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MUNICIPAL REVENUES AND LAND POLICIES

Edited by Gregory K. Ingram and Yu-Hung Hong

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Intergovernmental Transfers to Local Governments

David E. Wildasin

Intergovernmental transfers to local governments, both explicit and implicit, are large and persistent elements in the U.S. fiscal system. In 2006 local governments were the recipients of approximately $475 billion in explicit transfers from the state and federal governments. The transfers exhibited substantial interstate variation, ranging from a low of about $400 million in total transfers to local governments in Hawaii (in the continental United States, the low was about $700 million in South Dakota) to a high of $91.5 billion in California. These transfers accounted for about 38 percent of all local government revenues, ranging from a low of 19.2 percent in Hawaii (in the continental United States, 27.8 percent in Colorado) to a high of 70.2 percent in Vermont, with Arizona second highest at 55.4 percent. Per capita local government revenues from intergovernmental transfers were about $1,600, ranging from $322 in Hawaii (in the continental United States, $908 in South Dakota) to $2,526 in California.[1] Relative to personal income, transfers to local governments in 2006 amounted to less than 1 percent in Hawaii (as low as 2.6 percent in Connecticut) to 6.4 percent in California, with the U.S. average at 4.3 percent. These basic observations testify to the overall importance of intergovernmental transfers as revenue sources for

Gyeoreh Lee provided helpful research assistance. I am grateful to Michael Smart and conference participants for helpful comments on an earlier version. I retain responsibility for any errors.

1. Because of its special status, the District of Columbia is ignored in the following discussion, but it is heavily dependent on transfers from the federal government, receiving transfers in excess of $5,000 per capita in 2006.

local governments, as well as to the wide variation in the amounts of these transfers among the states.

In an accounting sense, transfers are used to support a very wide range of local government functions, including education, health, transportation, public safety (police, fire, corrections, the judiciary), sanitation, natural resource and environmental management, and social and public assistance programs. But this is merely a superficial listing of accounting flows. The real effects of these transfers, and their real role in the fiscal system, are far less obvious. Understanding the role of intergovernmental transfers in a complex federation presents deep analytical challenges, and, judging from recent activity and events, the level of academic, policy, and popular interest in this broad area is as strong as ever.

This chapter aims, first, to provide a descriptive overview of intergovernmental fiscal relations in the United States. A review of three decades of fiscal history shows that the finances of all three levels of government—federal, state, and local—are closely intertwined by virtue of the large and persistent fiscal flows that link them. Although intergovernmental transfers support many different types of public expenditures by recipient governments, intergovernmental flows in the U.S. fiscal system display a surprising degree of stability and persistence over time. As discussed later in this chapter, however, intergovernmental transfers are only one element in the entire system of intergovernmental fiscal and regulatory relations. Through their tax and expenditure policies, the federal and state governments directly and indirectly affect the ability of local government to raise revenues through taxation, the expenditure demands placed on them, and their ability to raise funds by issuing debt. Furthermore, the responsibilities and powers of subnational governments evolve continuously over time, as illustrated by the evolution of programs that provide cash and health assistance to low-income households and the intergovernmental transfers through which they have been implemented. The crucial role that the judicial system has played in determining the structure of public finance in the United States, as illustrated by the effects of court decisions on local public school funding, is also discussed.

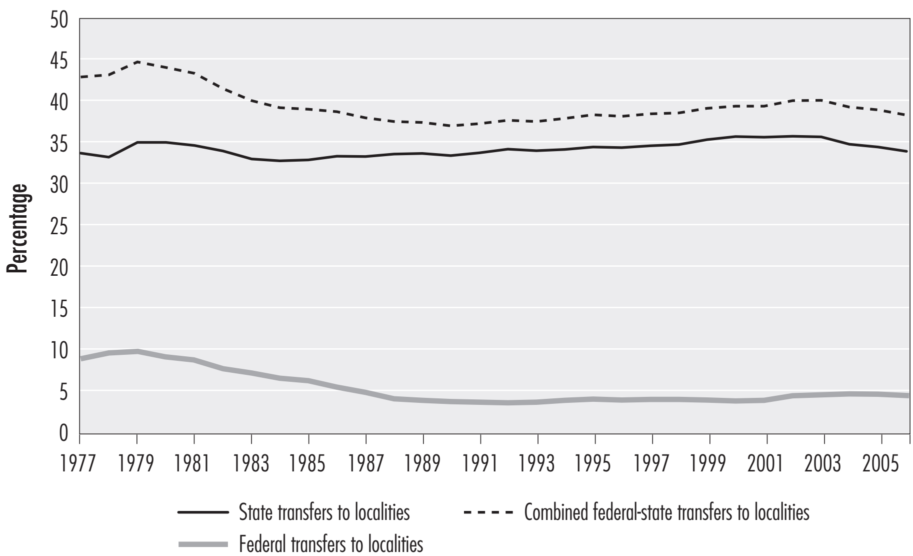
With this background, the chapter turns to some of the many important policy and analytical issues raised by intergovernmental transfers to local governments. Localities are continuously subject to all manner of fiscal disturbances. Often these are localized in nature, while at other times, like the present, local governments throughout the entire nation must deal with common economic and financial challenges. How do local governments manage, on the whole, to maintain fiscal solvency in the face of continuous and sometimes severe shocks? What role do intergovernmental transfers play in the process of local government adaptation to fluctuations in their fiscal environment? As a matter of policy, should higher-level governments provide more or less assistance to local governments in times of fiscal distress? Do transfers to local governments pose a risk to the financial stability of the donor governments? These questions and some of the open questions for policy and for research that they suggest are discussed here.

Intergovernmental Fiscal Transfers in the U.S. Federation: Major Trends

It is helpful to summarize some basic facts about the overall flows of intergovernmental transfers in the U.S. federation. As already noted, transfers to localities amount to hundreds of billions of dollars annually. Is this a large amount and, if so, relative to what? In order not to be distracted by absolute magnitudes whose significance varies with the price level and the aggregate size of the economy, it is useful to select a normalization for the measurement of intergovernmental transfers. In order to focus on their importance relative to the governments that receive and provide them, it is perhaps most useful to relate them to the revenues and expenditures of recipient and donor governments.

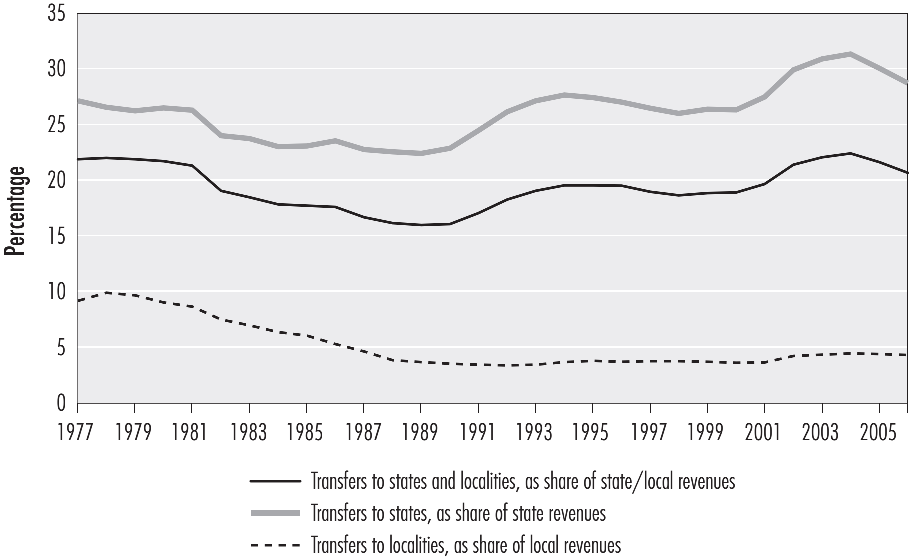
Figure 3.1 depicts the history of federal and state transfers to all local governments in the nation for the past three decades. The figure shows the magnitude of these transfers as a proportion of all local government revenues and, thus, their importance as a source of financing for localities. This period spans several recessions; sustained long-term economic growth; rapid technological and industrial change; significant change in the size, age structure, health, and nativity of the population; and shifts in political power at all levels of government. Against the backdrop of this ever-changing economic, demographic, social, and political

Figure 3.1
Intergovernmental Transfers to Local Governments as a Percentage of General Revenues, 1977–2006



Source: U.S. Census Bureau (1977–2007).

