

Research Department Federal Reserve Bank of San Francisco

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At The Local Level

Continued heavy spending by state and local governments has helped give the economy a lift during the recent business slowdown. These governments purchased \$185 billion (annual rate) of goods and services in the first quarter of the year, and thus kept their spending in step with the 13-percent increase recorded in 1973. At the same time, states and municipalities as a group remained in the strongest fiscal position of the past generation, although many large cities continued in difficult financial straits. This situation has helped make it possible for many states, for the second straight year, to reduce taxes instead of increasing them.

State-local spending almost tripled over the past decade—far exceeding the growth rate of the national economy, which showed a doubling of current-dollar GNP over the same time-span. Most of the differential was due to the much faster increase of employment at the state houses and city halls, which rose 65 percent over the decade to 11.3 million, or almost double the pace of the overall economy. In further contrast, Federal employment increased only 11 percent during this period, and most of that occurred prior to 1967.

This ten-year record of growth has not been costless. It has been built upon heavy borrowings in the credit markets, plus very large tax increases—on a per capita basis, a tripling of income taxes and a doubling of sales and property taxes within the decade. This has led to

mounting demands for relief on the part of hard-pressed taxpayers, especially in fast-growing areas of the country, which suggests that part of the widespread anti-growth sentiment may reflect a disillusionment with the popular belief that economic growth, by broadening the tax base, will make possible a reduction in taxes.

Strong fiscal position

In recent years, the fiscal position of most states and municipalities has improved considerably, making it possible in many cases to respond favorably to pleas for tax relief. After a quarter-century of very small surpluses and deficits—rarely exceeding \$1.5 billion—the aggregate state-local surplus soared to \$13.1 billion in 1972 and \$10.5 billion in 1973. Much, but not all, of this improvement was due to the introduction of the Federal revenue-sharing program. The largest surpluses coincided with the receipt of revenue-sharing funds, but the improvement had already started, as can be seen from the fact that the state-local sector recorded a \$7.0-billion surplus (annual rate) in the pre-grant period of 1971-72.

Federal grants-in-aid in the aggregate quadrupled over the past decade, reaching \$40.9 billion in 1973, or more than one-fifth of total state-local government receipts. Most of the growth occurred in the early 1970's, with heavy Federal funding for revenue sharing, at the expense of direct support for a number of separate Federally-

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directed programs. Altogether, Congress appropriated some \$30 billion for general revenue sharing for the 1972-76 period, and about \$11 billion of the total had been distributed as of last January. (Under the law, states receive one-third of the funds and local governments receive the rest). To date, state recipients have utilized about two-thirds of their grant money for educational purposes, while municipal governments have allocated a like proportion of their funds for public safety.

The improvement in public finances which occurred in the pre-revenue-sharing period was due in part to the substantial tax increases imposed during the fiscal crisis of the 1960's. Another cause for improvement was the deceleration in spending for the largest and (until recently) fastest-growing governmental activity, public education. The postwar baby boom has by now worked its way out of school and into the labor force, and the need for new teachers and expensive facilities consequently has tapered off.

Inflation and other forces

Inflation itself has helped boost governmental revenues, reflecting the increasing state-local reliance on

sales taxes and (in particular) progressive income taxes. (Income taxes now account for about 30 percent of all state-local tax revenues.) As prices and nominal incomes rise and income recipients move into higher tax brackets, the flow of tax revenues into public coffers rises disproportionately. Still, inflation is a two-edged sword, since it has also pushed up the cost of the goods and services purchased by all types of government.

The recent business slowdown has begun to affect state-local financing, helping to account for the reduction in their combined surplus. Receipts from sales taxes (a major revenue source) have proven vulnerable to the decline in consumer purchases of durable goods and the slowdown in other consumer purchases. Rising unemployment, while modest to date, has meanwhile necessitated larger governmental disbursements for unemployment compensation.

Another reason for a declining surplus is the current emphasis on tax reduction at the state level. State governments as a group initiated a statutory reduction of roughly \$500 million annually in 1973, and a similar revenue effect may develop from this year's legislative deliberations. The early-1974 tax-cut mood seemed to reflect continuing opti-

mism regarding state finances, reinforced perhaps by the political popularity of tax reductions in an election year. This year as last, most proposals have concentrated on tax relief for individuals, notably in the form of reductions in general sales taxes and income taxes—for example, by exempting food and other essentials from sales taxation.

Heavy borrowing

Despite their strong fiscal position, state and local governments relied heavily on borrowing during the early 1970's. From an already high 1970 level, the borrowing pace jumped 38 percent in 1971 to a record \$25.0 billion, and has remained near that level ever since. Municipal-bond activity in the past year or so has been concentrated in housing and utility issues, while educational and highway bond issues have fallen considerably.

Nonetheless, state-local financial planning may suffer this year from the recent weakness in the municipal-bond market, which in the past two months has led to a rise in yields (and fall in prices) approaching the record levels of four years ago. One major cause of the slump has been the lack of commercial-bank buying support for the market. The banks, which for more than a decade were the heaviest purchasers of municipals, have largely withdrawn from

the market because of their need for funds to meet surging business-loan demand. Casualty-insurance firms and other yield-conscious traders also have been putting fewer dollars than usual into bond purchases.

If state and local governments should again encounter difficulties in meeting their financial needs, we may see renewed interest in support for this sector through such entities as a National Development Bank. The Bank would guarantee as well as purchase municipal obligations, with funds obtained either through Congressional appropriations or through the sale of its own obligations to the Treasury or the general public. This approach would be designed to help smaller governmental units enjoy the same market standing as larger states and cities.

Critics of this proposal point out that Development Bank open-market borrowings in support of state-local projects would only tend to push interest rates upward. In addition, they claim that such borrowings would only reallocate—not increase—the total supply of loanable funds, and thereby reduce the amount of funds available for other potential borrowers.

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