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FEDERAL RESOURCES AND URBAN NEEDS

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Foreward

This paper analyzes some of the future implications of the changing patterns of defense and space expenditures. The possibilities for transferring potentially available financial and physical resources from Federal programs to state and local governments are explored.

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INTRODUCTION

As a Nation, we have a tremendous amount of discretion in making future allocations of our public resources, and it is quite likely that substantial additional amounts can be devoted to meeting urban needs. The three related purposes of this paper are (1) to sketch out the future prospects for Federal funds and other resources being available to meet the rising needs of non-defense programs within the public sector, (2) to examine the ways in which such resources might actually be released to state and local governments, and (3) to point out that we have no budgetary concepts or techniques for dealing with the public choices that lie ahead.

Before going into the details of my analysis, I would like to present some of the key findings. The most surprising one--in this period of continued deficit spending by the Federal Government--is the likelihood of federal revenue in the future outpacing the growth of current federal expenditure programs, and, hence, the vision presents itself of potential Federal surpluses. These financial surpluses may also have a counterpart in terms of real resources that will become available, and I will devote some attention to both the problems and potentials of that aspect.

The less surprising companion finding is that the reverse situation is likely to occur at the state and local governmental levels; the regressive tax structures are not likely to yield, at current rates, sufficient revenues to match rising expenditure requirements of education and other existing programs, and, hence, significant potential deficits are in prospect.

As Galbraith stated recently, "The great economic anachronism of our time is that economic growth gives the Federal Government the revenues while, along with population increase, it gives the states and especially the cities the problems. The one unit of government gets the money. The other gets the work."¹ Despite the overstatement in Galbraith's testimony, the interactions of these two strikingly different fiscal conditions are likely to have important repercussions, and also to make available heartening potentiality, for urban planners. However, we now have no satisfactory mechanism for reallocating large amounts of governmental funds among the various levels of government, and the latter portion of this paper is devoted to an examination of the various possibilities for doing so.

FEDERAL BUDGET TRENDS

As a starting point for analyzing the future availability of Federal resources for urban growth, as well as for other purposes, I would like to report on some preliminary findings of a study of Federal revenue and expenditure trends in the 1965-75 time period.² I will not be presenting any recommendations as to the levels of governmental revenues and expenditures which, in any sense, could be considered to be most desirable or optimum.

Rather, my purpose is narrower, but perhaps more useful -- to estimate the budget results that are likely to occur during the next ten years on the basis of existing statutory authorizations and commitments. I will try to answer the following questions:

- (1) What is total Federal revenue likely to be in 1975, under the existing tax laws?
- (2) What changes in the composition of Federal expenditures are likely to take place under these conditions?
- (3) What is total federal expenditure likely to be in 1975, assuming the continuation of current programs and the fulfillment of current statutory commitments (e.g. payment of veterans' pensions required by existing laws governing veterans' benefits)?
- (4) How much discretion is there likely to be in the Federal Budget? That is, will there be revenues above and beyond those required to finance programs and commitments that already are on the statute books? Hence, will we have some significant choices between tax reduction, further expenditure increases, or some combination of the two, without encountering political constraints arising from long-term deficit financing?

METHOD OF MAKING PROJECTIONS

In this study, the various categories of Federal revenues were projected by extrapolating their past relationships to Gross National Product, and such related series as personal income and corporate profits, on the basis of assumed future levels of these measures of economic activity. In a manner of speaking, Federal revenues are projected as an element which is endogenous to our economic model, that is, determined primarily by the level of economic activity. The expenditure estimates, in contrast, are in general exogenous-- they influence the level of economic activity, but are not significantly affected by it.

A combination of approaches was found necessary in projecting the various functional categories of Federal expenditure. For one category of programs, actuarial estimates are available of future expenditure requirements under existing legislation. The largest single example of this nature is the old-age and survivors' insurance trust fund. The Department of Health, Education, and Welfare has carefully estimated the receipts and expenditures on the basis of detailed examination of the U.S. population distribution, the coverage of the social security system, the life expectancy of the beneficiaries of the system, and the benefit rates established by legislation. Other programs for which some actuarial projections are available include the disability insurance trust fund, veterans pensions, veterans compensation, and the civil service retirement and disability trust fund.