Figure 3.2
Federal Transfers to State and Local Governments as a Percentage of General Revenues, 1977–2006

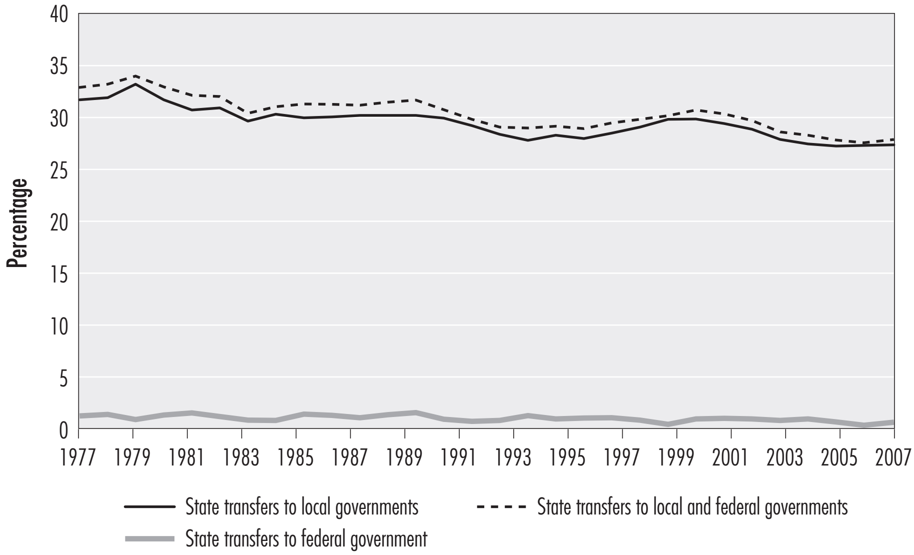


Source: U.S. Census Bureau (1977–2007).

landscape, the stability of intergovernmental transfers as a source of funding for localities is remarkable, even astonishing. In particular, since 1982, the total amount of federal plus state transfers to local governments has ranged between 38 and 41 percent of the general revenue of local governments. These total flows consist of state government transfers ranging between 32.7 and 35.7 percent over the entire period, with federal transfers never exceeding 10 percent. The total amounts of state and federal transfers in 2006 were $422 billion and $54.6 billion, respectively, adding up to 38.3 percent of the $1.244 trillion of total local government general revenues in that year. As discussed further below, state government assistance to local school systems accounted for a large fraction of these transfers.

In constitutional terms, local governments are fundamentally subsidiary to the state governments that create and regulate them; they are "creatures of the states," in the memorable phrase of Judge John Dillon (1911, 209). In fiscal terms, as just noted, state governments are the principal sources of intergovernmental transfers to localities, particularly but by no means exclusively in the context of primary and secondary education. With noteworthy exceptions, federal government assistance to localities is relatively modest, and the exercise of federal regulatory powers over localities is generally mediated through state governments. Thus, as a matter of convenience and without much apparent vio-

Figure 3.3
State Government Transfers as a Percentage of Total State Expenditures, 1977–2006

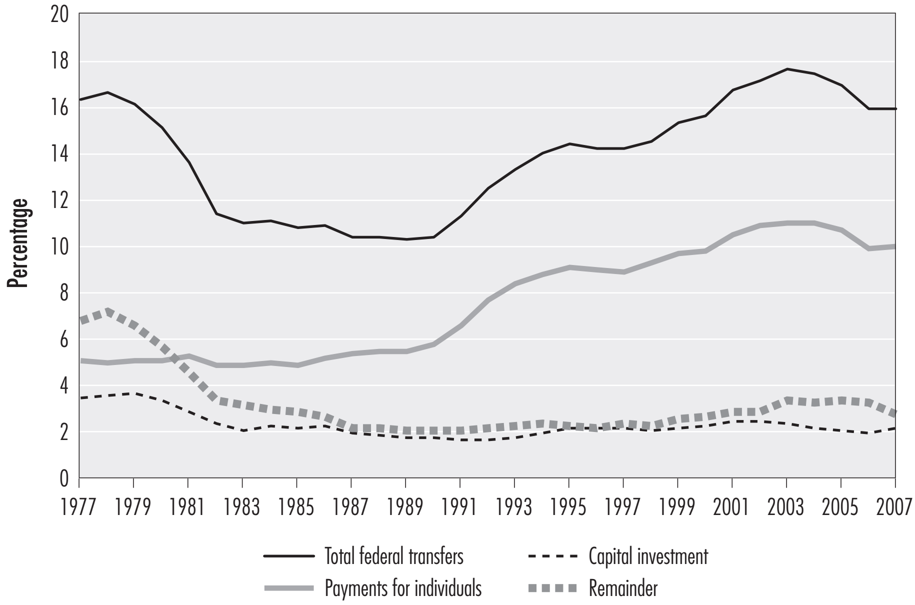


Source: U.S. Census Bureau (1977–2007).

lence to the facts, an analysis of intergovernmental transfers to localities might ignore the federal government altogether. Nevertheless, in understanding the role of intergovernmental transfers to localities within the overall context of the U.S. fiscal system, it is important to recognize that state governments are linked to the federal government just as localities are linked to their states. The magnitude of federal-state transfers over the period 1977–2006, expressed as a proportion of state government general revenue, is depicted in figure 3.2. For comparison, this figure also displays federal transfers to all state and local governments combined relative to their combined revenues (with no double-counting), and, once again, federal transfers to localities. As illustrated in the figure, grants from the federal government to the states range in value from 22.4 percent to 31.3 percent of state government general revenues over this time period. The transfers totaled $398 billion in 2006, or 28.7 percent of total state government revenues of $1.385 trillion. As a funding source, federal transfers to states and localities appear to exhibit relatively greater variability than do state transfers to localities, although it is not obvious from simple descriptive statistics whether this is attributable mainly to variability of funding flows or to variability of the state government revenues relative to which these flows are measured.

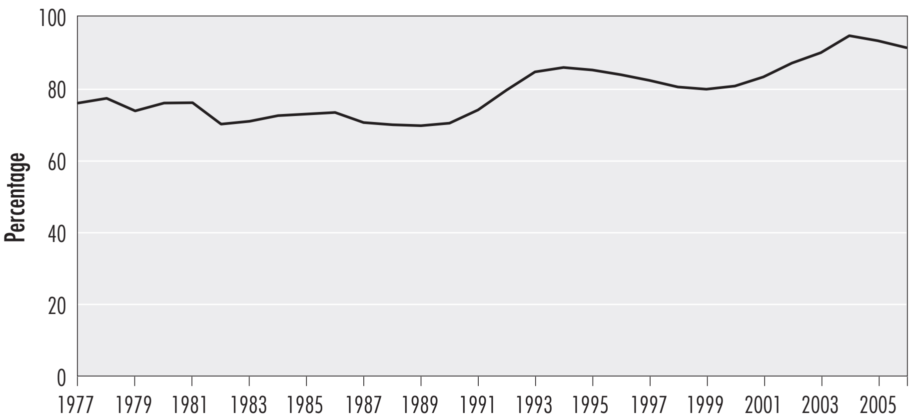
Transfers that are revenues for recipient governments are expenditures for donor governments. Figures 3.3 and 3.4 depict the roles played by

Figure 3.4
Federal Transfers to State and Local Governments as a Percentage of Federal Outlays, 1977–2007



Source: U.S. Census Bureau (1977–2007).

Figure 3.5
Federal-State Transfers as a Percentage of State-Local Transfers, 1977–2006



Source: U.S. Census Bureau (1977–2007).

intergovernmental transfers in the budgets of the state and federal governments, respectively. Figure 3.3 displays state government intergovernmental expenditures expressed as a proportion of total state expenditures. As it demonstrates, state transfers to localities account for by far the largest share of state government intergovernmental transfers; state transfers to the federal government never exceed 1.5 percent of total state spending, and these transfers are henceforth ignored. State transfers to localities have been a large but gradually declining share of state budgets over the past three decades. They reached a high of 33.0 percent in 1979 and a low of 27.1 percent in 2004. Figure 3.4 shows analogous data for federal transfers to states and localities for roughly the same time period. The figure shows that transfers to subnational governments have fluctuated between 11 percent and 18 percent of the federal budget over the past several decades. For the most part, these funds flow to state rather than to local governments. Transfers to the states have exceeded 72 percent of all federal transfers to subnational governments since 1977. Excluding the revenue-sharing program, the state share of federal transfers to subnational governments has ranged between 76 and 89 percent; since revenue-sharing payments ended in 1987, the state share has ranged between 85 and 90 percent. Thus, transfers to subnational governments, especially to state governments, have long been a major component of the federal budget, particularly of the nondefense budget. For 2007 federal grants to subnational governments were approximately $440 billion, making up about 23 percent of federal nondefense, noninterest expenditures.

