Fiscal Federalism in the United States

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TABLE OF CONTENTS

A. FEDERALISM IN THE USA: THE CONSTITUTIONAL AND POLITICAL CONTEXT 1
1. CONSTITUTIONAL STATUS OF VARIOUS ORDERS OF GOVERNMENT 2
The Federal and State Legislatures 2
The Courts 3
Constitutional Status of the Federal and State Governments 3
Local Governments 4
2. CONSTITUTIONAL ALLOCATION OF REVENUE AND EXPENDITURE RESPONSIBILITIES AND PROVISIONS RELATED TO INTERGOVERNMENTAL TRANSFERS
Constitutional Allocation of Revenue 4
Personal Income Taxes 5
Corporate Income Taxes 5
Sales Tax 5
Constitutional Allocation of Expenditure Responsibilities 5
Constitutional Provisions Related to Intergovernmental Transfers 5
3. INSTITUTIONAL OR OTHER SPENDING POWER PROVISIONS 7
4. POLITICAL AND LEGAL DYNAMICS- INCLUDING THE ROLE OF LAW AND ROLE OF POLITICS IN THE DECISION-MAKING PROCESSES 7
Role of Law in the Decision-Making Process 9
Reference Procedures 10
Appointments to the Appeal Courts 10
Role of Politics in the Decision-Making Process 11
5. TRANSPARENCY AND ACCOUNTABILITY 11

B. SUMMARY OF FEDERAL, STATE, AND LOCAL BUDGETARY RELATIONS IN THE UNITED STATES 13
Federal, State, and Local Government Shares of Total Public Spending 13
Federal, State, and Local Government Shares of Total Government Revenues 15
The Importance of Intergovernmental Transfers 15
Vertical Fiscal Imbalances ....

The Need for Intergovernmental Transfers 38
(i) Correcting for externalities 38
(ii) Correcting for vertical fiscal imbalances 39
(iii) Correcting for horizontal fiscal imbalances 39
Programs Mainly Focused on Vertical Fiscal Imbalances 40
Programs Mainly Focused on Horizontal Fiscal Imbalances 41
D. TAX HARMONIZATION AND TAX COLLECTION 42
E. **ANALYSIS** 44
1. Economic Aspects 44
1. Impacts on Economic Efficiency 44
2. Impacts on Equity 46
2. Political Aspects 48
1. Impact on Stability 48
Areas of Consensus 48
Areas of Dispute 48
Ability to Adapt to Changes 52
2. Transparency and Accountability Considerations 52
3. Political Culture 53
Notes 55
References 57

LIST OF TABLES

FISCAL FEDERALISM IN THE U.S.A.

A. FEDERALISM IN THE USA: THE CONSTITUTIONAL AND POLITICAL CONTEXT

The United States of America became the first modern federation in 1789 following the failure of the previous confederal form of government established in 1781. At its origin the federation was composed of 13 states. Since then it has expanded across the continent and evolved into a federation

Although there is no constitutional requirement for the federal government to cooperate with the states in carrying out policies in those areas in

have no crucial interest for support from other members on legislation in which they do have a critical interest.

Weak party bonds mean that members of both Houses are, to a great degree, individual 'political entrepreneurs'. Election campaign costs are high, and candidates are largely responsible for raising their own election campaign finances. Thus, members of both Houses, but especially Representatives due to their short electoral terms, are constantly aware of the need to remain attentive to their constituencies. The result is that a member of either House is highly motivated to ensure the member's constituency receives the maximum benefit from the federal treasury.

leaves the unspecified residuum to the states. Administrative authority is allocated coincident with legislative authority.

The federal government's legislative ambit includes: the power to levy taxes, provided it does not discriminate among states; the exclusive power to negotiate treaties and conduct foreign relations; t

Personal Income Taxes

The amendment of the federal Constitution requires the consent of both a majority in the federal Congress and a majority of the state legislatures. This process has proved to be relatively rigid in practice: after the first ten amendments were agreed during the ratification process and enacted in 1791, there have only been seventeen other successful amendments in the ensuing two hundred years.

The perception of the failure of many of the 'Great Society' initiatives, combined with the disillusionment caused by the Vietnam War and Watergate crises, led to a turn back to state powers beginning in the mid-1970s. The Ford and Carter administrations made some attempts to come to grips with this trend, but it was the Reagan administration that pushed the decentralist agenda. Transfer programs were restructured and cut back, and regulations associated with state receipt of federal funds were reduced. States responded by becoming stronger initiators of government services. These trends continued through the Bush and Clinton administrations.

