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FISCAL FEDERALISM: PROGRAM BUDGETING AND THE MULTILEVEL GOVERNMENTAL SETTING

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The purpose of this article is to determine what theoretical and policy conclusions are consistent with the orthodox theory of social and merit wants,¹ the treatment of distribution as a component of efficiency,² and a Planning-Programming-Budgeting System when they are placed in a federalist setting with states' rights and local autonomy. The conclusion is that neither matching nor equalization grants should be used in inter-governmental fiscal relations and that use of traditional intergovernmental fiscal devices will not assure success of a programmed budget.

THE ECONOMIC EFFECT ON THE ALLOCATION BUDGET CAUSED BY HORIZONTAL AND VERTICAL SPLITTING IN POLITICAL FEDERALISM

In this section the effect of political federalism on fiscal matters will be approached in two ways. The first model will have no spatial spill-outs or spill-ins of cost or benefits and will have a desirable distribution of income. The other model will relax the stringent assumptions of the first and analyze spill-outs through indifference analysis.

Model without Benefit Spills

The first model is of country A with initial assumptions as follows:

1. There are two levels of government—the central authority *A* and subsidiary (sub) units *W*, *X*, *Y*, and *Z*.
2. There are two types of social goods—*M*, which benefits everyone in *A* equally, and *N*, which benefits everyone equally in the sub in which it is provided (uniform benefits). Thus there are no benefit spills.
3. Social goods are tax-financed with no debt creation.
4. Full employment prevails.
5. There are no cost spills from sub to sub. Thus there is no tax shifting to citizens of other subs.

¹Richard A. Musgrave, *The Theory of Public Finance* (New York: McGraw-Hill, 1959).

²Burton A. Weisbrod, "Income Redistribution Effects and Benefit-Cost Analysis," in Samuel B. Chase, ed., *Problems in Public Expenditure Analysis* (Washington, D.C.: The Brookings Institution, 1968).

6. All incomes are equal, and the tastes regarding income distribution are such that the citizens of *A* wish to leave it equal.

7. All benefits and costs can be measured.

The central government *A* will provide *M* and the subs will provide *N* to suit the tastes of their own citizens. To satisfy the benefit principle, all citizens of *A* will pay equal taxes to *A* because they share *M* equally (not because their incomes are equal). All citizens within each sub will pay equal taxes to that sub, although the amount may be different from sub to sub due to differences in taste. Of course, *A* will provide *M* up to the point that the marginal social cost of *M* is equal to the marginal social benefits of *M*, and *W*, *X*, *Y*, and *Z* will determine their level of *N* in a similar manner.

In deciding upon an *M*, central government *A* will need to define what kind of *M* is desired (for example, not all education is alike) and what level of service is to be provided, and will design a plan to take account of the technical difficulties involved. That is, a well-defined programmatic approach to achieve a well-defined goal is appropriate. Programmatic funds may or may not pass through sub offices. That will be determined by administrative ease, but administrative ease is not our interest here. Now if all are to benefit equally, there must be no discrimination among areas by providing different service levels.

Having equal service levels does not mean equal expenditures in all sub units nor does it mean that expenditures will vary in any given manner with income. Expenditures must be varied to allow for technical variations. Such variations include everything from soil chemistry to ethnic groups and the vestiges of history—everything that will affect cost in providing the desired level of performance. Assume *A* is to provide an integrated transportation system and a venereal disease prevention program. Unless there is a definite correlation between the hardness of rock for road beds and income or between venereal disease susceptibility and income, expenditures should not be tied to income levels.

If *M* is provided to the point that social costs equal social benefits, there is no reason for voluntary matching grants and/or unconditional grants to provide a programmatic service. In the first place, the government of *A* wants a certain level of social good *M* provided, but unless the citizens' wants of *A* are not to be frustrated by *Z*, then the power structure of *Z* should not be allowed voluntarily to reject the program by rejecting the funds or by accepting the funds but using them for other than the intended program. Second, the citizens of *A* should not be forced to share the costs beyond program needs that a sub area decides to add for local enjoyment, such as a lavish gymnasium, simply because *Z* will get matching funds for

all "educational" expenditures. Third, matching funds may induce a misallocation of local resources by bribing local governments to withdraw funds from local wants.

Now let us change the second assumption and assume that a social good is such that part of the benefits will accrue to the people of *A* and part of the benefits to those of the sub only (uniform benefits in each). Now if only *A* provides the social good to the point that the marginal social cost is equal to the marginal social benefit, there will be an underallocation of resources unless the local government also provides the same social good to the point that its marginal social cost equals its marginal social benefit. That is, the citizens of the sub may discover that they want a level of the social good beyond that provided by central *A*.

