal system respond?

It might respond like Argentina, which in 1994 rolled the insolvent pension programs of eleven provinces into a federal pension system (and redeemed the obligations not in the promised US dollars but in Argentine pesos).[63] The Federal Reserve might ride to the rescue, either by buying state debt or, more likely, through fiscal repression. ("Dear CEO, we would hate to see anything bad happen to your bank. It would be a *very* good idea to lend to Illinois.") Or the executive might find money under some statutory rock and determine that this or that particularly "innovative" state program deserves a really big federal waiver, while the funds keep flowing. It is also possible, however, that crisis conditions might prompt a recognition that a policy of rolling debt relief is no longer sustainable—and a political decision to reverse the tide. I will return to this discussion after a look at a program that illustrates cartel federalism's absolute outer limits: the Affordable Care Act.

61. See, for example, Jonathan R. Bolton, "The Case of the Disappearing Statute: A Legal and Policy Critique of the Use of Section 1115 Waivers to Restructure the Medicaid Program," *Columbia Journal of Law and Social Problems* 37 (2003).

62. For a pragmatic defense of this regime, see David J. Barron and Todd D. Rakoff, "In Defense of Big Waiver," *Columbia Law Review* 113, no. 2 (2013).

63. The devaluation amounted to roughly 13 percent of outstanding obligations. For discussion see Tommasi, Saiegh, and Sanguinetti, "Fiscal Federalism in Argentina," and Fabio M. Bertranou, Rafael Rofman, and Carlos O. Grushka, "From Reform to Crisis: Argentina's Pension System," *International Social Security Review* 56, no. 2 (2003).

VI. THE AFFORDABLE CARE ACT AS CASE STUDY

The Patient Protection and Affordable Care Act of 2010 ("ACA") is the most consequential and controversial piece of legislation enacted in several decades. Contrary to a widespread misunderstanding, the ACA is not a nationalist imposition. Rather, it builds on and mobilizes cartel federalism's nastiest incentives and dynamics. The dark cloud, however, has a silver lining. The implementation of the act to date suggests that cartel federalism has reached and probably exceeded its limits—fiscally, administratively, and constitutionally.

The ACA owes its nationalist image to the ruthless means of its adoption and to its notorious "individual mandate"—that is, the provision that uninsured individuals, beginning in 2014, must either purchase health insurance or else pay a financial penalty. In *NFIB v. Sebelius* (2012), the Supreme Court held that the mandate exceeded the powers of Congress under the Commerce Clause and the Necessary and Proper Clause.[64] However, the Court sustained the payment requirement as a constitutionally permissible tax. The Court's ruling caused a great deal of heated discussion. In the end, however, two other parts of the ACA will have far greater effects on the health care and insurance system and, more broadly, on American federalism. One of them is the ACA's massive expansion of Medicaid; the other, the establishment of state-run health-insurance "exchanges" to administer the act's convoluted system of tax credits and mandates for individuals and small businesses. Both parts of the act have encountered enormous problems for a heretofore unthinkable reason—the failure on the part of many states to cooperate in the programs.

Medicaid Expansion. Medicaid is the most generous and, for that reason, far and away the largest federal transfer program (see side bar). For the same reasons, Medicaid is a principal source of the states' structural fiscal problems. Program expansions look

64. *National Federation of Independent Business v. Sebelius*, 132 S. Ct. 2566 (2012).

MEDICAID

Originally enacted in 1965, Medicaid is a "cooperative" federal-state program. It is an uncapped matching grant: if a state agrees to provide medical services for certain populations, the federal government will match the expenditures. Among large federal transfer programs, Medicaid is the most generous: it reimburses states for between 50 and 83 percent of all qualifying expenditures. The match, or "FMAP," depends on the state's wealth, with poor states receiving higher matches.

