The Implication of State Fiscal Stress for Local Governments

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revised, April 2003

Prepared for:

State Fiscal Crises  
Causes, Consequences, & Solutions  

April 3, 2003  
The Urban Institute, Washington D.C.

Sponsored by:  
The Urban Institute-Brookings Institution Tax Policy Center  
The Kellogg School of Management, Northwestern University  
The Institute for Policy Research, Northwestern University  
in conjunction with  
the National Tax Association

The author would like to thank Nathan Daugherty for his research assistance, and Howard Chernick, Eugene Steuerle, and Robert Tannenwald for comments on an earlier draft.
Introduction

Each passing day brings new reports of the worsening budgetary conditions of state governments. Over the past couple years, most states have had to repeatedly revise their revenue forecasts downward. At the same time, state government expenditures, especially on Medicaid, have been growing at faster than projected rates. As a result, most state governments are reporting very large budgetary shortfalls for the period between now (February 2003) and the end of fiscal year 2004. According to the most recent surveys of state fiscal conditions, the sum of reported state budget deficits for the 50 states exceeds $100 billion, an amount equal to about 14 percent of current spending levels.

State governments, which in nearly all states must balance their budgets on an annual or biennial basis, are responding to their large deficits by planning large cuts in state spending, and in some cases raising taxes or fees.¹

The primary purpose of this paper is to try to explore what impacts these state government budgetary shortfalls will have on local governments (including school districts). To the extent possible, I would like to ascertain whether state governments will try to protect their local governments relative to direct state programs. Making predictions is always a risky business. This is particularly true in this case, as the outcomes depend on the fiscal decisions made by the 50 states, by decisions made by tens of thousand of local governments throughout the United States, on decisions by the federal government about whether to assist state governments, and by future events, such as the state of the economy. Despite these difficulties, studying the actions of state governments in previous recessions, and exploring changes over time in the fiscal relation-

¹ In some states the governor must submit a balanced budget and/or the legislature must enact a balanced budget. If a revenue shortfall develops after the budget has been passed, however, in many states legislatures are not required to close the budget gap prior to the end of the fiscal year (Levinson, 1998).
ships between state and local governments will help shed light on the likely impact of state budgetary shortfalls on local governments ability to finance the delivery of public services.

State and local governments are bound together in a complex set of intertwined relationships. First and most obvious, state governments provide substantial amounts of direct financial assistance to local governments and school districts. In some states, grants to local governments and school districts account for over half of state governments general fund budgets. It is thus, not surprising that state grants are at risk when state governments face large budgetary shortfalls. Second, each state must decide how to divide responsibilities for the provision of public services between its state and local governments. State governments are thus in the position to shift some of their current responsibilities to their local governments. By mandating that general-purpose local governments or schools provide additional services, but not providing adequate funding for these services, state governments are able to reduce their budgetary shortfalls without cutting public services. Third, and more subtly, cuts in state government programs, particularly those providing direct services for the poor, can raise the costs of public service provision for local governments. Large cities that have heavy concentrations of needy people are particularly at risk when state governments choose to cut services for the needy in response to budgetary crises.

The rest of this paper is organized into seven sections. In the next section, I briefly discuss the magnitude of the budgetary problems currently facing state governments. In the section that follows, I begin exploring the relationship between state government fiscal conditions and the potential impacts on local governments by looking in some detail at the role direct state aid plays in the financing of municipal governments and school districts. After looking at limited data on budget cuts enacted to balance the current year (fiscal 2003) budgets and a few proposed
budgets for 2004, I explore how state governments chose to fill their budgetary shortfalls during the fiscal crises associated with the economic downturn of the early 1990s. I then suggest several reasons why it is likely that local governments may face even larger budget cuts during the current budget crisis than they did in the early 1990s. In the rest of the paper, I briefly discuss the possibilities that the current state government budget crisis will increase unfunded mandates imposed on local governments or result in an implicit shifting of costs from the state to local governments. The final section of the paper, explores the question of whether local governments will respond to less state aid and more responsibilities by raising taxes or cutting public services.

How Large are State Government Budget Deficits?

