

# CBO

## Federal Grants to State and Local Governments



MARCH 2013

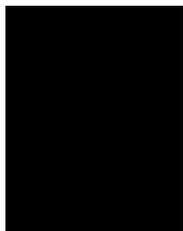
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## Notes

Unless otherwise noted, all years referred to in this report are federal fiscal years, which run from October 1 to September 30.

On the cover (clockwise from the top): © Olesya Feketa; Washington, D.C., highway, photo by Maureen Costantino, Congressional Budget Office; coastal construction and protection using tires to protect the shore at Port Wing, Wisconsin, photo by Dale R. Baker, Environmental Protection Agency; © wavebreakmedia; © Espelt.

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# Federal Grants to State and Local Governments

## Summary

In fiscal year 2011, the federal government provided \$607 billion in grants to state and local governments. Those funds accounted for 17 percent of federal outlays, 4 percent of gross domestic product (GDP), and a quarter of spending by state and local governments that year.<sup>1</sup> Over the past 30 years, those “intergovernmental” grants—financial transfers from the federal government that support a wide range of state and local programs—have fluctuated as a share of federal outlays. Federal grants for health programs, primarily Medicaid, have grown rapidly, and grants for programs and initiatives not related to health—such as those associated with income security, education, and transportation—have also increased, albeit at a slower rate. In total, the federal government reported outlays in 2011 for more than 200 intergovernmental grant programs, which were administered by 30 federal departments and independent agencies.

## Why Does the Federal Government Make Grants to State and Local Governments?

Grants to state and local governments can promote economic efficiency in instances when those governments have localized knowledge that would permit them to implement a program more efficiently and effectively than the federal government could but when they have insufficient incentives or funding to provide a good or service—infrastructure, for example—whose benefits extend beyond their jurisdictions. In addition, some grants use the broad federal tax base to redistribute resources among communities and individuals, and certain intergovernmental grants can help stabilize the economy. In some cases, federal policymakers turn to intergovernmental grants to encourage state and local

governments to adopt federal policy priorities. Finally, such grants may help foster policy experimentation at the state and local levels that would be difficult to achieve in a single national program.

## How Much Flexibility Do State and Local Governments Have When Spending Federal Grant Money?

Federal grant programs offer state and local governments varying degrees of flexibility over the use of grant funds. For instance, block grants provide only broad parameters for using those funds, leaving state and local governments considerable latitude when they make spending decisions. By comparison, state and local governments face more spending constraints on how they use categorical formula grants. For example, certain criteria govern the types of roads that state governments may build or improve using federal highway grant funds. However, among all possible road projects that meet the established criteria, states are typically able to choose which ones to fund. Project grants provide state and local governments the least flexibility over spending, as the use of grant funds is typically limited to the specific project selected. Some grants place additional conditions on recipients that may be closely related to the purpose of the grant—for instance, the requirement that students demonstrate adequate progress for states to remain eligible for certain education grants. Other grants may have more general spending rules, such as those requiring recipients to complete environmental assessments for many federally funded projects.

## How Does the Federal Government Distribute Grant Funds to State and Local Governments?

The federal government allocates grants to state and local governments on the basis of formulas established by law (for block grants and categorical formula grants) or through a competitive process (for project grants). Some formulas are based on historical distributions of grant

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1. Detailed data on federal grants are not yet available for fiscal year 2012.

funds, while others are based on a more complicated set of demographic or other factors relevant to the purpose of the grants. For project grants, federal policymakers set out a list of criteria that will form the basis for evaluating applications from state or local governments. Certain grants to implement education reforms and to construct transportation projects have recently been awarded through competitions.

### **How Does the Federal Government Determine the Budgetary Cost of State and Local Grants?**

The federal government can achieve different degrees of control over the amount and predictability of budgetary expenditures for grant programs by making them either mandatory or discretionary programs and by making their funding either open-ended or limited for a given period (such as within a single fiscal year). Spending for some mandatory grant programs is open-ended; that is, the relevant agency has unlimited authority to disburse funds as required by the conditions set forth in authorizing legislation.<sup>2</sup> Medicaid, for example, falls into that category. Spending on other mandatory grant programs, such as Temporary Assistance for Needy Families (TANF), may be limited to amounts specified in the authorizing law for a given program. Discretionary grant programs are also limited because they are funded through annual appropriation acts, which set out the maximum amounts that the federal government can commit to spend in a fiscal year for those grants.

### **How Do Federal Grants Influence State and Local Government Spending?**

Federal grants are typically intended to supplement the efforts of state and local governments rather than supplant them. To that end, many grant programs include matching requirements or maintenance-of-effort (MOE) provisions that require state and local governments to partially pay for a program from nonfederal revenues. Some such provisions may cause state and local governments to spend more on a program than they otherwise would and may constrain their ability to spend their own revenues according to their own policy priorities. Based on the current body of economic literature, the extent to which federal grants supplant state and local spending that would have occurred anyway is unclear. That may be

because the wide variety of intergovernmental programs and accompanying rules and conditions make it difficult to draw broad conclusions.

### **What Are Some Implications of Changing the Level of Funding or Flexibility of State and Local Grants?**

Changes in federal spending on intergovernmental grants could lead to changes in government investment in both human capital (education and other activities that enhance people's well-being and productivity) and physical capital (buildings and other infrastructure)—particularly if state and local governments decided not to, or were unable to, make other adjustments that would partially offset federal changes. Less federal control over the administration of grant programs could permit state and local governments to find ways to operate those programs in a more economically efficient manner. At the same time, more federal control could make it harder for them to adopt practices that do not closely match federal policymakers' goals.

### **Federal Outlays for State and Local Grants**

Federal outlays for grants to state and local governments have grown as a share of the federal budget and the nation's gross domestic product since the middle of the 20th century. In 1960, for example, such grants accounted for 7.6 percent of all federal outlays and 1.4 percent of GDP, compared with 16.8 percent and 4.1 percent in 2011. In the 1960s and 1970s, spending on grants generally increased after the creation of Medicaid and the introduction of other grant programs for low-income households during that period. Since 1980, intergovernmental grants have fluctuated as a share of the federal budget and GDP, but grants for health programs have grown as a share of all intergovernmental grants. Most of those health grants stem from mandatory programs (rather than from discretionary funds), and spending on them is expected to grow in the future.

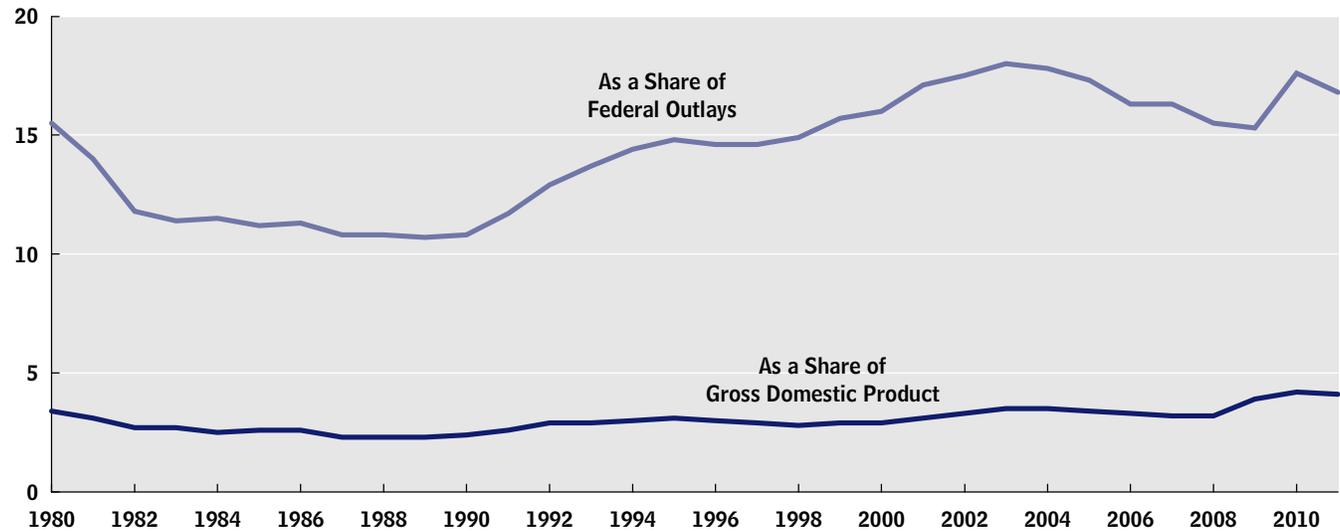
### **Trends Since 1980**

Over the past three decades, federal expenditures on intergovernmental grants have fluctuated as a share of total federal outlays and GDP (see Figure 1). Spending declined by those measures in the 1980s, a period that also saw the combination of many grants into block grants, which provide state and local governments a

2. Mandatory spending is the budget authority provided by laws other than appropriation acts and the outlays that result from that budget authority.

