How Federal Grants Increase Arkansas Taxes

By Marc Kilmer
11/19/15

Federal grants to state and local governments may seem like "free money," in that they pay for projects that the recipients would not otherwise be able to afford. However, new research by Dr. Eric Fruits shows that instead of supplementing or replacing local funding, accepting federal grants actually costs state and local taxpayers more money.[1] In this paper, I will summarize Fruits's work on how federal grants increase state and local spending and the implications of Fruits's findings for Arkansas.

Fruits, who has taught economics and finance at Portland State University for more than a decade, recently concluded that, historically, **every dollar from federal monetary transfers to the Arkansas state government and local governments resulted in an additional 59 cents in taxes, fees, or other revenue increases borne by Arkansas citizens.** If federal government transfers to Arkansas increased by 10%, this upsurge would lead to an additional $390 million in state and local spending -- which translates to an additional tax burden of $130 per Arkansan.

The Magnitude of Federal Grants

Grants by the federal government to state and local governments are also known as intergovernmental transfers. These transfers can be specific grant programs (such as grants from the Department of Justice to local police departments to pay for equipment or training) or larger programs such as federal education spending or state transportation funding. They also include spending on Medicaid, which is a joint federal/state health care program.

In 2012, the State of Arkansas and its local governments received $6.5 billion in federal intergovernmental transfers. That is a significant amount of money, considering that these entities spent $15.5 billion raised from state and local sources. In other words, roughly 30% of the total spending from Arkansas state and local governments comes from federal intergovernmental transfers.[2]

(continued on other side)

HOW FEDERAL GRANTS INCREASE STATE SPENDING

There are many different kinds of federal grant programs and intergovernmental transfers, and each has various conditions attached. Some of these conditions help explain why state and local governments spend more of their own money when they accept federal handouts.

Matching Funds

Some federal programs mandate that the state match federal funding at a certain rate. For instance, to receive a dollar in federal Medicaid funding, Arkansas must generally spend 30 cents (although the matching rate for the newly eligible under Obamacare is different: it gradually moves up to 10 percent -- that is, the federal government picks up 90 percent of the tab). This matched funding is the most direct way that federal intergovernmental transfers can cause increased state and local government spending.

Other federal programs require indirect matching funds, which means state or local governments must hire new personnel or create or expand departments to help provide services funded by grants. A 2013 incident in Saline County illustrates this dynamic, although this particular event did not involve federal money. In Saline County, now-Rep. Julie Mayberry was able to persuade several state legislators to designate roughly $120,000 in general improvement funds to pay for a public park in Saline County to serve children with disabilities. Notably, Saline County does not have a parks department: when its Quorum Court members noted that this transfer implied that Saline County would have to set aside funds in the future for park maintenance, Mayberry reportedly responded by suggesting that the county should create a parks department.[3] This "free" land therefore would have required ongoing county expenditures. Federal grants, with strings attached, can create the same dynamic.

Maintenance of Effort

Some federal grants come with "maintenance of effort" requirements. This means the federal grant will be available only if states or municipalities maintain their current level of spending. A requirement like this prevents states from substituting federal spending for state spending, which leads to no net reduction in the state or local tax burden in the short run.

In the long run, a maintenance of effort requirement can lock in higher spending. By tying federal funding to a certain level of state or local spending, it makes it costly or politically painful for policymakers to cut that spending. Consider the hypothetical example of a city that must continue to spend $10 million annually on some particular educational program in order to maintain an annual $3 million federal education grant. If that city faced budget problems, then policymakers might otherwise want to cut $1 million from that educational program to help balance their budget. If faced with a maintenance of effort constraint, however, such a budget cut would eliminate the $3 million federal grant; that $1 million cut would jeopardize $4 million in education spending. Faced with that choice, city policymakers might decide instead to raise taxes (or cut spending in other areas) in order to preserve the influx of money from the federal grant.

The "Ratchet Effect"

Federal funding can also increase state spending because of what is known as the "ratchet effect." When states or local governments accept temporary federal funding for a program -- and that temporary funding runs out – those governments must then allocate spending to keep the program in operation. Many times state or local officials accept federal funds for a temporary program, but when this money ceases to flow, the officials find that either the bureaucracy or the public has no appetite for the program to end. This effect can be exacerbated when federal grants expressly require an additional funding commitment after an initial period. Consider, for instance, the COPS (Community Oriented Policing Services) program, which subsidized police payrolls for three years, but required a commitment that new officer hires would stay on the payroll for at least a year after the federal grant expired.[4] This financing structure encourages budget decision-makers to view higher levels of spending as the "new normal."

THE IMPACT OF FEDERAL GRANTS: THE CASE OF ARKANSAS

Different states respond in different ways to federal transfers. Part of this is because some states, like Arkansas, are relatively poor, so federal programs like Medicaid require a smaller state match. Other factors, such as politicians' willingness or unwillingness to eliminate ostensibly temporary programs once federal funding goes away, also play a role. Regardless of the differences between states, federal intergovernmental transfers demonstrably affect local spending (and thus local taxes and fees).

