State and Local Government Finance in the Current Crisis: Time for Emergency Federal Relief?

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A review of recent fiscal history can help us understand the mechanisms by which subnational governments adapt their tax, expenditure, and debt policies to an ever-changing economic environment as well as the role fiscal assistance from higher level governments plays in this process. In principle, proposed federal assistance to states and localities may provide useful macroeconomic stimulus and financial support, but past experience, in the United States and elsewhere, highlights the pitfalls in achieving rapid delivery of substantial assistance while simultaneously targeting scarce fiscal resources to the most urgent needs and preserving incentives for prudent financial management by states and localities.

INTRODUCTION

State and local governments are among the many institutions, both public and private, that are suffering from the recent turmoil in financial markets. Disruptions of the market for auction-rate securities, doubts

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about the financial stability of municipal bond insurers (reflected in downgrades by rating agencies), and uncertainty about the meaningfulness of bond ratings themselves are among the symptoms of this turmoil.[1] Increasingly, stresses arising within the financial markets are compounded by changing economic conditions. A downturn in overall economic activity is reducing revenue flows to state and local governments at the same time that demands for many public services—income- and employment-conditioned social services in particular—are rising. As of the time of writing, it is far too early to draw any firm conclusions about the fundamental causes and ultimate consequences of the current economic and financial crisis. But it may be useful to review some branches of previous research, based on the experience of subnational government finance in the United States and abroad, that can provide some partial insights into recent events. As will become apparent, our understanding of subnational government finance in the midst of financial crises is imperfect, and there are many fruitful lines of inquiry for future research.

This paper begins, in the next section, with a short review of some of the history of state and local public finance in the United States. Even in the postwar era, to say nothing of earlier periods, subnational governments have had to cope with episodes of economic, financial, and fiscal distress. At least to date, they have demonstrated a capacity to adjust their policies, when necessary, to maintain their long-run financial viability.

The following section describes an analytical framework for modeling this adjustment process and summarizes the findings of some recent research devoted to the study of municipal government finance. Research to date has examined municipal governments in the United States and Germany, and a comparison of the two shows that they differ in important ways because of the differing degrees to which municipal governments are supported by fiscal transfers from higher level governments. These findings are of some interest in view of recent proposals to extend special financial relief to state and local governments in order to deal with current exigencies. The final section of the paper discusses some of the potential advantages, as well as the pitfalls, of such policies.

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[1] Many examples could be cited to illustrate the difficulties facing bond market participants. This quotation, from a December 2007 news report (Barr, 2007), captures some of the flavor:

> By issuing warnings on FGIC and XL Capital Assurance, [Moody's] is also putting more than 90,000 securities that the companies had guaranteed on review for a possible downgrade, according to global fixed-income analysts at UBS. The majority of those securities—89,709—are in the public finance sector, the analysts said, noting that this was "unprecedented" in the municipal bond market.

SOME HISTORICAL PERSPECTIVES

To begin with, it should not be forgotten that state and local governments have been through many ups and downs during past decades. Each "crisis" has its own distinctive features, but it is well recognized that the public finances of state and local governments have never been immune to economic cycles. At the same time, state and local government finances have exhibited a certain overall stability, suggesting that their fiscal systems, and the legal and political frameworks underpinning them, have displayed a significant degree of resiliency.

Some references to previous literature can help to provide perspective. Edward Gramlich, an eminent long-time analyst of subnational government finances in the United States, wrote a paper in 1978 entitled "State and Local Budgets the Day After It Rained: Why Is the Surplus So High?" which begins by stating that: "Readers of the financial press will be shocked to find that . . . the 78,000 state and local governments in this country are running a hefty surplus" (p. 191).