An example is education. The central government may provide a given level to all subs, and some subs may want additional education to capture additional local benefits. Now, once *A*'s level of education has been established, there is no reason that the sub cannot have its own program to provide still more. From the standpoint of efficiency, there is no reason to reward or punish those who provide more education than the central level. Nor should financial punishment and reward be meted out by *A* according to the tax effort of the sub unit's program. It is not the place of the higher level to make judgments about purely local wants. The higher level has its responsibility to provide a given level of service. If *A* wants a higher level of service, then its program should provide that higher level. If *A*'s program is intended to provide four years of a specific type of education to each child, then *Z* cannot use *A*'s funds to give twelve years of education to a few and none to others. Therefore the total educational program may be different in each sub, but in all subs *A*'s program is guaranteed.

Let us assume that sub *Z* decides not to cooperate with central *A* in administering *A*'s program of insuring a given level of services in all cities. There is no reason from the standpoint of efficiency that *A* cannot go directly to city *P* to administer the program if *P* is willing to cooperate. It is an administrative question, not a question of who should provide how much of the service. The latter question has already been answered. The decision has been made by the higher level *A* to provide the service. Since *Z* will not cooperate, the question is whether *A* should set up its own administrative facilities or share *P*'s.

Model with Benefit Spills

Thus far it is evident that there is no reason for matching and equalization grants from one level of government to another. We have not thus

far considered, however, the most important aspect of intergovernmental fiscal relations, the aspect usually used to rationalize matching grants—namely benefit and cost spill-outs and spill-ins. A case of a benefit spill-out, for instance, is one in which part of the benefits that are provided by one sub unit accrue to individuals across a political boundary in another sub unit. In a system where vertical and horizontal splitting of authority exists, spills occur across political boundaries into areas over which the providing government has no jurisdiction. In order to show the effect of benefit spill-outs on resource allocation, let us assume that each sub decides how much education it will provide and that part of the benefits of that education will become spill-outs to another sub; and, in a similar manner, the other sub will contribute spill-ins to the former sub.

Let us assume that without the phenomena of spill-outs or spill-ins, school district X would be faced with a transformation curve AB (Figure 1) between education on the vertical axis and a composite of all other goods on the horizontal axis. Likewise Y is faced with transformation curve $A'B'$ (Figure 2). Figures 1 and 2 indicate that Y is a less wealthy district than X but that they both have the same technical possibilities. Equilibrium for X is at a and for Y it is at a' . The optimum allocation of resources to education, if the distribution is assumed desirable, is the provision of ob education in X and ob' in Y .

Now let us consider the fact that benefits from education spill out to other areas for the following reasons:

1. Migration of students to other areas transports the production-creating capacity, the taxation capacity, the lower unemployment rates, and the lower social welfare costs.

2. Advances in technology and improvements in skills from education increase productivity and decrease costs. The decreased costs enhance the income of people in other areas through the national market.

3. The option value of education provides the opportunity to obtain still further education, the opportunity to have broader employment choices, and the opportunity to hedge against the vicissitudes of technological change. The whole society benefits from this inventory of options.

4. Education helps to provide an informed, literate electorate in national, state, and local elections.

In introducing external benefit spill-outs into our school districts, X and Y , we will assume that the benefit spill-outs are the same proportion of the total benefits at all levels of educational output. We will also assume the Myrdal "backwash" effect in that the poor school district will lose a greater percentage of its total educational benefits. These two assumptions

Figure 1
District X

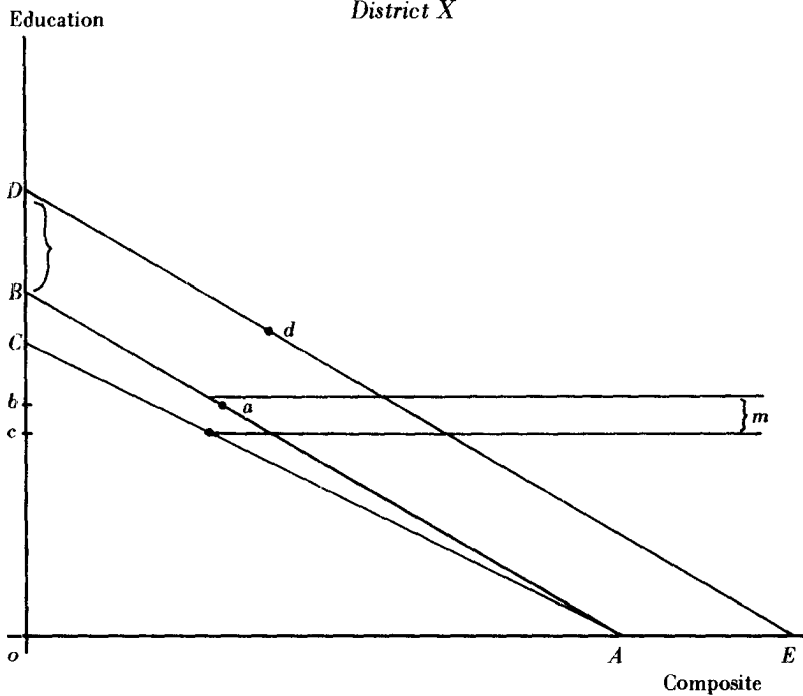
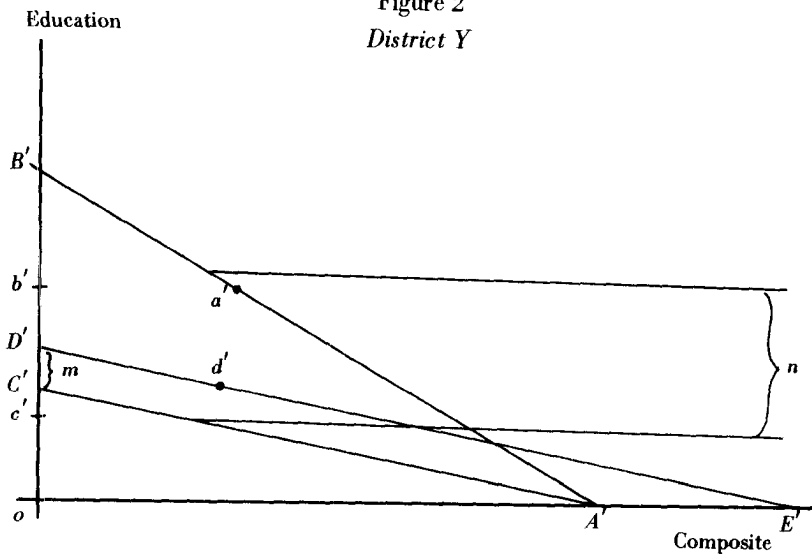