Another category of expenditures consists of those for which relatively firm program estimates are available. The major example

here is federal grants to states under the Federal-aid highway legislation. For still another category of expenditures, statistical extrapolations were utilized. Because, in the past, annual Federal outlays for public assistance were closely associated with the number of persons in the United States over 65 years of age, these expenditures were projected on the basis of the future age distribution of the Nation's population.

However, a very large group of government expenditure programs remained, those whose size is determined primarily through relatively subjective decision-making processes, or at least those which cannot be projected in an objective manner. These include national defense, agriculture, and housing outlays. Nevertheless, we can evaluate some of the factors that will influence program and budget decisions and also make reasonable estimates of expenditures in, say, 1975. An example of such relevant factors is the likely future relationship of farm output to demand for agricultural commodities and, hence, the general magnitude of imbalances in agricultural production, which give rise to farm subsidy payments.

Perhaps the key program development affecting the estimates is the status of the defense program. It is clear that total expenditures for national defense have been declining recently. To date, the overall reductions have been slight--3 percent last year and an estimated one-half of one percent this year. The fundamental change is that the rapid expansions in defense/space programs, which were initiated at the beginning of the Kennedy Administration, are either over or are rapidly drawing to a close.

We are witnessing the transition of the defense/space market from a major growth sector of the American economy to a relatively stable one. This is resulting from some reductions in both international tensions, especially vis-à-vis the Russians, and the Pentagon's numerous attempts to reduce costs and improve efficiency.

At least for the next several years, the long-term rise in defense spending will be halted, because the bulk of the funding on major strategic (or general war) aircraft and missile programs has been completed. In the short run, at least, this will not be offset by new major long-range bomber, ICBM, anti-ICBM or military space programs phasing into production, because of the long lead times required for developing such technologically sophisticated systems.

GENERAL ASSUMPTIONS

It also was necessary to make numerous general economic assumptions in preparing the estimates contained in this report. The underlying assumption here is that there will be a high degree of continuity in the political, social, and economic institutions that set the pattern of life in the United States. Changes in such basic conditions evolve slowly for the most part. The reasonableness of this assumption can be seen by examining recent experience. Despite several shifts in national political administrations in recent years, the basic pattern of governmental programs and activities has continued. In fact, no major program initiated under the previous Democratic administrations was eliminated under the Republican Administration. The rate of expansion of existing programs may have been altered, but the upward trend, particularly in the health-education-welfare area, was not reversed.

The underlying tensions between the United States and the communist nations are assumed to continue, although there may be periods when such tensions subside. Nevertheless, it is assumed that no major disarmament agreement will be achieved and, thus, a continued high level of military preparedness will be likely.

The overall level of economic activity in the United States, as measured by the Gross National Product, is assumed to increase at the average rate of three and a half percent a year between 1965 and 1975, measured in terms of constant dollars. This growth rate corresponds to that achieved by the American economy during the 1955-62 time period. This may be considered by some to be a conservative assumption. The January 1965 Economic Report of the President states:

"The prospects for growth of the labor force and productivity suggest that the increase of potential GNP in 1965-70 will exceed the $3\frac{1}{2}$ percent annual rate--Indeed, over the next five years it is likely to average about 4 percent a year, a rate approaching that of the early postwar period."

Should GNP expand at the 4 percent rate, the departures from the estimates that I will present would be significant but not fundamental on the revenue side and marginal on the expenditure side. Although it is likely that cyclical fluctuations will continue to occur during the coming decade, I have made no attempt to forecast their timing or amplitude. Hence, the values shown for 1975 are points on long-term trend lines. That is, there are assumed to be years characterized neither by recession nor above-average expansion.

All of my projections are in terms of the average price level prevailing in the fiscal year 1965 (so-called "constant 1965 dollars"). This does not signify that I think that no further inflation will occur.