This surplus was shocking because it occurred soon after the 1975 recession. (New York City nearly defaulted on its municipal debt in 1975, marking this not only as a recession year, but as a year of substantial financial market distress.) This mid-1970s episode may serve as a reminder that not all risks, in the neutral sense of fluctuations, are to the downside; financial and economic conditions can change rapidly and unexpectedly for the better. Of course, *plus ça change, plus c'est la même chose:* such is the way of cycles. By 1991, Gramlich had occasion to write an article entitled "The 1991 State and Local Fiscal Crisis," which begins with these telling remarks: "Every decade or so the state and local government sector begins to behave strangely." On that occasion, of course, subnational fiscal balances were worsening.

Despite the inevitable cycles to which subnational governments have been subject, one must acknowledge that the current system by no means represents the worst of all possible worlds. The precise extent to which the policies of state and local governments in the United States have contributed to the development of the U.S. economy for the past two centuries can certainly be debated, but they have evidently not prevented U.S. economic growth over long periods of time. Indeed, there is at least a prima facie case that subnational governments, involved as they have been in the provision of education, transportation, public safety, and other important services, may well have provided an essential part of the framework for economic growth over long periods of time. In any case, these services have been provided essentially uninterruptedly for almost all citizens for the past century and longer, surely a sign that the fiscal systems of state and local governments have generally been quite able to adapt to the many short- as well as long-term economic, demographic, technological, and other shocks and trends that have confronted them for many decades.

These adaptations are by no means costless, of course, and many groups might wish that subnational government policies would take their interests more prominently into account. The beneficiaries of public services have been disappointed when services have been cut, taxpayers have been disappointed when taxes have gone up, public-sector employees have been disappointed when jobs have been cut, and bondholders have been disappointed when debt has not been repaid.[2] Few would wish to argue that every policy decision by every unit of subnational government has been fully optimal, but the system of fiscal federalism in the United States has arguably served the nation reasonably well. This is a system that scholars continue to study. One good reason to do so is that sound policymaking, in times of crisis, should preserve and build upon the strengths of the existing system, even if policy innovations are needed in order to cope with some of the strange and unique problems that seem to crop up every decade or so.[3]

SUBNATIONAL GOVERNMENT FISCAL ADJUSTMENT: SOME RECENT FINDINGS

At times of fiscal and financial distress, it is commonplace and very natural for policymakers and commentators to make many proposals for large and small reforms. How can governments continue to provide essential

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[2] Subnational governments certainly do go through periods of financial distress. Nonetheless, defaults on subnational government debt, municipal bankruptcies, and other extreme breakdowns of the financial underpinnings of subnational governments are rare.

As described in more detail in Wildasin (2004), there have been fewer than 1,000 municipal bankruptcies under Chapter 9 of the U.S. bankruptcy law since its enactment in 1937. Moreover, many of these bankruptcies have been comparatively small units of local government, such as special-purpose districts (e.g., small water districts). Given that there are almost 100,000 subnational governments in the United States, these bankruptcies are clearly exceptions to the rule. Indeed, it is possible that the number and scale of local government bankruptcies is inefficiently small. Further investigation of the optimal level of municipal bankruptcies may well be warranted.

[3] The fiscal and financial history of subnational governments in the United States is a large subject and one that is the subject of ongoing research. Ratchford (1941) recounts the history of U.S. subnational government debt from the Revolutionary War through the 1930s. Inman (2003) discusses how subnational governments have dealt with fiscal and financial crises through the 19th and 20th centuries, noting that higher level governments historically exercised substantial constraint in coming to the relief of distressed lower level governments. Zolt (2009) provides a recent analysis of the evolution of state and local government finances from the early years of the republic to the present, emphasizing the interaction between economic inequality, particularly within different regions of the country, and the levels of public expenditures and taxation. These works contain many additional references to related literature.

services? Where will the money come from? How can defaults and bankruptcies be averted? What policies can provide a needed economic stimulus? In the face of changing economic circumstances, and through a complex process of political haggling, at all levels of government, policies are finally determined. This complex process must inevitably respect fundamental economic and financial constraints on the revenue-raising capacities of governments and on the ability of financial markets to absorb government debt. Although the adaptation of fiscal and financial policies in times of crisis may capture greater attention and produce more controversy than in more ordinary circumstances, and although the crisis of the day often appears to be more severe than crises that have gone before, the adaptation of government policy to shifting economic, demographic, financial, and other circumstances is in fact a continuous process. Taxes go up and down, spending goes up and down, and borrowing goes up and down, at all levels of government and at all times.

