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Grant Impact Analysis: A Reinterpretation

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In the past five years a substantial volume of research has been conducted on how subnational governments have responded to fiscal stress and, in particular, to changes in grant.


Much of this research represents a useful addition to the traditional work on grant impact which has consisted of multivariate, primarily cross-sectional, analyses of the effect of grant change on subnational expenditure. This paper undertakes to explore the utility of the traditional grants analysis approach in the light of the findings of the more recent research cited above.

A. Grants Analysis and Grant Policy

Grants analysis, as traditionally performed, is concerned with the technical question of the expenditure change by a recipient unit of government resulting from the receipt of intergovernmental assistance in various forms (block grant, categorical matching grants, open or closed ended etc.). Grants policy is likely to encompass a broader range of concerns, some of which are not evaluable through grants analysis because they are essentially "value" rather than technical questions, e.g. should state governments have greater discretion over the shape of public expenditure within their boundaries; what is the proper balance between representation of the variations in public preferences among areas through decentralized decision-making and the achievement of national objectives; should the national government be concerned with the subnational geographic distribution of
federal grants and/or with the distribution of benefits among various groups by income class, race, etc.; is the stimulative effects of grants a proper concern of the Federal government?

Grants analysis may, in addition, ask the wrong questions, even from a technical point of view. The real analytic concern should be with the effect of grants of grants on service and benefit levels provided by subnational governments rather than on their expenditures. (Unless the concern is with the affect of grants on aggregate public sector spending - a macroeconomic concern - it is difficult to see why one should be concerned with the affect of grants on recipient spending.) Expenditures are used presumably because they are a proxy for outputs. But employment is likely to be a better proxy for output in service delivery programs as are benefit levels in income transfer programs. Grants analysis would be more informative for grants policy if it focussed on changes brought about by the receipt of grants on these variables rather than on expenditure.

Changes in grants policy are also likely to have redistributive effects - in terms of who benefits from any given level of community expenditure - which are at least as important as changes in aggregate expenditure, employment, or, more directly, level of service provided. These redistributive effects have not been the concern of grants analysis, though they may be vital in terms of an evaluation of grants policy.

Finally, grant analysis purports to provide an accurate picture of the long-term response to changes in grant. Grants policy is likely to be concerned with short and medium term responses. In fact, evidence from the body of recent research suggests that changes in grants - particularly in response to fiscal shocks such as local fiscal pressure or reduction in grant - may be substantially different in the short and medium term than in the
long term. Grants analysis may be concerned with long-term response in normal circumstances; the results of such analysis are quite unlikely to hold in non-normal situations.

B. Grants Analysis and the Impact of Grant Change

The use of cross-sectional techniques in grants analysis as a means of estimating responses to different quantitative changes in grants is particularly unconvincing. It assumes that each subnational government incorporates a similar set of decision-making and behavioural processes in response to intergovernmental assistance, an assumption which the recent case studies – as well as common sense – emphatically suggests is not the case. Time series analysis would be much more appropriate.

Grants analysis, because it has been cross-sectional, has also assumed a symmetrical response: the behaviour of subnational governments in response to grant reduction will simply be the inverse of their behaviour to grant increase. There is good a priori reason to believe this is not likely to be the case and the recent case studies support this. It is much more difficult to eliminate or curtail programs and activities than to bring them into existence. Retrenchment disturbs an existing external constituency (which, in many cases, the program has created) as well as an existing cadre of government employees hired to administer them. Case studies (see Wolman 1981, 1982) suggest that governments would make strenuous efforts to maintain expenditure (or keep reductions to a minimum) in response to grant reductions and that a one dollar grant reduction would result in less of a change in overall expenditure than would one dollar of grant increase.

The recent research suggests a very wide range of variables which might affect expenditure change in response to grant in addition to changes in tax price and household income brought about by grant changes. Many of these are institutional and vary substantially
from one subnational government to another. Their impact overwhelms that of changes in tax price and income and since they are not explicitly incorporated in most of the existing analytical models, makes nonsense of the results. Many of these factors relate to constraints on the ability of subnational governments, particularly in the United States, to increase own source revenues and thus to vary expenditures in response to changes in intergovernmental aid. They include the existence and nature of formal tax limitations which might constrain expenditure increase, the nature of the tax structure (and particularly its elasticity, with respect to growth in income and its buoyancy with respect to inflation), procedural requirements for increasing revenues - e.g. is a referendum required (the existence of a referendum requirement might reduce grant responses), proximity to the next election (tax increases are much less likely the nearer an election approaches), functions for which the unit is responsible, the condition of the local economy, the existing fiscal condition of the government upon which any change in grant is imposed, the fiscal position of intermediate levels of government and their willingness to provide additional aid, the existence and strength of municipal labor unions, etc.