**Figure 1.****Federal Grants to State and Local Governments, 1980 to 2011**

(Percent)



Source: Congressional Budget Office based on *Budget of the United States Government, Fiscal Year 2013: Historical Tables*, Table 12.1.

specified amount of money and broad flexibility over spending decisions.<sup>3</sup> For instance, block grants replaced existing grant programs that focused on mental health and alcohol and drug abuse; maternal and child health; low-income energy assistance; and community development. Subsequently, spending on intergovernmental grants grew as a share both of federal outlays and of GDP. That increase was largely the result of expansions in grants for health programs, although spending for grants not related to health also grew.

Much of the increase in outlays as a share of GDP over the past several years can be attributed, in part, to grants provided to state and local governments under the American Recovery and Reinvestment Act of 2009 (ARRA) and subsequent extensions of some provisions of that legislation. The slower pace of economic activity in general also played a role. State and local governments received additional grants in 2009 and 2010 to support and expand their spending for education, health, transportation infrastructure, and other programs. The increase in outlays for many of those programs started to abate in 2011. By one accounting, \$264 billion in ARRA funds

was paid out to states and localities as of January 18, 2013.<sup>4</sup> Most of the growth in federal grants to state and local governments since the early 1980s has been for programs that benefit individuals, through payments that state and local governments have made directly to those beneficiaries or through payments to service providers on their behalf. Such programs include Medicaid, the Children's Health Insurance Program (CHIP), housing assistance, and TANF.<sup>5</sup>

**Health and Nonhealth Grants.** In 2011, federal grants to state and local governments were \$607 billion, of which \$293 billion (roughly 48 percent) was for health programs and \$314 billion (roughly 52 percent) was for other programs.

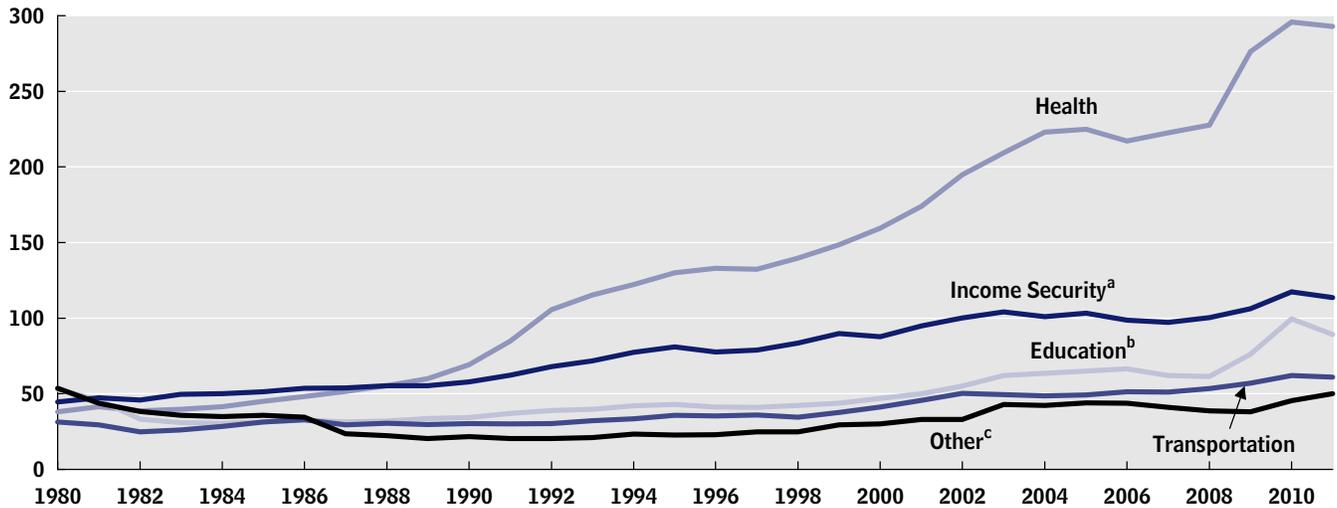
3. See General Accounting Office, *Block Grants: Characteristics, Experience, and Lessons Learned*, GAO/HEHS-95-74 (February 1995), [www.gao.gov/products/HEHS-95-74](http://www.gao.gov/products/HEHS-95-74).

4. See Government Accountability Office, "Following the Money: GAO's Oversight of the Recovery Act" (accessed March 1, 2013), [www.gao.gov/recovery](http://www.gao.gov/recovery).

5. The federal government also provides assistance directly to individuals through a number of programs that are not classified as grant programs. See, for example, Congressional Budget Office, *Policy Options for the Social Security Disability Insurance Program* (July 2012), [www.cbo.gov/publication/43421](http://www.cbo.gov/publication/43421); and *The Supplemental Nutrition Assistance Program* (April 2012), [www.cbo.gov/publication/43173](http://www.cbo.gov/publication/43173).

**Figure 2.****Outlays for Federal Grants to State and Local Governments, by Budget Function, 1980 to 2011**

(Billions of 2011 dollars)



Sources: Congressional Budget Office based on *Budget of the United States Government, Fiscal Year 2013: Historical Tables*, Table 12.2; Bureau of Economic Analysis, *Price Indexes for Gross Domestic Product*, Table 1.1.4, revised January 27, 2012.

Note: For the purposes of organizing the budget, federal resources are grouped into 20 general-subject categories—referred to as budget functions—so that all budget authority and outlays can be presented according to the national interests being addressed.

- Includes programs that provide cash and other benefits (for assistance with housing, the purchase of food, and energy costs, for example) to people of low income and to certain retirees, people with disabilities, and unemployed people.
- Includes funding for education, social service programs, and employment and training programs.
- Includes the following budget functions: national defense, international affairs, energy, natural resources and environment, agriculture, commerce and housing credit, community and regional development, Social Security, veterans benefits and services, administration of justice, and general government.

[On April 26, 2013, Figure 2 was revised to correct the placement of the labels “Education” and “Transportation.”]

Adjusted for inflation, the amount of federal grants for health programs in 2011 was about seven times the amount in 1980 (see Figure 2). Over that period, such grants more than tripled as a share of GDP, rising from 0.6 percent in 1980 to 1.9 percent in 2011. In particular, the share of federal health grants in the national economy has increased significantly, primarily because of rising federal spending on Medicaid. (For additional information about Medicaid and the related Children’s Health Insurance Program, see Box 1).

A number of factors have contributed to the growth in federal grants for Medicaid.<sup>6</sup> Over the past three decades, enrollment in Medicaid has nearly tripled, rising from

about 20 million enrollees in 1980 to about 53 million in 2011.<sup>7</sup> The amount that the federal government spent on benefits per enrollee grew rapidly as well, from about \$1,700 in 1980 to about \$5,200 in 2011 in real terms (that is, after adjusting the 1980 figure to 2011 dollars to remove the effects of overall inflation). Changes in enrollment were driven by population growth, by changes in the laws governing eligibility, by states’ choices about the groups of people eligible for the program, and by the effect of the economy on the size of the eligible population. Changes in spending per enrollee were driven by federal and state choices regarding covered health care services as well as by medical price inflation and

6. For more discussion of the growth of Medicaid spending, see Congressional Budget Office, *Growth in Means-Tested Programs and Tax Credits for Low-Income Households* (February 2013), [www.cbo.gov/publication/43934](http://www.cbo.gov/publication/43934).

7. See Centers for Medicare & Medicaid Services, Medicaid Financial Management Reports (CMS-64 and predecessors) and Medicaid statistical data (MSIS, HCFA-2082, and earlier statistical reports).

**Box 1.****Medicaid and the Children's Health Insurance Program**

Medicaid, enacted under title XIX of the Social Security Amendments of 1965, offers health insurance coverage to eligible low-income individuals and families, including children and their parents, pregnant women, the disabled, and the elderly. Funded jointly by the federal government and the states, the program is administered at the state level. In fiscal year 2011, an estimated 53 million people were enrolled in Medicaid on average each month, accounting for \$275 billion in federal expenditures. According to the Centers for Medicare & Medicaid Services, states spent \$157 billion on Medicaid in 2011.

The federal government's share of spending for Medicaid benefits varies from state to state. Historically, that share has averaged about 57 percent; but from fiscal year 2009 through June 2011, legislation temporarily boosted the federal share in response to the economic downturn. In 2011, the federal share averaged about 64 percent. Under the Affordable Care Act, starting in 2014, states may expand eligibility for Medicaid to most nonelderly adults whose income is below 138 percent of the federal poverty level.<sup>1</sup> From 2014 to 2016, in states that choose to participate in the expansion, the federal government will pay 100 percent of the costs of covering enrollees who are newly eligible for the program. From 2017 to 2020, the federal share of that spending will decline gradually to 90 percent, where it will remain thereafter.