This section summarizes some recent research that sheds light on the nature of this dynamic process of fiscal adjustment. To date, this research has examined fiscal adjustments by municipal governments in the United States and Germany during the past several decades.[4] The findings of this empirical research, and particularly the contrast between the results for the United States and Germany, shed light on some of the policy options that government policymakers face when considering such issues as possible expansions of fiscal transfers to subnational governments in times of distress.

To begin with, consider a very simple and fundamental question. In the long run, are the finances of a government "balanced," or, in somewhat different language, are they financially sustainable? This question has been investigated at the level of national governments by such authors as Bonn (1991) and others, who examine the long-run development of public expenditures, taxes, and debt for countries such as the United States and others. At any point in time, a government's expenditures can outpace its revenues, provided either that it has previously accumulated assets that can be liquidated and used to finance current spending or that it can borrow to make up the difference between spending and revenues. Current tax and expenditure decisions affect the future, however. The depletion of existing assets and the accumulation of new liabilities imply that future spending

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[4] The following discussion is based largely on studies of U.S. municipalities by Buettner and Wildasin (2006) and analogous research on German municipalities by Buettner (2007). As some of the following remarks suggest, this research builds upon a substantial body of earlier work, mainly focused on national governments, by a number of other researchers. Interested readers are referred to these papers for additional references and discussion of the literature.

must be lower or that future revenues must be higher than would otherwise would be the case.[5] If this year's borrowing B becomes next year's debt plus interest, $(1 + r)B$, it can be repaid at that time by raising more taxes or by cutting spending or by both.

Of course, it may not be absolutely necessary to repay this year's borrowing plus interest in the coming year. Instead, it might be possible to postpone repayment for an additional year, though of course at the expense of having to cut spending or raise revenues in that year sufficient to retire the debt plus interest of $(1 + r)^2B$. By continuing this process, it is possible to defer repayment of this year's borrowing for many years, or even indefinitely.

Nevertheless, one must anticipate that governments cannot simply rely indefinitely on borrowing to finance all of their expenditures; otherwise, why pay taxes at all? Indeed, as a condition of long-run solvency, it is usually postulated that governments must adhere to a long-run budget constraint of states that the present value of future government expenditures, plus the level of outstanding initial debt obligations, must be equal to the present value of government revenues. Symbolically, this "long-run government budget constraint" may be written as:

$$G + B_0 = R,$$

where G is the present value of all government expenditures, R is the present value of all government revenues, and B_0 is initial debt outstanding.

This long-run budget constraint embodies the important point that, at least in the absence of regulatory or other constraints, governments do not have to balance their budgets in the "short run." One cannot look at any one year's expenditures, revenues, and borrowing in isolation to see whether fiscal policy is sustainable. Indeed, one main function of government borrowing (and its negative, government saving) is to enable governments to "detach" the flow of current revenues from the flow of current expenditures. In particular, at a time of fiscal "crisis," governments can use borrowing to maintain or even increase expenditures in the face of declining revenues, and, in principle, this provides a means by which governments can "smooth" taxes and expenditures over time, even in the face of fluctuations in economic activity. Bohn (1991) and other authors have investigated the long-run dynamics of government finances at the federal level, confirming that fiscal policies have, in the past, seemed to comply with the government's long-run budget constraint.

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[5] For the sake of streamlined exposition, the following remarks make little or no explicit reference to many important complexities involved in the management of long-run fiscal policies, such as the problems of pension underfunding, infrastructure investment, the structure of taxation, or the management of natural resource stocks. See, e.g., Boadway and Wildasin (1993) for a more thorough discussion of these matters and references to a large body of related literature.