Figure 2
District Y



will shift the two transformation curves to AC and $A'C'$ in X and Y , and move the equilibrium to oc and oc' of education.

Education has become more expensive relative to the composite because a proportion of each dollar spent on education will become a spill-out to other districts. It is this technical nature of the benefit that changes the relative cost of the two goods. Due to this change in the cost of education, Weisbrod says that in making its decision each district will disregard both spill-ins to itself and the value of the benefits going to others:

While spill-outs of benefits tend to diminish expenditures from their optimal level, spill-ins may not bring opposite results. . . . To the extent that they are, the spill-ins constitute fixed benefits; as such they will have no influence on decisions at the margin. . . .³

Therefore there will be a total underallocation of resources to education. The composite good will be substituted for education.

Alan Williams⁴ objects to the fact that only the substitution effect is considered in Weisbrod's analysis and insists that the additional income created by benefit spill-ins must also be considered. According to his line of reasoning, in our model the benefit spill-in would cause the budget restraints, AC and $A'C'$, to make a parallel shift to ED and $E'D'$. The shift to ED for X will be equal to spill-out N from Y and the shift to $E'D'$ for Y will be equal to the spill-out M from X . Note though, that at the new equilibrium, the total of od and od' education is greater than the original total of ob and ob' .

After benefit spill-outs and spill-ins have been considered there is a total overallocation of resources to education if the original distribution of resources is considered the correct distribution. There is less education (underallocation) in the poor district but more education (overallocation) in the rich district because of the resources it has received from the poor district and because of its tastes. This is similar to the shift of educated people from the central city (X) to the suburbs (Y) where the suburb is given a greater tax base and therefore better schools. Even if the two districts had equal spill-outs, equal spill-ins, and the same tastes, the original equilibrium would not be reached because of the different effect caused by spill-outs and spill-ins, the spill-out being a substitution effect and the spill-in being an income effect.

³Burton A. Weisbrod, *External Benefits of Public Education: An Economic Analysis* (Princeton, N.J.: Princeton University Industrial Relations Center, 1964), p. 6.

⁴Alan Williams, "The Optimal Provision of Public Goods in a System of Local Government," *Journal of Political Economy* LXXIV (February, 1966).

Because of the redistribution of income, Williams termed this situation an overallocation of resources to education. Brainard and Dolbear, however, say that “. . . one should not stipulate a distribution of income, derive optimum amounts for the various commodities, and then compare these amounts with the amounts that would prevail under a different distribution of income.”⁵ Unless the original distribution is considered more desirable, the distribution after spills cannot be considered a misallocation. The general proposition that Samuelson and Musgrave have stressed numerous times is that the optimum allocation can be determined only after deciding upon an optimum distribution. Regardless of what distribution benchmark is used as the correct distribution, however, two conclusions remain. First, the substitution effect will cause fewer resources to be devoted to education than if benefit spills did not exist. Second, unequal spills among districts treat some districts more favorably than other districts.