States administer their Medicaid programs under federal guidelines that specify a minimum set of

services that must be provided to designated categories of low-income individuals. Required services include inpatient and outpatient hospital services, services provided by physicians and laboratories, and nursing home and home health care. Eligibility is mandatory for certain groups, including low-income children and families who would have qualified for the Aid to Families with Dependent Children program, certain other low-income children and pregnant women, and most elderly and disabled individuals who qualify for the Supplemental Security Income program. Subject to those requirements and other statutory limits, states have flexibility in administering the Medicaid program and determining its scope. States may choose to make additional groups of people eligible or to provide additional benefits, and they have exercised those options to varying degrees. Moreover, many states seek and receive federal waivers that allow them to provide benefits and cover groups that would not otherwise be covered under Medicaid. Partly as a result, the program's rules are complex, and it is difficult to generalize about the types of enrollees covered, the benefits offered, and the cost sharing required of enrollees.

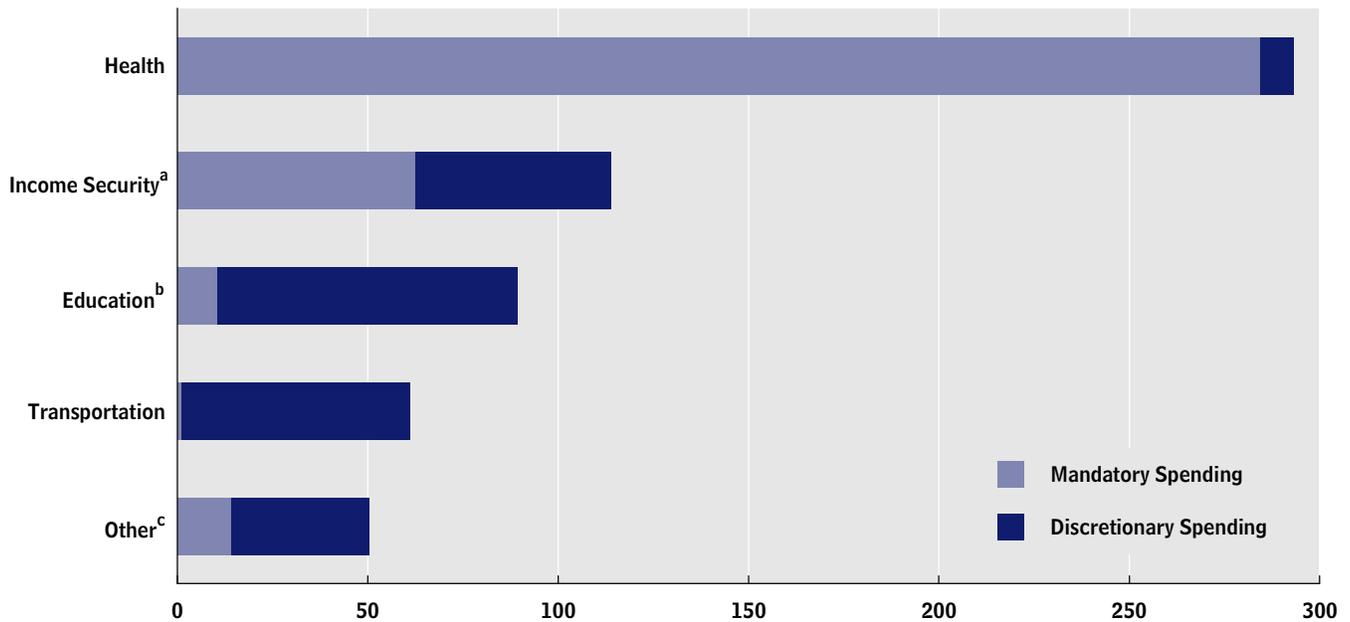
The Children's Health Insurance Program (CHIP) is a jointly funded federal-and-state program that provides health insurance coverage to uninsured children living in families with modest income that is too high for them to qualify for Medicaid. Like Medicaid, CHIP is administered by the states within broad federal guidelines. Unlike Medicaid, however, CHIP is a matching-grant program with a fixed nationwide cap on federal spending. In 2011, federal spending on CHIP was \$8.6 billion, and about 8 million people were enrolled in the program at some point during the year. The federal share of CHIP spending varies among the states but averages about 70 percent.

1. The Affordable Care Act encompasses the Patient Protection and Affordable Care Act and the health care provisions of the Health Care and Education Reconciliation Act of 2010 as well as, in the case of this document, the effects of subsequent related judicial decisions, statutory changes, and administrative actions.

**Figure 3.**

## Outlays for Federal Grants to State and Local Governments, by Budget Function and Type of Spending, 2011

(Billions of dollars)



Source: Congressional Budget Office based on *Budget of the United States Government, Fiscal Year 2013: Analytical Perspectives*, Table 18.1.

Note: For the purposes of organizing the budget, federal resources are grouped into 20 general-subject categories—referred to as budget functions—so that all budget authority and outlays can be presented according to the national interests being addressed.

- a. Includes programs that provide cash and other benefits (for assistance with housing, the purchase of food, and energy costs, for example) to people of low income and to certain retirees, people with disabilities, and unemployed people.
- b. Includes funding for education, social service programs, and employment and training programs.
- c. Includes the following budget functions: national defense, international affairs, energy, natural resources and environment, agriculture, commerce and housing credit, community and regional development, Social Security, veterans benefits and services, administration of justice, and general government.

technological changes. In addition, over the past 30 years, states implemented a number of financing arrangements that effectively shifted some program costs to the federal government.

Grants provided to state and local governments for purposes other than health have grown at a slower rate (see Figure 2 on page 4). Even so, in real terms, spending on grants for income security programs has more than doubled since 1980. (Income security programs provide cash or in-kind benefits for assistance with housing, the purchase of food, and other services.) As of 2011, income security constituted the second largest budget function for federal intergovernmental grant outlays after health. (For the purposes of organizing the budget, federal

resources are grouped into 20 general-subject categories—referred to as budget functions—that represent the national interests being addressed.) Expressed as a share of GDP, intergovernmental grants provided for purposes other than health declined in the 1980s and since then have been roughly stable.

**Mandatory and Discretionary Grants.** Grants to state and local governments for health spending stand out not only for their size, but also because they are overwhelmingly classified as mandatory spending, meaning that budget authority for those programs is provided by laws other than appropriation acts (see Figure 3). Some mandatory programs are also so-called entitlement programs, with spending controlled by the eligibility and

benefit criteria established in the programs' authorizing legislation.<sup>8</sup> For example, people may enroll in Medicaid if they meet the eligibility criteria established by their state, and as people enroll and consume health care, the federal government has a legal obligation to pay a share of those benefits (the share varies from state to state). Outlays for mandatory grants totaled \$372 billion in 2011, of which \$284 billion was for health and \$88 billion was for other purposes.

Except in the health area, most federal grants to state and local governments are classified as discretionary spending, which is provided for and controlled by annual appropriation acts. In the annual appropriation cycle, the Congress decides how much funding each discretionary program has available to obligate or legally commit to spend. In 2011, outlays for discretionary grants totaled \$235 billion, of which \$226 billion was not related to health and only \$9 billion was for health programs.

### Projections for the Next Decade

The Congressional Budget Office (CBO) projects that federal spending for mandatory intergovernmental grants will be increasingly dominated by Medicaid, which will continue to grow as a share of the economy over the next decade. Specifically, CBO estimates that federal spending for Medicaid will be 2.2 percent of GDP in 2023, an increase of about one-fifth from its 1.8 percent level in 2011. Provisions of the Affordable Care Act (ACA) will contribute to that growth by expanding eligibility for the program in states that choose to participate.<sup>9</sup> The ACA also introduced a number of new grants, for example, to help states set up insurance exchanges, review health insurance premium increases, and expand consumer assistance programs. At the same time, total spending on grants for major income security programs—TANF and child nutrition programs, for example—are projected to

8. Funding for some entitlement programs, such as the Supplemental Nutrition Assistance Program (SNAP), is provided in annual appropriations. (Although state governments administer SNAP, it is not primarily a grant program, as federal benefits are paid directly to individuals without passing through the state governments.) The amount appropriated each year is intended to cover the cost of providing benefits to all people who apply for the program and are eligible; it includes a reserve to cover unexpected costs. But if the appropriated amount does not cover those costs, either lawmakers must provide additional funds or the Department of Agriculture must reduce benefits. There is a diverse set of mandatory grant programs that are not entitlement programs, including, for example, TANF and some wildlife restoration programs.

account for a smaller share of GDP in 2023 than they did in 2011.