For participating states, coverage of certain populations and services is mandatory. However, states may cover additional populations and services. All have done so to varying degrees; by some estimates, some 60 percent of all Medicaid spending is attributable to states' voluntary expansion of services. Due to this feature, Medicaid's generous funding levels, and the lack of a federal budget cap, the program has grown at an extraordinary pace and now accounts for over 45 percent of all federal transfers. At the state level, Medicaid has displaced unfunded or less well-funded state programs. At close to 25 percent of all state spending (on average), it now eclipses K-12 education as the largest category of state spending. The ACA provides for a further, massive expansion of the program.

politically and fiscally attractive in prosperous times but prove disastrous in economic downturns, when demand rises, budgetary constraints force cuts, and a single dollar in own-source revenue saving from Medicaid would require a two, three, or four dollar program cut. Congress has responded to Medicaid-induced fiscal distress in the usual fashion, through de facto debt relief:

- Under the Clinton administration, Congress enacted a children's health insurance program ("CHIP") that, while principally intended to provide insurance to uninsured children, also provided states with the opportunity—and a powerful incentive—to reassign Medicaid-covered children from that overburdened program into the more generously funded CHIP program.

- In 2003, the Bush administration proposed and Congress enacted a Medicare prescription drug benefit program for seniors, producing substantial savings for Medicaid.
- During the 2008–9 financial crisis, Congress enacted a temporary increase in Federal Medical Assistance Percentages to shore up the states' Medicaid accounts.

All those measures, though, pale in comparison to the ACA. Beginning in 2014, the ACA requires participating states to cover all individuals up to 138 percent of the federal poverty line. The expanded program is expected to provide health coverage for an additional 16 million poor and near-poor heretofore uninsured individuals at a cost of upwards of $500 billion between 2014 and 2019. The federal government will pay *100 percent* of the costs for the "new eligibles." The ratio will gradually decline to 93 percent by 2019. Still, at least on paper and in the early years, the states' marginal cost of expanding Medicaid will be close to zero. For most participating states, moreover, the ACA would translate into a substantial increase of the average FMAP.[65]

The states' responses were unprecedented: immediately upon enactment, 26 states launched a constitutional challenge to the ACA. The act provides that a state's failure to participate in the Medicaid expansion might lose *all* federal Medicaid funding, including funding for existing services. This condition, the states argued, rendered the Medicaid part of the ACA impermissibly "coercive." By a 7-2 majority, the Supreme Court agreed. The threat of withholding all Medicaid funding, Chief Justice Roberts wrote, was a "gun to the head."[66] To save the statute from outright unconstitutionality, the court interpreted the operative provisions

65. "Medicaid Managed Care: Key Data, Trends, and Issues," Kaiser Commission on Medicaid and the Uninsured (Kaiser Family Foundation, Washington, DC, 2012), http://www.kff.org/medicaid/upload/8046-02.pdf.

66. *NFIB*, 132 S. Ct. at 2604.

as permitting the withholding of federal funds only for Medicaid's expansion, as opposed to funding for preexisting programs.

While the Court's decision has improved the holdout states' bargaining position vis-à-vis the federal government, it remains to be seen how long some of those states will be able to resist. In addition to the obvious lure of federal transfers, the ACA creates a vehicle for an Argentina-style transfer of state and local [health care] OPEB obligations (though not pensions) to the federal government. Potentially, it allows state and local governments to transfer hundreds of thousands of current and former employees and their health care expenses from state-funded programs either into Medicaid or into federally subsidized health care exchanges.[67] Some jurisdictions such as Detroit and Chicago have been very aggressive in availing themselves of that option.

And yet the startling fact remains that even a promise of full federal funding for the ACA Medicaid expansion has proven insufficient so far to produce universal state cooperation. The states' real concerns have to do, not so much with the ACA expansion itself, but with Medicaid's overall fiscal structure. Medicaid costs, including the portion paid by states, are expected to double in a decade *with or without* the ACA expansion.[68] In other words, the program would spell state-level fiscal doom even if the ACA had never been enacted. Moreover, Congress may amend Medicaid at any time—to the states' advantage or to their detriment.

67. Philip Bredesen, "Obamacare's Incentive to Drop Insurance," *Wall Street Journal*, October 21, 2010, http://online.wsj.com/article/SB10001424052702304510704575562643804015252.html.