Evidently Break thinks that the original (before spills are introduced) distribution and equilibrium is always the correct benchmark because he justifies matching grants on the basis of recapturing the escaped benefits. He says:

Intergovernmental grants designed to minimize the distorting effect of benefit spillouts on the level of state and local spending should . . . be matching grants with both the grantor and the grantee sharing in the cost of the supported programs Such a situation calls for variable matching grants⁶

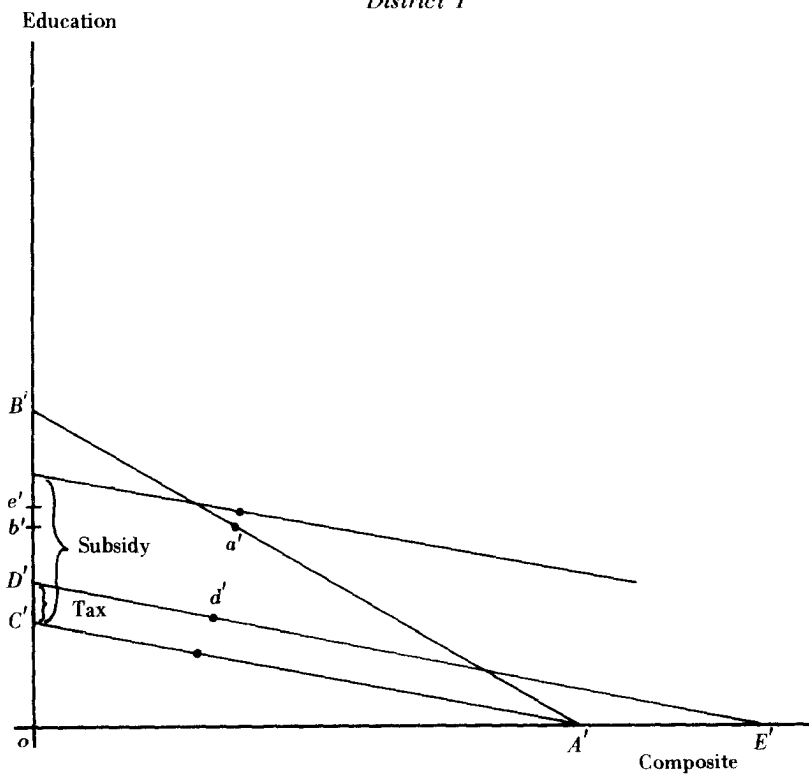
Therefore each lower level of government will be given a matching subsidy equal to its spill-outs, and since subsidies must be acquired from some source, they will all be taxed equal to their spill-ins. This means that poverty-stricken districts, which are distorting optimality by having more spill-ins than spill-outs, will be taxed more heavily and receive less subsidy than rich districts. Of course, this analysis is only an excuse used by advocates of matching grants. It is incorrect in principle, impractical for policy, and unacceptable in terms of equity.

We can see from Figure 3 that the analysis is incorrect in principle. Figure 3 is the same as Figure 2 after accounting for benefit spills and arriving at the equilibrium allocation of resources to education of $E'D'$.

⁵William C. Brainard and F. Trenery Dolbear, “The Possibility of Oversupply of Local ‘Public’ Goods: A Critical Note,” *Journal of Political Economy* LXXV (February, 1967), p. 87.

⁶George F. Break, *Intergovernmental Fiscal Relations in the United States* (Washington, D.C.: The Brookings Institution, 1967), p. 77.

Figure 3
District Y



Now if we give a subsidy to district Y equal to spill-outs n and tax equal to spill-ins m , we see that the new equilibrium is not the original benchmark ob' but a different amount, oe' . So district Y will end up, after subsidies and taxes, producing oe' of education and using part of the subsidy for increased production of the composite good.

Proposing the use of matching grants in order to minimize the distorting effect is also impractical for numerous reasons. These reasons will be discussed in the following section.

THE PROGRAMMATIC APPROACH AND SPECIFIC ISSUES

An approach more consistent with current thought than the use of traditional grant devices in providing a desired areawide goal is for the more central government to provide the service that is wanted. The significant benefit spills created by some government endeavors make it imperative that a higher level of government assume responsibilities for that endeavor. Therefore the policy which stresses "local responsibility" in the financing of education is an irrational one if economic efficiency is considered important. This does not mean, however, that the local district should not be allowed to finance the level it wishes to finance, given the local district's assessment of costs and benefits. The level of government that should provide a function depends on how wide an area is encompassed by the benefits from the function. At all three levels of government education provides direct benefits that do not spill over to other governmental units.

The programmatic approach, as its name implies, is an approach in which a specific program or plan is formulated and priced to obtain a governmental good or service. The program is formulated in order to take account of peculiarities that arise in different areas. The programmatic approach requires that the governmental unit responsible for a social or merit good be responsible for designing a budgetary plan for mobilizing the necessary resources to provide that social or merit good.

The traditional approach has been more concerned with matters such as total expenditures, financial matching devices, equalization grants, fiscal capacity, and fiscal effort than with formulating and pricing programs. The argument here is that these matters are not important to providing a given level of a given kind of program; therefore they are not legitimate determinants of expenditures. Each level of government has its own responsibility and therefore should not allow its program to frustrate the fulfillment of that responsibility through fiscal devices such as those listed. The most nonprogrammatic expenditure is the unconditional grant which requires no specific action on the part of the recipient. There is a wide

variety of approaches falling between the purely programmatic and the unconditional.