As these figures make clear, federal-state and state-local transfers are large and very durable features of the U.S. fiscal system. Local governments depend heavily on state governments for their funding, and the states, in turn, depend heavily on the federal government. From a pure flow-of-funds perspective, the states can be viewed, to some degree, as intermediaries between the federal and the local governments, since they are both recipients and donors of intergovernmental transfers. From 1977 to 2006, as shown in figure 3.5, federal transfers to state governments varied from 69 to 98 percent of the amounts transferred by states to localities. Since 1992 this proportion has never been less than 80 percent. Federal-state and state-local transfers clearly do not move in lockstep, but the similarity in magnitudes is remarkable, especially in view of the apparently quite different programs through which these funds are distributed at the federal and state levels. Flows of intergovernmental transfers evidently link together all three levels of government in the United States, and have done so for many decades. An interesting question for research is to understand better the nature of these multilevel intergovernmental fiscal linkages.

Uses of Intergovernmental Transfers

Intergovernmental transfers are implemented through a wide range of government programs. Federal programs such as Medicaid and Temporary Assistance to Needy Families (TANF) provide major financial support for state government spending on health care and cash assistance to low-income households, respectively. The importance of these transfers is depicted in figure 3.4, where it can be seen that payments for individuals have nearly doubled in magnitude as a share of the federal budget during the past two decades and now make up nearly two-thirds of federal transfers to subnational governments. The Medicaid program is responsible for the largest share of transfers. For instance, in 2003 the federal government transferred approximately $132 billion to the states for Medicaid, about 36 percent of all federal transfers to state governments. By comparison, federal transfers in support of Temporary Assistance to Needy Families, traditionally the main federally supported cash transfer program for low-income households, were just $16 billion, less than 5 percent of federal-state transfers (Marton and Wildasin 2007). The two programs together account for about 40 percent of federal-state transfers. As shown in figure 3.4, however, other forms of federal transfers to subnational governments are also important. They support capital (infrastructure) expenditures by other governments as well as other noncapital expenditures in a host of functional areas such as transportation, public safety (including homeland security and disaster relief in addition to police and legal services), economic development, and public health.

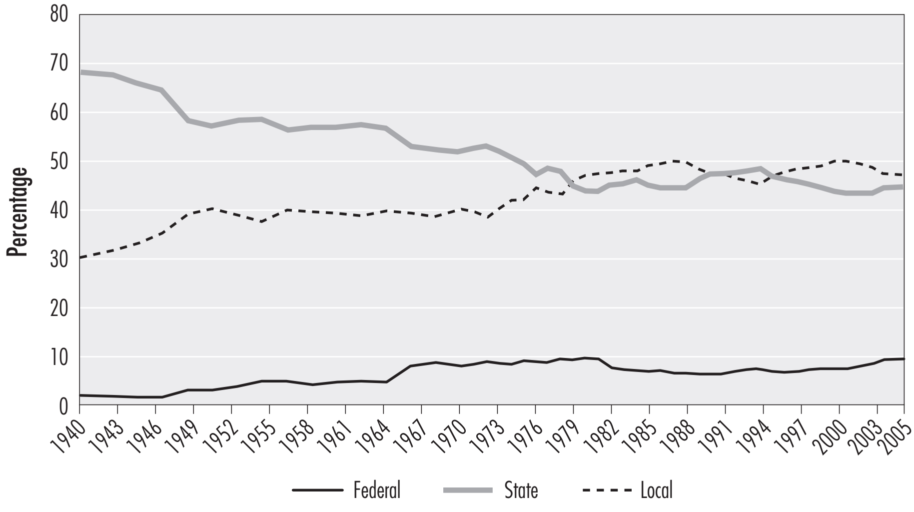
State-local transfers also serve many purposes, reflecting the diversity and complexity of functions performed by localities in the United States. According to 1997 census figures, there are almost 90,000 localities in the nation, including roughly 3,000 county governments, 20,000 municipalities, 14,000 school districts, 17,000 townships, and 35,000 special districts. Although the importance of different types of localities differs by state, none of them, with the exception of townships, are fiscally inconsequential from the viewpoint of the U.S. federation as a whole. Of 2002 total local government expenditures of $1.1 trillion, cities accounted for 31.8 percent, school districts for 31.4 percent, counties for 23.1 percent, special districts for 10.6 percent, and townships for 3.1 percent.

Elementary and secondary education is one major local government function, accounting for 35.2 percent of 2002 local government expenditures. (Although school districts were responsible for 81.2 percent of 2002 education spending, county governments, with 8.0 percent, and cities, with 8.5 percent, are also important providers of education.) Other major categories of local government expenditure, mostly undertaken by counties, cities, and special districts, include social services and income maintenance (11 percent of total local expenditures), public utilities (10 percent), environment and housing (9 percent), public safety (9 percent), and transportation (5 percent). Many of these functions involve major public infrastructure such as water, electricity, and natural gas plants and distribution networks; highways, airports, and seaports; and sewage systems and waste disposal facilities. Such infrastructure spending is frequently debt-financed, and thus these local governments, including special districts, are particularly important so far as local government borrowing is concerned. In 2002 outstanding local government debt was slightly more than $1 trillion, with cities accounting for 38.2 percent of the total; special districts, 20.1 percent; counties, 19.7 percent; school districts, 18.9 percent; and townships, 2.2 percent.

State governments make transfers to all these units of government. In 2002 transfers to local school districts accounted for more than half (53.7 percent) of all state government transfers to localities and more than half (54.5 percent) of school district revenues. Figure 3.6 shows that state governments have become the largest sources of funding for local public schools, a trend that began before World War II, as local own-source revenues have steadily declined in relative importance, first falling below half of local school spending by 1974 and accounting for just 44 percent in 2005. The federal government has provided some assistance to local schools, but during the 65-year period displayed in figure 3.6, federal grants to schools have never exceeded 10 percent of total school funding. States have also provided substantial assistance to other units of local governments. As of 2002, transfers to counties have accounted for more than one-third of county government revenues and nearly a quarter of all state-local transfers, while transfers to cities make up more than one-fifth of municipal government revenues and 17.6 percent of all state-local transfers.

Finally, there are even transfers from some local governments to others. Of note in this regard, 7.2 percent of special district revenues come from other localities. It is useful to bear in mind that special districts are sometimes created by

Figure 3.6
Sources of Education Financing, 1940–2005



Note: Biennial date to 1970; annual thereafter.
Source: National Center for Education Statistics (2007, table 162).

(or spun off from) municipalities or other local governments and often remain closely related to them, and the measurement and classification of their finances may in some cases be arbitrary. Conceptually, it is not easy to determine whether a government body is sufficiently independent of other governmental entities to be counted as a distinct unit of government. Perhaps for this reason, the quinquennial census data series on numbers of special districts has sometimes exhibited great variation, increasing from fewer than 25,000 units of government in 1972 to more than 50,000 by 1977 and more than 58,000 by 1987, and then declining to around 35,000 as of 2002. A given financial flow that might be measured as an intergovernmental transfer between different units of government might instead become an internal budgetary reallocation within a single unit of government under a more aggregated definition of governmental units.

In sum, federal-state and state-local government transfers help to finance nearly all aspects of recipient government expenditures. State government transfers for local schools are key expenditures for states and key revenue sources for school authorities; more than half of elementary and secondary education spending is now state financed. But fiscal linkages between states and their county, city, and other local governments are also very important; cities and counties receive about half of all state government transfers to local governments, and they depend heavily on state transfers as revenue sources. The states, in turn, rely on federal government financing, with Medicaid transfers increasing in importance over time and now accounting for more than one-third of federal-state transfers.

The Broad Structure of Intergovernmental Relations

The fiscal circumstances of local governments depend on the state and federal governments not only because these governments provide explicit intergovernmental transfers, as described above, but also because many of their tax, expenditure, and regulatory policies directly or indirectly influence local finances. A full treatment of intergovernmental fiscal and regulatory relations is well beyond the scope of the current chapter, but it is useful to provide some illustrative examples, and it is instructive to place intergovernmental fiscal transfers within the broader overall context of intergovernmental fiscal, regulatory, and constitutional relations.

INTERGOVERNMENTAL TAX, EXPENDITURE, AND ECONOMIC LINKAGES

The fiscal systems of the federal, state, and local governments are intertwined in a multitude of ways (Gravelle and Gravelle 2007). Policy decisions made by the federal and state governments affect local economic conditions and the effective costs and burdens of local government expenditures and revenues. Some of these interactions arise from tax expenditures. The exemption of state and local government bond interest from federal personal income taxation, a provision that results in revenue losses to the U.S. Treasury estimated at about $25 billion annually (Office of Management and Budget 2009, table 19.1), offers a classic illustration. This provision reduces the cost of debt financing for subnational governments and thus relieves these governments of a significant interest-expense burden. Other provisions of federal tax law may provide even greater amounts of implicit fiscal assistance to subnational governments, although it is not easy to translate federal revenue losses into subsidy-equivalent transfers to these governments. One important example is the deductibility of certain subnational government taxes, notably including local government taxes on real estate and personal income, from taxation at the federal level. The revenue loss to the federal government from the taxation of taxes on owner-occupied housing is estimated to be approximately $30 billion annually. This tax saving to individual taxpayers offsets a substantial portion of the burden of local property taxes, in effect matching local taxes with subsidies from the U.S. Treasury. The federal government is estimated to forgo another $50 billion in revenues from the deductibility of taxes other than property taxes by state and local governments. Of this amount, a substantial portion flows from the deductibility of state rather than local taxes, thus constituting an implicit fiscal transfer from the federal to the state governments, or at least to their taxpayers. Since state governments are major sources of explicit transfers to local governments, however, implicit federal transfers to the states, in the form of state tax deductibility, may significantly affect state support for localities.