68. John Holahan and Irene Headen, "Medicaid Coverage and Spending in Health Reform: National and State-by-State Results for Adults at or Below 133% FPL," *Kaiser Commission on Medicaid and the Uninsured* (Kaiser Family Foundation, Washington, DC, 2010): 6, http://www.kff.org/healthreform/upload/Medicaid-Coverage-and-Spending-in-Health-Reform-National-and-State-By-State-Results-for-Adults-at-or-Below-133-FPL.pdf; Charles Blahous, "The Affordable Care Act's Optional Medicaid Expansion: Considerations Facing State Governments" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, March 5, 2013), http://mercatus.org/sites/default/files/Blahous_MedicaidExpansion_v1.pdf.

In light of the overall fiscal picture, it stands to reason that future Congresses will curtail Medicaid in one way or another. In short, states no longer trust the federal government's statutory promises. That is a massive change in the federalism landscape. It suggests that cartel federalism has reached its fiscal limits.

Exchanges. For uninsured individuals outside Medicare or Medicaid's ambit and for small businesses, the ACA envisions coverage through "health benefit exchanges." The exchanges are the engine that drives the entire ACA. The federal government provides substantial subsidies for insurance obtained through—but not outside—an exchange. The exchanges are also the vehicles through which the ACA's complicated requirements concerning coverage, reimbursement rates, and the like are supposed to be enforced.

A key provision of the ACA declares that each state "shall" establish a health care exchange. Without more, that provision would be flat-out unconstitutional: it violates the principle against federal commandeering. Thus, another clause of the act provides that in states that fail to establish an exchange, the federal government will do so directly, through the US Department of Health and Human Services ("HHS"). Congress and the administration expected that virtually every state would establish an exchange so as to provide citizens with access to federal subsidies. To date, however, only fourteen states have chosen to establish an exchange, leaving HHS with the task of constructing exchanges for the rest of the country.

In several lawsuits, one of them pending before the Supreme Court as this goes to press, states and private plaintiffs argue forcefully that the ACA's subsidies and coverage mandates apply only in states that have established an exchange of their own, not in the large number of states with federally administered exchanges.[69]

69. *King v. Burwell*, 759 F.3d 358 (4th Cir. 2014); *cert. granted*, ___ US ___ (Nov. 7, 2014).

If that is right, much of the ACA's intricate architecture will be inoperative in much of the country. The government argues vehemently that Congress, notwithstanding the language of the statute, cannot possibly have intended that result. Regardless of the prospective outcome of the litigation, though, the states' failure to cooperate under the ACA's exchange provisions has already taught powerful lessons about cartel federalism's limits.

The launch of the federal exchanges in October 2013 demonstrated in spectacular fashion that in three years the federal government has been unable to build a functioning website. It cannot possibly run a complex insurance, subsidy, and penalty scheme for thirty-six states—not by law and not even by extra-legal improvisation. Numerous ACA requirements have already been waived, postponed, or amended outside the statutory confines.[70]

That lesson carries far beyond the ACA. Numerous federal programs (such as environmental statutes) operate on the same principle: you (state) regulate "voluntarily," or we (feds) will do it for you. Federal agencies are designed to hector state and local regulators; they lack the capacity to administer complex regulatory schemes on the ground, across the country. Thus, all such programs depend on near-universal state cooperation. When too many states say "no," federal agencies will often be unable to fill the void.

Beyond that, the ACA's fate illustrates an important constitutional point—the salutary transparency- and accountability-forcing effect of the anticommandeering rule. If Congress could have commandeered states to establish health care exchanges, it would have done so. In that event, there would be no litigation over the act's nationwide application. There would be fifty-one "cooperative" exchanges, many of which would work no better than healthcare.gov. The federal government would then blame any ill effects on the states, which in turn would blame the federal government. Experts and ordinary citizens alike would be at

70. Nicholas Bagley, "The Legality of Delaying Key Elements of the ACA," *New England Journal of Medicine* 370, no. 21 (2014): 1967.

a loss to identify the culprits. As it is, political responsibility for the ACA and its implementation is beyond peradventure. That is a substantial improvement over "cooperative" federalism's ordinary operation.