The object in adopting the programmatic approach as a design for expenditure policy is neither that of measuring present or future demand nor the impossible task of making an a priori determination of what the demand "ought" to be. Numerous correlations and regressions have been completed to discover the determinants of demand. Such indexes are helpful in making expenditure predictions, but they are not an index of how much ought to be spent because attitudes and preferences vary among political units in spite of similar "determinants." The purpose here is to adopt an institutional arrangement which will allow for the full expression of demand, whatever the demand may be, and to allow for changes in demand.

What Level for What Program?

In the approach suggested here each level of government would be allowed to decide what programmatic goals it wishes to pursue. No program would be excluded from any level. The idea has only partial acceptance in the literature. For instance, Roger Freeman says:

If the federal government feels it ought to determine what should be done in a particular public service, let it take over the whole service rather than have the local or state officials become mere agents of the central government.⁷

On the one hand, Freeman is theoretically correct in his perception that there are services the Federal government ought to provide. In addition, he indicates that state and local governments have prerogatives of their own and should not just be agents of the Federal government. Yet he denies the latter when he says, "... let it [Federal] take over the whole service. . . ." He is overlooking the possibility that the state or local area may want to capture additional local benefits by adding still more expenditures to the same service, and overlooking also the possibility of cooperation among Federal, state, and local levels in order for each to carry out its own program with the least administrative cost.

Other authors also advocate that programs for distribution, growth, and stabilization should be limited only to the central government. Brazer expresses this idea when he says:

. . . we recognize that government at the city level cannot really hope to operate effectively or importantly in

⁷Roger A. Freeman, "Federal Grants and the Decline of the Federal System," *Proceedings of the Fifty-eighth Annual Conference on Taxation of the National Tax Association* (November, 1965), p. 149.

what Professor Musgrave has called the "stabilization" and "distribution" branches of the public economy. . . .⁸

Hirsch says, "The Federal government . . . by a broad consensus has been assigned the income redistributing function . . ."⁹ Two pages later, however, he contradicts himself by saying that public welfare services can be effectively provided by the local urban government, and on his table of service spillovers he claims that no benefit spillovers can be expected from public welfare services. Therefore local governments do have an interest in these redistribution programs. If the central level sets a minimum standard of income for everyone, there is no reason for preventing local areas from raising that standard to their own satisfaction.

Individual Freedom

There is also a noneconomic argument often given for limiting the provision of specified government programs to a given level of government. Some try to exclude certain types of fiscal activity in a federalist system simply on the basis that local autonomy is coterminous with individual freedoms. An example is Freeman, who has said:

. . . the spectacular expansion of federal grants to state and local units is leading to a centralization of governmental power at the expense of home rule, local autonomy, and individual freedom.¹⁰

Another example is Weisbrod, who says:

Individualism has long been a vital part of the American culture. One of its manifestations has been the strong tradition of local control over the system of public education.¹¹

When one remembers that India, Pakistan, the Soviet Union, the Congo, Switzerland, Ethiopia, and Brazil are all federalist states, it becomes somewhat difficult to fit federalism into any rigid political, social, or economic system. In some cases local autonomy may protect individual freedoms, yet we are aware that in other cases it protects only local power structures and institutions that are anathema to individual freedoms.

⁸Harvey Brazer, "The Role of Major Metropolitan Centers in State and Local Finances," *Papers and Proceedings of the Seventieth Annual Meeting, American Economic Review* XLVII (May, 1958), p. 312.

⁹Werner Z. Hirsch, "Local Versus Areawide Urban Government Services," *National Tax Journal* XVII (December, 1964), p. 336.

¹⁰Freeman, *op. cit.*, p. 135.

¹¹Weisbrod, *Public Education, op. cit.*, p. 10.

Obsolescence and Feedback

With a programmatic approach there is a much better chance of noticing obsolescences of techniques, of analyzing effectiveness, of obtaining feedback information, and of making future fiscal predictions. Presently many programs are never analyzed to determine whether they achieve even the indefinite goal for which they were intended. Instead, only a few guideposts are indicated at the beginning—guideposts that later become vaguely defined requirements which must be met by the grantees in order to qualify for the grant. Drew says:

Those who picture Washington as one mass of files and computers containing more information than they would like will be comforted by the experiences of program-planners in attempting to evaluate on-going programs. Whatever the files and computers do contain, there is precious little in them about how many and whom the programs are reaching, and whether they are doing what they are supposed to do. If the purpose of an adult basic education program is to teach people how to read and write, the Office of Education might reasonably be expected to know how many people thereby actually learned how to read and write, but it does not The Public Health Service might be expected to know whether its various health services are in fact making people healthier, but it does not Those working on the income maintenance study found that the Welfare Administration could not tell them very much about the public assistance caseload—who was on welfare, where did they come from, why were they on it, what they needed in order to get off.¹²

Due to the dichotomy of responsibility, feedback information is seldom brought together for analysis. Without this analysis, prediction for future needs cannot be made.