Determining the size of the budget gaps that state governments are facing is extremely difficult. First, the fiscal environment that states are facing is constantly changing. For example, based on surveys conducted through the end of 2002 by the Rockefeller Institute of Government, state tax revenues adjusted for tax law changes and inflation have declined for six quarters in a row (Jenny, 2003b). As a result, many states have been forced to repeatedly revise downward their revenue estimates. Spending has also proved difficult to track, with Medicaid and welfare spending growing at faster than anticipated rates in many states.

Second, state governments do not report their budget deficits in a consistent way. On the revenue side, each state is obviously free to choose its own assumption upon which to base its revenue estimates. On the spending side, a reasonable approach would be to calculate a current services budget. This budget can be defined as the amount of money needed in the next fiscal year to continue providing the same level of public services provided this year. The current services budget would be expected to grow from year to year to reflect any increases in populations
served (e.g. students, the elderly), and changes in the costs of necessary inputs. For example for fiscal year 2004 rapid increases in health insurance premiums will be one factor that will lead to increases in states’ current service budgets. It appears that while some states are calculating their budget deficits on the basis of current service budgets, other states are basing their deficit calculations on the nominal value of expenditures in the current year, and other states, on current spending modified by some limited increases mandated by state statute.

The State of Texas provides a good example of the differences in deficit estimates that emerge from different definitions of required spending. The Comptroller estimated a budgetary shortfall of $9.9 billion for the 2004-2005 biennial budget period based on current spending with adjustments for increases in health care and health insurance costs, but no adjustments for K-12 or higher education enrollment growth nor increases in debt service. The state’s Legislative Budget Board bases its $10.5 billion budget shortfall estimate on a spending projection that assumes slower growth in health insurance, but allows for higher spending for debt service and higher education enrollment increases. The Budget Board however ignore extra spending due to a projected increase in the number of K-12 students. Finally, a Texas-based non-profit research organization projects a budgetary shortfall for Texas of $15.6 billion on the basis of their estimate of the state’s current services budget (Center for Public Policy Priorities, 2003).

A recent compilation of estimated budgetary shortfalls from now through the end of fiscal year 2004 indicates that all but three states anticipate a budget deficit (Stateline.org, 2003). The largest deficits measured as a percentage of current spending are in Alaska (46 percent), Oregon (31 percent), and California (30 percent). Twenty-two other states report budget shortfalls be-
tween 10 and 20 percent of their current spending levels. It seems reasonable to assume that in states facing these large deficits, funding cuts for local governments and schools are most likely.

State Fiscal Assistance to Local Governments

In the United States, the fiscal conditions of state and local governments are closely intertwined. According to Census of Government figures, nearly a third of the total expenditures of state governments are in the form of direct transfers to local governments. While the largest amount of this intergovernmental spending is for education, in many states, both county and municipal governments receive substantial amounts of state funds.

Local governments are most at risk of facing cuts in direct state government fiscal assistance in states which allocate a relatively large share of their budgets to grants to local governments and schools. The U.S. Census Bureau in its annual Census of Governments divides all state government spending into two categories—direct expenditures and intergovernmental expenditures. In fiscal year 2000, the latest year for which these data are available, 30.2 percent of the total spending by state governments were classified as intergovernmental expenditures. Included in this spending category are all fiscal transfers to other governments, primarily counties, municipalities, and school districts. In five states, intergovernmental expenditures were in excess of 35 percent with California in first place with nearly 44 percent of all state expenditures in the form of grants or transfers to local governments.²

²In contrast, in Hawaii, where the state directly administers the public schools and the health and welfare system, only 2.4 percent of state expenditures go to intergovernmental transfers.
These Census data generally understate the vulnerability of local governments to cuts in state fiscal assistance. In most states, significant amounts of state spending comes from restricted or segregated funds. State legislatures, faced with big budget deficits, are often limited to making cuts in their states’ General Fund. In fiscal year 2000, the sum of state government General Fund expenditures totaled $498 billion, while total state government expenditures reported by the Census Bureau equaled $1,084 billion. It is thus not surprising that intergovernmental spending is a much larger share of state General Fund spending than of total state government spending. For example, Census data indicate that nearly 36 percent of total state government spending in Wisconsin was devoted to intergovernmental spending in fiscal year 2000. In the same year, however, the state reported that 57 percent of General Fund appropriations were spent on local government assistance (Wisconsin Legislative Fiscal Bureau, 2000). In Illinois, approximately 44 percent of the General Fund can be classified as intergovernmental spending, compared to only 29 percent of total state spending.