In the latter 1990s one symptom of the decentralist trend has been the conversion of some categorical transfers to block transfers. In the mid-1990s, for example, one of the longest-running welfare state programs, the federal Aid for Families with Dependent Children (AFDC) program, established in 1935, was dismantled and replaced by a block grant program (see Section C, 1(b) below).

Role of Law in the Decision-Making Process

As noted, the non-constitutional processes of shifting of responsibilities according to the principle of concurrency and the noncentralized bargaining processes of intergovernmental relations have played the largest role in the resolution of issues affecting both the overall federal system and the fiscal arrangements within that system. However, the courts, as the third element

Supreme Court Justices as an opportunity to entrench their political philosophy in government in a way that will outlast their own term in office. As most Supreme Court nominees are sitting appellate court judges, they have a long history of judgements. The Senate ratification hearings are thus occasions of high political drama, in which the nominee's judicial record, personal qualities, and political leanings are closely examined.

Role of Politics in the Decision-Making Process

Decisions concerning the use of the federal power to spend in areas of concurrent or exclusive state jurisdiction do not require any special procedures.[23] Thus, decisions about federal spending in these areas has rested with the Congress and the President. The Congress has not

of intergovernmental transfers has developed. This combination conduces to a system with both low transparency and low accountability.

Consequently, there has been a high degree of concern in the U.S. literature on fiscal federalism around the principle of financial responsibility.[24] It is often argued that the achievement of political accountability depends upon adherence to the principle that the order of government that raises revenue should be the order of government that determines how that revenue is expended.

It is to be expected that this would be a particular concern in a separation of powers system. In a parliamentary system, accountability for funds transferred intergovernmentally is enhanced as the executive in receipt of the funds is directly responsible to a legislature and thus to an electorate. In the U.S. system, however, the executive branch has no such direct responsibility.

The mechanism used to compensate for this lack of accountability at the state level is the conditional transfer. As the federal government has raised the funds that are transferred, it maintains its accountability for those funds by setting conditions on how the state or local government may expend them. Thus, currently virtually all federal grants to state and local governments are conditional in form. The trade-off for this level of accountability is decreased state autonomy. To the extent that the spending priorities established by the federal government do not coincide with state priorities, but states accept the conditions in order to access the funds, state autonomy is undermined.

One benefit of the extensive use of conditional grants is a higher degree of transparency than is found in some other federations. While we have noted that U.S. intergovernmental relations constitute a complex web, the adherence, to some degree, to the principle of financial responsibility means that citizens have been able to identify the federal government's responsibility.

B: SUMMARY OF FEDERAL, STATE, AND LOCAL BUDGETARY RELATIONS IN THE UNITED STATES

In this section, we describe the trends in the evolving division of responsibilities for expenditures and revenue-raising of the federal, state, and local levels of government in the United States.

Our description of the trends in responsibilities of the various levels of government begins with the shares of federal, state, and local governments in public expenditures. We then examine the trends in the shares of federal, state, and local governments in government revenues. Following this, we examine the importance of transfers in total revenues of state and local governments. Lastly, we describe the importance of vertical and horizontal imbalances.

Federal, State, and Local Government Shares of Total Public Spending

Table B1 provides data from 1960 through 1995 on the shares of federal, state, and local government in total public spending. We have divided the data into two categories: one including intergovernmental transfers and one excluding them. We do this to avoid duplication so that, for example, transfers that are reported as expenditures of the federal government are not also included implicitly in the expenditures of state and local governments that they help finance. Thus, data including transfers treat transfers as expenditures of the disbursing governments, whereas data excluding transfers treat them as receipts of the recipient governments.

Examination of the data in Table B1 shows that there has been a small tendency for spending to become more decentralized over time from the federal to the state governments. This is true both including and excluding transfers. The federal share of total spending including (excluding) transfers was 64.3% (59.7%) in 1960 and had fallen to 60.1% (51.9%) in 1995. During the same period, the states' share of spending has increased from 16.5% (14.5%) to 22.2% (21.1%). Despite the tendency for state spending responsibilities to grow over time, the federal government still commands a dominant role in public spending in the United States. While many state and local expenditure responsibilities are in areas of high growth (e.g. education and health care), the federal

Table B1: Federal, State, and Local Government Shares of Total Public Spending (Percentages)

government is actively involved in many high growth areas either concurrently with the states (e.g. health care) or predominantly independently (e.g. national defense and social security). Somewhat surprisingly, the same trend of increasing expenditure shares has not occurred with respect to local governments.