Cartel Federalism's Limits. The ACA's Medicaid expansion illustrates cartel federalism's fiscal limits; the controversy over the ACA's exchanges suggests its constitutional and structural boundaries. Both programs illustrate cartel federalism's practical and institutional limits. Intergovernmental cartels require willing state participants and federal means—including fiscal means—to induce cooperation. When those conditions cease to obtain, the system breaks. By all indications, the conditions *have* ceased to obtain. The concluding section explores the implications.

VII. THE LIMITS OF CARTEL FEDERALISM

The scholarly literature on federalism, buttressed by ample experience from countries around the globe, strongly suggests that cartelization is an iron law of federalism. While competitive federalism thrived in the United States for more than a century, it is a distant memory. The cartel federalism that has taken its place is enormously resilient, and it is self-reinforcing. Barring very unusual circumstances, it will lurch from one level of dysfunction to the next, higher level. These observations counsel realism and a healthy skepticism toward "silver bullet" reforms, such as constitutional amendments.

They do not, however, provide a cause for fatalism or despair. A few federal systems, confronted with similar difficulties, have managed to implement successful reforms. Brazil and Canada are examples. The United States may be capable of doing likewise. Three reasons provide grounds for cautious optimism. First, cartel federalism has reached the outer limits of fiscal affordability and political plausibility. Second, the resurgence of sharp divisions among states—"sectionalism," in political scientists' parlance—

provides a political base for a more competitive, constitutional federalism. And third, our singularly competitive Constitution retains a great deal of force.

Affordability. In large measure, cartel federalism is a product of affluence and confidence about the future. So long as the country felt prosperous and optimistic, no one cared—enough, that is, to mount full-throttled opposition—about the cascading regulatory impositions that are cartel federalism's hallmark. Similarly, the dissipation of federal transfer payments in intergovernmental bureaucracies seemed distressing, but no cause for alarm. And few worried about the fact that transfer programs drive up state and local taxes and spending; in fact, that was and is the *intended* result. However, now that our affluence has come to an end, cartel federalism's debilities appear in a different light. A more sensible, competitive, constitutional federalism may get a hearing.

In the fiscal arena in particular, cartel federalism confronts an upper bound of affordability. State and local governments are under severe fiscal strain, and few knowledgeable observers expect much improvement. The failure of many states to participate in the ACA Medicaid expansion—as well as smaller programs, such as grants for high-speed trains—reflects a growing recognition that rolling debt relief in the form of ever-increasing transfer payments is a principal cause of the states' fiscal travails, not a cure. And there are other indications, some noted earlier, that the strategy of "saving" fiscal federalism by feeding it with more money may have reached its limits:

- Given federal budget constraints, increased transfers will have to be largely debt-financed. The certain knowledge that the system will hit a wall sooner rather than later changes the calculus of politicians at all levels—for the better.
- The largest transfer programs, Medicaid and education, have crowded out unfunded or less-well-funded state

programs, to the point where those programs and their constituencies now compete directly against each other. (Since 2009, state Medicaid spending has eclipsed K-12 education spending.[71]) The uncomfortable, zero-sum "Medicaid or education" choice may profoundly affect politicians' incentives and calculations—again, for the better.

- As previously noted, the Affordable Care Act offers states that participate in Medicaid's expansion a reimbursement of 100 percent for expansion-related costs. At that level, federal transfer programs can no longer serve the purpose of creating fiscal illusions. They simply become an open-ended commitment to spend federal dollars at whatever level states may deem appropriate. That is not a plausible commitment for federal legislators, or for their constituents.

After the end of affluence, under conditions of acute fiscal stress, cartel federalism's limits will gain political salience in any debate over the future of Medicaid, a bailout of state and local pension funds, or some other issue. Those sure-to-come debates will provide opportunities for structural reform.