### Other Federal Support for State and Local Governments

The federal government also provides financial support to state and local governments through the tax system. That support takes the form of tax credits or deductions that make it less expensive for state and local governments to borrow money or to raise revenues through taxes.<sup>10</sup> For example, state and local governments can issue bonds for which the interest income is exempt from federal taxes. As a result, those governments are able to borrow money more cheaply than they otherwise could. In 2011, tax-exempt bonds resulted in an estimated cost to the federal government of \$30 billion in forgone revenues.<sup>11</sup> Similarly, individuals who itemize deductions on their federal returns are able to deduct state and local income taxes, sales taxes, and personal property taxes from their taxable income. The resulting reduction in federal income tax liability from those deductions was estimated to be \$67 billion in 2011. Together, those tax expenditures were about one-sixth as large as the \$607 billion in federal spending for state and local grants that year.

### Rationales for Intergovernmental Grants

A number of different rationales can explain federal policymakers' decisions to provide funding for intergovernmental grant programs:

9. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023* (February 2013), [www.cbo.gov/publication/43907](http://www.cbo.gov/publication/43907). The ACA encompasses the Patient Protection and Affordable Care Act and the health care provisions of the Health Care and Education Reconciliation Act of 2010 as well as, in the case of this document, the effects of subsequent related judicial decisions, statutory changes, and administrative actions.
10. For more details, see Statement of Frank Sammartino, Assistant Director for Tax Analysis, Congressional Budget Office, before the Senate Finance Committee, *Federal Support for State and Local Governments Through the Tax Code* (April 25, 2012), [www.cbo.gov/publication/43047](http://www.cbo.gov/publication/43047).
11. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2011–2015*, JCS-1-12 (January 17, 2012). The estimate for tax-exempt bonds does not reflect the exclusion of interest from qualified private-activity bonds issued by state and local governments. Interest from most private-activity bonds is subject to the individual alternative minimum tax.

- Such programs can increase economic efficiency in instances when state and local governments have localized knowledge that would allow them to implement a program more efficiently and effectively than the federal government could, but they lack an incentive or funding to provide as much of a good or service as would be desirable from a national perspective;
- The federal government is better able to redistribute resources in the economy;
- The federal government can borrow money more readily than most state or local governments so it has greater ability to stabilize a weak economy;
- Intergovernmental grants can be used as a tool to influence the policy priorities of state and local governments; and
- Intergovernmental grants can encourage state and local governments to innovate or experiment with new programs and activities.

Those rationales for establishing grant programs are not mutually exclusive. Although they are often cited in the literature on grants, they may be more or less relevant to individual programs.

### **Economic Efficiency**

From the point of view of economic efficiency, decision-making authority is best placed with those who have the information and the incentive to weigh all of the benefits and costs of such decisions. Whether the federal government or state or local governments make more efficient decisions in particular circumstances depends in part on who benefits from those decisions and who bears the costs.

State and local governments typically provide certain goods or services for which the beneficiaries are concentrated locally. In such cases, state and local governments tend to be better informed about both citizens' priorities and local conditions.<sup>12</sup> If federal policymakers have a goal in mind (for example, to foster community development) but do not have sufficient information to implement that goal at the state or local level, they may turn to grants to take advantage of the additional information available at the state and local level.

However, if some or most of the benefits of an activity extend outside a state or local area, then state and local governments would tend to underinvest in that activity. Under those circumstances, it would be efficient for the federal government to provide funds to state and local governments to encourage them to invest more. For instance, a highway that would serve as a main thoroughfare through a state might benefit surrounding states or even the nation as a whole, not just the state's residents, but the local benefits it provides might not be sufficient for the state to justify building or improving the road entirely with its own funds. Then, federal support for that road can lead to a more efficient outcome.<sup>13</sup> When projects are likely to provide both local and national benefits, the state or local government that receives a federal grant is often required to partially match the federal funding. Though a matching requirement may be intended to recognize that a program has local benefits, the required matching rate does not typically depend on the share of benefits that accrues to localities or to entities outside of those localities.

Intergovernmental grants may also affect efficiency through their administrative costs. Structuring programs so that they are funded partially or solely with federal grants and implemented by state and local governments raises questions about whether involving multiple levels of government leads to the duplication of administrative expenses and higher auditing or compliance costs. Alternatively, using grants may allow the federal government to take advantage of state and local governments' existing administrative infrastructure and avoid adding a separate federal layer. (For additional information on the costs involved with federal grants, see Box 2.)

### **Redistribution of Resources**

Federal grants to state and local governments may also be used to reduce perceived inequities among certain communities or individuals. In particular, grant programs

12. The ability of local governments to provide goods and services in the amounts preferred by their citizens also allows individuals to move from one community to another to find the mix of goods and services that best matches their own preferences. See Charles M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy*, vol. 64, no. 5 (October 1956), pp. 416–424.

13. See Jeffrey Petchey and Garry MacDonald, "Financing Capital Expenditures Through Grants," in Robin Boadway and Anwar Shad, eds., *Intergovernmental Fiscal Transfers: Principles and Practices* (Washington, D.C.: World Bank, 2007), pp. 425–451.

may serve to redistribute resources by paying for health care coverage, food, or housing for low-income individuals and households. Many federal grant programs—such as Medicaid, CHIP, TANF, and Title I grants for the education of disadvantaged children—redistribute resources. Those and other programs provide federal funds to state and local governments to encourage those governments to implement programs that meet certain national standards. If states or localities opt not to accept such federal funds, their residents could end up paying federal taxes that support benefits they do not receive while residents of other states do.

If, in the absence of federal grants for programs that are intended to reduce income inequality or redistribute resources, some state and local governments attempted to finance those programs entirely on their own through higher taxes or fees, individuals might leave those areas to seek jurisdictions with a lower tax burden and smaller redistribution programs. People who would not expect to directly benefit from the government services their tax payments financed might be especially likely to depart, leaving behind those who expected a net benefit from the programs that aimed to improve equity or redistribute resources. Because moving to avoid federal taxes is usually more difficult than moving to avoid state or local taxes, the federal government is better able to redistribute resources by collecting taxes and funding both fully federal programs and intergovernmental grants that finance programs administered by state and local governments.<sup>14</sup>

### **Economic Stabilization**

Federal programs that provide grants to state and local governments may serve as automatic stabilizers if spending on those programs increases when the economy contracts or decreases when the economy expands without requiring any new action on the part of the government.<sup>15</sup> In particular, grant programs with open-ended funding commitments tend to dampen the peaks and troughs of the business cycle if their funding

increases automatically when the economy weakens and decreases automatically when the economy strengthens. That is true, for example, if spending rises to keep pace with rising enrollments when the economy worsens and declines in line with enrollments when people's circumstances improve.<sup>16</sup> State and local governments are typically constrained in their ability to borrow by their state constitutions or state law, so additional federal grant funds that arrive automatically may be especially useful in allowing state and local governments to maintain their activities during an economic downturn.<sup>17</sup>

In contrast, grant programs for which funding is not open-ended are less well equipped to serve as automatic stabilizers. Funding for TANF, for example, was set in its authorizing legislation at a predetermined level that does not vary over time, so the program is not able to provide assistance to all who may become newly eligible when the economy slows. Discretionary intergovernmental grants, such as those included in ARRA, can also stabilize the economy, though they must be approved by lawmakers and so cannot respond as quickly to changing economic conditions.

### **Influence on State and Local Government Activities**

Federal grant programs provide a mechanism for federal policymakers to promote their priorities at the state and local levels by influencing the amount of money spent by state and local governments and the types of activities on which those governments spend their money. Many federal grants require that state and local governments provide partial funding from nonfederal sources for the programs paid for by those grants. Matching requirements are one way to ensure that local beneficiaries share in a portion of the cost of a program that is funded by a federal grant. A number of federal grant programs also require that state and local governments maintain a certain level of spending for an activity. The purpose of such

14. See Wallace E. Oates, "An Essay on Fiscal Federalism," *Journal of Economic Literature*, vol. 37, no. 3 (September 1999), p. 1125.

15. A number of other federal spending programs function as automatic stabilizers, though they are not intergovernmental grant programs. Those include the SNAP and regular unemployment insurance. For more information, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, Appendix C (January 2012), [www.cbo.gov/publication/42905](http://www.cbo.gov/publication/42905).

16. Glenn Follette and Byron Lutz, *Fiscal Policy in the United States: Automatic Stabilizers, Discretionary Fiscal Policy Actions, and the Economy*, Finance and Economics Discussion Series 2010-43 (Federal Reserve Board, 2010).

17. The federal Medicaid program serves as an automatic stabilizer, but because of its matching requirements, the growth in Medicaid that occurs when a larger portion of the population becomes eligible for the program in an economic downturn also places an added demand on state budgets at the same time that state tax collections decrease.

**Box 2.****Administrative Costs of Federal Grants**

Because federal grant programs involve two or three levels of government, they engender administrative costs at multiple levels of government. However, the magnitude of such costs—and, in particular, how much bigger or smaller the costs would be if the programs were structured in different ways—is unclear.