A similar analysis can be undertaken for subnational governments, although, for these governments, it is particularly important to take transfers to or from other levels of government explicitly into account. In 2005–2006, federal transfers to state and local governments accounted for 22% and 4% of their revenues, respectively, while state transfers to localities amounted to 30% of local revenues. State government transfers to localities exceeded federal transfers to states, although by only about 6%. (Thus, in terms of aggregate net transfers, states may be viewed approximately as conduits for federal funds flowing to localities.) If T is the present value of net transfers from other levels of government, the long-run budget constraint for a subnational government can be written as:

$$G + B_0 = R + T,$$

which shows that subnational government expenditures and debt obligations can be financed not only through own-source revenues, but also through transfers from other governments. Thus, a state or local government may be able to finance a level of expenditures over time that would not be sustainable through its own tax and nontax revenues if it is the beneficiary of sufficiently large fiscal transfers from another (usually higher level) government.

As reported in detail in Buettner and Wildasin (2006), an analysis of the fiscal policies of approximately 1,000 municipalities, large and small, over a period of a quarter century, shows that municipal governments in the United States do adjust their finances over time so as to adhere to their long-run budget constraints. An increase in a municipality's deficit in one year, resulting, for instance, from increased spending or reduced revenues, is offset by changes in fiscal policies in later years, with large responses within a year or two and with diminishing impacts in later years. By decomposing municipal finances into outflows of expenditures and debt service and inflows of own-source revenues and intergovernmental transfers, one can examine the extent to which changes in each of these fiscal variables offset changes in any one of them so as to maintain long-run budget balance. For instance, for a typical municipality, an increase in expenditures in one year is followed in subsequent years by increases in taxes, in intergovernmental transfers, and in debt service, as well as by reductions in expenditures.

As a matter of fact, this latter "own-effect"—the response of future expenditures to changes in current expenditures—is quite large. In present-value terms, an increase in expenditures in one year is offset by a more than 70% decrease in future expenditures. Consequently, to maintain long-run fiscal balance when expenditures rise, comparatively modest adjustments are required for other fiscal instruments. In present-value terms, own-source revenues rise by about 16%, grants from higher level governments rise by about 8%, and debt service rises by less than 2% of the amount of an increase in municipal expenditures. All of these findings hold, in reverse, when expenditures fall.

In contrast, a change in own-source revenues gives rise to a rather different pattern of fiscal adjustment. If revenues go up in one year, future revenues fall by only about 35% of this amount in present-value terms. Future expenditures rise by 51%, grants fall by 9%, and debt service falls, but by less than 1%, in present-value terms.

These and other results indicate that municipalities have succeeded in navigating a path to fiscal sustainability over a long period of time. They have done so, in substantial part, by adjusting those components of fiscal policy over which they have relatively direct control—their spending and their own tax and nontax revenues. These adjustments, however, are not instantaneous. Moreover, transfers from higher level governments play a significant role in the process. To some extent, increases in expenditures or reductions in own-source revenues are offset by increases in transfers from higher level governments, enabling municipalities to adhere to their long-run budget constraints.

By way of comparison, Buettner (2007) discovers some interesting points of contrast between the fiscal adjustment processes of municipalities in the United States and Germany. As in the United States, intergovernmental transfers are quite important in the German Federation, and, in fact, they are larger, as a source of finance, for German than for U.S. municipalities. Furthermore, the German system has elements that are explicitly designed to equalize the fiscal resources of municipalities. No doubt largely for this reason, it seems, empirically, that changes in fiscal transfers play a much larger role in the fiscal adjustment process of German municipalities than is true for their American counterparts.

In particular, fluctuations in own-source revenues are offset by compensatory changes in fiscal transfers (especially through the equalization system) to a much greater extent than in the United States. Whereas a one-unit increase in local taxes is followed by a subsequent decrease in transfers of about 9% in the United States, as mentioned above, the corresponding figure for German municipalities is about 15%. For *sustained* increases in revenues (as opposed to a one-year fluctuation), the figure for the United States is about 13%, whereas for Germany it is about 34%, more than 2.5 times higher.