According to Fruits's research, these transfers make Arkansas's budget bigger and more expensive:

> Statistical analysis controlling for the economic and demographic factors that vary across states and over time indicates that—holding other variables constant—each additional dollar of federal intergovernmental transfers to Arkansas is associated with $0.59 in additional taxes, charges, and other state and local own source revenue.[5]

Although Arkansas's 59-cent figure is lower than the national average of 82 cents in additional taxes or fees in response to each dollar of federal grant funding, this nonetheless suggests that acceptance of grants places a heavy burden on Arkansas taxpayers as a general matter.

HOW THE PRIVATE OPTION BURDENS ARKANSAS TAXPAYERS: THE SPECIAL CASE OF ARKANSAS'S MEDICAID EXPANSION

According to the analysis by Dr. Fruits, increasing federal grants to Arkansas by just 10% would lead to "approximately $390 million more in spending from state and local own sources, or an additional $130 per person in taxes and charges."[6] This phenomenon threatens to impoverish Arkansas. Policymakers should take these hidden costs into account when they consider involving state or local governments in federal grant programs. The long-term cost of taking federal money may not be immediately apparent.

Consider Medicaid. Arkansas's implementation of the Affordable Care Act, or Obamacare, created a massive expansion in federal Medicaid spending. Medicaid (as mentioned above) is a joint federal-state program. Under this law, the federal government will pay for coverage of newly eligible recipients through 2016. Beginning in 2017, the federal contribution is reduced to 95 percent and phases down to 90 percent in 2020 and thereafter. At that point, federal spending per new Medicaid enrollee will have fallen significantly; states will then bear 10 percent of the cost for this class of Medicaid enrollees. Arkansas will also continue to pay the traditional Medicaid match rate for increased participation among those eligible under pre-expansion criteria.

Section 1115 of the Social Security Act authorizes Health and Human Services (HHS) -- for approved Medicaid demonstration projects -- to waive certain federal Medicaid requirements and to allow costs that would not otherwise be eligible for federal matching funds. In September 2013, HHS approved Arkansas's demonstration proposal to expand its program by allowing federal Medicaid funds to be used to provide premium assistance to enable newly eligible beneficiaries, with the premium assistance to be used to purchase private insurance offered through the state's health insurance exchange.

A widely reported analysis published by the Government Accountability Office concluded that the $4 billion cost of Medicaid expansion over the first three-year period of Arkansas's demonstration was $778 million higher than the costs without the demonstration.[7] By the time the state is responsible for 10 percent of the costs of Medicaid expansion, the State of Arkansas would face a demand for an additional $1.3 billion a year (in 2015 dollars) in state funding. The funding would likely come from reductions in spending in other state programs or an increase in state taxes equal to about $45 per person per year.

It is almost as if this aspect of Obamacare is designed to impose higher costs on state governments. Medicaid expansion lures states into accepting this "free" money, but full funding is only temporary. When federal funding shrinks, Obamacare expansion then requires matched spending from the state -- or, more precisely, from the taxpayers who live there.

Politicians, who often focus on short-term consequences, do not often acknowledge this specific problem with Medicaid -- nor do they always attend to the larger problems of accepting federal funding. During his tenure, for instance, Governor Mike Beebe called accepting Medicaid expansion funding a "no-brainer" because if Arkansas did not accept the money, state taxpayers would "still have to pay for it."[8] This view disregards the fact that state taxpayers pay more once Arkansas accepts this money, because it will shortly begin to require a federal match.

CONCLUSION

Especially given the growth of federal grant programs and intergovernmental transfers, state and local policymakers should think critically about the long-term consequences of accepting this funding. While it may seem like "free" (or cheap) money, the evidence indicates that these federal programs lead to more local and state spending -- which, in turn, burdens taxpayers. While it may be wise in some cases to accept federal money, policymakers should weigh the costs and benefits of doing so. In many instances it is likely more prudent to decline federal dollars -- especially if refusing federal funds ensures that state or local spending stays at levels taxpayers can afford.

Marc Kilmer is an analyst for the Advance Arkansas Institute.

---

[1] Eric Fruits, "Impact of Federal Transfers on State and Local Own-Source Spending," Interstate http://policyalliance.org/wp-content/uploads/2015/11/Impact-of-Federal-Transfers-on-State-and-Local-Own-Source-Spending-FINAL.pdf

[2] "Arkansas," Interstate Policy Alliance. http://policyalliance.org/wp-content/uploads/2015/10/Arkansas.pdf

[3] Chelsea Boozer, "Legislator's Letter Eased Funds for Wife's Park Project," *Arkansas Democrat-Gazette,* September 20, 2013.

[4] Peter Eisler and Kevin Johnson, "10 Years and $10B Later, COPS Drawing Scrutiny," *USA Today,* April 10, 2005.

[5] "Arkansas."

[6] *Ibid*.

[7] Government Accountability Office (2014). Medicaid demonstrations: HHS's approval process for Arkansas's Medicaid expansion waiver raises cost concerns. GAO-14-689R.

[8] Rick Kron, "Beebe Speaks on the Issues," *The Arkansas Leader*, April 20, 2013.