

Creative Federalism—A Challenge in Financial Management

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Federal social and economic programs carried out cooperatively with State and local governments under grant-in-aid arrangements have mushroomed in recent years. This development has been accompanied by discontent in some quarters with the grant-in-aid system, uneasiness of some State and local administrators on the extension of the Federal Government as a policy participant in traditionally local functions, and doubts by some observers that the management and administrative machinery for efficient and economical accomplishment of these cooperative programs can be put in successful operation.

The problems, both doctrinal and operational, involved in the Federal-State-local governmental cooperative arrangements are monumental. Those who are concerned with the Federal-State-local intergovernmental programs agree that they are confronted with a management and administrative challenge that also is of monumental proportions. This article proposes to outline briefly the growth of Federal grant programs in State and local governments and to discuss the problems which this growth has created in the field of financial management.

The increasing population and rapid urbanization of our Nation



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have multiplied demands for the services traditionally provided by State and local governments. The burden of financing these services has brought the Federal Government into the role either of providing the financial assistance in the form of grants in aid to the State and local governments or of direct operation of the programs. Advocates of jointly administered programs assert that their use enables national goals to be pursued more effectively in such areas as education, health, welfare, and urban development, because these arrangements:

- make it possible to recognize the diversity of local considerations and needs,
- spread creative innovation in public services from one jurisdiction to another, and
- preserve a fair and equitable tax system.

The partnership arrangement has been designated by its advocates and others as the “new federalism,” “cooperative federalism,” “dynamic federalism,” but more frequently “creative federalism.”

Growth and Development of Grant-in-Aid Programs

Some of the present characteristics of Federal grants in aid to State and local governments came into being more than a century ago. By the enactment of a law referred to as the Morrill Act of 1862, States could receive Federal lands by establishing colleges offering courses in agriculture, engineering, and home economics. The grants were subject to the conditions spelled out in the law and to supervision by Federal authorities.

This type of aid came to be known as “categorical” grants.

Federal aid to State and local governments was extended in the early 1900's by the initiation of other agricultural programs. The 1914 program providing for cooperative agricultural extension work introduced such new features as an apportionment formula, equal State matching of the Federal grants, and advance Federal approval of State plans.

Between 1916 and 1920, Federal assistance was made available for State highway programs and vocational education and rehabilitation. The economic problems in the 1930's resulted in the establishment of a large number of Federal welfare, employment security, public housing, and health programs. These programs were designed to alleviate the pressures on State and local resources as well as to help individuals. Grant conditions included the requirement that State and local personnel participating in these programs be covered by merit systems.

After World War II new Federal programs were authorized for education, health, and urban renewal. In more recent years the Federal Government has undertaken to broaden elementary, secondary, and higher education opportunities, to develop economically depressed areas, to help finance improved health services and medical care for the indigent, to attack poverty, and to transform areas of cities now encumbered by slums and blight into model neighborhoods.

The equalization factor, recognizing differences in State fiscal resources, was introduced in establishing allot-

ment and matching formulas. Also, a requirement that grant funds be administered by a single agency within the State was included in many grant programs.

Federal financial assistance to State and local governments, running at about \$4 billion a year 10 years ago, now amounts to about \$15 billion a year. It is expected to rise to about \$17.4 billion in fiscal year 1968. This amount, consisting primarily of grants in aid, is classified by function as follows:

	In millions of dollars
Health, labor, and welfare	\$8,042
Commerce and transportation	4,314
Education	2,498
Housing and community development	1,274
Agriculture and agricultural resources	559
Natural resources	541
General government	157
Other	54
Total	\$17,439

Other Federal expenditures affecting the finances of State and local governments, such as contractual payments or grants to public institutions for research and training in specialized fields, are not included in this tabulation. Also, loans and repayable advances are excluded.

The growth in number and size of grant-in-aid programs may be expected to continue the dramatic increase of recent years. By 1975, the annual expenditures under these arrangements are expected to rise to \$60 billion.

The Perplexing Problem of Multijurisdictions

Presently there are about 170 different Federal-aid programs. These are financed through more than 400 separate appropriations and are administered by 21 Federal departments and agencies through 150 major Washington bureaus and over 400 field offices.

Programs are carried on in each of the 50 States. To compound the administrative labyrinth, nearly 92,000 separate State and local governments within the United States are eligible for grants in aid under one or more of these Federal programs.

The number of authorizations for Federal assistance to State and local governments in January 1966 has been classified by functional categories as follows:

Health, labor, and welfare	153
Education	82
Natural resources	54
Commerce and transportation	37
Housing and community development	32
Agriculture and agricultural resources	15
General government	12
Civil defense and National Guard centers	11
Veterans benefits and services	3
Total	399

This tabulation shows that the principal emphasis of Federal aid is on those programs aimed at individual opportunity and development, such as health, labor, welfare, education, and housing and community development.

