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DO INTERGOVERNMENTAL GRANTS CREATE RATCHETS IN STATE AND LOCAL TAXES?
Testing the Friedman-Sanford Hypothesis

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Every dollar in temporary federal grants leads to 40 cents of tax increases. Economists have long suggested the existence of a "flypaper effect," wherein federal money given to states prompts additional spending. However, empirical research shows that federal grants to states also leads to additional state and local taxes when federal spending decreases.

As Milton Friedman pointed out, there is nothing as permanent as a temporary government program. As a consequence, when states accept federal aid to create or expand public programs today, they will inevitably be forced to decide whether to cut the program or raise taxes when federal aid ends.

Empirical evidence from the previous 15 years shows that tax increases are the likely result, averaging around 40 cents in state and local tax hikes for every federal grant dollar.

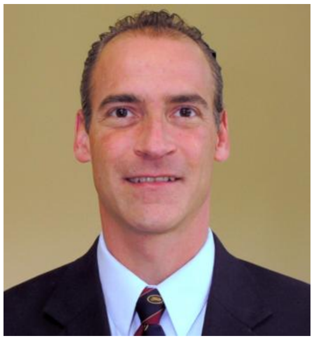
RESEARCH FINDINGS

- Every dollar of federal grants paid to states today will lead to about 40 cents of increased state and local taxes in the future. When the federal government provides temporary aid to states, it is just that—temporary. When federal aid dries up, states are left with the choice of either cutting the program or increasing its own source revenues (that is, taxes and fees) to pay for continuing the program. Because spending programs tend to create their own political constituencies and elected officials are loath to suggest cutting existing programs, at least some of the federal aid is likely to be replaced by state and local taxes in the future.

  For instance, Morgantown, West Virginia was recently given a federal grant to hire two police officers for three years. When the federal aid ends, the city is unlikely to lay off these officers, but will rather seek local revenues to pay for the positions.

- Federal stimulus aid to state and local governments will lead to $80 billion in tax hikes in coming years. Federal grants to state and local governments have risen from $461 billion in 2008 to $654 billion in 2010. As a result, state and local governments will soon either have to cut programs or increases taxes when these temporary federal grants recede. Using estimates of previous consequences of federal spending, this will likely result in about $80 billion in state and local tax increases.

- This effect is broadly similar across different grant-making agencies. The five federal agencies that provide the largest quantity of grants to states all show similar results on state and local taxes, with grants from the Department of Housing and Urban Development leading to slightly higher tax increases than grants from other departments. Grants to local governments from both state and federal sources result in future tax increases of similar magnitude.



ABOUT RUSSELL SOBEL

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To view the complete study by Dr. Sobel and Mr. Crowley, please visit:
www.mercatus.org/publication/do-intergovernmental-grants-create-ratchets-state-and-local-taxes/.

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