More tellingly, perhaps, the intensive case studies performed during the past few years suggest that the behavioural premises upon which grants analysis is based - the median voter theory - are not remotely related to the actual behaviour of governmental officials (although this, in itself does not necessarily invalidate the analyses - the true test, it might be argued, is their predictive value - it nonetheless indicates caution is called for. Furthermore it means that the models, even if they 'work', can predict, but cannot explain.) The median voter model stipulates that elected politicians will seek to tax and spend at the level preferred by the median voter - i.e. the voter with the median income in the community. This assumption is based on a theorem of public choice developed for very restrictive referendum types of choice situations. The theorem proves that, when voting
alternatives can be arrayed in terms of a single dimension (e.g. level of spending or left-right on a political spectrum) and when all voters have single peaked preferences in this dimension, the winning candidate or position will be the one supported by the voter with the median preference.

The use of the median voter model has been criticized on several grounds (see Wolman, 1982 pp.79-80). First, it is argued that local fiscal decisions do not meet the conditions of the median voter model, since they are rarely determined by referenda and since general elections quite infrequently present voters with choices arrayed along only one dimension. Level of spending may co-exist as an issue with police-community relations, land use policy, public facility location etc. A more general critique argues that the model ignores political variables and naively assumes that 1. the individual with the median preference is necessarily the one with the median income, 2. the utility function of the median voter is known to public officials, 3. the spending decisions of the incumbent administration and the prospective spending decisions of the challengers are known to the voters, 4. voters' choices in local elections - the mechanisms through which the will of the median voter is supposedly imposed on local officials - are concerned wholly or even mostly with community spending levels, and 5. public officials, once elected, have no policy preferences of their own with respect to community spending which they translate into public policy (suggesting that a change of administration or party should make no difference to public spending levels or functional allocations so long as community income or the tax price of public goods has not changed).

The most telling criticisms of these studies, however, is levelled by Bahl et.al. (1980, p.60), who notes

"The most striking feature of the vast determinants literature, and the most damning criticism of its approach, is that it has come to no firm conclusions... The literature is rife with
empirical contradictions: expenditures have been found income-elastic and inelastic...grants in aid have been estimated as both stimulative and substitutive of locally raised revenue. It seems fair to argue that there is not a received positive theory that explains either public expenditure growth for a single jurisdiction or public expenditure differences across jurisdictions"

The case studies also suggest that the necessary conditions linking the budget decision-making process to the preferences of the median voter simply do not exist. In both the US and Britain, the local budgetary process - even under situations of great fiscal stress - occurs in a situation nearly devoid of public input. Nor do decision-makers motivated by a concern over electoral consequences actively attempt to assess what the median voter might prefer. The bureau maximisation model developed by Nisaken and others to explain allocations of total budget changes (usually increments) among departments and bureaus also bears little relation to reality - the decision process we witnessed in our case studies was a highly centralised executive-centered one with bureau chiefs having relatively little input.

C. A Model of local fiscal decision-making

As a result of case studies performed at the Urban Institute, a more convincing model of the decision-making process was developed (Wolman and Peterson, 1981, pp.773-776 also Wolman, 1983, pp.276-278. The model sees decision-makers as faced with the problem of matching income with expenditure in a manner which will minimize disruption to organizational equilibrium. The fiscal decisions which result have little to do either with median voter preferences or with changes in the tax price of public goods or in household income.
The case studies, together with the model developed from them, enable us to make a variety of statements about 1) the impact of grants on the behaviour of fiscally pressured governments, and, 2) the likely impact of grant reductions and changes from categorical to block grants on the fiscal behaviour of subnational governments generally. Some of the statements are empirically based from the case states; others are derived from the model. Most of the statements refer directly to the American experience.

1). The Impact of Grants on the Behaviour of Fiscally Pressured Governments. We examine first the situation in which subnational governments are facing fiscal pressure, but national level grants are not being reduced. In this situation, service delivery programs funded through categorical grants - even with relatively high matching rates - are largely protected. Subnational governments, in an effort to maintain services and employment in order to maintain organizational equilibrium, do not reduce the local match because of its leveraging effect - that is, a reduction in local matching funds means a reduction in badly needed grant. Maintenance of effort requirements in some cases serve to protect local expenditure in these areas as well, provided that the requirements have not been made irrelevant by inflation.