All that this assumption is intended to convey is that "real" rather than monetary changes in governmental budgets are projected here. Use of constant dollar comparisons does not require a companion assumption of rigidity in average wage rates. Average increases in pay rates equal to the trend increase in productivity would be consistent with the assumption of price stability.

The rates of Federal taxation are assumed to be those provided by current legislation. Thus, already scheduled increases in social security tax rates will take place, but no allowance is made for further legislative changes in the revenue structure.

THE EXPENDITURE PROJECTIONS

On the basis of my detailed estimates (see table 1), a very striking shift will occur in the composition of federal expenditures during the 1965-75 period. The fundamental shift would take the form of a reallocation from the national security categories--defense and space programs--to the individual welfare and "Great Society" areas, such as education, social security, housing, and community development. Given my assumptions, during the coming decade, national security expenditures will decline in relative importance from a little more than half of the Federal Budget to a little less than 40 percent. For the first time in many years, the domestic-civilian programs are likely to come to dominate the Federal sector. In a manner of speaking, this would constitute a mild form of unilateral disarmament.

Table 1

Federal Government Cash Expenditures, Fiscal Years 1965 and 1975

<u>Category</u>	1965 <u>In Billions of Dollars</u>	1975 <u>of Dollars</u>	1965 <u>Percentage</u>	1975
National Defense	52.8	52.0	43.5	33.9
International Affairs and Finance	3.6	3.5	3.0	2.3
Space	4.9	5.0	4.0	3.3
Agriculture	4.6	5.5	3.8	3.6
Natural Resources	2.8	4.3	2.4	2.8
Commerce and Transportation	7.4	9.0	6.1	5.9
Housing (excess of loan repayments)-	0.2	3.0	- 0.1	2.0
Health, Labor, and Welfare	28.9	47.0	23.8	30.7
Education	1.5	5.0	1.2	3.3
Veterans	6.0	7.0	4.9	4.6
Interest	8.5	11.0	7.0	7.2
General Government	2.4	2.9	1.9	1.9
Adjustments for selected intra- governmental transactions	<u>- 1.8</u>	<u>- 2.2</u>	<u>- 1.5</u>	<u>- 1.5</u>
TOTAL	121.4	153.0	100.0	100.0

Source: M.L. Weidenbaum, Federal Government Budget Trends, 1965-1975, Working Paper 6502, Washington University Department of Economics.

This shift is far more than a financial one. It signifies a larger proportion of transfer payments and a smaller proportion of Federal purchases from private industry. The former category consists of such items as social security payments, veterans' pensions, and similar disbursements which serve to influence the distribution of income among the various groups within American society. It is the latter category which has been, since World War II, the primary market for the major growth industries in the United States, notably electronics, aerospace, and scientific instruments. Moreover, it is precisely these industries that employ the lion's share of the scientists and engineers working in American industry.

The future budget situation envisioned here would not eliminate the large governmental market for our research and development talent. However, on balance, it is likely to provide little if any growth potential. Hence, normal increases in the supply of scientists and engineers (which could be expected if a constant fraction of the rising absolute number of college students majored in technical fields) would either move directly into non-defense fields or would replace ("bump") engineers or scientists now engaged in defense work, who would in turn be available for civilian pursuits.

The preliminary impacts of this reallocation of federal resources are already being felt. ¹³ Numerous defense contractors are becoming interested in the potentialities of civilian work, particularly in the public sector of the economy, which responds to the unique type of market stimuli that they understand so well. Some recent projects of this nature include a parcel sorting system for the post office,

a civilian national communications link for a foreign country, advanced electronic monitoring devices for hospitals, and automated training devices.

The emphasis on the public sector arises because past commercial diversification efforts of the major specialized defense producers have been unsuccessful. These companies generally are geared to the requirements of governmental rather than commercial markets, to high technology rather than high volume, to high quality rather than low price, and to a single or small group of customers rather than mass distribution. Hence, a major focus of current diversification efforts is on the application of the advanced engineering and technology-- and especially the so-called large-scale systems management capability-- to meeting non-defense needs in the public sector of the economy.