Although these figures must be interpreted with care, they strongly suggest that the German system is one in which a substantially larger fraction of the ups and downs of local revenue fluctuations are absorbed by higher level governments than is the case in the United States. At a time of financial and fiscal distress, when local revenues are falling, changes in equalizing transfers can provide German municipalities with significantly greater relief than would be true for their American counterparts. Not surprisingly, then, a fall in revenue for U.S. municipalities is followed by substantially larger reductions in expenditures in subsequent years than is true for German municipalities. In these important respects, and others, the process of fiscal adjustment for German local governments differs significantly from that of the United States.

Buettner (2007) also points out that the own-source revenue bases of German and U.S. local governments differ in important ways. Property taxes account for a large fraction of the own-source revenues collected by local governments in the United States. German municipalities also derive revenue from similar taxes. However, they are much more dependent than U.S. municipalities are on taxes on business activity—a revenue source that is far more sensitive to changing economic conditions than the property tax. As a consequence, their revenues may exhibit greater variability than is true for U.S. cities. The equalization system may therefore be particularly important and useful in the German case, because it helps cities to cope with relatively large revenue fluctuations—the contributions of those with high levels of revenues are transferred to, and thus insure, those with revenue shortfalls. However, as Buettner notes, cities do have some discretion about the mix of revenue sources they employ. One dimension of policy discretion is the balance between relatively stable and relatively volatile sources of tax revenue, and the fiscal equalization system may well influence the policy tradeoffs between these types of taxes. By protecting municipalities from some of the consequences of revenue shortfalls, equalizing transfers may encourage greater reliance on revenue sources that would otherwise be seen as too risky to support important municipal government functions.

FEDERAL ASSISTANCE TO SUBNATIONAL GOVERNMENTS: POLICY GOALS AND CHALLENGES

In the current financial and fiscal crisis, some commentators—including economic policy advisers for the incoming administration—have called for large increases in federal government assistance for states and localities (Romer and Bernstein, 2009). There are several purported benefits to be realized from such relief. First, because subnational government revenues have fallen, states and localities are likely to curtail spending. From a macroeconomic perspective, such a response may exacerbate the recession by weakening aggregate demand. From a financial perspective, falling revenues may impair the ability of subnational governments to repay their debt obligations in a timely manner, and this prospect may limit the willingness of market participants to purchase subnational government financial obligations on favorable terms. From a public finance and public policy perspective, falling revenues, possibly combined with reduced access to capital markets, may force subnational governments to limit their expenditures and thus to forgo the provision of public goods and services and investment in public infrastructure. It seems that all of these effects would likely be mitigated by increased federal assistance to subnational governments.

The evidence from the research just mentioned, as well as previous research on state and local government finance, provides partial (but not complete) support for the notion that increased federal assistance to states and localities could have a salutary macroeconomic, financial, and fiscal impact. Fiscal transfers to subnational governments typically do result in higher levels of public expenditures by recipient governments, although, to some degree, these transfers are also offset by reductions in recipient government taxes. From an aggregate fiscal stimulus perspective, it seems likely that sufficiently large transfers could indeed increase aggregate demand, both by raising state and local expenditures and, through the less direct channel of local tax relief, by increasing consumption and investment expenditures by households and businesses.[6]

In terms of short-run liquidity and debt management, federal government transfers can provide immediate relief to subnational governments that are unable to pay their debt obligations or that face significant restrictions in raising funds through capital markets. Research by Poterba (1994), Bohn and Inman (1996), Alesina and Perotti (1999), and other authors indicates that limitations on the ability of subnational (particularly state) governments to borrow (for instance, as a result of balanced-budget rules) may indeed restrict their spending, a finding that also emerges in some current research on municipal government infrastructure spending (Buetter and Wildasin, in progress). Federal fiscal assistance may protect the ability of subnational governments to maintain public services and to sustain investments in infrastructure, even in the face of declining revenues and unusual financial market constraints. In the absence of such relief, the results summarized in the previous section, as well as research reported elsewhere, suggest that municipalities may increase taxes and cut spending now and in future years as they adjust their fiscal policies to adhere to their long-run budget constraints.