Still other aspects of federal tax policy affect local tax bases and, thus, local tax revenues. The federal tax treatment of housing is one important example. It is estimated that the deductibility of mortgage interest expense, special tax treatment of capital gains, and other federal tax provisions result in the annual loss of federal tax revenues of approximately $100 billion. The immediate beneficiaries of these tax expenditures are the consumers of housing, whose net-of-tax housing costs are thereby reduced. But it is also clear that these policies expand the local property tax base and thus the flow of property tax revenues to local governments. To be sure, this is an indirect effect of federal tax policy on local revenues, characterized by a much greater degree of transactional distance than direct, explicit transfers of funds from the federal to the local governments. At the same time, these provisions in federal tax policy have major positive consequences for local government revenues, even as they have major negative consequences for federal government revenues. In this sense, their effects are similar to those of explicit intergovernmental transfers.

As is apparent, the list of federal tax provisions that affect local government finances could be expanded considerably. For most localities, special tax provisions affecting business investment have important consequences for the size of the local revenue base, particularly the amount of commercial and industrial property. For other localities, special tax treatment of farm income may have substantial fiscal impacts. The list could also be expanded to include special provisions of state tax systems. There is no clear boundary that defines what aspects of federal or state tax law affect local government finances. Any federal or state tax provision that influences economic activity is sure to have an impact on local government tax revenues. This includes many types of tax expenditures, but it equally includes the rate structure of higher-level government tax systems and their variations over time.

Nor are the finances of local governments independent of state and federal government expenditure policies, quite aside from the explicit intergovernmental transfers discussed earlier. Like tax policies, the expenditure policies of higher-level governments influence overall economic activity, its sectoral composition, and its spatial allocation. As a simple example, federal or state policies that affect the capacity and location of air, sea, rail, and highway transportation facilities affect local economic development and thus the finances of local governments. Federal policies that maintain the prices of agricultural goods affect land values and incomes in rural areas and thus the revenues of state and local governments. Alaska's "bridge to nowhere," Boston's "Big Dig," the levee systems in New Orleans, and the military bases targeted by the Base Realignment and Closure Commission are all examples of public expenditure programs, often involving a mixture of federal and state government financing, that have significant effects on local economic development; on local population, employment, income, and property values; and on local government finances.

Not all actions of higher-level governments affect the revenue side of local fiscal accounts. As already remarked, implicit subsidies for municipal government borrowing reduce interest expenses for municipal governments. State and federal policies that affect local economic activity influence the demand for local public services through their impacts on the size and demographic composition of local populations, employment, property values, and all other conditions in local economies. To take a topical illustration, many types of state and especially federal government expenditures may increase during recessionary periods, whether through the operation of automatic stabilizers or as a result of the reform of existing policies or the introduction of new ones, such as the recently enacted stabilization package. Such expenditures affect the entire macroeconomy and thus, presumptively, the finances of all subnational governments. Since they often involve targeted expenditures on particular public projects in particular locations, their size and distribution may have important differential impacts on local economies and on local public finances.

THE ASSIGNMENT OF TAX AND EXPENDITURE RESPONSIBILITIES

The above remarks have highlighted the impacts of federal and state policies on localities without addressing even more fundamental questions about the boundary lines between local and higher-level governments and their evolution over time. A classic problem in fiscal federalism concerns the assignment of expenditure functions and revenue instruments to different levels of government. Various normative principles have been developed in the literature to shed light on these issues. For instance, following the Musgrave (1959) characterization of the public sector in terms of its fundamental branches of activity, corresponding to the allocative, redistributive, and stabilization functions of government, many authors have proposed that the national government should take on primary responsibility for the stabilization and redistributive functions of government, with localities mainly charged with the efficient delivery of public services whose benefits accrue primarily to local residents (see Oates 1972 for a classic treatment). These principles can equally be viewed as predictive hypotheses about what levels of government are likely to bear certain responsibilities; indeed, the rough correspondence between these principles and the assignment of expenditure functions in the U.S. federation is immediately evident. Similarly, on the tax side, one can ask what types of revenue instruments local, state, and federal governments should use or, alternatively, how the configuration of revenue instruments has come to be what it is and how it changes over time.

The implications of higher-level government decisions regarding the assignment of expenditure and tax responsibilities have very important impacts on the finances of local governments. If a higher-level government were to relieve local governments of responsibility for some function that they presently carry out, as would occur, for instance, if a state government were to take over all local police responsibilities, there would be, in the first instance, a positive impact on local government fiscal balances because existing local revenues would no longer have to carry the burden of paying for police services. Similarly, a state prohibition on local government use of an existing revenue source—for instance, requiring localities to cease the taxation of public utilities, perhaps because they are henceforth to be taxed at the state level—would limit local government revenues, ceteris paribus. The reverse of these actions—allowing or perhaps requiring localities to perform certain tasks, or allowing or perhaps requiring them to implement certain types of taxes—would have the reverse effect. Expansion or contraction of federal government responsibilities, and federal government regulation of local government taxing powers, generally through the intermediary form of regulations on state governments themselves, would have, and have had, similar effects on local government finances. Such policy actions are not customarily viewed as intergovernmental fiscal transfers, but their impacts on local finances have been great. Over time, the federal, state, and local governments have adapted the assignment of responsibilities and revenue-raising powers, along with the system of explicit state-local and federal-state intergovernmental transfers, to arrive at the current configuration of revenue sources and expenditure responsibilities at each level.

The evolution of cash welfare transfers provides an important illustration. As discussed by Wallis (1984), cash assistance for poor households, as of the early years of the twentieth century, was largely a responsibility assumed by subnational governments, including local governments. Circumstances changed markedly during the Great Depression, with much increased federal government involvement during the New Deal, a trend that persisted and grew in the post–World War II period, though never to the point of complete centralization of this aspect of redistributive policy, as might have been expected if governments were to adhere strictly to the normative principles alluded to above. As already remarked, cash assistance to the poor in the postwar period has been largely implemented through a program of intergovernmental transfers from the federal to the state governments, with varying degrees of federal government control over the uses of funds by subnational governments. Although it is not easy to measure the importance of the strings that donor governments may attach to the funds they transfer to recipient governments, it is probably roughly accurate to say that the postwar period, prior to the passage of welfare reform in the mid-1990s, was one in which cash welfare policies were relatively highly centralized not only by virtue of federal government financing but, as much as or more so, by virtue of federal government regulations on the levels and conditions of welfare benefits.

Such regulations are a standard component of almost all forms of intergovernmental transfers, including the transfers received by local governments. Representatives of recipient governments frequently find the regulations burdensome and costly, even as donor governments view them as essential tools in the attainment of the policy objectives of intergovernmental transfer programs, as viewed by the donors. In the case of welfare, a major change occurred with the passage of the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) of 1996. This act resulted in a major overhaul of cash welfare assistance, although, notably, it was designed to have only a modest effect on the magnitude of intergovernmental transfers from the federal to the state governments. More precisely, to a first approximation, federal-state transfers under PRWORA were designed to provide each state with approximately the amount of funding it had previously received under Aid to Families with Dependent Children (AFDC), the predecessor program. However, the funds received by each state would no longer be explicitly conditioned on state government welfare expenditures: under PRWORA, subject to a federal floor (a "maintenance of effort" requirement), states that spend more on welfare assistance do not receive additional federal funds, and states that limit welfare spending do not lose federal funds, in sharp contrast to the AFDC funding rules under which the federal government would fund at least half and as much as three-fourths of state government welfare expenditures through a program of open-ended matching grants. At the same time, PRWORA provided states with much greater flexibility in the administration of welfare programs. One manifestation of this devolution is the further decentralization of program implementation to the local level, with county governments or local governing boards in 14 states, often assisted with grants funds, now taking responsibility for ensuring compliance with TANF work requirement rules, the development of local employment opportunities, and other functions (Fording, Soss, and Schram 2007; Kim, Fording, and Cho 2009). This second-order devolution, in some respects, is reminiscent of the highly localized programs of cash assistance for the poor that antedated the New Deal.