The Federal Government, in turn, has set up several new study groups to deal with some of the problems that emerge as a result of these shifts in public demand. The President's Committee on the Economic Impact of Defense and Disarmament was set up to analyze existing economic adjustment programs in light of shifts in military demand and to determine what additional actions are warranted.

The Congress has also authorized a National Commission on Technology, Automation, and Economic Progress to study these and related problems. The far-reaching mandate of the Commission covers:

- (1) Defining those areas of unmet community and human needs towards which application of new technologies might most effectively be directed

- (2) Assessing the most effective means for channeling new technologies into promising directions
- (3) Assessing the proper relationship between governmental and private investment in the application of new technologies to large-scale human and community needs.

Also, in a modest way, some of our State governments are now devoting attention to this area of technological transfer. Some of the most interesting developments are occurring in the State of California, where so much of the pertinent capability resides. The State government there has undertaken a program of exploratory research to demonstrate how defense corporations can apply their sophisticated analytical techniques to important civilian areas. Awards have been made to several aerospace companies to do preliminary work in four fields:

- (1) A long-range plan for a state-wide transportation system.
- (2) An analysis of the State's prisons and mental institutions, to search out ways to improve efficiency.
- (3) A method of collecting, storing, and retrieving the masses of information used by the State Government.
- (4) A system for handling the State's tremendous waste problems, which are creating air, water, and soil pollution problems in turn.

It certainly is conceivable that the type of talent which can be utilized in these projects may also find useful application in the similar problems that beset our major urban areas.

To return to the budgetary outlook, a review of past experience reveals that not all categories of expenditures continue to rise indefinitely, and certainly that there are significant differences in their growth rates over time. For example, with the completion of most of the World War II GI Bill program, veterans services and benefits are currently being funded at rates far below those of the early period. Similarly, economic foreign aid is being conducted at lower levels than during the time of the Marshall Plan. Here are some of the more striking differences in growth rates projected for the coming decade:

Education	+233%
Health, Labor, & Welfare	+ 63
Total Expenditures	+ 26
Space	+ 2
National Defense	- 2

In absolute terms, however, the only functional areas for which actual decreases are projected are foreign aid, the civilian space program (following the scheduled lunar landing by 1970), and national defense, between 1965 and 1970. The latter decline represents a continuation of the current downturn in the present military procurement cycle; the estimates provide for a moderate upturn by 1975.

To avoid any misunderstanding about the nature of these projections, I reemphasize that they are not the result of the exercise of judgment as to what are the most desirable or even likely future levels of total government spending. These estimates represent an evaluation of the future financial dimensions of current programs and commitments. There are numerous examples of possible new budgetary items which could involve large expenditures in subsequent years, some of which may very

well be enacted. Typical examples of such new programs, which are not included in my estimates, are the following:

1. Large scale exploration of Mars and other planets.
2. Transforming the Department of Agriculture into a rural affairs agency.
3. An operational salt and brackish water desalinization program.
4. Federal financing of a civil supersonic transport development program.
5. Construction of a substitute for the Panama Canal.
6. Expanding the social security system in line with rising living costs and general improvements in the standard of living.
7. Expanding Federal assistance to research and development, particularly to the "underresearched" industries catering to non-defense markets.
8. General pensions to all World War I veterans.

THE BUDGET TOTALS

I would now like to turn to the likely changes in the overall fiscal picture (see table 2). According to my calculations, total Federal revenues under current tax provisions are likely to reach almost \$180 billion by 1975, compared to \$117 billion in 1965. Federal revenues would become an increasing percentage of the Gross National Product because of the slightly progressive character of the Federal income tax structure (technically, the income elasticity of the revenue structure is greater than unity).

Table 2

Projections of the Gross National Product and the Federal Budget

(Fiscal years; in billions of dollars)

<u>Category</u>	<u>1965 Estimated</u>	<u>1975 Projected</u>
Gross National Product	640.0	903.0
<hr/>		
Federal Revenues	117.4	179.0
Revenues as Percent of GNP	18.3	19.8
<hr/>		
Federal Expenditures	121.4	153.0
Expenditures as Percent of GNP	19.0	16.9

Source: M. L. Weidenbaum, Federal Government Budget Trends, 1965-1975, Working Paper 6502.

