

The New Palgrave Dictionary of Economics Online

intergovernmental grants

Nora E. Gordon

From The New Palgrave Dictionary of Economics, Second Edition, 2008

Edited by Steven N. Durlauf and Lawrence E. Blume

Abstract

Intergovernmental grants are payments from one level of government to another, such as from the federal government to a state government, or from a city to a school district. Theoretically, such grants allow more local choice in public goods provision than purely centralized provision would, while still enabling some redistribution across local jurisdictions. Empirical research on these grants has focused on the extent to which these grants ultimately affect spending by receiving jurisdictions, both on the intended programme area and overall, and on other unintended consequences of the grants.

Keywords

block grants; bureaucratic capture; crowding out; fiscal federalism; flypaper effect; intergovernmental grants; interjurisdictional spillovers; matching grants; public spending; targeted public spending; Tiebout hypothesis

Article

Intergovernmental grants are payments from one level of government to another, such as from the federal government to a state government, or from a city to a school district.

Intergovernmental grants are widely used in the United States across a range of policy functions and are an important tool for redistribution in a federalist context. Under the Tiebout hypothesis, providing public goods locally rather than centrally improves match quality between individual preferences and local provision levels and generates competition in efficiency of public goods provision across communities, limiting bureaucratic capture. In a purely local system, however, any spillovers to public spending across local jurisdictions generate inefficient levels of public spending, and the ability to redistribute is limited to within local borders. Intergovernmental grants provide a mechanism to retain some benefits of local provision, while allowing for more optimal levels of public spending in the presence of interjurisdictional spillovers and increasing the capacity for redistribution.

The economic literature on intergovernmental grants investigates both their fiscal and their non-fiscal effects. Research on the fiscal impact of intergovernmental grants focuses on the extent to which they supplement local revenue formerly dedicated to the programme area, rather than supplanting it. Because intergovernmental grants are used in such a variety of policy functions, they have the capacity – especially if they do not crowd out local revenue – to affect a wide range of non-fiscal outcomes. Before discussing the research on the effects of intergovernmental grants, I briefly discuss the main types of intergovernmental grant structures.

Block grants and matching grants

The most important distinction between block grants and matching grants is that matching grants change the relative prices facing the receiving jurisdiction, making the publicly provided good or service in question relatively cheaper, while block grants provide income but do not change prices. Both types of grant typically are directed to particular agencies or programmes.

Block grants transfer funds from one jurisdiction to another, and are theoretically equivalent to the receiving jurisdiction facing a positive income shock from any source. A conditional block grant requires that the receiving jurisdiction spend at least the grant amount on the governmental activity targeted by the grantor jurisdiction. The extent to which the condition is binding depends on the preferences of the receiving jurisdiction. Despite this constraint, the fungibility of grant income makes it difficult to force receiving jurisdictions to increase spending by the full grant amount. Grantor jurisdictions often attempt to address this issue through ‘maintenance of effort’ requirements, by which receiving jurisdictions are required to continue funding the programme to which the grant is dedicated at some set percentage of previous years’ levels in order to receive the grant. When a grantor jurisdiction offers matching grants, it sets a rate at which it will match contributions from the grantee jurisdiction. These rates may vary depending on the level of contributions. Matching grants differ from block grants in fundamentally changing incentives for spending on education by making education spending ‘cheaper’ than other spending.

Data on intergovernmental grants in the United States

The Census of Governments, conducted every five years in years ending in 2 and 7, collects data from states, counties, cities and other municipalities, independent schools districts, and special districts on all revenues and expenditures, including intergovernmental grants. For intergovernmental grants, the Census of Governments details the source of revenue or destination of payments (federal, state, or local) and the policy function to which it is dedicated (for example, health, education, or fire).

Evidence of fiscal impacts: the flypaper effect

Economic theory predicts that a jurisdiction receiving an intergovernmental lump-sum grant targeted to a particular function of government will view the grant as income and spend it as such, with a fraction going to the targeted function, and the remainder going to other projects or to private consumption through reductions in tax rates. Many empirical studies, however, have observed that the marginal propensity to spend an intergovernmental grant on public expenditures is higher than the marginal propensity to spend other income on public expenditures. Arthur Okun called this phenomenon the flypaper effect, because the money ‘sticks where it hits’ (see Gramlich, 1977). There are three main categories of explanation for these observed effects: (a) they are real and reflect the preferences of bureaucrats but not of voters; (b) they are real and reflect

