Statement of Alice M. Rivlin
Director, Congressional Budget Office
Before the
Subcommittee on Intergovernmental Relations
of the
Committee on Government Affairs
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There should be no
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Each year the federal government provides grants to state and local governments to support a wide range of services. These grants, which totaled over $91 billion in 1980 or about 16 percent of federal outlays, are an important source of state and local financing. Consequently, changes in federal expenditure patterns could have substantial repercussions for state and local governments.

As background to your deliberations on the fiscal year 1982 budget and possible modifications to the 1981 budget, I would like to discuss three issues:

- The role that federal grants play in state and local budgets;
- Proposed reductions in the 1981 and 1982 budgets that would affect state and local governments; and
- Several strategies for limiting potentially adverse effects of federal budget reductions on state and local governments.

The Role of Federal Grants in State and Local Finances

Over the last decade, federal grants have grown from 17 to 22 percent of total state and local revenues, although the importance of these grants to individual governments varies. During this period, state governments have received a large, and constant, share of their revenues directly from the federal government--about a quarter of their revenues annually. Local governments, in contrast, have received a smaller but growing share of their revenues directly from the federal government. About 10 percent of local revenues now comes directly from federal grants--up from 3 percent in 1970. In addition, local governments receive another 35 percent of their revenues from the states. These state transfers include both funds directly raised by states and federal funds given to states for distribution to local governments. Thus, the total share of federal grants in local budgets--both direct and indirect--is somewhere between 10 and 45 percent, although it is not possible to identify the proportion more precisely.

Over one-third of federal grants to states and localities support aid to individuals, through programs such as Aid to Families with Dependent Children (AFDC), child nutrition, Medicaid, and housing assistance. The remaining grants provide funding for other state and local activities, such as urban mass transit, community and economic development, education, and environmental management.

Although the volume of federal grants has been increasing steadily in current dollars, in constant dollars grants to state and local governments have declined by 2 percent since 1978. Only grants for assistance to individuals have experienced real growth in recent years. In constant dollars, individual assistance grants have grown by 5 percent from 1978 to 1980, while grants for other types of state and local services have declined by 6 percent over the same period.

Proposed Budget Changes That Would Affect State and Local Governments

The Reagan Administration has proposed reducing total fiscal year 1982 expenditures by 6 percent--or $43.8 billion--below the level proposed by the Carter Administration. Although it is not yet possible to determine the exact figure, it appears that at least 30 percent of the announced fiscal year 1982 cuts, or $12 billion, will come from the 14 percent of the budget previously proposed for state and local grants in the Carter Administration's budget submission. The additional $6 billion in spending reductions to be specified later may also affect the proportion of cuts borne by state and local governments. Among the proposed reductions that would affect state and local governments are the following.

Eliminating Public Service Employment Under the Comprehensive Employment and Training Act (CETA). The Administration has proposed terminating all public service employment jobs--about 300,000--by the end of fiscal year 1981. This would reduce CETA fiscal year 1982 outlays by about $3 billion from 1981 levels.

Eliminating Mass Transit Operating Subsidies and Reducing Funding for Mass Transit Capital Expenditures. The Administration would end operating subsidies for mass transit between now and 1984, although outlays from previous commitments would continue through 1986. Construction assistance for current large fixed-rail projects--those in Washington, Miami, Buffalo, Baltimore, and Atlanta--would be postponed, and new systems would not be federally funded. These changes would reduce mass transit grants by about $200 million in fiscal year 1982 relative to 1981 levels and by $2.8 billion in fiscal year 1986 relative to the Administration's current base levels.

Restructuring Community and Economic Development Aid. The Administration proposes to eliminate the Economic Development Administration, which makes construction grants to state and local governments, and the regional commissions that plan and administer some interstate development activities. In addition, the Administration proposes to consolidate the Urban Development Action Grant and the Community Development Block Grant programs and to reduce outlays for these programs by 15 percent by 1986 from the Administration's base level.

Capping Medicaid Payments. The amount of federal assistance provided under Medicaid each year would be held to a specific limit, instead of being open-ended as it is now. This cap would be set at $100 million below the fiscal year 1981 base and would be allowed to grow just 5 percent in 1982 and to grow subsequently only at the rate of inflation, measured by the GNP deflator. This would reduce 1986 federal Medicaid payments by nearly 20 percent from the Administration's current policy estimates. States would be allowed more flexibility in their Medicaid programs, however, to help offset some of the effects of limiting federal spending.