The important role that intergovernmental spending plays in state government finance, plus the aversion of many governors and state legislatures to raising state taxes, makes it very likely that many state governments will enact large reductions in state government funding of schools and local governments.

In a recent survey of state governments, the National Conference of State Legislatures (2003) reported that 15 states reduced or are planning to reduce aid to schools or local govern-

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3 The data on General Fund expenditures come from the National Association of State Budget Officers (2001). Steven Gold (1995a) provides a very clear discussion of the strength and weaknesses of various sources of data on state government spending.
ments in fiscal year 2003. For example, cuts in state education aid are forcing most school districts in Oregon to cut short the current school year by at least three weeks (Dillon, 2003). In order to balance their fiscal year 2003 budgets, Massachusetts reduced state aid to municipal governments by over $114 million and California reduced state aid to school districts by $700 million.

Given the size of the projected state government deficits for fiscal year 2004, there is little doubt that reductions in state fiscal assistance to local governments will be substantially larger than they were in fiscal year 2003. An indication of the likely size of these aid reductions comes from the budgets that governors have already submitted to their legislatures. Table 1 lists the changes in nominal dollars of education and municipal government aid that have been proposed by governors in five states. Where the information is available, I indicate the change in aid relative to spending in that category in the previous year.

Looking only at reductions in nominal levels of state fiscal assistance gives a partial picture of the impacts of state policy decisions on local governments and schools. As the costs of providing public education and local government services rise over time, state fiscal assistance must increase annually at a rate proportional to the increase in the costs if the state role is to be maintained. For example, in Wisconsin the governor has proposed an increase in state education aid of $40 million—a less than one percent increase—for fiscal year 2004. Although state aid would rise in nominal terms, this increase in aid is only 20 to 25 percent of the amount of money needed if the state is going to maintain its previous share of education funding.

4The NCSL reports that while some states were reducing support for local governments in 2003, an even larger number of states increased state aid to education or financed additional prop-
It should be emphasized that not all states are choosing to solve their budget gaps with cuts in aid to local governments. Some states are protecting local governments and schools and directing most of their budget cuts to state programs, often in the area of human services. In some other states, governors are proposing substantial increases in taxes and fees and/or various one-time policies to increase revenues.5

As state legislatures have yet to enact fiscal year 2004 budgets, it is too early to know with any degree of certainty how close the actual budgets will be to their governor’s original budgets. Past history suggests, however, that at least in some states the final enacted budgets will differ

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5Predicting which states will pursue which type of policies is extremely difficult. For example, in Georgia, the newly elected Republican governor proposed tax increases as a means of dealing with the state’s budget shortfall, while in Wisconsin, the new Democratic governor proposed a budget that calls for deep cuts in spending and no increases in taxes.
substantial from the budgets proposed by the governors. In the absence of firm predictions about the nature of fiscal year 2004 budgets, it may be possible to learn something about how states will respond to a fiscal crisis by exploring how state governments filled their budget gaps in the early 1990s, the last time a substantial number of states faced large deficits.

**Lessons from the Early 1990s**

The decade of the 1990s started with a relatively mild recession that on the basis of national data only lasted from July 1990 to March 1991. While the effects of the current economic slowdown have been felt in all parts of the country, the recession of the early 1990s was most severe on the two coasts. As is happening now, the recession of the early 1990s caused serious fiscal problems in a number of states. In a comprehensive analysis of state fiscal conditions, Steven Gold (1992) identified 12 states as suffering the most fiscal stress as a result of the 1991 recession. These included all the New England states plus New York, Pennsylvania, Maryland, Virginia, California, and Michigan.

In fiscal year 1990, intergovernmental expenditures totaled 30.6 percent of total state government expenditures. This percentage declined annually to a level of 28.8 percent in fiscal year 1993. By fiscal year 2000 (the latest year for which these data are available), intergovernmental expenditures are equal to 30.2 percent of total state spending.

The composition of intergovernmental expenditures varies across states. In all states but Hawaii, intergovernmental spending includes grants to school districts. In some states, municipal governments receive relatively large unconditional grants, while other state governments allocate almost no resources to municipalities. In a few states, such as New York, where local governments are responsible for administering welfare and Medicaid, intergovernmental grants also in-
clude the states’ share of welfare and Medicaid spending. The diverse composition of these data makes it difficult to interpret differences across states in changes in aid relative to total state spending.