Despite these potential benefits from increased federal transfers to subnational governments, the overall desirability of major increases in fiscal transfers to subnational governments remains unclear. First, from an aggregate

[6] Romer and Bernstein (2009, n. 3) assume that federal assistance to states will result in higher spending equal to 60% of the amount transferred and that taxes will be reduced by 30% of this amount, with the remainder adding to financial reserves.

demand management viewpoint, it is debatable whether Congress can enact appropriate fiscal stimulus legislation sufficiently rapidly to achieve desired macroeconomic goals if it is simultaneously to promote other public policy desiderata. After Congress acts, it takes time for recipient governments to respond to federal assistance. It is quite possible that any such assistance may arrive too late to help with recovery from the current recession; in fact, it may augment demand expansion during the anticipated future economic recovery to an undesirable degree, thus solving few macroeconomic problems and perhaps adding some new ones.

The time lags involved in this process can be minimized by swift congressional action on financial relief programs that have a minimum of regulatory oversight and control, perhaps by directing assistance to projects that are already on the drawing boards and that are ready to be implemented—so-called "shovel-ready" projects. However, in this case, it is quite possible that other possible policy objectives may be compromised. The stock of "shovel-ready" projects may or may not be distributed among states and localities in a way that matches fundamental public assistance priorities. For instance, some relatively disadvantaged regions, coping with limited revenues, may have only limited plans in place for immediate increases in expenditures on infrastructure or other projects, even though their capital stocks may have deteriorated substantially due to ongoing economic weaknesses; in this case, federal assistance delivered with a mandate for rapid action may end up in regions where needs are less pressing. Furthermore, projects that are ready for immediate action may, in fact, be projects that would have been undertaken in any case, which is to say that federal assistance for these projects would have little impact on subnational government spending over a short time horizon (less than one year, say).

This problem is not an unfamiliar one. Writing of an earlier period of fiscal crisis, Gramlich (1978) recounts:

> In July 1976, Congress passed a strange piece of legislation called the Local Public Works Capital Development and Investment Act of 1976. . . . This act, intended to stimulate the economy, gave free money . . . to state and local governments for projects that could be started within 90 days, almost ensuring that the projects were the sort that might have been constructed anyway.

Gramlich (p. 209) goes on to describe some of the problems regarding the timing of this assistance, which created considerable uncertainty for potential recipients, and he concludes that the upshot may well have been that:

> In the name of stimulating the economy, the government passes a $2 billion program that appears to have caused a postponement of as much as $22 billion in total government spending and a reduction in GNP of perhaps $20 billion!

These figures are trifling by today's standards, but the lesson is a valuable one nonetheless. Subnational governments, as of late 2008, may be wisely (from their viewpoints) postponing important public projects in order to have them ready to go when (and if) a major relief bill passes Congress in 2009—just the sort of perverse response to policy uncertainty that seems to have undermined the 1976 initiative. The timely manipulation of fiscal policy to achieve desired macroeconomic impacts is a subtle and difficult undertaking, and it is far from clear whether it can be successful in the present context.

However important it may be for the federal government to stimulate aggregate demand through fiscal policy initiatives, the assessment of proposed federal relief to state and local governments cannot focus exclusively on macroeconomic factors. Large amounts of government expenditure ought to do something useful. It is natural to wonder whether incremental expenditures undertaken by subnational governments in response to federal financial relief would be directed to high-value uses or whether a new program of federal assistance to subnational governments would instead result in wasteful public expenditures. In recent months, the prospect of using federal assistance to expand spending on "infrastructure" projects—roads, bridges, transit systems, and the like—has been much discussed. For many years, commentators have expressed concern about the condition of the nation's infrastructure, and some seem to feel that a program of federal assistance in support of public capital investment is needed. Indeed, it is possible that states and localities have a large backlog of infrastructure projects that are now, and perhaps for some time have been, right at the cusp of adoption—almost, but not quite, important enough to cross the approval threshold in the budgeting process. If so, federal assistance may "tip the balance" in a way that facilitates a sudden expansion of very useful upgrades to the stock of public capital.