Benefits from income support programs funded through categorical matching grants are more likely to be reduced in response to fiscal pressure (although total expenditure - as opposed to benefit levels - may be rising rapidly from increased caseload, particularly if the fiscal pressure results from problems in the state or local economy.) Their clientele is weak and the programs do not require many employees relative to money spent; the potential for disrupting equilibrium is thus low. Even still the reductions are likely to occur only after a lag, since the most common means of achieving reductions is simply not to increase benefit levels in line with inflation.
Reductions in these assisted programs occur only if the unit of government has control over benefit levels and/or eligibility. Many local governments do not have such control; the program parameters are fixed by the state. In these cases income transfer benefits are protected (and expenditures may increase substantially) even in the face of severe local fiscal pressures. However fiscal pressure on state governments in the U.S. may - and indeed has - resulted in substantial declines in the real value of income support benefit levels.

The structure of categorical grants for specific nationally defined objectives protects the services funded by them from the effects of fiscal pressure at the expense of basic services funded completely by own-source local revenues. Thus, in the U.S. general education spending falls while special education and bilingual education spending rises; public health spending falls while mental health spending rises; parks, sanitation, and streets spending falls while housing rehabilitation spending increases.

Overall the impact of local government response to fiscal pressure on local citizens depends critically on the way in which local services are funded through government grant. Individuals whose services are funded through intergovernmental aid are largely protected from state and local expenditure reductions; needy individuals whose services are not funded through intergovernmental aid (e.g. general assistance recipients) are at great risk, as are the marginally eligible in income support programs generally.

2) The Impact of Grant Reductions on State and Local Government Fiscal Behaviour. We now turn to the situation in which reduction in government grant is the cause of local government fiscal pressure.

Case studies indicate governments respond to fiscal pressure - such as that brought about by grant reduction - by engaging in short-term strategies designed to maintain spending (e.g. drawing
down surpluses, one time revenue devices such as sales of assets, borrowing, etc.). Thus a grant reduction may, in the short run, result in a relatively small reduction in expenditure; the response may be a lagged one.

In the longer run, grant reductions for manpower intensive programs will bring about real reductions in manpower costs. However, in the United States where wage levels are locally determined, governments will try to achieve this through reductions in real wages rather than reductions in employment. They will do so as a means of protecting service levels. The impact of grant reductions may thus weigh more heavily on public sector wage levels than employment or service levels.

In the long run state or local fiscal response to grant reductions will be determined by the set of institutional and other factors listed above (p.3). The model derived from the Urban Institute case studies suggests that governments will attempt to maintain service levels in the face of grant reductions through increasing revenue from other sources - including own source tax revenues - if it is feasible to do so. (Thus it suggests that the expenditure response to grant reduction is likely to be asymmetrical to the response to grant increase. A one dollar grant increase may call forth $0.80 in local expenditure; a one dollar grant reduction may call forth only a $0.30 reduction in local expenditure.) Governments which are constrained by formal fiscal limitations, referenda requirements, etc. from raising additional revenues in response to grant reduction will, perforce exhibit a much greater expenditure response to grant reduction than will other governments. The experience of British local authorities in response to the imposition of grant penalties (i.e. increases in local rates which ultimately called forth the government rate capping legislation) is fully supportive of this conclusion.
The case studies and model provide indications of where expenditure reductions are likely to occur as a consequence of grant reduction. Since reductions will be carried out in a manner designed to maintain stability and minimize conflict, they will be focussed in areas of low visibility and marginality. This implies reduction in capital expenditure, maintenance, administrative overhead, and in activities which have diffuse and unorganized clienteles and constituencies. More broadly grant funded programs viewed as "frills" - i.e., not central to the operations of local government - will be seriously at risk if grants are reduced. Reductions in categorical grants for "non-central activities" are unlikely to be replaced through additional local funds unless they visibly affect large numbers of citizens or small but organized and powerful interest groups.

Summary

During the past decade many subnational government's have had to respond to increased fiscal pressure, frequently resulting from national government grant reductions. Research on the responses of these governments has prompted re-examination of some of the basic "accepted wisdom" of the impact of grant on local government fiscal behaviour. In this paper we have set forth some of the implications of this research for a revised understanding of the relationship of grant and local fiscal behaviour.

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References