Sectionalism. The cartelization of American federalism, we have seen, comes as no great surprise. State demand in that direction is a constant, and virtually all federal systems have succumbed. The surprise is competitive federalism's resilience for over a century of American history. The most likely explanation of that striking phenomenon is sectionalism: a divide among states that is too fundamental to be overcome by means of compromise and side payments. The division must be deep and, moreover, encompass enough dissident states to block the majority states'

71. State Budget Crisis Task Force, "Final Report" (State Budget Crisis Task Force, New York, NY, 2014), 21–24, http://www.statebudgetcrisis.org/wpcms/wp-content/images/SBCTF_FINALREPORT.pdf.

cartel initiatives. The magic number (US history suggests) is one-fourth of the states—sufficient to block constitutional amendment proposals and to bottle up Congress.

The competition-protective sectional issue for most of our history, of course, was slavery and, after its demise, the protection of the racial caste system in the South. Those defining issues have mercifully disappeared from American politics. However, sectional divisions have re-formed around overlapping economic and cultural issues. Our federalism hangs on roping all states underneath federally sponsored regulatory and fiscal cartels. Increasingly, however, some states have concluded that they have little to gain under such a federalism and that it may in fact prove ruinous for them. As that recognition sets in, major disagreements no longer run along "states versus Washington" lines; they run among and between states.

Exhibit A, of course, is the states' dramatic division over the ACA, both in the *NFIB* litigation and in the implementation of the act's Medicaid expansion and healthcare exchange provisions. But the pattern recurs in other policy arenas. For example, the Environmental Protection Agency (EPA) is in the process of creating a comprehensive global warming program under the auspices of the Clean Air Act, a statute that was never designed for, and poorly fits, the regulation of greenhouse gases. The origin of this undertaking is *Massachusetts v. EPA* (2007), a lawsuit instigated by some states in close cooperation with environmental groups.[72] Other states, however, have been fighting back in the courts. In one of these many engagements, *Utility Air Regulatory Group v. EPA* (2014), EPA's ambitious—but extra-legal—plans to regulate greenhouse gas emissions from stationary sources suffered a serious setback.[73] The states' most potent weapon, though, is not the federal judiciary but the competitive federalism principle embodied in the anti-commandeering rule: EPA cannot *tell* the

72. *Massachusetts v. EPA*, 549 US 497 (2007).

73. *Utility Air Regulatory Group v. EPA*, 134 S. Ct. 2427 (2014).

states to do anything at all. Under a separate, rarely used provision of the Clean Air Act, EPA is seeking the states' "voluntary" cooperation for a radical overhaul of the nation's power grid, a plan that would compel the phase-out of numerous coal-fired plants and sharply increase electricity prices. If, as seems likely, more than a few states refuse to cooperate, EPA will have to implement the plan on its own. It probably lacks legal authority to do so; it most surely lacks the administrative capacity.[74]

These and other highly salient controversies consistently feature virtually identical state blocs: a "blue" cartel coalition, anchored by New York, California, and Illinois, and a "red" competitive coalition, anchored by Texas. Both blocs are "for federalism," but of a very different kind. Blue states favor and depend on cartel federalism: high federal transfer payments, with substantial side payments to domestic constituencies; federal standards that neutralize red states' competitive advantages. Red states, on the other hand, have little to gain and much to lose from those arrangements. They now tend to oppose an expansion of the federal transfer state (even at some immediate cost to their own citizens), and they vehemently resist federal regulation of the private economy within their borders. These divisions map, and are probably reinforced by, profound cultural divisions over God, gun rights, and gay marriage.

The picture just sketched probably exaggerates the divide and, in particular, the cohesiveness of the pro-competitive state bloc. In the rough and tumble of politics, those states may fail to recognize that they *are* a coalition. And while partisan divisions may reinforce sectional dynamics, they may also complicate and attenuate them. Still, sectionalism has re-emerged as an important dimension of American politics. In fact, on economic matters, the sectional divide looks almost as sharp as it did in the

74. Peter S. Glaser, Carroll W. McGuffey III, and Hannah Williams Gaines, "EPA's Section111(d) Carbon Rule: What If States Just Said No?," *Federalist Society White Paper* (2014).