Eliminating Some Child Nutrition Subsidies. The Administration has proposed modifying child nutrition programs to eliminate the subsidies received by middle- and upper-income children. It would also discontinue other nutrition-related grants, such as purchases of food service equipment, nutrition education and training, and subsidized snacks. These changes would save about $1 billion in 1982 compared with 1981 levels and about $2 billion in 1986 from the Administration's base level.

Possibly offsetting part of these proposed reductions in grant programs are increases in defense spending that would affect state and local governments. Businesses and industries receiving defense contracts will undoubtedly grow and generate benefits to these governments through increased employment, income, and tax bases. There is no guarantee, however, that the governments most affected by reductions in grant programs will be those most assisted by increased defense spending.

Strategies for Limiting the Effect of Budget Cuts on State and Local Governments

In cutting the federal budget, a number of strategies could be employed to limit the impact of reductions on state and local governments. The strategies discussed below are not mutually exclusive, but could affect each other. For example, carefully constructed consolidations of grant programs could in themselves bring about efficiencies in program administration.

Encourage Efficiency in Program Administration. First, federal programs could be restructured to encourage efficiency in state and local program administration. One option would be to share with states some of the savings that result from their efforts to reduce hospital expenditures. Currently, states that have effective rate-setting programs receive only 11 cents for every dollar reduction in Medicare and Medicaid expenditures. Increasing the return to states on their cost-saving efforts could lead to additional state and federal savings.

Simplify Administrative Requirements. Simplifying the administrative requirements that accompany federal grants would save money for state and local governments, thus lessening the overall impact of federal grant reductions. For example, state health offices are required to prepare as many as 11 separate plans and applications each year for various grant programs. If states had to prepare just one plan--an option now being tested on an experimental basis--this saving in administrative costs would help offset cuts in federal grants.

Consolidate Grants. A third strategy would be to consolidate grants programs that are being reduced, thereby allowing state and local governments the flexibility to design their own programs, and thus increase efficiency and reduce administrative costs. State and local governments have long argued that programs designed in Washington cannot be fully responsive to local needs and conditions and that the same levels of service could be achieved at lower cost if recipients designed the programs. The President's economic message last week proposed a 20 percent decrease in 1982 funding for elementary and secondary education programs, to be offset in part by consolidation of those programs, and a 25 percent decrease in 1982 funds for health and social services, also accompanied by proposals for consolidation.

Increase Targeting of Funds. A final strategy for limiting the impact of federal budget reductions would be to distribute the remaining assistance so that those jurisdictions with the least capacity to finance services received the greatest amount of federal assistance. This targeting could be achieved in several ways.

First, program allocation formulas could be modified so that jurisdictions with proportionately less fiscal capacity would receive higher allocations. For example, the Administration has proposed merging the Urban Development Action Grant (UDAG) and the Community Development Block Grant (CDBG) programs and reducing total funding by 5 percent between fiscal years 1981 and 1982. UDAG is presently allocated on a discretionary basis, and funds have been concentrated among the most distressed jurisdictions. Most CDBG funds are distributed on an entitlement basis among cities of 50,000 or more. Some of the effects of a reduction in total funding could be offset by designing an allocation formula that gave jurisdictions least able to support local services larger program shares than they receive under the current CDBG allocation formulas.

Another way to modify formula allocations would be to change the measures used to determine fiscal capacity. Several formulas, such as those for General Revenue Sharing and Medicaid, use per capita income as a measure of a jurisdiction's fiscal capacity. Individual income does not reflect the availability of other sources of revenue such as severance taxes and corporation wealth. Using more inclusive capacity measures could increase the aid given to jurisdictions experiencing the most fiscal strain.

A third way to increase targeting would be to lower minimum payments in some programs. For example, the AFDC and Medicaid federal matching rate is determined on the basis of states' per capita income, with the minimum matching rate set at 50 percent. If there were no minimum, the matching rates for 13 states would be below 50 percent. The funds saved by eliminating the floor could be used either to decrease total federal expenditures or to increase support for states less able to provide services.

A final way to increase aid to jurisdictions most in need of funds would be to raise maximum payments. For example, under General Revenue Sharing, no local government may receive a per capita payment higher than 145 percent of its state's per capita average. If this provision were eliminated, cities like Philadelphia and St. Louis would receive increased support while other jurisdictions, particularly suburban ones, would receive less.

Conclusion

In recent years, total federal support for state and local governments has been declining in real terms. As the Congress moves to constrain federal spending, grants are likely to continue to decline in constant, if not also current, dollars. The Congress has available many options, however, for restructuring grant assistance that would limit the negative effects of budget cuts on state and local governments, while still reducing overall federal expenditures.