This example is illustrative of the interplay between regulatory oversight and funding, at multiple levels of governments, through which policy is implemented in the U.S. federation. Although intergovernmental transfers have played and continue to play a vital role in welfare policy, continuing changes in the specific responsibilities and authorities of each level of government reflect the complex and ongoing process of rebalancing responsibilities among governments and the difficulty, in practice, of arriving at a transparent determination of the assignment of public-sector functions to different levels of government. Explicit intergovernmental transfers have helped to underpin the financing of cash assistance to the poor for most of the past century, but the form of these transfers and their regulatory and administrative accompaniments have changed substantially over time, producing ever-shifting divisions of authority among the federal, state, and local governments.

At present, Medicaid and other programs affecting states and localities are the subject of (re-)intensified scrutiny in the policy debate over health care. As in the case of cash welfare assistance, the history of intergovernmental participation in health finance is replete with tensions and controversies surrounding the levels and utilization of health care funds at all levels of government, local governments as well as the states (Baicker 2001; Baicker and Staiger 2005; Coughlin, Ku, and Kim 2000; Marton and Wildasin 2007; and references therein). At one extreme, the nation may move to a unified system of health care finance implemented entirely at the federal level, an upward reassignment of policy responsibilities that would relieve state and local governments of major expenditure burdens. Other reforms would strengthen and expand subnational government provision or financing of health care. In view of the widely remarked variations in health care costs among localities and states (Orszag and Ellis 2007), any reforms, whether they involve increased or decreased centralization of health care financing, are sure to have very uneven impacts on state and local government health care expenditures. The net impacts on state and local budgets will depend in part on whether and how intergovernmental transfer programs are revamped as reforms proceed. Side-by-side comparisons of cash welfare and health care policy, two related but distinct areas of public policy in which intergovernmental fiscal and regulatory relations are of central importance, may reveal much about the nature of policymaking within the institutional structure of the U.S. federation.

CONSTITUTIONS AND INTERGOVERNMENTAL FISCAL RELATIONS

No review of the basic structure of federalism in the United States, and of the finances of local governments in particular, can avoid at least passing reference to the role of the federal and state constitutions, as interpreted by the judiciary. The U.S. Constitution and the state constitutions define the basic structure of taxing powers and expenditure responsibilities for subnational governments, and they define the legislative frameworks within which federal and state statutes regulate subnational government fiscal policies in detail (Wildasin 2007a). Although constitutional and judicial constraints and interpretations are of pervasive importance in all branches of public policy, perhaps in no area have they figured more conspicuously than in the realm of local education policy and finance. Research on this subject was spurred by famous school finance cases in California and Texas in the early 1970s, and a rich literature—far too extensive to be discussed in detail here—has since investigated a multitude of fiscal, legal, educational, political, and other issues associated with local school finance. (Inman and Rubinfeld [1979] provides a thorough early treatment of many of these issues.) Two cases can be singled out for brief mention.

First, the 1971 California Supreme Court decision in *Serrano v. Priest* (5 Cal. 3d 584) found that the then-current system of local property tax financing of schools in that state violated the state's constitution, requiring the state legislature to find appropriate substitute sources of funding. A substantial increase in state funding for local schools was to follow, the consequences of which are still very much in evidence today. As noted at the outset, state-local transfers in California now exceed those in every other state in both aggregate and per capita terms, a trend that has no doubt been magnified by the workings of voter referenda limiting local property taxation as well as by referenda mandating high levels of state government support for local school authorities. For present purposes, what is most significant in the California case is the impact of a judicial interpretation of a state's constitution on the financing of a core local government function, notably by spurring the development of an extensive program of state-local government transfers. Plausibly, these developments contributed to the local property tax limitation movement in California and, perhaps, to the substantial relative reduction in educational expenditures per pupil in California relative to other states. The far-reaching implications of these legal, political, and fiscal developments cannot be discussed in detail here, but they have been the subject of extensive analysis elsewhere (Brunner and Sonstelie 2006; Fischel 2001; and references therein).

Second, the fundamental role of the U.S. Constitution in all aspects of governance in the U.S. federation can never be overlooked. Litigation involving the public schools of Kansas City, Missouri, offers much insight into the interplay between courts, legislatures, local government authorities, and the U.S. and state constitutions (O'Leary and Wise 1991). These cases, with initial filings in 1977, largely involve remediation for racial segregation in the Kansas City schools. By 1984 a federal judge ordered the state government to fund $68 million to improve the local schools, also requiring the school district to pay $20 million in outlays for this purpose. By 1987 the court found that initial cost estimates were too low and that some $300 million of operating and capital expenditures were needed; the capital expenditure requirement later grew to over $500 million, with annual operating outlays of $200 million. These amounts exceeded the revenue capacity of the local school system, which was subject to state constitutional constraints on local property tax rates, leading the court to order a voter referendum to approve extra taxes. Although the taxes were rejected by the voters, the court nonetheless ordered a doubling of local property tax rates. The Kansas City school cases highlight the powers of federal courts to override local government authorities, local referenda, and state constitutional restrictions on local taxation in the pursuit of outcomes dictated by the federal Constitution, in this case the remediation of inequalities in schooling arising from racial segregation.

INTERGOVERNMENTAL TRANSFERS TO LOCAL GOVERNMENTS IN RISKY ENVIRONMENTS

As noted earlier, the aggregate flows of intergovernmental transfers to state and local governments in the United States have been remarkably stable components in the U.S. fiscal system of the past three decades. Of course, aggregate flows conceal substantial amounts of variation at the level of individual jurisdictions, which operate in an environment that is subject to all manner of fluctuations. Business cycles, demographic shifts, industrial growth and decline, technological change, policy changes by other units of government, judicial rulings, and natural disasters are but a few examples of events that can affect subnational government revenues, expenditures, and borrowing. To some degree, these events may be predictable, and at least some of them are at least partially under the control of the subnational governments themselves. For instance, state and local government tax policies affect investment, employment, and economic activity and thus the size of state and local tax bases, as well as the size and composition of the population to be provided with public services and thus the demand for public expenditures. To some extent, however, states and localities are subject to stochastic shocks that cannot be perfectly foreseen; in some cases, the nature and magnitude of the risks that governments face can be extremely difficult to discern, as is the case with terrorist attacks or extreme natural disasters such as Hurricane Katrina.

Intergovernmental grants and other fiscal and regulatory policies by higher-level governments may potentially play an important role in risk mitigation (or exacerbation) for lower-level governments. At the time of writing, for instance, the federal government is providing substantial amounts of extra funding for state and local governments to assist them in coping with an economic and financial crisis. Other federal and state programs have long since been created to help localities deal with natural disasters by providing grants, loans, and other assistance to local governments, businesses, and individual households in the aftermath of floods, earthquakes, hurricanes, and other natural events. Operating somewhat in the background, but no less important, many higher-level government policies serve as automatic insurance mechanisms for local governments and their residents. For instance, federal taxes on personal and business income, sales, and other economically sensitive bases collect relatively large amounts of revenues from states and localities experiencing low unemployment, rapid growth, and otherwise favorable economic conditions, while imposing smaller burdens on individuals and firms in localities experiencing negative economic shocks. On the expenditure side, many means-conditioned benefit programs, including Social Security, Medicaid, food stamps, and cash welfare assistance, provide disproportionately high benefits to households in localities experiencing adverse economic conditions. These policies smooth variations in local incomes and fiscal resources over time as well as among localities, and thus contribute to more stable local revenue flows and public expenditure demands.

Of course, insurance mechanisms of all kinds can give rise to well-known incentive problems. If participation is voluntary, insurers may face problems of adverse selection, and the insured of all types, including local governments, may reduce the level of risk-avoiding behavior when losses fall on outside parties. These issues are potentially important for local government finance. How do localities manage the risks that they face? To what extent do higher-level governments absorb the risks to which localities are exposed? Should higher-level governments expand their support for local governments in times of fiscal distress? Do these governments need to regulate or otherwise indirectly control local government policy making in order to limit their exposures to different kinds of risks?

At an aggregate level, it appears that the finances of local governments in the United States have been managed prudently over long periods of time. Subnational government bankruptcies have occurred on occasion, although they are by far the exceptions to the rule. Exceptional cases are sometimes important, and they include not only the formal bankruptcies that rarely occur, but also those that are narrowly averted when higher-level governments take extraordinary actions, such as the creation of financial control boards, the assumption of debt obligations, and, of course, the use of exceptional explicit intergovernmental transfers.[2] Nevertheless, as illustrated by the data presented earlier, waves of extraordinary intergovernmental transfers, or exceptional transfers to individual jurisdictions that affect national aggregates, are not apparent in the U.S. experience of the past several decades. Local governments in the United States do not, in aggregate, appear to face risks that destabilize the overall system of intergovernmental fiscal relations.