In many cases, the federal government’s responsibility for a given grant program and the state or local government’s responsibilities are sufficiently different that extensive duplication is unlikely. For example, funds from Title I grants for the education of disadvantaged children reach local education agencies by way of state education agencies. The U.S. Department of Education allocates funds to states, which then reallocate them to local education agencies, in both cases according to formulas specified in authorizing legislation. The local agencies that ultimately receive such grants spend the funds on educational activities, and the states choose methods to assess students’ progress and ensure that teachers are qualified. Federal administrative expenses for education are limited; for instance, about 3 percent of the Department of Education’s budget authority in 2012 was devoted to national activities, management, and research, with the rest of the agency’s budget authority split about evenly between student financial aid and grants to state and local governments and schools. With different responsibilities, each level of government is also likely to have different administrative needs.

Administrative costs of grant programs vary considerably depending on the features of the programs. For instance, programs such as Medicaid and Temporary Assistance for Needy Families, which provide benefits to individuals who must be identified and assisted on an individual basis, tend to be more expensive to administer than programs that include only state or

local governments as recipients. Unfortunately, it is difficult to measure the total administrative cost of a federal grant program for all levels of government: Different programs allow state and local governments to account for their administrative costs in different ways, and the federal government’s expenses for administering a particular grant program are difficult to estimate reliably because those costs often cannot be separated from the costs of administering other grant programs or running the sponsoring agency.

In some cases, state and local governments receive reimbursement from the federal government for the costs of administering a grant program. The authorizing legislation or other rules for a program often outline the eligible expenses that recipient governments can categorize as administrative expenditures when they seek federal reimbursement; but permissible expenses and the nature of the reimbursement vary by program.<sup>1</sup> For programs such as Medicaid, the federal government reimburses a portion of the states’ actual administrative costs; reimbursement for some other programs is determined by formula, which sets the portion of grant funding that can be used for administrative purposes. The federal government pays at least half of most state administrative costs for Medicaid. In 2010, the federal government paid \$9.8 billion out of a total of \$17.9 billion in costs that states incurred for administering Medicaid. (Those federal payments were less than 4 percent of total federal Medicaid outlays to states that year.) By comparison, for costs related to the administration of child nutrition programs, a state’s reimbursable

1. Government Accountability Office, “Administrative Expenditures and Federal Matching Rates of Selected Support Programs,” letter to the Honorable Wally Herger (June 30, 2005), [www.gao.gov/assets/100/93367.pdf](http://www.gao.gov/assets/100/93367.pdf).

Continued

## Box 2.

Continued

## Administrative Costs of Federal Grants

administrative expenses are limited to 1.5 percent of the amount that state spent providing meals to children two years before. For Title I education grants, states may generally spend no more than 1 percent of their grant funding on administration, but local education agencies face no similar constraints and vary widely in the amount of grant funding they direct to administration.<sup>2</sup>

When federally funded programs are implemented at the state and local level rather than directly by the federal government, additional compliance and auditing costs may result because more agencies and actors are involved. The amount that the federal government spends to monitor grant programs—to prevent or uncover waste, fraud, and abuse—must be weighed against how much those problems cost the federal government. The Government Accountability Office (GAO) has found deficiencies in the oversight of federal grants to state and local governments and to nongovernmental organizations throughout the grant cycle (which begins when the availability of funding is announced, continues as the applications are reviewed and grants are awarded, and concludes when funding ceases or the program closes).<sup>3</sup> According to GAO's analysis, some agencies did not perform thorough reviews of a recipient's capacity to carry out programs before awarding a grant. GAO also found that, in some cases, grant programs lacked sufficient

oversight and monitoring while programs were in process, contributing to improper payments in a number of programs that awarded grants to state and local governments.

In an effort to win competitive federal grants, such as Race to the Top grants for education reforms or Transportation Investment Generating Economic Recovery (TIGER) grants for transportation projects, state and local governments sometimes expend considerable effort and money preparing an application with no guarantee of success. For instance, over three funding rounds, TIGER grants were awarded for 172 projects totaling \$2.6 billion, but the Department of Transportation received applications for more than 3,000 projects seeking more than \$95 billion in total funding.<sup>4</sup> As of December 2012, 24 states and the District of Columbia had received Race to the Top grants; but as part of the competitive process, all 47 states that applied for the grants had to demonstrate that they planned to implement substantial reforms to their education programs.

Although preparing applications for competitive grants can be costly for state and local governments, the practice of identifying projects that are valuable to the local community could prove useful to state and local policymakers as they consider how to spend their own funds. In addition, even attempting to satisfy the requirements for receiving a particular grant—such as instituting the reforms necessary just to apply for Race to the Top funding—could serve federal policy objectives.

2. Government Accountability Office, *Disadvantaged Students: School Districts Have Used Title I Funds Primarily to Support Instruction*, GAO-11-595 (July 2011), [www.gao.gov/new.items/d11595.pdf](http://www.gao.gov/new.items/d11595.pdf).

3. See statement of Jeanette M. Franzel, Managing Director, Financial Management and Assurance, Government Accountability Office, GAO-11-773T, *Federal Grants: Improvements Needed in Oversight and Accountability Processes*, before the Subcommittee on Technology, Information Policy, Intergovernmental Relations and Procurement Reform, House of Representatives, June 23, 2011.

4. U.S. Department of Transportation, "U.S. Transportation Secretary LaHood Announces Fourth Round of Funding under Highly Successful TIGER Program" (press release, January 31, 2012), [www.dot.gov/briefing-room/us-transportation-secretary-lahood-announces-fourth-round-funding-under-highly](http://www.dot.gov/briefing-room/us-transportation-secretary-lahood-announces-fourth-round-funding-under-highly).

MOE provisions is to ensure that federal grants do not replace state and local funds for a program.

The federal government attaches conditions to many intergovernmental grants requiring recipient state and local governments to take certain prescribed actions.<sup>18</sup> Those conditions may be central to the program at hand, such as the requirements that school districts must meet to qualify for federal grants under No Child Left Behind; or they may have little direct bearing on the grant program, such as the requirement that, in order to receive highway funding, a state must set a minimum drinking age of 21.

The constitutionality of the federal government's imposing conditions on the receipt of intergovernmental grants gained prominence recently when the Supreme Court considered the expansion of Medicaid under the ACA. Although the Court rejected the requirement that states expand Medicaid or risk losing all Medicaid grant funds, it maintained the ability of the federal government to place conditions on grant funding as long as those conditions were not coercive and could be reasonably anticipated by recipients. The Court noted that certain conditions of other grant programs, such as the requirement that states adopt a minimum drinking age of 21 in order to continue receiving federal highway grants, do not rise to the level of coercion and would not be subject to similar questions about their constitutionality.

Instead of grants, federal policymakers also use mandates to require state and local governments to adopt federal policy priorities. As required by the Unfunded Mandates Reform Act of 1995, CBO reviews bills to assess whether they contain mandates or provisions that, if enacted, would impose an enforceable duty on state, local, or tribal governments or on private-sector entities.<sup>19</sup> Of the

81 public laws enacted in 2011, 12 contained at least one unfunded intergovernmental mandate.

### Policy Experimentation

A further objective of federal grants to state and local governments is to encourage experimentation and innovation that cannot be achieved in programs that are uniformly implemented by the federal government. Many federal grants leave decisions about design and implementation to the state or local government receiving the grant, which can result in a variety of different approaches to a given policy issue. Block grants in particular tend to give state and local grant recipients broad latitude in designing and implementing programs. Other grant programs place more restrictions on the way state and local recipients spend grant funds, but some of those programs have mechanisms in place that afford states additional flexibility to experiment with alternative approaches to meeting a goal or to choose the amount or type of services they provide. For example, states may seek waivers that exempt them from meeting certain education performance requirements under No Child Left Behind in exchange for implementing other reforms they identify themselves. In addition, federal legislation governing Medicaid provides states several different options for conducting demonstrations or waiving certain program rules, giving them some flexibility over the design of programs. State and local governments can then learn from one another about which aspects of their programs are more or less successful.<sup>20</sup>

### Federal Control Over State and Local Grants

The federal government makes decisions in three key areas when it distributes funds to state and local governments in the form of intergovernmental grants:

- It chooses the parameters that govern how recipients may spend federal grant funds;
- It determines a method for allocating those funds among state and local government recipients, typically with a formula or through a competitive process based on specific criteria; and

18. Paul Posner, "The Politics of Coercive Federalism in the Bush Era," *Publius: The Journal of Federalism*, vol. 37, no. 3 (Summer 2007).

19. Mandates also include provisions that reduce or eliminate funding authorized to cover the costs of complying with existing mandates; provisions that increase the stringency of conditions that apply to the distribution of funds to state, local, and tribal governments through certain mandatory programs; and provisions that make cuts in federal funding for those programs. For more information, see Congressional Budget Office, *A Review of CBO's Activities in 2011 Under the Unfunded Mandates Reform Act* (March 2012), [www.cbo.gov/publication/43140](http://www.cbo.gov/publication/43140).