Table B3: Transfer Payments from Federal to Subnational Governments as a Share of Subnational Government Revenues (Percentages)

Year	Federal to SPayment

Beginning with the column showing transfers from federal to state governments, we see that

government are measured as the difference between expenditures net of transfers to lower-level governments and revenues as a percentage of expenditures net of transfers. The vertical fiscal imbalances for the states are measured as the difference between expenditures net of transfers to local governments and own-source revenues as a proportion of expenditures net of transfers. In the last column, the vertical fiscal imbalances for the local governments are the difference between expenditures and own-source revenues as a proportion of expenditures.

Vertical fiscal imbalances excluding transfers measure both the extent of deficit financing and the extent that own expenditure needs exceed own-source revenues. Since deficit financing is much more accessible to the federal government in the United States, the deficit financing component of the vertical fiscal imbalance is evident for the federal government in Table B4.[25] In particular, we observe a sharp turn-around in the early 1980s when the federal government began to run very large budget deficits. During this period, the vertical fiscal imbalance went from negative to positive, reflecting the large deficits of the federal government.

The vertical fiscal imbalances for the states are consistently negative and large in absolute value, whereas those for the local governments are consistently positive and large. From this data we see the importance of intergovernmental transfers from state to local governments. The importance of transfers is also evident when we examine the data including intergovernmental transfers. When intergovernmental transfers are included, the vertical fiscal imbalances measure only deficits and surpluses.

Horizontal Fiscal Imbalances

Horizontal fiscal imbalances (HFIs) result from differences in the abilities of state and local governments to provide government services. HFIs can occur because of differences in the ability to raise revenues and because of differences in expenditure needs and costs. Programs that address HFIs are called equalization programs. A good equalization program addresses need, cost, and fiscal capacity differences. In contrast to several other federations (e.g. Canada and Australia), the United States has no explicit equalization program. However, many categorical grant programs have equalization components built within them.

Table B4: Vertical Imbalances Between Federal, State, and Local Governments
[(Expenditures-Revenues)/Expenditures]*100

	Excluding Intergovernmental Transfers			Including Intergovernmental Transfers		
Year	Federal	State	Local	Federal	State	Local
1960	-10.5	-18.8	30.3	-2.6	-3.4	4.5
1961	-3.6	-13.4	30.4	3.4	1.2	5.2
1962	-0.7	-18.5	30.2	6.2	-2.5	4.6
1963	-3.9	-18.2	29.8	3.6	-2.5	3.0
1964	-4.4	-19.9	29.6	4.0	-5.3	2.6
1965	-5.7	-22.5	30.8	3.2	-6.1	3.0
1966	-8.6	-26.7	31.9	1.3	-7.6	1.9
1967	-6.3	-18.0	33.0	3.3	-2.9	2.2
1968	0.7	-21.2	34.3	10.4	-3.8	0.4
1969	-13.0	-20.6	35.8	-1.8	-3.0	2.9
1970	-11.2	-24.8	36.0	1.3	-4.8	0.6
1971	-2.0	-12.9	39.3	10.4	1.4	3.6
1972	-					

In tables B5 through B7, we provide data on differences among states with regard to expenditures and revenues. To make the tables less cumbersome to read, we have grouped the states according to regions. This aggregation will necessarily smooth out differences among states. Consequently, in the appendix tables 1,2 and 3, we provide similar data on a state-by-state basis.

(i) HFI of State Expenditures

The data shows that New England, the Mid-Atlantic, and the Pacific regions have been

Table B6: State Governments Per Capita Revenues, Before Intergovernmental Transfers, as a Percentage of the United States Average