Federal expenditures under current programs and commitments are estimated to rise from \$121 billion in 1965 to \$153 billion in 1975. Such an increase of 26 percent would be significantly lower than either the 41 percent rise in GNP or the 52 percent rise in revenues. This may be one of the fundamental, although quite simple, results that emerge from my study: under the current budget structure, Federal revenues are likely to increase faster than the national economy and Federal expenditures are likely to increase more slowly than the national economy.

Hence, despite the current experience of a series of budgetary deficits, the future result of the current program and revenue structure of the Federal Government is likely to reverse the situation. The budget results which will actually be obtained, of course, will be determined by the incremental decisions to be made during the coming decade.

The projected gap between revenues computed on the basis of existing tax laws and expenditures estimated on the basis of continuation of current programs mainly signifies the amount of discretion that may be exercised by policymakers in the future. First of all, past experience indicates that it is most unlikely that an entire decade will go by without important changes in both tax legislation and governmental program authorizations.

Moreover, economic analysis has increasingly pointed out the adverse affects of a potential large surplus in the governmental budget. In effect, such potential net inflow to the Federal government is self-defeating, because it exercises a depressive influence on the

level of economic activity, thereby reducing governmental revenues from their potential, and preventing the actual realization of a large budgetary surplus.^{/4}

FEDERAL-STATE-LOCAL FISCAL RELATIONS

This leads us to the central question I would like to consider-- the fiscal relations between the Federal Government and state and local jurisdictions. The contrast with Federal finance is striking. There is hardly a potential budget surplus to worry about at the "lower" governmental levels. The reasons are rather simple.

As has been amply demonstrated in the public finance literature, the average state and local tax structure is relatively regressive, while that of the federal government is, on balance, progressive.^{/5} There is no need, for our purposes, to debate the social desirability of progressive versus regressive taxes. The objective results of these two tax structures are what is relevant to the present inquiry. By definition, under a progressive revenue structure, the tax bill rises faster than the taxpayer's income. The reverse is true under a regressive system, whereby the tax bite is a declining percentage of income as income rises.

The implications for our analysis are fundamental. As incomes increase, the revenues under our generally progressive Federal tax structure rise considerably faster than income. This was the result of our Federal Budget study. Almost the reverse occurs at state and local levels. Many taxes do not rise as rapidly as income. The average state and local tax structure is more inelastic than the

Federal; that is, relatively less sensitive to changes in economic growth. Only by adjusting assessment ratios and increasing tax rates, do property tax yields tend to keep up with the expansions in GNP. Other major state-local revenue sources, such as general sales or income taxes, tend to be proportional to economic activity; specific excises, licenses, fees, and other sources yield increases in revenues far below the rate of economic growth.¹⁶

The story, of course, is quite different on the expenditure side. For example, the requirements for education, which dominate these budgets, continue to expand far more rapidly than either population or the economy as a whole. The reasons are generally well known, such as the above-average rise in the school-age population, which continues as the impact of the post World War II baby boom is experienced successively by elementary schools, then high schools, and finally institutions of higher learning. On the basis of rather conservative assumptions, the United States Office of Education has projected a 50 percent increase in public education expenditures in the next decade (making for a relatively high implied income elasticity of 1.22). The estimated increases are due, chiefly, to rising enrollment at all levels, especially in high schools and colleges. (see table 3).