20. Pierre Salmon, "Horizontal Competition Among Governments," in Ehtisham Ahmad and Giorgio Brosio, eds., *Handbook of Fiscal Federalism* (Cheltenham, England: Elgar, 2008), pp. 61–85.

- It decides how much to spend on grants and how to set the rules that determine that spending.

Those decisions entail certain tradeoffs. For example, policymakers can structure grant programs in a way that limits federal spending, but such an approach will also limit the responsiveness of grants to economic downturns. Restricting the control that state and local governments have over spending decisions may better promote some federal goals, but such an approach may also limit the ability of state or local governments to respond to specific conditions in their jurisdictions or to experiment with different program designs.

### **Determining How Grant Recipients May Spend the Funds They Receive**

Intergovernmental grants are frequently categorized as block grants, categorical formula grants, or project grants. They differ in the amount of control the federal government exerts over how state and local governments use the grant money and in the way the federal government allocates grant money to recipients. The boundaries between those groupings are not always clear, however, making it difficult to place many grant programs neatly into just one category. In addition, the federal government may place other conditions on spending grant funds, regardless of the type of grant involved.

**Block Grants.** Block grants, though not widely used, afford state and local governments substantial control over spending decisions. Although that flexibility can encourage states and localities to seek innovative ways to meet the needs of their communities, it also leaves open the possibility that those funds may be spent in ways that federal policymakers would not have chosen. In addition, if block grants do not include requirements that state and local governments use a portion of their own revenues to supplement the grant funds they have received, those governments could use the flexibility afforded by block grants to replace money from local revenues with federal funds.

**Categorical Formula Grants.** Categorical formula grants are typically allocated to all qualifying state or local governments on the basis of a formula set out in legislation or by federal administrators. Although those grant programs generally include rules or directions that specify the types of projects on which the funds can be spent, recipients usually determine the specific projects that receive funding. For example, the largest education grant

program of this type—Title I funds for the education of disadvantaged children—leaves decisions about how best to spend those funds up to state and local agencies, within certain guidelines. That approach is consistent with the traditional practice in which state and local authorities set education policies and choose curriculums for public school systems, while the federal government ensures that each state has resources available to provide educational opportunities for disadvantaged families. Similarly, many federal highway grants allow states to choose which highway projects to undertake from among eligible roadways. Likewise, Medicaid programs also vary across state lines, with states having some flexibility to set their own eligibility rules, provider payments, and covered services, as long as they conform to federal eligibility requirements and coverage criteria.

**Project Grants.** Project grants offer the federal government greater control and oversight of the way state and local governments spend the funds they receive. For example, grants for the Race to the Top program and the Transportation Investment Generating Economic Recovery (TIGER) grants are awarded through a competitive process in which federal administrators choose projects to fund from among the applications submitted. In those cases, the recipient state or local government agency is typically limited to implementing the project for which the grant was awarded.

Funding for project grants is generally very small in comparison to that for categorical formula grants. For instance, during the 2011 round of funding for TIGER grants, \$511 million was awarded to state and local governments. By contrast, all federal budget authority for transportation grants that are allocated by formulas to state and local governments in 2011 totaled \$54 billion. Project grants tend to be very specifically defined. During the most recent round of TIGER funding, grants were awarded for bridge replacement projects, intermodal transfer facilities, and rail projects. Similarly, when applying for Race to the Top grants, states generally submit lists of projects, benchmarks, and timelines that describe the scope of the work to be implemented.

**Conditions Attached to Various Grants.** Whether structured as block grants, categorical formula grants, or project grants, many federal grant programs impose additional conditions on recipients to ensure achievement of federal goals. Since the passage of the No Child Left Behind Act of 2001, for example, states and local

education agencies must show that students are making adequate yearly progress to remain eligible for Title I education grants.

Although grants may include conditions that are specific to the programs they fund, other spending rules accompany a variety of federal intergovernmental grants. For instance, the Davis-Bacon Act requires that employers pay prevailing local wages and benefits to workers on any federal or federally assisted public works project that costs \$2,000 or more. Many federally funded projects also require an environmental assessment to comply with the National Environmental Policy Act. In addition, public works projects that use funds from ARRA and some other programs include “Buy America” provisions requiring that American products be used in state and local projects funded by federal grants, unless certain exemptions apply.

In some instances, states apply for waivers that exempt them from particular conditions normally imposed on grants, thereby allowing them greater flexibility in the way they spend grant funds. As of February 2013, 34 states and the District of Columbia had received, and another 10 states, Puerto Rico, and the Bureau of Indian Education had requested, waivers from the federal government granting them flexibility in meeting education performance targets while maintaining their Title I funding.<sup>21</sup> States can also apply for Medicaid waivers that allow them to experiment with new options for financing or delivering services, to require beneficiaries to enroll in managed care plans, and to provide long-term care in homes and communities rather than institutions. As of February 2013, more than 300 state Medicaid waivers were in effect.<sup>22</sup>

However, the flexibility afforded by waivers is limited by federal administrators, and it sometimes comes at a substantial cost to states. To receive federal approval for Medicaid or education waivers, states typically have to prepare applications that describe how they plan to make use of the expanded flexibility, negotiate with the federal agency that administers the grant program, solicit public comments, and set out plans for federal monitoring of

the agreed-upon waiver. That waiver process can be time-consuming and expensive. For example, states’ applications for flexibility in meeting educational performance requirements average nearly 400 pages.

In other cases, instead of seeking waivers, several states have begun to offer local governments the opportunity to exchange some federal transportation grant funds that would have come with conditions for a smaller amount of state funds (typically 80 cents to 90 cents on the dollar) that come without such conditions. For instance, local agencies that participate in the Kansas Department of Transportation’s federal funds exchange can choose from a broader set of projects than federal grants would permit; in addition, those agencies need only comply with state rather than federal regulations.<sup>23</sup>

### Methods of Allocating Federal Grants

The federal government uses either formulas or a competitive process to allocate money to state and local governments. Formulas are typically used to allocate funds for block grants and categorical formula grants, and the complexity of those formulas varies a great deal. In some cases, grants are allocated to states, which then distribute some or all of those funds to localities. Project grants are awarded through a competitive process, with federal officials selecting projects to receive funding on the basis of some measurable criteria.

**Formula-Based Allocation.** Block grants and categorical formula grants are usually distributed on the basis of formulas or other criteria set by law. In some cases, the formulas are based on historical distributions of funds; in other cases, a variety of demographic and other factors determine how the money is allocated. The basic TANF block grant program distributes funds to states according to the share each state received under its predecessor program, Aid to Families with Dependent Children (AFDC), in the mid-1990s. In addition to that basic grant, some states also received supplemental grants for a number of years on the basis of their high population growth or their historically low welfare grants per low-income person. Community Development Block Grant (CDBG) funds are distributed to state and local governments according to a formula that takes into account a community’s population, poverty levels, and housing

21. For more details, see Department of Education, “ESEA Flexibility” (February 20, 2013), [www.ed.gov/esea/flexibility](http://www.ed.gov/esea/flexibility).

22. For more details, see Department of Health and Human Services, “Waivers” (accessed March 1, 2013), [www.medicaid.gov/Medicaid-CHIP-Program-Information/By-Topics/Waivers/Waivers.html](http://www.medicaid.gov/Medicaid-CHIP-Program-Information/By-Topics/Waivers/Waivers.html).

23. Kansas Department of Transportation, Bureau of Local Projects, *Federal Fund Exchange Program Guidelines* (November 22, 2010), [www.ksdot.org/burlocalproj](http://www.ksdot.org/burlocalproj).

conditions. The \$1.7 billion appropriated for the Social Services Block Grant program in 2012 is allocated to states according to the relative size of their population to support a wide variety of social services.

Funding for many categorical grant programs is similarly allocated among states and localities by formula. Highway grant allocation formulas typically include factors such as a state's highway lane miles and the number of vehicle miles traveled there. Title I funds for the education of disadvantaged children are distributed to local education agencies by the states on the basis of formulas that consider, among other factors, the concentration of students in a given school who come from low-income families. Medicaid's open-ended funding means that the federal government does not allocate fixed grant amounts to states. However, a formula based on a state's per capita income determines the Federal Medicaid Assistance Percentage, the share that the federal government contributes toward a state's Medicaid expenditures.

**Competition-Based Allocation.** The federal government allocates money for project grants through a process in which state and local governments compete with one another for funds. Race to the Top, a competitive education grant introduced in 2009 and administered by the Department of Education, awards funds to state and local education agencies on the basis of demonstrated improvements in student achievement and plans that show that the applicants intend to implement further reforms. The Department of Education laid out a list of criteria that it would consider in evaluating states' applications for Race to the Top grants, including the relative weight it would place on each aspect. In 2012, lawmakers appropriated \$549 million for the program. As of December 2012, 24 states and the District of Columbia had received Race to the Top Grants.