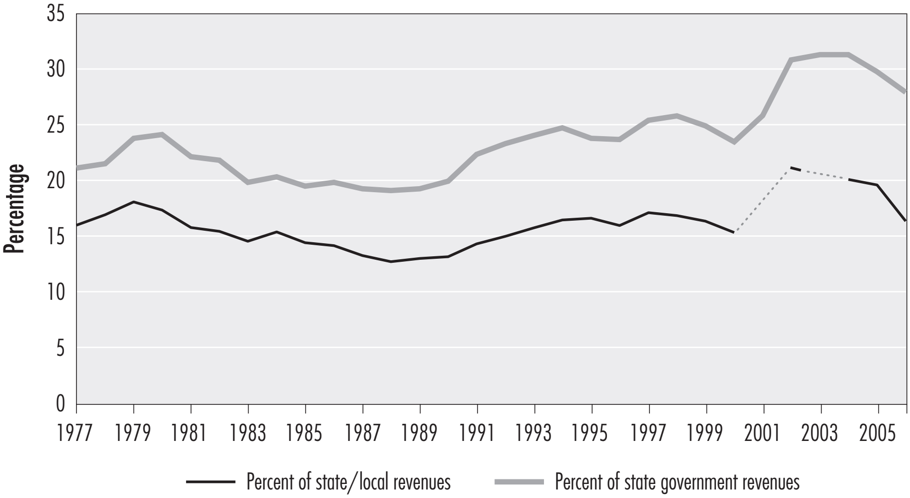
EXCEPTIONAL DISASTERS AND EXCEPTIONAL FISCAL ASSISTANCE: THE CASES OF 9/11 AND HURRICANE KATRINA

This does not mean that exceptional events do not trigger exceptional responses, including exceptional levels of intergovernmental transfers. The terrorist attacks on New York City on 11 September 2001 and the exceptional flooding from Hurricane Katrina in New Orleans in 2005 are two important instances when higher-level governments, including the federal government, have taken aggressive action to relieve disaster-stricken localities.

In the New York case, census data displayed in figure 3.7 reveal sharp increases in federal government transfers to New York State and New York City in 2002 and, to a lesser extent, in subsequent years. Chernick (2005) describes

2. See Inman (2003); Oates (2005, 2008); Wildasin (1997, 2004); and references therein for discussion of bankruptcies, bailouts, and related institutional issues and experience in the United States and abroad.

Figure 3.7
Intergovernmental Transfers as a Percentage of State and Local Government Revenues, New York, 1977–2006



Note: Missing state-local observations in 2001 and 2003.
Source: U.S. Census Bureau (1977–2007).

the role of Medicaid and other established public insurance mechanisms that provided substantial relief to New York City over and above explicit intergovernmental transfers. It is noteworthy that state and federal fiscal policy responses to the 9/11 attacks have involved a mixture of normal insurance and transfer mechanisms and of case-specific interventions in the form of special assistance programs created in the aftermath of the attacks.

In the New Orleans case, census data are not yet available, but estimates of total federal Katrina-related expenditures for the Gulf states as a whole are in the range of $110 billion (Murray and Bea 2007), about the same magnitude as total property losses from Katrina and the other major hurricanes of that season. Existing federal and state fiscal policies also provided assistance to the region through combinations of social assistance programs, reduced federal and state tax burdens, and the like. Explicit intergovernmental transfers, both to the state of Louisiana and to local governments in the New Orleans metropolitan area, have been important components of the assistance provided by higher-level governments. For example, state budget figures for fiscal year 2006–2007 estimate state revenues from the federal government of approximately $14 billion, including more than $8 billion of hurricane-related assistance, compared to about $12.6 billion of own-source revenues; comparable figures appear in the fiscal year 2007–2008 budget. In fiscal year 2004–2005, by comparison, federal government transfers to the state were approximately $6 billion. Although a detailed accounting remains to be undertaken, intergovernmental transfers to Louisiana and to New Orleans, as well as related regionally targeted fiscal assistance, clearly shifted a large portion of the costs of the 2005 disasters from the New Orleans region, including local governments in the New Orleans area, to the rest of society.

It is hazardous to generalize from a few rare events. It is noteworthy, however, that rare but large disasters account empirically for a large fraction of all disaster losses.[3] Analyses of risk-sharing mechanisms for disasters that omit exceptional disasters thus neglect the empirically most important cases. Both the 9/11 and Katrina experiences have revealed an important aspect of intergovernmental and interregional assistance in the U.S. federation, namely, that exceptional local shocks produce exceptional responses by higher-level governments. Local shocks are transmitted, and local risks are shared, both through the operation of the established fiscal instruments of higher-level governments, including both tax and expenditure policies, and through the ad hoc creation of special assistance programs. These ad hoc adjustments have been revealed to be part of the implicit system of insurance provided by the institutional structure of the federal system (Oates 2008; Weingast 2006). The policy implications of these institutional mechanisms have not yet been fully explored, but they raise questions about the intergovernmental division of responsibility not only for ex post disaster relief, but also for ex ante disaster avoidance and preparation (Goodspeed and Haughwout 2006; Wildasin 2008b).

Intertemporal Management of Local Government Finances

Extreme disasters are, thankfully, rare events. In the more routine circumstances of economic life, how do localities deal with localized and macroeconomic shocks? As remarked by Edward Gramlich about the recurrent episodes of fiscal distress encountered by subnational governments, “Every decade or so the state and local government sector begins to behave strangely” (1991, 249). The 2008–2009 recession has likewise produced its share of distress, and it has triggered a substantial intervention by the federal government in the form of a fiscal stimulus package designed to assist households, businesses, and state and local governments. Although no two crises are the same, the use of stimulative federal fiscal policy at a time of recession, including increased government transfers, is by no means unprecedented. Experience has shown that the timely delivery of desired amounts of fiscal transfers to subnational governments is no simple task (Gramlich 1978, 1991; Wildasin 2009; and references therein), and the fiscal and macroeconomic effects of the 2009 stimulus package remain to be seen. Still, an

3. See Wildasin (2007b, 2008a) for additional discussion of the distribution of disaster risks among U.S. states and of the importance of extreme realizations of disaster risks in Louisiana and in the nation as a whole.

examination of past experience can reveal some basic facts about how subnational governments cope with economic fluctuations.

Macroeconomists have long been interested in the fundamental question of fiscal stability: over time, do governments manage their debt obligations in a sustainable manner? Do they adhere, over the long term, to their intertemporal budget constraints, as theory suggests must be the case? And if so, what mechanisms of fiscal adjustment do they use? These basic questions have been examined at the level of national governments; for instance, Bohn (1991) has studied the debt policy of the U.S. government from the founding of the nation to the present time, finding that the national government has not (so far!) displayed explosive tendencies. Similar analyses of other countries and times (see, e.g., the analysis of Indian public finances by Buiter and Patel 1994) sometimes reach less optimistic conclusions, and fiscal history over the long term certainly provides numerous dramatic illustrations of fiscal collapse.

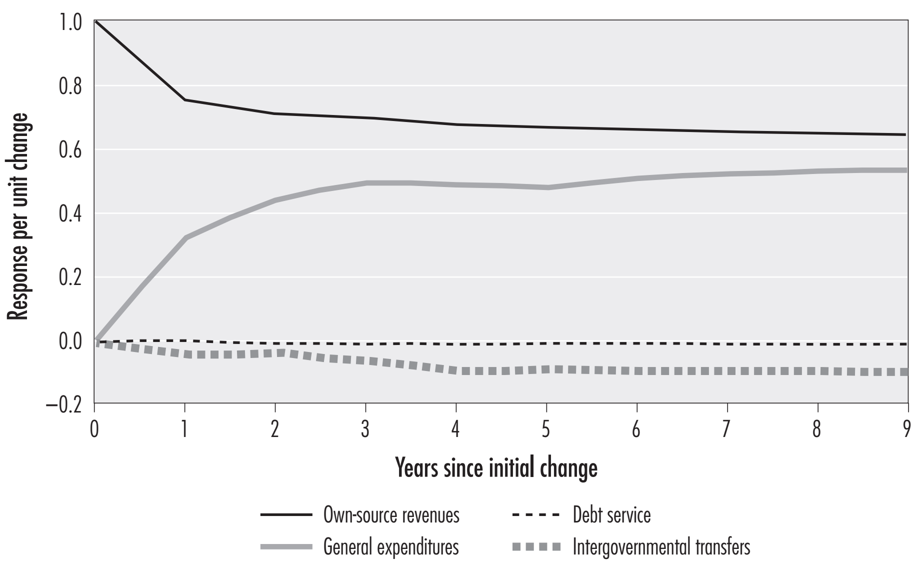
On a less grand scale, it is of interest to ask whether the public finances of subnational governments in the United States and elsewhere follow sustainable paths over long periods. Subnational governments are particularly interesting from the viewpoint of empirical research because they operate within a common overall economic and institutional framework and yet display potentially important institutional variation. In the U.S. context, for instance, several studies have investigated whether and how state-level balanced-budget requirements affect state government spending, taxation, and borrowing, typically finding that these institutional constraints have a significant impact on state fiscal policies (see, e.g., Bohn and Inman 1996; Poterba 1994). Related questions arise with respect to state budget stabilization (rainy day) funds, which also seem to have significant effects on the management of state government finances (Knight 1999).