Other pressures for rapid increase in state or local expenditures arise from the continued suburbanization of the Nation, requiring expensive new governmental infrastructure for many new areas. Some estimates indicate that, by 1975, three out of every four persons will be living in urban or suburban areas. The importance of this

Table 3

Public Expenditures for Education
(School years. Billions of 1961-62 dollars)

Year	Total	Elementary and Secondary Schools				Higher Education Institutions		
		Total	Current Expenses	Capital Outlays	Interest	Total	Current Expenses	Capital Outlays
1955	14.1	11.7	8.6	2.9	0.2	2.4	1.9	0.5
1960	20.1	16.3	12.8	3.0	0.5	3.8	3.1	0.7
1964	26.2	20.6	16.9	3.0	0.7	5.6	4.4	1.2
1965	27.1	20.9	17.8	2.4	0.7	6.2	4.8	1.4
1966	28.3	21.6	18.6	2.2	0.8	6.7	5.3	1.4
1970	34.1	25.7	22.3	2.4	1.0	8.4	7.2	1.2
1975 ^{/1}	41.2	30.1	26.3	2.6	1.2	11.1	9.9	1.2

^{/1} Extrapolated by the author on the basis of Office of Education methodology for 1964-1974 data.

Note: Estimated increases are due chiefly to increases in enrollment at all levels, especially in high schools and colleges, and cost increases in salaries and facilities. No allowance is contained for improvement in the quality of education beyond trend levels.

Source: Office of Education, U.S. Department of Health, Education, and Welfare, Projections of Educational Statistics to 1973-74, 1964 Edition, Washington, U.S. Government Printing Office, 1964, pp. 31-32.

"incremental" growth can be seen from another estimate that, in recent years, 8 out of every 10 new private homes have been built in suburban communities. Continuation of such growth and movement would place increasing demands on public services, utilities, and transportation facilities. On balance, the outlook for state and local governments, on the basis of current tax structures and program requirements, is just the reverse of the Federal situation--potentially large excesses of expenditure demands on states and localities over available revenues.

Thus far in the period since World War II, the rising requirements of State and local governments have been met in a variety of ways: increasing tax rates and assessment ratios, imposing new taxes, grants-in-aid from the Federal Government, and debt creation.

It is likely that each of these sources will continue to be relied upon, but that some of them will be utilized with increasing reluctance. The debt of state and local governments has risen spectacularly in recent years; total debt of the states went up 339 percent from 1950 to 1964, while that of local governments rose by 236 percent during the same period.¹⁷ Constitutional debt limits and similar institutional restrictions tend to dampen further increases. New and heightened tax rates apparently are running into increasing opposition at state and local levels and, of course, are in striking contrast to the two rounds of tax reduction at the Federal level since the end of the Korean War.

One very knowledgeable student of state and local taxation, in reviewing this situation, made the following striking statement to the Joint Economic Committee recently:

"I would hazard the guess that resistance to higher taxes is perhaps the greatest obstacle to the exercise of executive and legislative leadership in State and local government today. Also, as taxes go up, the question of the 'tax climate' of a particular State or locality and its ability to expand job openings become of increasing concern. Even aside from this consideration, the existence of State borders and the mobility of persons, resources, and trade are facts of life which tend to put a ceiling on tax rates far under these Federal counterparts." 8

In contrast, it is clear that Federal aid in the form of specific grants will continue to expand. The current general-aid-to-education legislation provides for aid, through the state governments, to school districts with children from low income families. However, total federal grants, which are now running at about ten billion dollars a year, are hardly likely to increase by anything approaching the magnitude of the potential Federal surplus of \$26 billion estimated for 1975 (on the basis of current legislation).

WAYS OF AIDING STATES AND LOCALITIES

I may disappoint some of my listeners by not coming up with a solution to the financing problem of state and local governments. However, the idea I am trying to get across is that we will begin to solve the problem if we start looking at the potential Federal surpluses in combination with the anticipated deficits in other governmental budgets. The so-called Heller (or Pechman) plan for unrestricted Federal grants to state governments is obviously one way out. The Eisenhower effort to shift Federal tax sources to State governments is another approach. That did not work, in part, because that administration attempted to shift program expenditures to the states at the same time. There are other possible approaches, which some imagination may supply.

The general idea of Federal distribution of surplus funds has a long history. Thomas Jefferson, in his second inaugural address on March 4, 1805, suggested that the revenues from import duties, above those needed for current expenses and debt retirement, "may, by a just repartition among the States...be applied, in time of peace, to rivers, canals, roads, arts, manufactures, education, and other great objects within each state."