One way to explore the extent to which state governments reduced fiscal assistance to lower level governments during a period of budgetary stress is to narrow our focus to a single type of intergovernmental grant. Figure 1 shows that grants to school districts as a percentage of total state government spending declined from 17.5 percent in fiscal year 1989 to 15.2 percent in fiscal year 1994, before rising to 17 percent in the period from 1998 through 2000. Although education grants continued to grow in nominal dollar terms during the period of the early 1990s, the data in figure 1 suggest that on average state governments favored spending on state programs over providing fiscal assistance to school districts.

The aggregate data hide a great deal of variation among the states. Between 1990 and 1994, the share of state spending allocated to state aid to education declined in all but 12 states. In four states—California, New Hampshire, Pennsylvania, and South Carolina, the share declined by over 20 percent. In another 18 states, the share of state school aid declined by between 10 and 20 percent.

Although many states are enduring budget crises that are the most serious that they have faced since the Second World War, the State of California, even though its current budget gap is $35 billion, weathered a series of budget shortfalls in the early 1990s that were at least as large relative to state general fund spending as the current gap. Between fiscal year 1991 and 1994,

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6 These data are calculated by dividing data from the Common Core of Data (National Center for Education Statistics, 2003) on total school district revenue from state governments with
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The budget crises currently facing state governments are probably the most severe that many of those states have faced since the Second World War. The State of California, however, although it faces a current budget gap of $35 billion, weathered a series of budget shortfalls in the early 1990s that were at least as large relative to state general fund spending as the current gap. Between fiscal year 1991 and 1994, California faced recurrent budgetary shortfalls that totaled $37.1 billion. In fiscal year 1992, California faced a $14.3 billion gap, an amount equal to one-third of total General Fund spending (Chapman, 1995).

California got through the first half of the 1990s by using a full array of policies including spending cuts, increases in taxes and fees, government restructuring, including shifting of responsibilities to lower level governments, and a number of one-time budgetary gimmicks. The state’s efforts to balance its budget had a major impact on local governments. The single most important state action was a shift of property tax revenue from cities, counties, and special districts to school districts. This move allowed the state to substantially reduce state education aids without causing large cuts in education. Although municipal and county governments were given some new tax revenue, they suffered a substantial net loss of revenue. Because Proposition 13 prevents most property tax rate increases, these revenue loses resulted in widespread cuts in public services (Chapman, 1995). The shifts in property tax revenues to school districts allowed school districts to avoid nominal cuts in spending per pupil. Between 1990 and 1994, however, education spending in constant dollars fell by over 10 percent.
Massachusetts was also hard hit by the recession, but in its case, the economic and fiscal problems began a couple years earlier than in California. By 1988, the Massachusetts economy was beginning to slow down, resulting in a series of recurring budgetary shortfalls over the next few years. William Weld was elected governor in 1990 after a campaign in which he promised to downsize state government. It is thus not surprising that he responded to the continuing budgetary shortfalls with large cuts in state spending. Particularly hard hit were state funding for elementary and secondary education and for fiscal assistance to general-purpose local governments. The magnitude of the cuts in aid are striking. Between fiscal years 1988 and 1994, education aid was reduced by 15.8 percent and general-purpose local government aid by 20.3 percent. During this period, total aid fell from 24.6 to 15.2 percent of state government spending (Wallin, 1995). Although local governments responded with increases in property taxes and user fees, reports indicate that public services suffered with schools being particularly hard hit.

**Prospects for Fiscal Year 2004**

The fiscal history from both California and Massachusetts suggests that in states with large budget shortfalls, municipal and county governments and school districts face a substantial risk of large reductions in state funding. In this section, I discuss three reasons why reductions in local government assistance may be relatively greater over the next couple years than they were, on average, in the early 1990s.

First, the budget gaps faced by many state governments are a larger share of state spending now than they were in the early 1990s. As the magnitude of states’ fiscal problems are greater, it is likely that the impacts on local governments will be greater than they were during the most previous economic downturn.
Second, budget gaps can be filled by cutting spending or by raising revenues. During the early 1990s, a number of states chose to deal with their budget shortfalls by raising tax revenues. According to Gold (1995b), state governments legislated tax increases equal to 3.5 percent of tax collections in 1991, 4.8 percent of tax collections in 1992, and 0.4 percent of collections in 1993.