Year	New England	Mid Atlantic	E. No. Central	W. No. Central	So. Atlantic	E. So. Central	W. So. Central	Mountain	Pacific
1970	99.7	112.1	96.1	91.7	93.2	84.3	85.5	107.8	129.7
1971	101.5	112.4	97.4	92.5	95.5	85.0	88.3	110.3	117.2
1972	106.7	114.0	96.6	93.2	95.3	84.8	87.3	106.0	116.1
1973	108.6	118.2	97.2	95.5	96.6	85.6	84.1	101.5	112.6
1974	103.8	115.9	97.9	101.0	95.4	85.5	86.9	102.4	111.3
1975	97.6	111.7	96.4	97.8	93.9	86.2	87.9	108.1	120.4
1976	105.0	113.0	93.6	96.4	90.3	84.0	90.3	106.0	121.4
1977	103.9	115.4	95.4	95.2	89.9	84.7	87.2	103.4	124.8
1978	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)
1979	102.8	106.0	96.6	96.1	91.8	85.9	87.9	107.5	125.6
1980	102.9	105.9	93.7	96.6	88.6	81.3	90.9	105.5	134.6
1981	102.9	104.3	90.9	92.5	87.1	84.3	95.5	106.2	136.3
1982	109.0	109.6	91.1	94.8	89	81.8			

Table B7: State Governments Per Capita Revenues, After Intergovernmental Transfers, as a Percentage of the United States Average

Year	New England	Mid Atlantic

APPENDIX TO SECTION B

Appendix B, Table 1 (Continued): State Government Per Capita Expenditures as a Percentage of the United St

Appendix B, Table 2: State Government Per Capita Revenues, Before

Appendix B, Table 2 (Continued): State Government Per Capita Revenues, Before Intergovernmental Transfers, as a Percentage of the United States Average, Selected Years

Appendix B, Table 3: State Government Per Capita Revenues, After

Appendix B, Table 3 (Continued): State Government Per Capita Revenues, After Intergovernmental Transfers, as a Percentage of the United States Average, Selected Years

Year	1970	1975	1980	1985	1990	1995
West South Central	68.8	79.5	77	70.9	76.6	82.8
Arkansas	91.2	101.6	95.4	88.7	93.9	102.6
Louisiana	87.1	90.3	86.7	85.4	84.3	78.3
Oklahoma	65.3	75.5	70.1	65.6	67.8	72.9
Texas						
Mountain	89	99.9	100.6	96	101.6	99.8
Montana	80	95	81.3	73.8	87.9	85.4
Idaho	130.6	132.9	142.4	191.3	162	127.5
Wyoming	83.4	96.2	80.8	73.1	77.9	76.2
Colorado	119.6	129.4	127.7	124.9	119.3	117.6
New Mexico	92.7	94.2	79	77	84.6	79.3
Arizona	98.5	96.3	89.2	89.7	90.9	91.5
Utah	105.8	108.4	86.9	85.3	83.8	82.1
Nevada						
Pacific	99.8	110	97.9	96	105	109
Washington	83.2	99.1	97.9	86.7	91	102
Oregon	103	108.6	104.7	99.8	103.3	100.9
California						

C. THE SYSTEM OF INTERGOVERNMENTAL TRANSFERS IN THE UNITED STATES

(b) Income Redistribution[30]

Another large cat

(e) Housing and Community Development

Federal grants to state and local governments for housing and community development comprised nearly 70% of state and local funding in 1996. The funding is distributed by the Department of Housing and Urban Development (HUD). Close to half of the funding from HUD is directed towards lower income housing assistance and, thus, can also be grouped with the federal government's income redistribution programs.

2. Conditional Block Grants

Conditional block grants are funds provided for expenditures incurred within a general functional area such as welfare or housing. There is no matching component. They allow greater discretion for how funds are spent than do categorical grants. The states and local governments generally prefer the added flexibility of block grants. In addition, regulations for block grants tend to be shorter and simpler than for categorical grants. Critics of block grants argue that there is less adherence to standards, less

4. Tax Deductions

Historically, Congress allowed deductibility of most state and local taxes from federal income tax. Today, only income and property taxes are deductible, and limitations on this have also been imposed. Tax deductibility allows state and local governments to raise their taxes without the full burden falling on their citizens. In essence, then, tax deductibility is a form of financial assistance from the federal government to the state and local governments.

5. Tax-Exempt Municipal Bond Interest

Interest income from state and local government bonds are exempt from federal taxation. This provision essentially lowers the rate of interest that state and local governments pay on borrowed funds. To the extent that the proceeds from issuing debt are used to finance government services such as education, policing, etc, this provision provides another means through which the federal government helps finance services provided by subnational governments.