One of the more frequent criticisms of grant-in-aid programs by State and local government officials has been the inability to keep track of all the overlapping benefits for which their governments may be eligible. For example, funds for job recruiting can be obtained from nine manpower program sources, adult basic education from 10 (in addition to general education sources), prevocational training and skill training from 10, and work experience from five. On-the-job training can be financed under five programs and supportive services under nine. Income maintenance is available to participants of nine programs. Eligibility rules, application procedures, allocation formulas, expiration dates, and contracting arrangements also vary.

The rapid increase in numbers and amounts of grant programs has focused attention on the need for improved coordination, management, and administration. Certain steps by the Federal Government have been either taken or proposed, among which are:

- high-level liaison with State and local governments,
- strengthening of the coordination of Federal programs within the Executive Office of the President,
- assignment of specific categories of programs to designated departments and agencies,
- consolidation of grants into fewer categories,
- consultation with State and local government officials in the development and execution of programs,

—establishing coordination of State and local actions.

These steps suggest potential for improvement in the management and administration of grant-in-aid programs, but the effective fulfillment by concrete measures will tax the ingenuity of the most capable managers.

As a hopeful trend in the structuring of Federal grants in aid to State and local governments, the 89th Congress approved legislation which consolidated about a dozen separate grant authorizations for categorical health programs, in such fields as tuberculosis, cancer, communicable diseases, and venereal diseases, into a single program for comprehensive health services of a flexible nature and variety as set forth in plans developed by the States. There will be a single set of requirements, a single authorization, and a single appropriation.

This enactment has triggered a number of studies both within and without the Federal Government as to ways that this approach may be applied to other categorical grant programs.

Bridging the Gap of Management Capability

Recent congressional hearings brought forth frequent testimony that State and local administrators, including their financial managers and accountants, often were lacking in qualifications, unimaginative, and too subject to local pressures. The demands of many of today's programs and the sophistication of the techniques for their successful accomplishment frequently require a greater capability than can be satisfied by the limited training and experience of many State and local officials.

Serious deterrents in attracting qualified professional people to State and local government often exist because merit systems, personnel development systems, in-service training programs and the like are lacking or are ineffective in their application. Suitable working environments, office space, equipment, and adequate pay scales also are needed in many cases. As a result, the managers, operating personnel, and supporting staff often do not have the degree of competence and dedication essential to the successful and efficient direction and management of the grant-in-aid program.

To overcome the lack of sufficiently qualified personnel at the State and local levels, the President as well as congressional leaders in the field of intergovernmental relations have proposed Federal-aid programs for strengthening and improving State and local administration. The recently introduced Intergovernmental Manpower Act of 1967 deals with some of the problems in this area—the merit system, personnel management, and in-service training—and would provide for interchange of personnel between the Federal Government and State and local governments.

Many Federal Government officials have endorsed similar bills. For example, the Under Secretary of the Department of Health, Education, and Welfare, in commenting on one of the bills, stated that it goes to the very essence of what is necessary to the development in this country of more effective merit systems and the training of personnel to carry out grant programs at the State and local levels.

The Intergovernmental Manpower Act would:

- Authorize Federal agencies to open their training programs to, and to conduct training programs for, State and local employees and officials engaged in federally aided programs.
- Authorize the U.S. Civil Service Commission to make grants to States or to local governments for up to 75 percent of certain costs of conducting and supporting programs if training is not adequately provided for under grant-in-aid or other statutes and up to 75 percent of the cost of developing and carrying out programs to strengthen personnel administration.
- Authorize the temporary assignment of personnel between the Federal Government and State and local governments for periods not to exceed 2 years.

Financing Under Letter-of-Credit Arrangements

For many years, payment procedures for Federal grants in aid differed widely in some cases between the departments and agencies and between grant programs administered by the same department or agency. Many of the methods of disbursing the funds to grantees gave no recognition to the time of actual need for cash by the recipient. GAO reviews of National Institutes of Health and other HEW grant programs disclosed that some recipients of grant funds accumulated large balances of grant funds in excess of their current needs. The withdrawal of funds from the Treasury before they were needed by the grantees resulted in an interest expense to the

Treasury Department and an unnecessary cost to the Federal Government.

As a result of our observations and information obtained from other sources, a project to explore ways and means by which advances could be minimized was instituted by the Steering Committee of the Federal Government's Joint Financial Management Improvement Program. Subsequently, in May 1964, the Treasury Department issued a departmental circular which prescribed a letter of credit and draft procedure to be used for disbursing funds to finance programs carried out by State and local governments and other grantees.

This procedure requires that Federal agencies operating programs covered by the circular issue letters of credit to the Federal Reserve banks in the districts in which the programs are to be carried out for the total amount of all grants outstanding to each State or local government or other grantee. These grantee organizations are required to draw against the letters of credit only as funds are needed for the grant purposes. The grantees are required to submit periodic reports showing the status and disposition of the funds they have drawn.