However, states and localities may have limited their expenditures on these types of projects in the past because they view other types of spending as more valuable. In this case, perhaps federal assistance would better be directed toward those uses, whatever they may be—primary and secondary education, higher education, health, public safety, debt service, or the funding of public employee pension systems, to mention only a few. In principle, nothing would prevent the federal government from directing its resources to these objectives instead of, or in addition to, programs of infrastructure investment. It is not easy, however, for federal authorities to choose among such policy options, as it is not easy for them to ascertain how state and local governments, collectively and individually, ought to use their scarce budgetary resources.

As an alternative mechanism of assistance to states and localities, the federal government could provide relief for states and localities in a way that leaves them with a high degree of autonomy in the use of these funds. A program that provides cash transfers to each state on an equal per capita basis, for instance, could be enacted and implemented very quickly. This would allow states to determine whether to spend incremental funds on infrastructure, education, debt service, transfers to local governments, tax relief, or any other alternative use of funds.[7] Insofar as the goal of federal assistance is to help subnational governments overcome liquidity constraints, such a program would at least serve the purpose of putting cash in the hands of state governments. A substantially more complex alternative, but one that would more likely stimulate recipient government expenditures, would be an open-ended matching grant program. The fewer the restrictions on the uses of grant funds, the more quickly these funds could be disbursed and utilized.

Federal authorities may be reluctant to turn over large amounts of funds in such an unrestricted manner, however. The tension between the desire of donors to control the uses of funds and the desire of recipients to use funds in whatever way may seem most important is a familiar one, and there are valid concerns on both sides. In ordinary circumstances, this tension can be managed through careful analysis of programmatic alternatives. In the midst of a fiscal crisis where rapid policy responses seem urgent, such analysis may well fall by the wayside, with unpredictable consequences.[8]

From the viewpoint of state and local government debt policy, a program of federal assistance could backstop subnational government debt

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[7] Equal per capita transfers to localities might seem to be a rather similar and perhaps attractive option, but they would be much harder to implement, particularly in a short period of time. The 80,000 local governments in the United States are organized in quite different ways in different states, and they perform many different functions. Any one household may simultaneously be a resident in a county, a city, a township, a school district, and zero, one, or several special-purpose districts. In such a setting, it is far from obvious how federal resources would best be distributed to localities.

[8] By way of illustration, some of these policy challenges may be encapsulated in the following quotation from a recent news article in a Las Vegas newspaper (Eckhouse, 2009):

> Local jurisdictions have compiled lengthy wish lists of potentially "shovel-ready" projects, or those that could be under construction within 180 days. Among them: a $200 million project to build a more efficient ramp from the airport connector onto eastbound Interstate 215, $63 million in regional road repair and, of course, Las Vegas Mayor Oscar Goodman's proposed $60 million mob museum downtown—a request that is being roundly rejected on Capitol Hill.

Should Congress simply turn over funds to localities for new highway ramps, road repairs, and mob museums, or should it apply its usual, more rigorous standards of scrutiny to the use of federal funds? It is worth noting that the above-named projects evidently have not previously risen to the top of the local budget priority list, whether for good or for ill. Whether they would, and should, cross the project approval threshold with federal assistance of one type or another is a debatable issue.

obligations and perhaps prevent a series of defaults that would further undermine the operation of the capital markets. If a major state or locality faces a serious risk of default, as may occur before the current crisis subsides, it is likely that pressure will build for emergency federal relief.