6. Federal Mandates

Often, the federal government mandates that subnational governments undertake specific activities or provide specific services. Examples of federal mandates are the removal of asbestos from school buildings, the filtering of drinking water, and access by the disabled to public buildings and public transportation. While state and local governments often support these regulations, they are expensive and the federal government often does not provide the funds needed for their implementation. The imposition of "unfunded mandates' by Congress has been highly controversial.

7. Threats of Loss of Funds

The federal government sometimes threatens the loss of funds if state and local governments do not comply with congressional statutes. For example, in 1974 Congress wanted the official speed limit on highways to be reduced to 55 miles per hour. To ensure that states complied with this reduction, the federal government threatened to

remove 10% of a state's highway aid funds if it did not reduce the speed limit. Other examples where threats of loss of funds have been employed are allowing right turns on red lights, raising the minimum age to purchase alcohol, and implementing affirmative action programs.

The Need for Intergovernmental Transfers

There are varied opinions on the need for intergovernmental transfers. Those in favour of transfers point to the improved efficiency and equity that results from assigning superior taxing powers to higher levels of government while assigning greater spending

progressive tax system or a generous welfare or health care program. Intergovernmental transfers can then be used to persuade subnational governments to implement national redistributive policies.

(ii) Correcting for Vertical Fiscal Imbalances

The mobility of people and business activity creates a rationale for assigning a greater responsibility to higher levels of government in raising tax revenues from mobile tax bases. In the United States, the federal government dominates the personal income tax, corporate income tax, and payroll tax fields. The state and local governments rely mostly on sales and property taxes. In addition, the federal government can resort to deficit financing much easier than can states and local governments. As a result, federal receipts have traditionally grown faster than state and local revenues. Furthermore, demand for state and local government services has grown considerably. These two facts have resulted in a vertical fiscal imbalance whereby federal revenues exceed federal expenditures (excluding intergovernmental transfers) and state and local government expenditures exceed their tax revenues. Similarly, the limited taxing ability of local governments has resulted in a large vertical fiscal imbalance between states and local governments. Intergovernmental transfers correct for vertical fiscal imbalances and offer subnational governments the ability to provide more and better government services.

(iii) Correcting for horizontal fiscal imbalances

In the United States, there is considerable variation in the abilities of state and local governments to raise revenues to finance their expenditures. The ability to raise revenues is defined as the government's fiscal capacity. Differences in fiscal capacity are especially prominent among local governments. Thus, poor jurisdictions must levy higher tax rates than rich jurisdictions in order to provide the same level of services. Furthermore, there is considerable variation in the need for and the costs of certain types of expenditures across jurisdictions. For example, some states or municipalities may have a larger proportion of elderly or poor individuals. Inefficiencies arise when individuals make their location decisions based on horizontal fiscal imbalances. Intergovernmental transfers can correct for these horizontal inequities.[31]

Programs Mainly Focused on Horizontal Fiscal Imbalances

Horizontal fiscal imbalances arise when state or local governments differ in their

D. TAX HARMONIZATION AND TAX COLLECTION

In the United States, the federal government and the states have considerable independent taxing powers. While the federal government is the dominant player in raising revenues, the United States Constitution allows the states to levy any type of tax except import and export duties and duties on tonnage. Thus, states raise a considerable proportion of their revenues through the use of personal and corporate income taxes, sales taxes, property taxes, and payroll taxes. There is, nonetheless, an enormous variation among states in the ty

E. ANALYSIS

1. ECONOMIC ASPECTS

There is a large body of theory dealing with the optimal relationship among levels of

federal government stipulates conditions in many of its grant-in-aid programs to the state and local governments, the United States follows a general principal of state sovereignty in the provision of subnational goods and services. As a result, inefficiencies that may result from spillovers across jurisdictions may be left uncorrected in the United States. On the other hand, efficiency may be enhanced for those goods and services with benefits or costs accruing to citizens within a particular jurisdiction.

Turning to the raising of revenues, we saw in Section B that large vertical fiscal imbalances exist in the United States and, thus, revenue-raising is much more centralized in the United States than expenditure provision. This is true despite the fact that states have access to most major tax sources. Whether this situation is more efficient than one where states have greater revenue-raising responsibilities is open to debate. Certainly, the fact that state and local governments are responsible for providing various goods and services to their citizens but are not fully responsible for financing them detracts from accountability. It is also true, however, that administrative and compliance costs are lowered by assigning greater taxing powers to the central government. Also important are the facts that citizens and businesses are fairly mobile in the United States and that there are no tax harmonization agreements. These two facts imply that that tax competition

2. POLITICAL ASPECTS

1. Impact on Stability

The process of intergovernmental relations and fiscal arrangements has been both a stabilizing influence and a source of conflict in the United States.