Madison vetoed, on constitutional grounds, a bill which would have distributed the dividends on the Federal subscription to the second national bank to the states in proportion to population. The funds were to have been applied to construction of "such roads, canals, and so forth, in the several states, as Congress might direct with the assent of the States." In 1826, Senator Mahlon Dickerson of New Jersey introduced a bill, which was considered but not enacted, that prescribed that \$5 million a year should be distributed for four years among the states in the ratio of direct taxation. No restrictions were to be placed on the funds, but the object was to aid internal improvements and education.¹⁹

It may be helpful to examine each of the major alternative ways which have been suggested recently in order to deal with the fiscal situation which is likely to occur in the coming decade. Each of these approaches may be examined from a number of viewpoints: their tendency to expand or reduce the role of the Federal Government in the economy generally, and in state and local governmental affairs specifically; their effects on the progressivity of the overall tax structure; their impact on the stabilizing effectiveness of the tax structure;

their influence on the distribution of income (i.e. equalization between high and low income states); and their relationship to local government roles vis-a-vis the state legislatures.

I would like to analyze six major approaches for utilizing potential surpluses in the budget of the Federal Government to aid state and local governments:

1. Direct federal expenditures
2. Conditional grants-in-aid
3. Block or unconditional grants
4. Tax sharing
5. Tax credits
6. Income tax reduction

These alternatives are not necessarily mutually exclusive; some combination might be considered. ¹⁰

Direct Federal expenditures. The potential increase in federal revenue, above that required for financing continuing programs, could be devoted to additional domestic civilian activities, to be conducted by the Federal Government itself in all 50 states. For example the Federal Government could institute new programs of an interstate character, such as the construction of mass transportation or air pollution control facilities, or the Federal Government could increase existing federal programs, such as public works construction projects in the field of water resources, or it could mix new programs with expansions of old ones. This approach would call for the largest amount of federal intervention, since no provision would be made for state or local government participation. There would be state and local benefits, however, since

facilities could be provided to urban areas which otherwise might have to be financed locally. This approach would tend to optimize the size of the public sector of the U.S. economy. Appendix A indicates the wide variety of Federal activities which, at present, are available at the local level.

Several positive effects would emerge if this approach were utilized. Abstaining from reductions in Federal income taxation would maintain the progressivity of the over-all tax structure and the role of the built-in or automatic stabilizers. This would not be the case were reductions in federal income taxes to be made and be accompanied by increases in state and local revenues, because of the more regressive and inflexible nature of the latter tax structures. Depending on the type of expenditure programs selected (subsidies to business versus transfer payments under the anti-poverty program), the impact on income distribution could be either more or less equalizing.

Conditional Grants. Another alternative use of potential increases in federal revenue is to expand the use of "tied" or conditional grants made to state and local governments for financing specific functions, such as medical research or airport construction. This approach would make the Federal Government an even more important influence in state and local fiscal operations, and also would tend to give the Federal Government added influence over the allocation of funds in state and local budgets. It is sometimes claimed that a disproportionate share of state and local revenues is devoted to providing matching funds for Federal grants-in-aid ("We can't afford to lose the federal money").¹¹

Like the direct federal expenditure approach, the use of conditional grants-in-aid would not adversely affect the progressivity or stabilizing effects of the tax structure. Again, the selection of the specific types of expenditure programs would determine the impact on income distribution, as well as on economic stability (public assistance grants are estimated to have a higher degree of automatic stabilization effects than highway grants). Most federal grant programs have an income equalization effect because Congress traditionally uses allocation formulas based on population or income. To some extent, increases in federal grants-in-aid can lead to increasing the regressiveness of state and local tax structures, if the matching requirements necessitate raising rates of regressive tax sources. Further use of the grant-in-aid mechanism would not tend to increase the importance of the federal sector, because such funds are not recorded in the Gross National Product until they are respent by the ultimate recipient for goods and services.