voters' preferences, but voter preferences may reflect some behavioural anomalies, such as loss aversion and lack of fungibility; (c) they are not real, but are generated by econometric misspecification. Hines and Thaler (1995) describe more specific cases within these categories in detail. Given the current and historical prevalence of such grants, whether they ultimately supplement, or 'stick to', local spending is, unsurprisingly, the subject of a lengthy empirical literature, of which Hines and Thaler provide an excellent review. Studies included typically find that intergovernmental grants increase expenditures on the targeted programme by 25 to 100 per cent of the grant amount, with most estimates clustered at the high end of the range. This is much more than the receiving government's estimated propensity to spend on public programmes out of regular income (here Hines and Thaler estimate that only five to ten per cent of new non-grant income would be spent on public programmes), corresponding to a strong flypaper effect. One of the most convincing studies in their review is that of Ladd (1992), which shows that plausibly exogenous increases in state tax bases (stemming from the fact that some states link their tax base definition to the federal one, and exploiting changes in the federal income tax base following the Tax Reform Act of 1986) generate increases of about 40 per cent in state revenue. Many other studies simply correlate intergovernmental grants with spending, often in a cross-sectional context, without regard to potential bias from the fact that the same factors which make some jurisdictions receive more intergovernmental payments in a particular policy area may also make them have higher demand for public spending in that area.

Several recent additions to this literature have focused more explicitly on isolating exogenous variation in grant levels, and in doing so have yielded much less 'sticky' results. Knight (2002) accounts for political endogeneity in the amount of federal highway aid received by states by exploiting variation in legislative bargaining power due to seniority of state representatives in the US House. His technique reveals significant crowd-out of states' own support of their highway programmes.

A number of recent papers focus on the heterogeneity of flypaper effects. Gordon (2004) shows that governments receiving intergovernmental grants may need time to adjust other revenue sources in response. Federal Title I grants to school districts for compensatory education, based largely on child poverty counts, appeared to stick completely to school spending in the first year following a shock to grant amount after the release of new census poverty data. Three years after the shock, however, there appears to be no effect on spending. Baicker and Staiger (2005) highlight the importance of institutional factors in determining how much receiving jurisdictions are capable of crowding out. In examining state responses to federal Medicaid Disproportionate Share Hospital (DSH) grants, they find that states which allow different levels of government to transfer funds directly between one another crowded out about half the federal grants. In states without this institutional capacity, the DSH funds were much stickier. Strumpf (1998) shows that the share of local spending on administrative overhead (a proxy for bureaucratic power) predicts the extent to which intergovernmental payments stick to local budgets, supporting a bureaucratic capture explanation of the flypaper effect.

Evidence of non-fiscal impacts

Intergovernmental grants have a wide range of effects, intended and unintended, on non-fiscal outcomes. The intended effects of intergovernmental grants may be due to the productive use of the grant. For example, Baicker and Staiger (2005) go on to show that federal DSH grants have significant impacts on mortality, despite the substantial crowd-out observed. Their findings suggest that the effects on mortality are due to the sticky part of the grant, which improves quality of hospital care. More often, studies evaluate the effect of the total intergovernmental grant amount rather than the effective or sticky grant amount on the outcome targeted by the grant. Such studies may conclude that public spending in that area is not effective, when in fact other revenue was crowded out so that total public spending in that area did not rise.

Jurisdictions making intergovernmental grants may do so to create incentives for the receiving governments that differ from simply spending the payment as designated. For example, Title I of the Elementary and Secondary Education Act of 1965 strengthened incentives for school districts to desegregate in compliance with the Civil Rights Act of 1964, and school districts responded accordingly (Cascio et al., 2005), though Title I funded compensatory education activities rather than desegregation-related costs. The current incarnation of this programme, the No Child Left Behind Act of 2001, similarly uses the threat of losing compensatory education funds as an incentive for schools to meet criteria for academic achievement growth benchmarks.

Finally, intergovernmental grants may create incentives that generate consequences unintended by the granting jurisdiction. For example, Cullen (2003) attributes 40 per cent of the significant rise in the special education classification of Texas public (government) school students from 1991 to 1996 to increased payments from the state to districts on a per-classified-student basis.

See Also

- fiscal federalism
- Tiebout hypothesis

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How to cite this article

Gordon, Nora E. "intergovernmental grants." The New Palgrave Dictionary of Economics. Second Edition. Eds. Steven N. Durlauf and Lawrence E. Blume. Palgrave Macmillan, 2008. The New Palgrave Dictionary of Economics Online. Palgrave Macmillan. 20 July 2008
<http://www.dictionaryofeconomics.com/article?id=pde2008_I000295> doi:10.1057/9780230226203.0822