Lack of Equalization: One area in which a consensus exists is in attitudes to a generalized equalization program. No such program exists, and none is contemplated. The U.S. is,

higher per capita incomes or stronger economies to finance programs that less wealthy states would be unable to support using their own resources alone.

A third conception of the federal financial role is that net redistribution of resources and economic activity among states is allowable as long as it is an *unintended consequence* of individual programs designed to achieve important federal purposes. This conception prescribes that programs should be financed through a unified tax system, but that program spending should be located wherever activities need to be, or best can be, carried out; program spending would thus be 'blind' to any redistributional effects.

Given this lack of consensus as to the goals of federal transfers, it is no surprise that concerns about whether states receive a 'fair' proportion of federal expenditures, or pay more than their 'fair' share in federal taxes, have become a prominent feature of political debates at the federal level. That is, as participants in policy debates have differing conceptions of the goals of the system, they differ as to their evaluations of what is 'fair'. Consider, for example, the political difficulties involved in designing a new welfare system to replace the AFDC (Aid to Families with Dependent Children) program.

The AFDC program, a categorical transfer program, was in 1996 converted to a block transfer program and renamed Temporary Assistance for Needy Families (TANF). Under TANF, the states were given almost total discretion to set program rules; thus, there is relatively little policy to be set at the federal level, other than the distribution of federal funding levels among states. Consequently, one of the most contentious issues in designing TANF became finding 'fair formulas' to allocate and distribute federal transfers.

Some wealthier states argued that fairness prescribed that future allocations should be based on past allocations. Under AFDC, state contributions were matched by federal transfers, so that states had an incentive to contribute more. If the new block transfers were distributed based on prior year allocations, states that were receiving a relatively large amount of federal support because of their own spending would continue to receive higher funding. This would persist even if they subsequently cut their own contributions.

Many poorer states took a different view of what would be a fair allocation. At one point, a group of 30 Senators from the "Sunbelt" states proposed a formula that would have taken child poverty rates and the size of the state into account. Under this formula,

more money would have been directed to southern states and states with small populations. Wealthier states, that had been able to afford higher own-source funding under AFDC, would have experienced a commensurate drop in federal transfers.

Third, there are ‘cross-cutting requirements’ attached to many transfers. Technically, these are conditions of transfers as well. However, these cut across policy areas, making it difficult for recipient governments to avoid them. The stipulation that capital funding on any federally-funded facility is dependent upon the facility being accessible to the disabled is an example

The significant use of mandates began in the 1960s, and continued through the 1970s. The Reagan administration ameliorated the effects of unfunded mandates in the 1980s by requiring all executive regulations to undergo cost-benefit analyses. However, the

concern in

represents itself in the uncoordinated bargaining that occurs in Congress. State legislators, and state and local executive agencies pursue what they perceive to be in their individual or institutional interests. Definition and representation of a collective, state-wide interest has not been in practice the overriding concern.

The fiscal transfer system is also in accord with a political culture rooted in individualism. The lack of an overarching equalization system is consonant with a focus on individuals, rather than on states as collectivities. The tolerance for horizontal fiscal imbalances among states may be related to the belief that individuals have the ability to avoid the effects of such imbalances by relocating to more prosperous areas. Such relocation is in practice facilitated by the relative cultural homogeneity of the United States since there are no linguistic barriers to overcome when moving from one region of the country to another.

NOTES
[1]

[1] Ronald L. Watts, *Comparing Federal Systems* (2nd ed.; Montreal and Kingston: McGill-Queen's

provides preschooling for children of low-income families, Pell grants, which provides funding for college education for children of low-income families, and the Low-Income Home Energy Assistance Program (LIHEAP).

[31] Note that some economists argue that transfers directed towards correcting for horizontal imbalances create inefficiencies in that they result in individuals staying in less productive regions.

[32] For a description of the General Revenue Sharing program, see Aronson and Hilley (1986), pp. 56-58.

[3333] Tax effort is measured as the ratio of total tax revenue to personal income.

[34] These inequities among local governments have led poorer regions to file lawsuits against the state. School districts in several states have won court battles arguing that, since the state is responsible for

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