Matching Grants and Local Choice

The programmatic approach does not require higher level governments to make value judgments for lower level governments. When a central government requires a sub unit to pay a certain percentage of a program, it is making judgments about a satisfaction received by the sub unit, and the decision is made without the participation of the sub. As stated above, Break favors this, but his own work can be used as support for the idea that matching grants should not be used. He says:

¹²Elizabeth B. Drew, "HEW Grapples with PPBS," *The Public Interest*, No. 8 (Summer, 1967), p. 11.

In principle, the grantor's share of program costs should equal the ratio of external benefits to total benefits, but in practice problems of measurement compel the use of only a rough approximation of the idea. Nevertheless, some reasonable distinctions between programs, and between states under a given program should be possible. The spillout of benefits from state and local educational programs, for example, is *presumably* greater for low-income than for high-income areas, since the former typically have the higher rates of out-migration. Such a situation calls for variable matching grants, the grantor government paying a higher share of program costs in the lower-income states and localities.¹³

Thus Break indicates that the grantor will impose value judgments on the grantee in the case of education on the basis of *presumptions* about the *typical* grantee. Not only are benefits difficult to measure, but Break admits that they vary. To him such a situation calls for a variable matching grant. This sounds like an administrative impossibility. Since benefits are difficult to measure and since they vary from local district to local district, the more defensible policy is for *each* level of government to provide its own expenditures without fiscal coercion by another level and without making value judgments for another level. In this way the participants of all levels can express their demands in relation to their self-assessed benefits.

Additional support from Break which indicates that matching grants should not be used is that matching grants do not guarantee that the function will be performed. He says:

Consider . . . a state spending program that generates external benefits whose importance is indeterminate within a wide range, say between 10 percent and 40 percent of total social and private benefits. . . . [Grants] covering 10 percent of total cost, would expand that program and move its operation to the levels justified by its total benefit-cost ratio. To stop federal aid at the point, however, would not guarantee optimal results. Even if external benefits were only 10 percent of total benefits, some states might be unable to finance their own 90 percent shares, and if external benefits were more important than that even states with ample funds would lack incentives to give the program as much support as it should have.¹⁴

¹³Break, *op. cit.*, p. 77. (Italics added.)

¹⁴*Ibid.*, p. 153.

Even if the correct appraisal is made of the internal benefits, Break admits that some grantees may wish to devote their scarce resources elsewhere. He says that the grantee will also wish to devote its resources elsewhere if the initial benefits have been overestimated. In both cases the desired program would not be provided. The wider area unit should not let absence of a matching device frustrate its purpose.

The argument for imposing value judgments is usually not economic efficiency. Usually it is the more honest one of stimulation. The stimulative argument is that sub units will feel they are getting a "free ride" and this will stimulate them to provide the necessary matching funds. Selma Mushkin suggests that *all* matching grants be put on the same percentage basis,¹⁵ which does not indicate that efficiency is the consideration. The consideration is to coerce sub units into a desired action.

The case against matching grants becomes even more compelling when one moves from principle to designing pragmatic policy. From the viewpoint of principle, the local district favors local choice in determining expenditures. From the viewpoint of policy, allowing each level to express its own demand does away with the impossible task of determining the multitude of matching percentages to coincide with benefits, and does away with the possibility that the social good will not be provided.

Subsidiary Equilibrium

Local equilibrium is established by local districts allocating their resources according to their needs. The programmatic approach does not upset this equilibrium; the matching approach does. Brazer explains that in Detroit matching funds must be used for highways instead of for severely needed mass transit facilities.¹⁶ Break comments on this same problem in the following way:

Among grant programs, the Interstate Highway System is distinguished by the high proportion of costs financed by the federal government (90-95 percent) and by the fact that these costs are met from earmarked taxes on motor fuels, tires and tubes, and other products purchased by highway users. The program consequently is free of the usual appropriation controls, and since it clearly finances a large share of intrastate highway benefits, it is likely to divert state funds from superior uses.¹⁷

¹⁵Selma Mushkin, "Barriers to a System of Federal Grants-in-Aid," *National Tax Journal* XIII (September, 1960), p. 211.

¹⁶Brazer, *op. cit.*, p. 314.

¹⁷Break, *op. cit.*, p. 96.

A similar criticism has been made of Federal welfare grants. States have taken funds from one welfare program where they were needed and put them into other welfare programs in order to get the greater matching funds. Although the rational action for the lower level may be to devote resources where they will give the greatest benefits, no financially-pressed legislature wants to be accused of turning down the large Federal bribe.