After nearly seven straight years of legislated tax reductions, in calendar year 2002, state governments enacted tax changes that will increase fiscal year 2003 tax revenues by nearly 8 percent (Jenny, 2003a).\(^7\) Compared to the tax increases of the early 1990s, the current round of legislated increases are quite modest, amounting in total to a 1.4 percent increase in state tax revenues.\(^8\) Although a number of states are considering tax increases to fill a portion of their fiscal year 2004 budget gaps, in a substantial number of other states there appears to be very strong resistance to using tax increases as part of a solution to current budgetary problems. Although predicting the actions of 50 state legislatures is nearly impossible, I believe that it is a reasonable assumption that spending reductions will play a more important role in filling budget gaps over the next year or two than they played during the period of fiscal stress in the early 1990s.

Third, reductions in spending on public education are a somewhat more likely outcome of cuts in state assistance than they were 12 years ago because on average revenue from state governments is a larger share of the total revenue of school districts than it was in 1989, just prior to the 1990-1991 recession. In fiscal year 1989, state revenue made up 47.8 percent of the total

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\(^7\) The $8 billion estimate includes $1.6 billion in non-renewed tax rebates. Jenny (2003a) points out that his tax increase estimates are similar in magnitude to independent estimates made by the National Conference on State Legislatures and the National Association of State Budget Officers.

\(^8\) This number is obtained by dividing the $8 billion in legislated tax increases by total 2001 state tax collections of $560 billion.
revenue of school districts. This percentage share fell to 45.2 in 1994, but has risen to 49.6 per-
cent in 2000, just prior to the current economic slowdown (National Center for Education Statis-
tics, 2003). These averages hide a great deal of variation across states in the relative importance
of state aid. It appears that education spending is most at risk in states that both face big budget
shortfalls and finance through state government fiscal assistance an above average share of spending on education.

**State Imposed Unfunded Mandates on Local Governments**

Although cutting state grants to local governments is the most direct way for state gov-
ernments to impose part of the solution to their fiscal problems on local governments, an equally
effective way for state governments to close their budget gaps is to shift the responsibility for
providing some public services to lower-level governments without providing those governments
with adequate additional funding to carry out their new responsibilities. Municipal and county
governments throughout the country have complained for years about the growth of these un-
funded mandates. In some states, for example New York, the governor’s fiscal year 2004 budget
propose contains explicit mandate relief. In other states, however, budget proposals call for ex-
panding the use of unfunded mandates. For example, in Wisconsin, the governor’s budget would
shift responsibility for assessing manufacturing property from the state’s Department of Revenue
to local municipal assessors, and a legislative task force proposes the elimination of the state po-
lice with their functions to be filled by county sheriffs. In neither case would the local govern-
ments be provided with additional funds, in fact, the budget proposal calls for a cut in state aid to
municipal and county governments.
In what is undoubtedly the nation’s largest proposed shift in responsibilities, California Governor Davis’s budget calls for counties to take over a large set of services related to mental health, substance abuse, child welfare, foster care, long-term care, health care, and security for trial courts—services on which the state is currently spending $8.3 billion. To finance these new responsibilities, the governor has proposed raising sales tax, individual income tax, and cigarette excise tax rates. Although these proposed revenue increases should be adequate to fund the shifted functions during the next fiscal year, it is unclear whether they will generate sufficient revenues in future year for county governments to meet the costs of their new responsibilities (California Budget Project, 2003).

Implicit Cost Shifting to Local Governments

In attempting to balance their budgets, many states are cutting or planning to cut spending on a wide range of state programs for the poor and needy. California, for example, is considering cuts in subsidized childcare, in housing programs, the elimination of a wide range of services currently provided by Medicaid, including optometry and dental services, restriction to Medicaid eligibility, and reductions in welfare benefit levels.