It was expected that, through the letter-of-credit procedure, withdrawal of funds in advance of need would be reduced by hundreds of millions of dollars, with related savings in interest costs to the Treasury and a simplification of the process for funding on the basis of a request accompanied by a report. Many departments and agencies have reported savings through use of this procedure. One

department, for example, claimed savings of \$1.2 million during the past fiscal year in just two of its programs by using this procedure.

However, the large and expanding number of Federal departments and agencies involved in the large number of grant-in-aid authorizations, combined with the large number of separate departments and other organizational entities in State and local governments that are the recipients of grant funds, requires further efforts to make effectual use of the letter-of-credit procedure. A meaningful control by the Federal agencies over the withdrawals of Federal funds in advance of needs remains to be fully achieved.

The Planning, Programming, and Budgeting Predicament

The multijurisdictional dimensions of the Federal-State-local intergovernmental programs compound the problems of Federal decisionmakers in planning, programming, and budgeting for specific grant-in-aid projects. Likewise, the counterparts of these decisionmakers at the State and local levels are confronted with an array of problems related to planning and funding.

Until fairly recently, the Federal budget was a program plan in financial terms for a relatively short period of time with the agency programs and activities not always specified with clarity and completeness. In addition, the alternatives were not spelled out and in many cases the estimated costs were not projected beyond the budget year. Thus, formalized planning and systems analysis had little effect on budget decisions.

In 1965 a major effort was initiated to help remedy the shortcomings in the Federal planning and budgeting system by introducing at nearly all major departments and agencies an integrated planning-programming-budgeting system. This system is designed to:

- spell out more concretely the objectives of the governmental programs,
- analyze systematically the possible alternative objectives and alternative programs to meet those objectives,
- evaluate and compare the benefits and costs of programs,
- produce total, rather than partial, estimates of costs of programs, and
- present on a multiple-year basis the prospective costs and accomplishments of programs.

This system is expected to significantly improve Federal budgeting and decisionmaking, but its potential in the intergovernmental programs will not likely be fully realized until the system, to the extent appropriate, is also adopted and in operation by State and local governments.

The magnitude of the problem may be illustrated by the education budget. Over 40 units of the Federal Government, including 10 departments and 15 agencies, have funds for education in their budgets, and education is provided in the United States by some 40,000 local administrative units. The Federal education budget now approximates \$12.3 billion annually, of which about \$5.3 billion are for purposes related to elementary, secondary, and higher education. The Federal decisionmakers are faced with the

problem of appraising the place of the Federal Government in education and the role of the Federal Government in providing and financing education. The State departments of education and the administrators of the local educational units are faced with the problem of ascertaining which Federal aids are available to them and of fitting the availabilities into their operations.

An effective and operative program budgeting system for education could facilitate the Federal decisionmaking at three different levels. At the highest level, it could aid in selecting the proper budget size for education in relation to other major programs competing for the Federal dollar. At the next lower level, it could aid in determining the best composition of the educational program to be federally financed or subsidized. At the third level, by relying on the factors of cost and output, it could aid in determining the most effective way for attaining a given program objective.

An effective program budgeting system for education is not likely to become operative, however, until all the Federal Government departments and agencies receiving funds for education and the State education departments adopt reasonably uniform budgets and cost-benefit analysis procedures and, more importantly, use them intelligently when decisions are made. Federal and local school officials, however, are not likely to always have mutual interests. Therefore, an integrated program budget will not be easy to come by. Several years may well elapse before education decisions at the local level are

harmonized with national objectives so as to accommodate the effective use of the integrated planning-programming-budgeting system in the educational field.

Federal management personnel concerned with other grant-in-aid programs will be faced with problems having degrees of magnitude differing from that of education. Programs which are heavily concentrated in a single bureau or department—such as, for example, water pollution control in the Department of the Interior and air pollution control in the Department of Health, Education, and Welfare—should be able to respond much quicker to innovations in management techniques.

The Diversities in Accounting and Reporting Requirements

The acceptance of a grant from the United States creates a responsibility on the part of the grantee to use the funds in accordance with the conditions of the grant. Accordingly, the grantee must maintain such accounting records of the grant transactions as will permit a reporting by the grantee in a manner determined by the grantor agency and an audit of these transactions by the Federal Government.

Accounting for the grant begins with the executed agreement, approved application, or similar document in which the amount, the purposes, the period of performance, the obligations of the parties, and other basic terms are stated. Such agreements describe the allowable costs and may provide for the vesting of property purchased from grant funds in the Federal Government, the disposition of property and unused grant

funds at the termination of the grant, and the frequency and kinds of reporting.