As discussed above, intergovernmental transfers are major revenue sources for subnational governments, notably including local governments. These transfers can potentially affect the tax, expenditure, and borrowing policies of recipient governments in important ways. For instance, if a local government's revenue falls short of its expenditures, it may be able to borrow funds in the capital market or draw down financial reserves. Alternatively, the expenditure-revenue gap may be covered by transfers from a higher-level government, as has happened in the exceptional cases of New Orleans and New York described earlier and as happens routinely, in less exceptional circumstances, for local governments throughout the nation. Access to intergovernmental transfers could conceivably weaken local fiscal discipline if the anticipation of ever-rising transfers leads localities to pursue expenditure and revenue policies that, sooner or later, become unsustainable. The prospective availability of intergovernmental transfers at times of financial distress could also lead localities to pursue policies that result in greater fiscal risks, for instance by opting for more volatile revenue sources, such as local taxes on personal or business incomes instead of real property, by committing to the provision of public services (income-dependent social services would be one example) that result in expenditure volatility, by investing in risky local public enterprises, by increasing exposure to financial risks through the structure of local debt instruments, or by failing to accumulate and maintain significant liquid financial reserves. In the first of these instances, the question is whether intergovernmental transfers may be conducive to structural deficits, whereas in the second case, the issue concerns the volatility of local finances; either, both, or neither may be affected by intergovernmental transfers.

These are not simple questions to answer. One analytical approach, presented in Buettner and Wildasin (2006), builds on the modeling techniques used in macroeconomics literature. An analysis of a panel of approximately 1,000 U.S. municipalities over more than a quarter century shows that the finances of these governments adjust over time in compliance with long-run budget constraints; that is, there is no evidence of explosive imbalanced growth on the expenditure and revenue sides of local fiscal accounts. By breaking down municipal government fiscal flows into two revenue categories—own-source and intergovernmental revenue—and two expenditure categories—primary expenditures and debt service expenditures—it is possible to assess fiscal flows over time as localities adjust to changes in any one of these revenue or expenditure items.

Figures 3.8 through 3.11 illustrate several relevant sets of impulse response functions. Figure 3.8 shows the estimated response of municipal fiscal variables to a one-unit increase in own-source revenues. A revenue increase in one year is followed by subsequent reductions in own-source revenues, increases in expenditures, and reductions in debt service and intergovernmental transfers, all

Figure 3.8
Responses to Changes in Own-Source Revenues



of which tend to offset the initial increase in revenues. The latter two effects are very small, implying that intergovernmental transfers absorb a small portion of fluctuations in local revenues. These responses of transfers include the combined effects of all grant flows, whether from project grants, formula-driven transfers, or any special ad hoc fiscal transfers. Figures 3.9, 3.10, and 3.11 are interpreted analogously. In all cases, intergovernmental transfers in later years exhibit some offsetting response to initial variations in any of the four fiscal variables, including intergovernmental transfers themselves. However, intergovernmental transfers play a quantitatively rather limited role in the adjustment of municipal public finances to fluctuations in primary municipal expenditures or revenues; that is, they do not result in a pronounced softening of municipal government budget constraints. Note that this finding is a characterization of the joint interactions of municipalities and of their higher-level donor governments: the incentives embedded in the entire system of local government finance result in policy choices at all levels of government, including the design and implementation of donor-government transfer programs, that generate the dynamic adjustments in municipal finances revealed in these figures.

In subsequent research, Buettner (forthcoming) has investigated intergovernmental transfers to German municipalities using similar analytical methods. The German fiscal system differs from that of the U.S. in important ways, notably through the fiscal equalization program that transfers revenues to localities with low levels of fiscal capacity (in particular, with low levels of local tax bases) at the

Figure 3.9
Responses to Changes in Intergovernmental Transfers

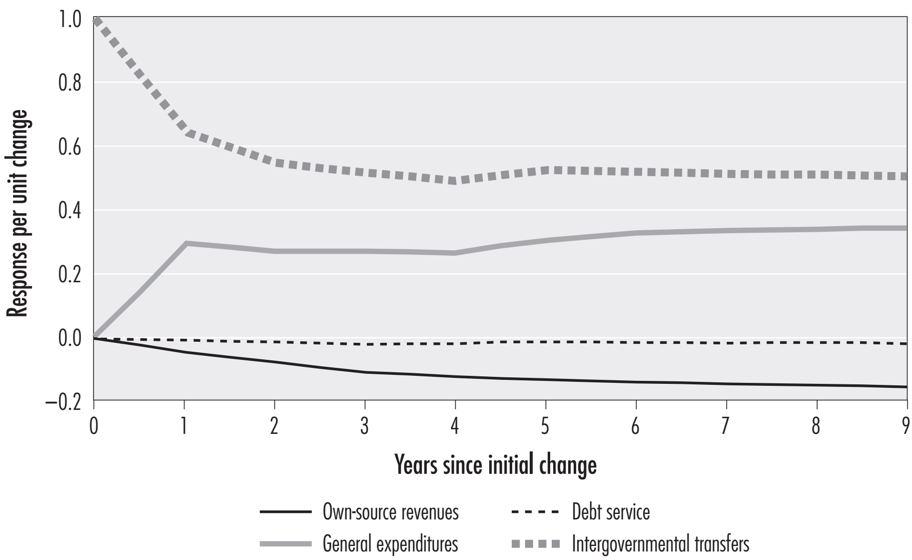


Figure 3.10
Responses to Changes in General Expenditures

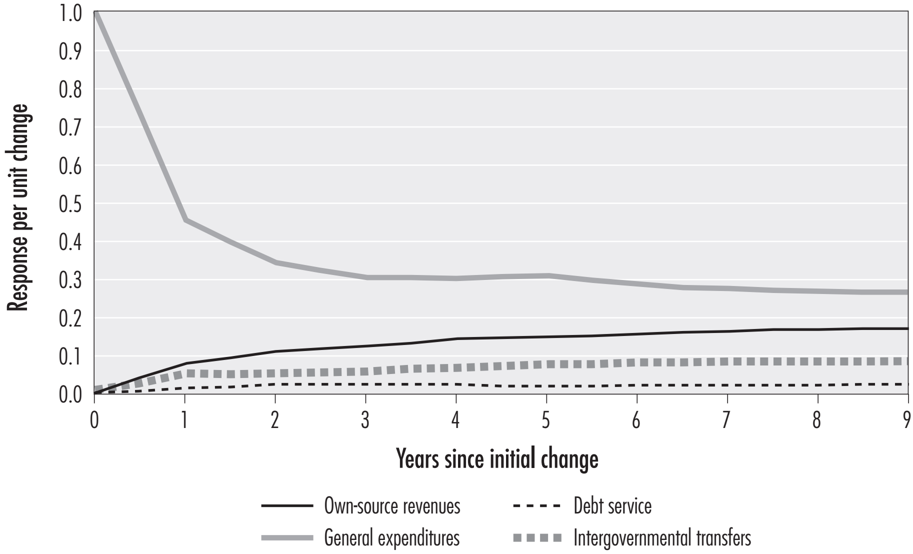
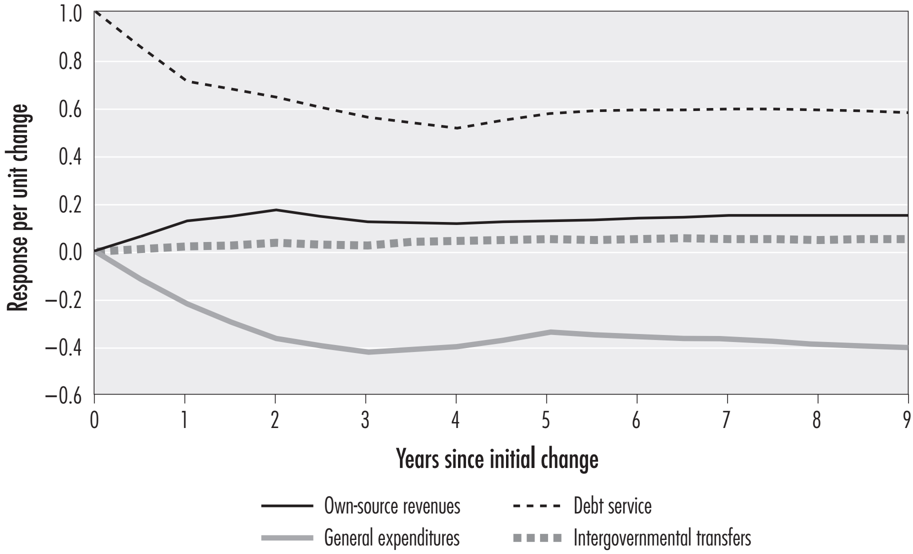


Figure 3.11
Responses to Changes in Debt Services



expense of localities with high capacity. In any given year, a particular municipality may be a net beneficiary or a net contributor to this system. Again using a sample of about 1,000 municipalities over approximately a quarter century, it is possible to ascertain that German municipalities, like their U.S. counterparts, follow sustainable long-run fiscal paths. As in the U.S. case, local fiscal variables tend to adjust in the expected directions over time. There is a marked contrast with the United States, however, in the role of intergovernmental transfers, as a much higher proportion of the burden of local fiscal adjustment is absorbed by offsetting changes in equalizing transfers (see figure 1 in Buettner forthcoming).