Although, municipal governments have no formal role in the funding of these programs, funding reductions at the federal and state level may have direct fiscal implications for local governments, especially in cities with heavy concentrations of poor families. Local governments have always played the role of service provider of last resort. Reductions in state funded human services, not only create hardships for individuals, but often have direct and indirect fiscal implications for the communities in which they live. Thus, cuts in state spending may well result in an implicit shifting of costs from the state to local governments.
This cost shifting might be quite direct. For example, if, as might be expected, a reduction in state Medicaid funding leads to an increase in the number of uninsured families, it is likely that some of the newly uninsured will seek care at city health clinics or in emergency rooms of public hospitals. Also, reductions in state-funded housing programs, or cuts in welfare benefits may directly increase the demand for places in city-run homeless shelters.

Reduced funding for state-financed social programs can also have indirect fiscal impacts on local governments. For example, there exist econometric evidence that concentrated poverty is associated with higher costs of achieving any given level of public safety (Bradbury et al, 1984; Ladd and Yinger, 1991; Green and Reschovsky, 1994). Not only is the incidence of crime higher in areas of concentrated poverty, but community attributes associated with poverty, such as high density and poor housing conditions, increase the amount of resources required to provide public safety in these neighborhoods. Increased poverty caused by high unemployment and exacerbated by cuts in cash and in-kind assistance are likely to increase the amount of money city governments will need to maintain current levels of public services.

**How Will Local Governments Respond to Less State Aid and More Responsibilities?**

I have suggested that many of the state governments currently facing large budgetary shortfalls will enact substantial cuts in state financial assistance to local governments and schools and in some cases impose new unfunded mandates. In this final section of the paper, I explore the question of how local governments are likely to respond to a reduction in resources. As most local governments operate under quite strict balanced budget requirements, they essentially have only two options–enact increases in locally-raised revenue or reduce spending. To the extent that
spending is reduced, unless efficiencies in service delivery can easily be implemented, local government services, including public education will be cut.

In general, local governments are fortunate that their locally-raised revenues are less sensitive to economic downturns than the revenues of state governments. While, state governments rely heavily on the individual and corporate income tax and the sales tax, local governments rely primarily on the property tax—a tax whose revenue is much less likely to decline during recessions. While per capita state tax revenue after adjusting for inflation and legislated changes has declined by more than eight percent since early 2001 (Jenny, 2003), property tax revenue has continued to grow throughout the period. Census data show that for the nation as a whole four-quarter total property tax collections for the quarter ending in September 2002 are 9.6 percent higher than the four-quarter total ending in September of the previous year (U.S. Census Bureau, 2003).

The increases in property tax collections are due in part to rapid increases in property values in many parts of the country. In general, the ability of local governments to benefit from extra property tax revenues without raising property tax rates will make it easier for some governments to compensate for the loss of state government fiscal assistance. That being said, property tax limitation in place in some states limit the extra property tax revenue flowing from increases in property values by restricting annual increases in assessed values or in property tax revenue. For example, in California, Proposition 13 limits annual increases in the assessed value of property to two percent unless properties are sold. And Proposition 2½ in Massachusetts limits annual increases in property tax levies to 2½ percent per year.

In 2001, inflation-adjusted home prices increased by 5.7 percent over their level in 2000 (Joint Center for Housing Studies of Harvard University, 2002). This increase appears to have
Although many local governments, especially school districts, get nearly all their tax revenue from the property tax, it is important to emphasize that in some states, local governments also rely on income and sales taxes.\textsuperscript{10} For these governments, cyclical reductions in local tax revenue will exacerbate the fiscal problems caused by cuts in state aid. New York City, for example, is facing an enormous budget deficit in part because it relies quite heavily on revenue from both a city income and a city sales tax.

Drawing general conclusions about how local governments will respond to cuts in state aid is particularly hard to do. The economics literature contains a few studies about the response of state and local governments to cuts in federal aid. The evidence, which is described in Gakhar (2002) is mixed. Some studies suggest that state and local governments act symmetrically to increases and decreases in grants. This implies that cuts in aid will result in declines in spending. Other studies, however, suggest that state and local governments respond to cuts in grants by raising taxes sufficiently to make up for most of the lost grant funding. It is also not clear to what extent empirical results about responses to cuts in federal grants will hold for cuts in state grants.