Gilded Age, the heyday of competitive federalism. It runs along very similar lines, with this crucial and striking the difference: many of the Northeastern and littoral states that were the backbone of America's industrial economy a century ago are now the worst-performing states in the nation. Conversely, the plantation states of old now are among the most competitive, dynamic, best-performing states.[75]

When the sectional divide becomes too harsh; when a sufficient number of pro-competitive states recognize their common interest; and when Congress runs out of money to bribe dissident states into a winning coalition, opportunities will arise to protect a more competitive, constitutional federalism. A pro-competitive state bloc will be able to block attempts to cartelize the economy and public policy in new arenas. For example, efforts to cartelize Internet sales taxes—through state compacts or federal legislation that would permit state and local jurisdictions to impose collection and remittance obligations on sellers throughout the country—date back two decades. Owing to implacable opposition from states without a sales tax, very little has come of the enterprise. For another example, the explosive development of new energy sources (such as shale gas) has taken place almost entirely under state auspices, and state regimes range from encouragement to *de facto* prohibition. Attempts to bury this game-changing development under federal regulations are under way; little will come of it so long as pro-development states and producers hang tough and hang together.[76] In other areas, sustained state refusal

75. For a widely used ranking of states by performance and competitiveness, see Arthur B. Laffer, Stephen Moore, and Jonathan Williams, *Rich States, Poor States: 2014 Edition* (American Legislative Exchange Council, Arlington, VA, 2014), http://www.alec.org/publications/rich-states-poor-states/.

76. By any measure, state cooperation to resist federal regulation, especially on environmental and energy matters, has increased substantially in recent years. See, for example, Eric Lipton, "Energy Firms in Secret Alliance with Attorneys General," *New York Times*, December 6, 2014, http://www.nytimes.com/2014/12/07/us/politics/energy-firms-in-secretive-alliance-with-attorneys-general.html.

to cooperate with federal initiatives will bring entire programs to a fall. Witness the ACA. Our federalism is rapidly becoming less "cooperative," and therefore more competitive and constitutional.

Constitutionalism. The Progressives and New Dealers turned the Constitution's competitive federalism upside down. Even so, by virtue of its deep structure and logic, the Constitution continues to exert gravitational force.

The natural tendency is to associate the Constitution with the Supreme Court and to look to the justices for help. The Supreme Court has played a highly significant federalism role throughout our history. It certainly could play a more constructive role in the contemporary federalism struggles—foremost by doing *much* more to protect the commerce of the United States.[77] However, one should not expect too much at this front. Federalism's transformation during the Progressive Era and the New Deal suggests the limits: when the basic premises of constitutional understanding and the dominant incentives of political actors and institutions change, the *text* of the Constitution provides very little defense. The insight seems distressing, but it is in keeping with the Founders' view. The Founders looked to institutional incentives and competition, not to "parchment barriers," as the principal safeguard of constitutional arrangements.

Now as ever, the Constitution fragments power vertically (between states and the national government) and horizontally, among federal institutions. Now as ever, institutional fragmentation inhibits (cartelizing) coordination; now as ever, the absence of any distributive federalism formula deprives would-be cartelizers of a focal point. And now, more than at any time in many decades, the end of affluence and the re-emergence of political

77. For my (somewhat contemptuous) critique of the Supreme Court's lack of resolve on this front, see Michael S. Greve, "Atlas Croaks, Supreme Court Shrugs," *Charleston Law Review* 6, no. 1 (2011). *The Upside-Down Constitution* presents a more judicious but equally critical assessment.

sectionalism generate powerful incentives and opportunities to protect and perhaps to re-establish competitive federalism arrangements.

The biggest obstacle in that path may have to do with constitutional ideology and understanding—specifically with a continued obsession with federalism's "balance" rather than its structure. That deeply engrained perspective appeals to state and local politicians who understandably seek to improve their relative position in an entrenched system of regulatory and fiscal cartels. It also appeals, for respectable reasons, to conservative voters and politicians. Even so, the balance perspective is wrong. Cartel federalism will produce intergovernmental thickets, regulatory cascades, and fiscal profligacy at *any* level of federal-state balance. Nothing can be gained by adjusting the balance; what needs reform is the structure.