It is noteworthy that German municipalities depend heavily on the taxation of local business activity as a principal component of own-source revenues, while deriving very modest amounts of revenues from taxes on land, another permissible source of municipal tax revenue. The revenues of these municipalities are consequently comparatively volatile, since the business tax base is more variable than are land values. In this respect, the German experience differs from that of U.S. municipalities, which derive less than one-third of own-source revenues from sources other than property taxes or charges and fees. These findings, though limited to only two countries, suggest that systems of intergovernmental transfers that are highly responsive to fluctuations in local revenues may be associated with comparatively volatile local revenue structures. Additional research is needed to determine whether this conjecture is more generally valid for different types of local governments or for state or provincial governments in the United States and elsewhere.

The findings also provoke questions about the coevolutions of local revenue systems and intergovernmental transfers. It is possible that intergovernmental transfer programs that are highly responsive to fluctuations in local fiscal conditions, like that in Germany, induce localities to rely on comparatively volatile revenue sources because revenue risks are shifted upward to donor governments. However, it is also possible that such intergovernmental transfer programs tend to emerge when local governments have adopted own-source revenue instruments that yield volatile revenue streams. Conversely, if state governments limit local government access to revenues from taxes on bases other than real property, as sometimes occurs, the relative stability of local revenues might be accompanied by state-local intergovernmental transfer systems that are relatively insensitive to fluctuations in local government revenues. This, too, is an interesting topic for further investigation.

Before closing this discussion, it is perhaps of some interest to revisit the discussion of state and local government taxation in California, a state whose finances have been hit particularly hard in the 2008–2009 recession. The combined state and local revenue system of California generates a comparatively modest flow of revenue from taxes on real property (see Wassmer 2008 for a thorough discussion of state and local finances in California, the state's recent fiscal history, and the problems it has faced in achieving fiscal stability). Whereas property tax revenues in recent decades have accounted for about 15 percent of total state and local government revenues in the nation as a whole, the comparable figure for California is only about 10 percent. State-local intergovernmental transfers in California, as noted earlier, are comparatively important sources of local government finance, and the state's overall fiscal system is relatively heavily dependent on personal and business income taxes. (Whether this overall revenue structure is attributable to property tax limitations like Proposition 13—or, indeed, is ultimately attributable to judicial school finance rulings in the 1970s—can be debated, but California's system of state-local intergovernmental transfers has a strongly equalizing impact on local revenues.) For this reason, California's consolidated state and local fiscal system may be more sensitive to economic fluctuations than those of most other states.[4]

Finally, it is interesting to note that intergovernmental fiscal relations in California continue to be the subject of political controversy and the source of fascinating policy developments. The state of California, facing a large fiscal deficit,

4. It is interesting to observe that the fiscal system of Kentucky, like that of California, also depends very heavily on income taxation and only modestly on property taxation. Local property taxes accounted for only 18 percent of local government general revenue in both states in 2006, compared to 32 percent for localities in the rest of the country, while income taxes were 19 percent of *combined state-local* revenues in Kentucky in 2006 and 21 percent in California, compared to only 14 percent for the rest of the country—a striking similarity, and a surprising one, in view of California's 11th-place ranking among the states in 2008 per capita income, compared to much-poorer Kentucky's ranking of 46th. While the revenue systems of both states are very income tax–dependent, they differ in that local governments in California, as in most of the country, do not impose income taxes, whereas local governments in Kentucky obtain substantial revenues (11 percent of local revenues in 2006) from income taxes. Income taxes are thus concentrated at the state government level in California, where they were 33 percent of revenues, compared to Kentucky, for which 20 percent of state government revenues derive from income taxes, approximately equal to the 19 percent of income-tax-derived revenues for other states. Localities in California, on the other hand, are unusually dependent on transfers from the state government, which came to 43 percent of local revenues in 2006, compared to 39 percent in Kentucky and 32 percent elsewhere. Thus, California and Kentucky are states where income taxes are especially important and where property taxes play a relatively modest role in local finances. In both states, but especially in California, an unusually large share of local revenues derives from state transfers to localities. In California these transfers are obtained from a state revenue system that relies comparatively heavily on income taxes, while in Kentucky, localities obtain substantial revenues from their own income taxes. These two income tax–dependent states thus differ in that localities in Kentucky collect income taxes directly, whereas in California, income taxes are collected at the state level, and the proceeds are then transferred to localities. Arguably, reliance on income taxes in both states can be attributed in part to property tax limitations from Proposition 13 in California and HB44, passed in 1979, in Kentucky. (Further details on the Kentucky case are available in Wildasin et al. 2001.) In any event, the fiscal systems of both states are relatively sensitive to income fluctuations. In California the immediate fiscal impact of such fluctuations is felt at the state level, whereas both state *and* local revenues in Kentucky are directly affected by income fluctuations. Further analysis and comparison of the revenue and state-local transfer systems of these two states may shed significant light on the adaptation of state and local fiscal systems, including intergovernmental transfers, to revenue fluctuations.

has engaged in a lengthy and contentious struggle over fiscal policy. Attempts to increase tax revenues through voter referenda have recently been rejected, and, at the time of writing, it appears that the deficit will be closed with a combination of expenditure cuts, indirect revenue increases (e.g., higher tuition for students at state universities), accounting gimmicks (postponing state employee paychecks by one day to shift expenses to the next fiscal year), and—of particular interest in the present context—a program of mandatory loans from local governments to the state. The state will require cities, counties, and special districts to lend $1.9 billion of local property tax revenues to the state government, to be repaid within three years. Such intergovernmental loans are not, strictly speaking, intergovernmental transfers as customarily measured, but, in a cash-flow sense, they serve an analogous function, especially at a time of fiscal crisis. Such inverted loans, a unique innovation in state-local intergovernmental fiscal relations, will partially offset an unusually large state government deficit at a time when cyclical income volatility has resulted in significant revenue shortfalls at the state level. From the viewpoint of localities, however, mandated loans to the state government may necessitate difficult expenditure cuts, particularly in view of the limits that have been imposed on local government revenue autonomy by Proposition 13 and other regulations. In the longer term, it will be of interest to see whether California rebalances its fiscal system so that it becomes less dependent on income taxation and, perhaps, places greater weight on property taxes, whether at the local or at the state level.

Conclusions

The finances of local governments depend heavily on intergovernmental transfers, especially from state governments. These intergovernmental transfers are, however, just one element in a complex system of intergovernmental fiscal and regulatory linkages. Local finances depend on the entire national fiscal system, as illustrated by the changing roles of federal, state, and local governments in the provision of social assistance to low-income households. In addition, local finances can be much affected by regulations and rulings imposed by higher-level governments and by the judiciary, as illustrated by the impact of court decisions in a number of important school finance cases.

This complex system defies simple summarization. However, it has proven to be generally resilient in the face of ever-changing economic and other conditions. Indeed, it seems that intergovernmental transfers contribute to its resilience. Much of the cost of the terrorist attacks of 9/11 and the floods produced by Hurricane Katrina has been effectively shifted to the rest of society through a mixture of explicit intergovernmental transfers, regionally targeted assistance to local businesses and households, and the routine operation of income-dependent tax and transfer systems. Empirical investigation has shed some light on the mechanisms of local government fiscal adjustment, showing that intergovernmental transfers play a role, but a modest one, in offsetting fluctuations in local government expenditures and own-source revenues. These transfers have not undermined the long-run fiscal stability of local government finances. Further investigation of intergovernmental transfers to local and other subnational governments in different states and nations may shed additional light on the development of the fiscal institutions of federations and on their performance.

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