In some local jurisdictions, constitutionally- or legislatively-imposed property tax limitations will limit the extent to which local governments can increase local revenues to make up for loses in state aid. In those cases, cuts in spending will be the only alternative. It is at least possible that some state legislatures will take actions to enforce cuts in local spending. For example, in Wisconsin, some members of the legislature are discussing the possibility of linking cuts in state

\textsuperscript{10} In fiscal year 2000, property tax revenue accounted for 72 percent of all tax revenue raised by local governments (including school districts and counties).
aid to policies that will prevent property tax increases, thereby forcing local governments to cut spending.

In many states, school districts are finding themselves in a particularly difficult position. The new federal education bill, the *No Child Left Behind Act of 2001* mandates annual testing of all students in grades 3 through 8, and requires that schools make annual progress in meeting student performance goals. The legislation will reward schools that succeed in meeting state-imposed achievement goals and will sanction schools that fail. The intent is that all students, but especially students from disadvantaged backgrounds, show annual improvements in their academic performance as measured against state standards. A growing body of evidence shows that in order to meet these new performance standards, school districts will need to increase spending, especially in schools with heavy concentrations of poor children (Reschovsky and Imazeki, 2003; Dumcombe and Yinger, 2000).

The lose of state aid will put great pressure on school districts to raise property taxes in an attempt to maintain or increase current levels of per pupil spending and hopefully meet the new federal performance standards. In states where reductions in state funding for education are combined with limitations on local school districts ability to make up for lost revenues, one can expect to see a significant rise in the number of “failing” schools, and students receiving inadequate educations.

The impact of state cuts in fiscal assistance on the ability of local governments and schools to deliver public services depends to a significant degree on exactly how states choose to implement their aid reductions. States generally distribute fiscal assistance to local governments in an equalizing manner. This implies that grants per capita or per student are larger in local ju-
risdictions in weaker fiscal condition, which in most states means jurisdictions with smaller per capita or per student property tax bases. As a result, financial assistance from the state finances a large portion of local spending in some jurisdictions compared with others.

If a state government chooses to reduce aid by an equal percentage amount in each local jurisdiction, the result will be very large reductions of aid relative to local spending in the municipalities or school districts in the weakest fiscal conditions. Equal per capita or per student reductions, although they may result in the complete elimination of state aid to some rich communities, will have a much less deleterious impact on the ability of local governments to continue to provide public services. If a state wanted to maintain its current level of equalization, reductions in state aid should be targeted to the local governments and school districts in the strongest fiscal condition.

Although there is little systematic information about the pattern of previous aid cutbacks, it seems reasonable to assume that a different set of political forces may operate in periods of economic growth and periods of decline. Systems of intergovernmental grants may become disequalizing during economic recessions because local governments may come to consider any grant amount received in one year to be their “entitlement” in the next year. If this is true, then one would expect that each member of a state legislature would support a cutback plan that results in the smallest possible aid reduction for the communities he or she represents. Under this model of decision-making, a majority of legislators would probably vote for a cutback plan that targets large aid cutbacks to a relatively small number of communities. Applying this model of decision-making, Amy Schwartz and I simulated the voting of Massachusetts legislators on several alternative aid cutback plans (Reschovsky and Schwartz, 1992). The results of this exercise suggested
that a plan that involved cutting aid to all local governments by an equal percentage amount would receive the most votes, and that there would be no support for a plan calling for equal per capita cut in aid.

Conclusions

The full magnitude of the fiscal crises facing nearly all state governments in 2003 is not yet known. Even under the most optimistic economic growth projections, however, most states face large budgetary shortfalls in fiscal year 2004. The evidence to date strongly suggests that state governments will rely more heavily on cuts in spending than on tax increases than they did during previous budgetary crises. In this paper, I trace the complex inter-relationship between state and local government finance, and suggest that the fiscal problems facing state governments put local governments and school districts at substantial risk of facing both large cuts in state financial assistance and an increase in unfunded mandates. Relying in part on an analysis of the behavior of state governments in response to budgetary shortfalls that resulted from the recession of the early 1990s, I attempts to determine whether in balancing their budgets state governments will tend to favor their own programs or, alternatively, to protect their local governments and school districts from large revenue cuts. My tentative conclusion is that in many states, aid to local governments and school districts will be reduced by a greater percentage amount than reductions in overall state spending. It is likely that many of these cuts in state aid will translate into reductions in public services, with the largest cuts coming in local governments and school districts in the weakest fiscal conditions.
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