The TIGER grant program provides money for projects that are expected to have a significant impact on the nation, a metropolitan area, or a region. The selection criteria include a number of factors, such as a project's anticipated contribution to economic competitiveness, its environmental sustainability, its safety, and its potential for creating jobs. The 2012 program awarded nearly \$500 million in grants to 47 projects in 34 states and the District of Columbia.

### **Expected Federal Budgetary Cost and Its Predictability**

The federal government can achieve different degrees of control over the expected cost and predictability of budgetary expenditures for grant programs by making them either mandatory or discretionary programs and, for mandatory programs, by making their funding either open-ended or limited to a specific amount. Specifically, the total budgetary cost of some intergovernmental grants is determined in advance by the legislation that authorizes certain mandatory programs or appropriates funds for discretionary programs. Such grants have limited total resources, whether funded through authorizing legislation or through annual appropriations, and thereby provide greater certainty than do open-ended grants about the effects of a grant program on the federal budget. That certainty about expenditure levels, however, can limit the ability of the federal government to respond quickly to changing needs in times of economic or fiscal difficulty.

**Mandatory Programs.** Mandatory programs are generally funded outside of the annual appropriation process through authorizing legislation that may be in effect indefinitely or for a designated period. Funding for some programs, such as Medicaid, is provided on an open-ended basis so that when the conditions described in the authorizing legislation are met, more federal funds flow to recipients of state and local grants and the program grows. In addition, Medicaid gives states some control over the way they implement the program. By one estimate, 60 percent of total Medicaid expenditures in 2007 were for individuals and benefits whose coverage was not required by federal law.<sup>24</sup> Together with open-ended funding, that makes the federal financial commitment dependent on decisions made by state and federal policymakers.

By contrast, some mandatory programs are funded through grants that limit the amount spent by the federal government to a predetermined level. For instance, in determining funding for CHIP, the federal government sets a maximum amount that it will provide to each state. Each state determines the amount that it will spend and

24. See Brigette Courtot, Emily Lawton, and Samantha Artiga, *Medicaid Enrollment and Expenditures by Federal Core Requirements and State Options* (Kaiser Commission on Medicaid and the Uninsured, January 2012), [www.kff.org/medicaid/upload/8239.pdf](http://www.kff.org/medicaid/upload/8239.pdf).

receives a grant that matches that amount up to the limit established by the federal government.

TANF is also a mandatory program, but its funding is provided in the form of block grants, which means that funding is constrained by the size of the grants rather than determined by the number of participants or the benefits they receive. When the TANF block grant program was created in 1996 to replace AFDC, its funding level was set to match the amount that had been provided through AFDC and related programs in the previous year. That basic block grant has remained at the same nominal (current-dollar) funding level each year—\$16.5 billion—so its real value has declined over time. Some states have also received supplemental grants in certain years and have had access to contingency funds when faced with an economic need.

Highway grants have mandatory budget authority as well (because it is appropriated by the authorizing legislation for surface transportation programs), but annual appropriation acts generally limit how much of those grants the Department of Transportation can obligate each year. For that reason, almost all outlays for those grants are considered to be discretionary spending.<sup>25</sup>

**Discretionary Programs.** Discretionary grant programs are funded through annual appropriation acts, which limit the total amount that the federal government can provide to state and local governments in a fiscal year. Therefore, those funding levels are limited, as specified in law. Most federal intergovernmental grant programs that are not related to health are classified as discretionary. The CDBG program is an example. In 2012, the Congress appropriated \$3 billion for CDBG funding, a decrease of more than \$300 million from the previous year. CDBG funds go to state and local governments to pay for projects in neighborhoods with concentrations of low- and moderate-income households. The grants support affordable housing and address other community needs. Title I grants for the education of disadvantaged children and many other education grants also are funded through discretionary appropriations.

25. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* (January 2012), p. 48, [www.cbo.gov/publication/42905](http://www.cbo.gov/publication/42905).

## Federal Influence on Spending by State and Local Governments

In most cases, federal grants finance activities that state and local governments also fund out of their own revenues. Federal grants are typically intended to supplement those governments' efforts rather than supplant them. To that end, many federal grants include matching requirements or MOE provisions that necessitate some financial contribution by the recipient government. Those requirements can take on very different forms because they are tailored to a wide variety of intergovernmental grant programs. Despite the use of matching and MOE requirements, over time, state and local governments may change their spending decisions because of the funds that they receive from the federal government. However, the effect on state and local government spending of federal grants with such conditions has not been clearly established in the current body of economic literature.

States' contributions are typically financed with revenues generated by collecting fees, tolls, or taxes on sales, income, or property owned in a given jurisdiction or by borrowing funds through bond issues (which would be paid with future fees, tolls, or taxes). The mix of revenue sources that recipient governments draw upon varies, but successful bond issuances are typically intended to finance long-lived infrastructure projects rather than to pay for current consumption of goods and services through income security or other government programs.

### Matching Requirements

State and local governments that receive federal grants with matching requirements must contribute a designated share of the cost of a program from their own resources. Those requirements can help ensure that state and local governments participate financially in programs that have local benefits and that the choices they make when administering grant programs align better with federal interests.

For example, many federally funded highway grants require state or local governments to contribute 20 percent of a project's cost, with the federal government reimbursing the state or local government for the remaining 80 percent. For Medicaid, the largest intergovernmental grant program, the matching rate varies by state. The rate is determined by a formula based on per capita income, which, in 2012, left states responsible for

between 26 percent and 50 percent of most Medicaid expenditures; the federal government contributed the rest. In states that choose to expand Medicaid eligibility under the ACA to nonelderly adults with income below 138 percent of the federal poverty level, the federal government will pay all of the costs of covering enrollees who are newly eligible under the program's expansion from 2014 to 2016. From 2017 to 2020, the federal share of that spending will decrease gradually to 90 percent.

The effect of matching requirements on the incentives facing state and local governments depends on whether a grant program is open-ended or funded in a set amount and on how much a state is spending. With matching, federal grant programs effectively lower the price of a state's spending on a given program relative to other items in the state's budget for as long as the federal government continues to spend on the program. For instance, for every dollar that a state government spends on certain types of highway projects, the federal government contributes \$4 to the project, so the state gets \$5 worth of funding for each dollar it spends—until it reaches the maximum amount the state is slated to receive. However, when states spend more of their own funds than is required to receive the full federal contribution—which occurs in many states—then the lower price that is the result of the matching requirement no longer applies. The matching requirements for CHIP operate similarly to those for highway projects, although the matching rates differ.

In contrast, federal funding for Medicaid is not limited in the same way that highway funding or CHIP funding is; instead, the federal government shares all eligible state expenditures, although its share varies from state to state. Thus, the open-ended nature of Medicaid grants means that the relative price of state spending for Medicaid is always lower than the relative price of state spending on other programs that do not receive federal matching funds. That difference in relative prices tends to spur states to devote more of their budgets to Medicaid expenditures, to spend less than they would have on other benefits or services that do not receive federal matching, and to shift activities that had been funded entirely by the state into Medicaid.

Matching requirements may be seen as a way to ensure that state and local governments pay for the benefits of a program that accrue locally and that the federal government pays for benefits extending beyond the state or

locality. However, matching rates are not systematically linked to the share of benefits that remains in the locality. For example, although many federally funded highway grants require states to contribute 20 percent of a project's cost, with the federal government funding the remaining 80 percent, the benefits of such a project are not likely to be realized in the same proportions.

### **Maintenance-of-Effort Requirements**

MOE requirements are provisions of law that aim to prevent state and local governments from using federal funds to replace funds that states and localities would otherwise have used to pay for that program. MOE requirements take on a number of different forms, depending on the program. For instance, to receive their full allocation of Title I funds for the education of disadvantaged children each year, a local education agency must have spent on primary and secondary education in the preceding year at least 90 percent of what it spent the year before that from nonfederal sources. Although federal highway grants do not typically include MOE requirements, additional highway funding provided in ARRA was accompanied by a requirement that states spend at least what they had planned to before that legislation was enacted. That provision was meant to ensure that the ARRA highway grants provided additional funding rather than simply replace state spending that had already been planned. In the case of Medicaid, the ACA includes an MOE requirement that calls for states to keep their eligibility criteria unchanged for adults participating in Medicaid until 2014 and for children participating in Medicaid and CHIP until 2019. TANF requires that states spend at least 75 percent of what they spent from state funds in 1994 on AFDC and its other predecessor programs.

Those MOE requirements could be viewed as unfair to states that were already spending their own money to meet a goal that the federal government is promoting through the grant program. Such states would have to continue to make a larger financial contribution to satisfy the MOE requirement than other states that had not already been spending their own money to pursue the federal priority. In addition, to the extent that multiple federal intergovernmental grants have stringent MOE requirements, the cumulative effect of those requirements on a state's budget may be substantial, constraining the state's ability to use its funds in a manner that addresses its own current priorities. Alternatively, such requirements may be considered a way to recognize the differences in states' willingness or ability to pay to reach

a federal goal. Federal grant programs may make exceptions to MOE requirements if state or local governments suffer sudden, severe revenue contractions; for instance, both the Title I and Medicaid programs permit states to appeal for some relief from MOE requirements under certain circumstances.