The effective implementation of any such relief is a challenging undertaking, however. Not all states and localities are equally at risk of financial failure. Some have recently made difficult decisions to cut spending or to bolster revenues in order to mitigate such risk. In past years and decades, some have pursued relatively conservative financial and fiscal policies, while others have been less cautious. To offer only one illustration, the financial problems facing the state of California have attracted significant attention in the popular media. California is a wealthy state, but it currently faces revenue shortfalls, partly as a consequence of its reliance on comparatively volatile revenue sources such as the personal income tax.[9] Emergency federal assistance to states or localities facing particularly difficult financial circumstances in the current crisis would undoubtedly provide welcome relief to bondholders, taxpayers, public-sector employees, and others in these jurisdictions. It would also, however, likely flow to jurisdictions that have, in the past, followed relatively risky fiscal strategies.

These considerations raise a fundamental policy concern. Does federal assistance at a time of financial crisis implicitly create perverse incentives that may undermine the overall system of subnational government finance? As noted in the preceding section, German municipalities have developed a system of finance that depends, more so than is true for the United States, on revenue sources that may be relatively volatile.[10] Plausibly, the incentives for subnational governments to adopt such policies are significantly influenced by the extent to which transfers from higher level governments

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[9] The passage of California's Proposition 13 in 1978 may have shifted that state's combined state/local revenue system away from the local property tax and toward state-level income and sales taxes, affecting the overall riskiness of combined state/local revenues. Some have argued that the California Supreme Court decisions in *Serrano v. Priest* (1971 and 1976), which mandated equalization of local school spending in that state, contributed to the passage of Proposition 13. Thus, equalization of local spending—court-mandated in the California case, rather than the result of an explicit equalization program, as in Germany—may indirectly have contributed to increased volatility of state/local government revenues.

[10] The advantages and disadvantages of such a revenue structure can be debated—valid arguments can be advanced in favor of the taxation of volatile sources of income relative to more stable sources of revenue. (See Domar and Musgrave [1944] for a classic treatment that has stimulated a long line of subsequent research on the role of taxation as a form of implicit government insurance of private-sector risk taking.) Some elements of the overall U.S. fiscal structure, most notably the federal personal income tax, but also income, payroll, and sales taxes at all levels of governments, as well as complementary expenditure-side policies, are already relatively sensitive to fluctuations in overall economic activity. Especially in view of existing federal policies, the incremental advantages

help to insure subnational governments against the risks of revenue fluctuations. The anticipation of such transfers, whether they result from the operation of a formal system of equalizing transfers or from ad hoc interventions, can shift the fiscal system as a whole toward increased subnational government dependence on federal assistance in times of crisis. Such a shift would almost inevitably entail increased federal regulation of subnational government financial management and concomitant limitations on subnational government policy autonomy.

Of course, as a constitutional matter, the federal government's power to regulate state governments and their subsidiary local governments is quite limited. When backed by the prospect of generous funding, however, federal government policy preferences are not easily ignored by states and localities. An upward shift of decision-making authority—from localities to states, or from states to the federal government—may in fact be needed to limit the risks undertaken by lower level governments. Such centralization of power could, in principle, help to enforce state and local government adherence to financially sustainable fiscal policies. However, in view of the accumulation of large explicit and implicit liabilities at the federal level in recent decades, it could be argued, instead, that lower level governments, subject as they are to self-imposed and market-imposed constraints, have in practice demonstrated a comparatively greater commitment than the national government has to fiscal sustainability.[11] It is therefore far from clear that increased federal government financing and control of subnational governments would ultimately stabilize the fiscal system as a whole.

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of a shift toward more volatile subnational government revenue sources, if any, seem likely to be quite modest.

[11] Such, indeed, has been the experience in the United States and other countries when higher level governments have had to step in to avoid financial collapse by lower level governments. U.S. experience in this regard has been relatively limited, and state and local governments have continued to enjoy high degrees of fiscal autonomy even despite the occasional financial crisis. The experience in other countries has been somewhat different. See Wildasin (1997) for a discussion of the problem of "bailouts" and "soft budget constraints" in general, with particular reference to the experience in the United States and in countries such as Brazil and Argentina. This general subject has been the topic of significant research attention in recent years. See Wildasin (2004), Oates (2005, 2006), and Weingast (2006) for further discussion and references to a rapidly growing literature.

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