Accounting requirements by one grantor Federal agency may differ from those of other grantor Federal agencies and may not be readily susceptible of fulfillment under the State or local government's accounting systems. State agencies have alleged that the accounting requirements of some grantors have necessitated the keeping of a double set of books. To avoid these problems some State and local government officials have suggested the enactment of legislation to achieve uniform accounting for all grant funds.

Under his authority to prescribe principles and standards for Federal agencies, the Comptroller General has provided that, when payments are made to grantees in advance of work performed, Federal agencies shall account for such payments as advances rather than as costs incurred until evidence of performance is received from the grantees. Also, reports are to be required of grantees at reasonably frequent periods to show, as a minimum, how the funds or property were applied, details of property acquired, and unused fund balances.

There can be little dissent to consistency in accounting principles for application by Federal departments and agencies in grant accounting. Likewise, fiscal procedures for grant funds should not impede program execution at State and local levels. Within the framework of a common body of accounting principles, however, accounting should be useful in promoting program policies and objectives. Because of the differing characteristics of

many of the grant programs, it is unlikely that detailed accounting and reporting uniformity would, in all cases, be considered practical. As with accounting and reporting in other endeavors, accounting for operations under grants must be designed to serve the needs of the managers at all levels of government.

The Complications in Program Surveillance and Evaluation

Legislative enactments of grant-in-aid programs provide the basic limitations in the conduct of the program by the Federal department or agency. The law and the legislative history, including the congressional floor debates, may provide fairly extensive and specific direction for the accomplishment of the program, but in some cases the congressional direction may be stated only in general terms. In either event, the executive department responsible for administering the program will prepare regulations under which the grantees will be bound. It is through these regulations that Federal controls have their principal impact on the State and local governmental administrators. The latter develop the State or other plans for approval by the Federal program officials before the initiation of the program by the State or local governments.

Federal program officials usually have the responsibility for surveillance and evaluation of the execution of the program by State and local governments in accordance with the provisions of the law, the regulations, and the approved State or other plans. However, Federal agencies also have auditors to provide audit coverage of grant programs to determine whether

the Federal funds have been applied effectively and in a manner consistent with related Federal laws, program objectives, and underlying agreements. Many of the complications from program surveillance and evaluation stem from Federal multijurisdictional audit policies and practices and the internal or independent audits performed by State and local governments.

Bureau of the Budget instructions require Federal agencies conducting grant programs to establish audit policies that will give consideration to:

- the dollar magnitude and duration of the grant program,
- the extent of Federal matching requirements,
- the Federal management needs to be met, as developed in consultation with responsible program officials, and
- prior experience in auditing the program, including the adequacy of the financial management system and controls.

In addition, the audit policies are to provide for coordinating and for relying, to the maximum extent feasible, on internal and independent audits performed in the offices of the State and local governments and for appropriate use of the principles of statistical sampling.

Audits of all grant programs administered by a single Federal department are to be coordinated in all cases, and cross-servicing arrangements are to be entered into under which one Federal agency would conduct audits for another whenever such arrangements are to the best interest of the Federal Government.

These policies would appear to minimize the opportunities for complications in the surveillance and evaluation of the execution of grant programs. However, the Federal grant-in-aid programs are very diverse and involve many different kinds of activities carried out by many different kinds of specialists. Audit programs have to be tailored to the activities, purposes, methods, techniques, and other considerations if useful management reports are to come out of the audits. Much remains to be done at the Federal level to bring about commonality in audit objectives and in audit coverage in respect to similar-type programs.

Challenge in Financial Management

The grant-in-aid system for Federal financial assistance to State and local governments has been subject to increasing congressional and public scrutiny in recent years. In part, this interest stems from the proliferation and overlapping of the grant programs which have in turn created difficult organizational and management problems. On this matter one of the ablest administrators in Washington has stated that aspirations at the Federal level have outrun the organizational abilities of the administrators and that, if the job is to get done, better ways of doing it will have to be found.

Alternatives to the grant-in-aid device have been strongly advocated from time to time. Among them have

been the sharing of tax revenues by the Federal Government with the several States and the awarding of so-called block grants by the Federal Government to be used by the State and local governments with relatively fewer restrictions than the categorical grants.

Neither of these two alternatives, if adopted to the degree of political acceptance, is likely to reduce significantly the total amounts or slow the growth of existing Federal categorical grants. Moreover, each grant program finds support from specific interests and organizations and is built into the budgetary base of State and local governments. In this environment the Government's role and activity become accepted and virtually institutionalized. Thus the Federal-State-local governmental managers will continue to be faced with the management and administrative problems that have been spawned by the existing categorical grant arrangement.

An increasingly complex society will no doubt demand more and more public services, but a better informed constituency will likely become more articulate in assessing the effectiveness of the federally aided programs in achieving national objectives. A challenge in financial management derives from the inherent perplexing management problems. Meeting this challenge will require the efforts of many people at all levels of government.