Mushkin notes this misallocation problem and offers a solution:

. . . if the national government offers more dollars per state dollar for public assistance, states may be tempted to divert their funds from public health to public assistance. Financially induced transfers of this type can be avoided in state budgetary decisions by offering the same federal share to a state for each of the aided programs.¹⁸

This solution seems to fail on at least three counts. First, it does not attempt to account for the benefit received since this varies from grantee to grantee. Second, even though the aided share for each program is the same, the total amount going to the programs will differ and sub units which have already indicated that they spend their funds to get the largest Federal grant will continue to do so. Third, we are still left with the problem of comparing the lucrative Federal grant to local programs for which there are no grants. The better solution would be to replace the matching approach with a programmatic one.

Even if a functional matching grant is used it should not be open-ended. Break disagrees, saying that the

. . . fourth and final distinguishing characteristic of optimizing grants is that they should be open- rather than closed-end—that is, the grantor should agree to share whatever program costs the grantee wishes to incur and not to limit its support to some fixed amount each year.¹⁹

If the grantor decides on a given level of expenditures which matches benefits with costs, there is no reason to expect additional external benefits to be forthcoming from expenditures beyond that point. With a closed-end grant, local governments will be more likely to use the grant effectively.

Stimulation and Demonstration

A reason often given for a matching grant is that it will stimulate the lower level to take action on a function. With stimulation, as discussed above, the higher level is making value judgments about what the local

¹⁸Mushkin, *op. cit.*, p. 208.

¹⁹Break, *op. cit.*, p. 78.

level should be doing and what knowledge the local level should have. Spills are not involved except insofar as distribution of information and techniques is the central government's responsibility. Without spills the stimulation must come through demonstration. To demonstrate to the local level means that the project is a local matter and the choice of adoption should be left to the local unit. With the programmatic approach, rejection of the demonstration is not left to the volition of a local government by allowing the local to refuse to match the central matching grant. With the programmatic approach the demonstration is sure to be made, and the local government may accept or reject the idea.

Labovitz's evidence, as presented by Mushkin, seems to indicate that the programmatic approach could be an effective stimulant. She summarizes Labovitz's work on the effectiveness of categorical aid as a stimulus to state action under certain programs:

State and local expenditures for vocational education have increased over the period of operation of the vocational education program faster than federal aid. Similarly, state funds for vocational rehabilitation and for public health have increased more than federal monies. These relative changes are reflected in reduced federal share of cost

Thus to the extent that the grant mechanism is used to pinpoint a national objective and to encourage state and local action in a specific direction, block grants are not a substitute for categorical aids.²⁰

Mushkin also supports specific grants for demonstration purposes. She and Adams say:

In recent years . . . we have had a multiplication of small grant sums authorized as "seed monies" to focus attention on a needed public service through a demonstration of new techniques.

Innovation and experiment as primary devices for improving the efficiency of public services are gaining increased attention.²¹

To Mushkin the block grant proposal ". . . is not consistent . . . with a national objective of directing public services into specific channels."²²

²⁰Mushkin, *op. cit.*, pp. 200, 202, 203.

²¹Selma Mushkin and Robert R. Adams, "Emerging Patterns of Federalism," *National Tax Journal* XIX (September, 1966), p. 235.

²²Mushkin, *op. cit.*, p. 205.

Compliance

Two misconceptions about intergovernmental expenditure approaches which support unconditional block grants are: (1) that the primary purpose of Federal aid is to provide states with financial support to carry out the states' objectives, and (2) that states provide a more efficient and effective use of public funds if they have a wider latitude in directing expenditures. As discussed above, the purpose of central government expenditures is to provide neither of the two.

Is the national interest met simply by providing states with funds for a broad program area? An affirmative answer assumes that the national government has no interest in direction of program content and no more interest in one part of the broader program than in another.

Most Federal aid programs, however, originate in rather specific public needs and . . . categorical aids have become an important instrument by which national action is identified with those interests.²³

The programmatic approach spells out how these public needs will be met.

As has been explained, the central level should not dictate strictly state and local programs, but neither should state or local administrative ineffectiveness and noncompliance frustrate broad-based wants. Due to "home-rule" for education funds, the national and state interest has long been frustrated by denying minority groups access to education.

Formula Terms

In reviewing grant-in-aid formulas, expenditure determinants such as fiscal capacity, population, effort, and regression coefficients are found. These are of a rather dubious nature if the purpose is to provide a governmental function.

The fiscal capacity term is sometimes rationalized by a "fence post" theory of fiscal federalism. Like its political counterpart which denies one-man-one-vote political representation, this theory of fiscal federalism argues that the way to attack individual poverty is through a spatial grant based on fiscal capacity. This rationalization is used even when the grant to the spatial area is for some function's need that is unrelated to income, whether individual or spatial. Income distribution, however, should be pursued on an individual basis. The problem of fiscal federalism " . . . springs from the technical nature of the services and the federal system

²³Mushkin, *op. cit.*, p. 199.

itself rather than from differing economic potentials and the choice of redistributive fiscal systems by subordinate units."²⁴

Break agrees that equalization terms should not be included in functional grants in order to change the fiscal capacity of individuals or governments:

Though they have been increasingly exploited in this country in recent years, the equalization powers of functional federal grants are strictly limited. Basically, the reason is that the grants themselves have a restricted role to play in the federal fiscal system—namely, to raise interpersonal equity and increase economic efficiency by paying for the external benefits generated by the spending programs of state and local governments. Properly used, therefore, functional grants cannot help to equalize the abilities of those governments to support activities of purely local interest. To employ them for that purpose would be to interfere unjustifiably with state and local prerogatives to manage their own fiscal affairs. When equalization is the goal, it is unconditional grants-in-aid that should be the center of attention.²⁵

Another rationalization for income terms in expenditure formulas is that income, usually per capita, is a measure not only of fiscal capacity but of need as well. But as Schaller states, "Clearly need . . . can vary with per capita income."²⁶ Similarly, the same accusation can be made about terms such as population and regression coefficients of past expenditures. A policy to give all the population the ability to read does not make population a measure of expenditure need. Regression coefficients of past expenditures are useful for predicting what kind of social goods people may want, given certain economic and social institutions, but they are not useful for measuring present technical needs. Knowing that the Tullahoma school district in Coffee County, Tennessee has a high correlation between per pupil current education expenditures and per capita true cash value of assessed assets is no contribution toward planning education for the non-English speaking children in Zapata County, Texas. Using regression coefficients may merely help to perpetuate misallocations. The programmatic approach bypasses these dubious terms and concerns itself with the technical measures of need.

²⁴Howard G. Schaller, "Federal Grants in Aid: A Review," *Proceedings of the Fifty-eighth Annual Conference on Taxation of the National Tax Association* (November, 1965), p. 106.

²⁵Break, *op. cit.*, p. 127.

²⁶Schaller, *op. cit.*, p. 101.

Effort is included in some allocation formulas and is measured as the ratio of expenditures to fiscal capacity. When rewarding effort either on an individual program basis or on the basis of all governmental functions, the higher level is interfering with local value judgments. The higher level is bribing the lower to expend more on one program than on another; and on the basis of all governmental functions, the bribing is done to get the area to expend relatively more on social than on private goods. If effort is rewarded, then a wealthy area, where tastes for social goods are stronger than in poorer areas, will receive more than the poorer areas. This is an unacceptable concept of equity.

Intergovernmental Cooperation

As Hirsch²⁷ and Break²⁸ have explained, the overlapping and multiplicity of governmental units is necessary to adjust adequately for spills. Varying service spills indicate that some services, such as libraries, should be handled by local urban governments; other services, such as street maintenance, by metropolitan areas; still others, such as planning, water, and power, by more areawide governmental units. Since the areawide governmental units will overlap other units such as states, counties, and cities, cooperation among these units is necessary. An optimal solution is really impossible unless the multitude of overlapping governmental units do work together. Without cooperation one unit will not know what to expect in the way of spill-ins from the other units, and therefore cannot rationally adjust its own resources to provide the desired level of services.

Intergovernmental cooperation will become even more important in the future. As the population grows and mobility and the demand for public services increase, the spillover problem will become more pronounced and complex. In order to cooperate effectively, the respective units must be able to communicate well-defined programs with estimates about costs and about the direction and extent of benefits. The Advisory Commission on Intergovernmental Relations has expressed the same idea in the following manner:

Cost-benefit analysis designed to provide a basis for cooperative negotiations among jurisdictions has come into rather extensive use recently in conjunction with many Federal programs, especially in regard to water resources, recreation, and highways. This technique may offer helpful guidelines for use by separate jurisdictions in metropolitan areas.

²⁷Hirsch, *op. cit.*, p. 338.

²⁸Break, *op. cit.*, p. 69.

For many metropolitan areas, a single areawide government whose boundaries are coterminous with the scope of a particular service is neither likely nor necessarily appropriate. In many situations it appears more likely that ad hoc or function-by-function arrangements among existing local units will assure that these functions will be performed more efficiently on an areawide basis. Such arrangements will require allocating the costs of services among the independent units on a fair and equitable basis.²⁹

Program Coordination

Just as the technical knowledge contained in the programmatic plan makes intergovernmental cooperation easier, it also makes interprogram coordination easier. Program coordination is necessary if various programs are not to frustrate the objectives of one another. In addition, much administrative cost can be saved by program coordination. The programmatic approach increases the possibility of coordination because each governmental unit knows precisely how much of what specific program is to be accomplished. With matching funds the local level must decide to match the funds before coordination can begin, and each state may match a different set of programs. With unconditional grants, there is no prior knowledge of either which funds will be used or how they will be utilized.

After considering these specific issues in conjunction with theory, it appears that a programmatic approach which excludes matching and equalization grants possesses the greatest promise for efficiency in intergovernmental expenditure policy.

²⁹U.S. Advisory Commission on Intergovernmental Relations, *Metropolitan Social and Economic Disparities: Implications for Intergovernmental Relations in Central Cities and Suburbs*, A25 (Washington, D.C.: U.S. Government Printing Office, 1965), p. 57.