### Estimates of State and Local Responses to Federal Grants

Federal efforts to use matching and MOE requirements to encourage states to spend money on various programs have had mixed results. Researchers have often found that state and local governments tend to shift their use of their own funds as federal grants increase; however, the results of different studies are not always consistent. In addition, it is not clear from that research whether state and local governments respond symmetrically to increases and decreases in spending for federal grants. For example, certain studies have found the following:

- Increases in the amount of funding per student provided through Title I grants led to a nearly dollar-for-dollar increase in total spending by local school districts in the first year of that increase in funding; but those increases in total spending were largely offset by reductions in the local contribution to that total within three years.<sup>26</sup>
- Increases in federal highway grants have been partially offset by a decline in state spending of about 50 percent of the increase in federal highway grants; there is some evidence that the share of such displacement has increased over time.<sup>27</sup>
- Federal highway grants crowd out state highway spending.<sup>28</sup>

26. Nora Gordon, "Do Federal Grants Boost School Spending? Evidence from Title I," *Journal of Public Economics*, vol. 88 (August 2004), pp. 1771–1792.

27. Government Accountability Office, *Federal-Aid Highways: Trends, Effect on State Spending, and Options for Future Program Design*, GAO-04-802 (August 2004), [www.gao.gov/new.items/d04802.pdf](http://www.gao.gov/new.items/d04802.pdf).

28. Brian Knight, "Endogenous Federal Grants and Crowd-Out of State Government Spending: Theory and Evidence from the Federal Highway Aid Program," *American Economic Review*, vol. 92, no. 1 (March 2002), pp. 71–92.

- Increases and decreases in federal aid alike have been associated with a decrease in spending at the county level.<sup>29</sup>
- In response to cuts in federal grants, aggregate state and local spending fell, but aggregate state and local spending rose as such grants increased.<sup>30</sup>

Thus, drawing broad conclusions about how state and local governments respond to federal grants is difficult. The difficulty arises partly from the wide variety of intergovernmental grant programs, each with its own set of conditions and rules for state and local governments. In addition, the existing research literature can offer only very limited guidance because most studies examine specific programs rather than a broad set of intergovernmental grants and because researchers are unable to control for other changes that occur simultaneously with changes in grant amounts.<sup>31</sup> Moreover, the studies typically analyze changes in intergovernmental grants that are fairly small; the responses of state and local governments to more substantial changes in grants could be quite different.

One reason that matching and MOE requirements may not diminish the ability of state and local governments to use federal grant funds to replace their own revenues is that states can adapt to the provisions of some grant programs in ways that increase the funding they receive from the federal government. For example, states have been able to increase their federal reimbursements for Medicaid expenditures by using certain intergovernmental transfers or levying taxes on health care providers to offset the matching payments they are

29. William F. Stine, "Is Local Government Revenue Response to Federal Aid Symmetrical? Evidence from Pennsylvania County Governments in an Era of Retrenchment," *National Tax Journal*, vol. 47, no. 4 (December 1994), pp. 799–816.

30. Shama Gamkhar and Wallace Oates, "Asymmetries in the Response to Increases and Decreases in Intergovernmental Grants: Some Empirical Findings," *National Tax Journal*, vol. 49, no. 4 (December 1996), pp. 501–512.

31. A number of other factors may also make it difficult to reach a consensus on state and local government spending responses to federal grants, including the differing abilities of jurisdictions to raise revenues because of their size or because of legal limits on running deficits. See Shama Gamkhar, *Federal Intergovernmental Grants and the States: Managing Devolution* (Cheltenham, England: Elgar, 2002).

required to make.<sup>32</sup> That practice may have had the effect of raising federal Medicaid spending by making states' payments out of their own funds a weaker constraint on the size of the program. Similarly, local education agencies can measure spending to satisfy the MOE requirement for Title I grants in any given year in one of two ways—on an aggregate spending basis or on the basis of expenditures per pupil.<sup>33</sup>

## Implications of Modifying Federal Grant Programs

When considering whether to modify federal grant programs, lawmakers face choices about two key dimensions of those programs: how much federal funding to devote to them and how much federal control to exercise over funded activities. Different choices would have different implications for the federal budget and the way grant programs are implemented. Drawing general conclusions about changes to grant programs is difficult, though, because the features of those programs—their intended purpose, size, and implementation—vary widely.

### Amount of Federal Spending

To restrain federal spending or meet other policy objectives, lawmakers could choose to reduce funding for intergovernmental grants. Many federal grants to state and local governments foster investment in both human capital (education and other activities that enhance people's well-being and productivity) and physical capital (buildings and other infrastructure). Less federal funding for those grants would probably reduce such investments. In particular, the greater the national, as opposed to local, benefits of grant-funded activities, the less likely state and local governments would be to replace the lost federal funding, and thus the greater the net decrease in those investments. Reductions in funding for grants that redistribute resources across jurisdictions could lead to more persistent inequities among communities or individuals because redistribution is a more difficult task for state and local governments than for the federal government. State and local governments could also find it difficult

to compensate for lower funding levels during periods of economic weakness for grants that serve as automatic stabilizers. Even if a state's laws permit borrowing for the purpose at hand, it is likely to be at a higher cost than the federal government would face. More generally, the less that state and local governments share the policy priorities of the federal government, the less they would tend to increase their spending to offset reductions in federal grant spending, especially if there had been extensive federal control over spending those funds. When more of their own funds were at stake, however, states and local governments might implement programs more efficiently.

Conversely, lawmakers could choose to increase funding for federal grants. An increase in federal spending on grant-funded programs would probably not translate into a one-to-one increase in overall spending by all levels of government for such programs. If the benefits of certain grant-funded activities accrued more to the nation at large and less to a given locality, or if state and local governments did not share the policy priorities of the federal government, state and local governments would be more likely to attempt to reduce their own spending on such activities and rely more heavily on the increased federal funding. Such reductions in state and local spending could potentially be mitigated by changes in federal control or by the addition or expansion of matching or MOE requirements. If state and local governments succeeded in reducing the amount of their own funds at stake, they might implement grant-funded programs less efficiently.

### Extent of Federal Control

Lawmakers could choose to reduce federal control over funded activities in various ways—for example, by transforming more funding into block grants, removing some of the conditions on spending federal funds, or relaxing matching or MOE requirements. Those changes would have different effects depending on the program involved. In general, however, less federal control would produce efficiency gains to the extent that state and local governments had more information about the expected benefits and costs of projects than the federal government. Less federal control would also facilitate experimentation at the state and local level. If such experimentation was effective, other states and local governments could learn from the results and perhaps adopt similar approaches. Moreover, if people choose to live in a state or locality because of the programs offered,

32. For an overview of these financing mechanisms, see National Health Policy Forum, *The Basics: Medicaid Financing* (February 13, 2013), [www.nhpf.org/library/the-basics/Basics\\_MedicaidFinancing\\_02-13-13.pdf](http://www.nhpf.org/library/the-basics/Basics_MedicaidFinancing_02-13-13.pdf).

33. Department of Education, *Non-Regulatory Guidance—Title I Fiscal Issues*, Revised (February 2008), [www2.ed.gov/programs/titleiparta/fiscalguid.pdf](http://www2.ed.gov/programs/titleiparta/fiscalguid.pdf).

permitting their state and local governments more control over the design of programs could allow for more differentiation between programs that would encourage people to “vote with their feet” and live in states that offer the combination of programs that best suits their circumstances and preferences. At the same time, less federal control would make it easier for states and local governments to adopt practices that do not closely match federal policymakers’ goals. Such reductions in control would tend to decrease net spending on activities with national benefits, as states and local governments shifted funds to activities with more local benefits.

Lawmakers could also choose to increase federal control. The greater the information advantage that states and

localities have, the larger the potential loss in efficiency due to more federal control. Reducing jurisdictions’ control over program design, and thereby limiting their ability to differentiate their programs from those of other states and localities, would also limit the potential to learn from policy experimentation and would make it more difficult for people to find the combination of programs that best suits their circumstances and preferences. At the same time, more federal control would tend to increase net spending on activities favored by federal policymakers and would align programs more closely with their aims. Such increases in federal control would also tend to increase net spending on activities with national benefits.

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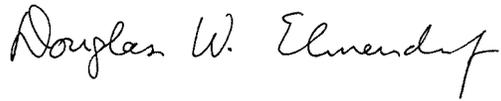
## About This Document

**T**his Congressional Budget Office (CBO) study was prepared at the request of the Chairman of the House Budget Committee. In keeping with CBO's mandate to provide objective, impartial analysis, the report makes no recommendations.

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Douglas W. Elmendorf  
Director

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