Opportunities for such reforms present themselves in many areas. The key is to view political debates not simply as a series of policy disputes but instead, or also, to recognize their *constitutional* dimension—and to press for approaches that promise to restore political and economic competition. While a full-scale agenda along those lines is well beyond the scope of this essay, the impending disintegration of the ACA provides an example of what that agenda might entail.

Medicaid in its post-ACA form is unaffordable and unworkable. The leading reform proposal is to cap and "block grant" Medicaid, giving states more freedom to configure the program to their own needs and preferences. However well intentioned, that proposal is a dead end. While responsible states might be able to run the program more efficiently and at lower cost, a national policy that allows "good" states to do good things will also invite irresponsible, opportunistic behavior on the part of other states. When that realization sets in, the only option is to recategorize the program. (This has been the experience with just about every block grant program.) The central fact is that *any* intergovernmental arrangement that authorizes one level of government to spend money raised by another level is intrinsically corrosive of fiscal discipline

and political responsibility. Thus, the constitutional, competitive solution is to disentangle federal and state programs and to realign taxing and spending authority. Based on that recognition, former Senator Buckley's plea to "save Congress from itself" (cited in the Introduction) translates into a bold proposal to phase out any and all federal funding programs. More modestly but along similar lines and for identical reasons, Senator Lamar Alexander has proposed a grand "swap": the federal government would accept full and exclusive authority for Medicaid and, in exchange, terminate any and all federal funds for education, thus freeing states and localities from impositions under No Child Left Behind or a future "Common Core" regime (already labeled "Obamacore" by some experts).[78] The swap proposal—to say nothing of James Buckley's root-and-branch program—is bold and strewn with political obstacles. But that will be true of any proposal that is commensurate to the federalism problems at hand. There is ample room for political prudence and judgment. What matters is a reorientation from balance to structure as federalism's lodestar and a concomitant resolve to recapture *constitutional* territory. No one had to tell the Founders that the joint (federal-state) production of public goods would produce a disaster: it was the operative principle of the failed Articles of Confederation. That is why the Founders wrote a Constitution that militates in favor of a "dual" federal *or* state production of such services under competitive conditions.

As with Medicaid, so with private and small business insurance. As the ACA's baroque exchange architecture crumbles, nothing would be gained by restoring the state-run health insurance cartels, fenced off from interstate competition, that preceded (and have largely survived) the ACA. The states' authority to administer those cartels—in many states, dominated by a single carrier—does not come from the Constitution. It comes from a federal statute

78. See James L. Buckley, *Saving Congress from Itself*; Lamar Alexander, "Time for a Medicaid-Education Grand Swap," *Wall Street Journal*, May 15, 2012, http://www.wsj.com/news/articles/SB10001424052702304371504577405782138051376.

(the McCarran-Ferguson Act of 1945) that *exempts* states from the procompetitive, free-trade constitutional rules that apply to every other industry. A full-scale repeal of that act—a monument to the New Deal model of corporatism and cartels—is the right policy. Like a Medicaid "swap," it would encounter formidable obstacles (not least, the vehement opposition of state regulators and their clientele). It, too, however, is commensurate to the problems at hand. It, too, would recapture constitutional territory.

Federalism's Future. Sooner rather than later, we will have to renegotiate our federalism bargain. Things may go very badly. An accelerating series of increasingly aggressive debt relief measures by any other name, with Argentine overtones and effects, is an entirely plausible scenario. As I hope to have shown, though, one can also envision a more promising scenario—a contraction of the transfer state and a return to a more competitive federalism. It is silly to try and predict the course of events. Federalism's future will depend on the decisions of real-world actors, acting in real time.

The predicament would sound familiar to the Founders: it was theirs. They knew that moments of great peril are also moments of great opportunity, and they seized the opportunity to write a Constitution built on "reflection and choice." Our federalism predicament is not quite of that magnitude. Courtesy of the Founders, we have a constitutional order, and no one seriously believes that it is nearing collapse. But we face the same "which federalism?" question and the same *kind* of problem. We do not need a new Constitution, but we must recognize the constitutional nature of the moment and appreciate anew the brilliant, competitive logic of the Constitution that we have.

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