The great bulk of federal grants is made to state governments. However, in the case of a few important grant programs, the national government bypasses the states and deals directly with localities. Examples include housing and urban renewal, federal aid to airports, and aid to mass transportation systems.

Unconditional Grants. Recently, a great deal of attention has been given to the concept of block or unconditional grants. One proposal would set up a permanent trust fund to distribute an amount equal to one or two percent of the federal income tax base among the states on a per capita basis. This approach would, of course, reduce the role of the Federal Government both in the national economy and in relation to state

and local government action. It would also exercise a moderately equalizing effect between high income and low income states, but would have no effect on the overall progressivity of the tax structure or on the importance of the automatic stabilizers.

This method--quite comparable to the Treasury distribution of 1837, discussed below--might be far from an unmixed blessing for urban areas because federal funds would be funneled entirely through the state governments. It could increase the problems that the typical metropolitan areas face in obtaining "fair" shares of state funds from their respective legislatures. Perhaps, some imagination and thought might be devoted to methods of including local as well as state governments as recipients of the federal funds. This, of course, raises some fundamental questions concerning the role of urban areas in a federal form of government.

Professor Musgrave of Princeton has described the issue as follows: "To what extent is the ability of lower level governments to deal with fiscal issues impaired by a lack of matching between existing borders of fiscal responsibility (i.e., states, cities) with the regions (e.g., metropolitan areas and regions cutting across states)?"¹² The institution of a new state revenue source (i.e. block grants) might well be the occasion for an improved matching of fiscal requirements and capabilities.

Tax Sharing. It has been suggested that a designated portion of federal tax revenues be distributed to the states on the basis of source of collection. This would clearly result in high income states, with high tax payments, receiving the larger shares. Like the block grants, this method would also diminish the federal role, because the state

governments would be left free to determine the allocation of their funds. In general, it would also have similar effects on progressivity and stability aspects of the overall tax structure. Although this proposal would create the same sharing problems for urban communities, it would tend to benefit the larger urban areas that frequently are located in states with above-average per capita incomes.

Tax Credits. This approach would provide federal income taxpayers a more liberal write-off of state and local taxes by providing them an option either to deduct their state and local tax payments from taxable income, as they can do now, or to deduct state and local tax payments (in excess of some percentage of their net taxable income) from their federal tax bills. The major benefits would accrue to persons in the low and middle tax brackets who carry above-average state tax loads. In contrast, persons in the high tax brackets already enjoy a liberal write-off through itemization. This method would give state and local governments an incentive to place more reliance on income taxes in order to maximize tax credit possibilities. This could help local, as well as state, governments by softening resistance to increases in state and local taxes. Also, the Federal role would be reduced in both the national economy and vis-à-vis state and local governments. At the same time, the strength of the built-in stabilizers and the progressivity of the overall tax structure would tend to decline because the Federal Government would be a smaller fiscal factor in the national economy.

Outright Reductions in Federal Income Taxes. This indirect approach to aiding state and local governments would permit them to increase their tax rates without increasing the total tax bill of the average

citizen. It also introduces major questions of interstate rivalry, however, and hardly has any positive effect on interstate income equalization. The overall national tax structure would become less progressive (as well as less anticyclical), because the Nation would be placing greater reliance on proportional and regressive state and local taxes and less on progressive federal taxes in financing domestic needs in the public sector. The role of the Federal Government, both in relation to state and local governments and to overall economic activity would be diminished with a reduction in its fiscal resources.

My purpose in analyzing the impacts of the six proposals in some detail has been to show that the choice is not easy. Given a society with plural objectives, no single fiscal approach would satisfactorily meet more than a few of them--and might adversely affect other goals. Direct Federal expenditures might optimize income stabilization and income redistribution objectives, but bypass completely both state and local governments. Tax reduction decreases the size of the federal sector, but meets state and local public needs only indirectly, if at all. Tax sharing and block grants provide for the allocation of public funds among programs to be made individually by the states, who presumably are more familiar with the needs and desires of their residents than the national government; however, no provision is made for the burgeoning financial requirements of counties, school districts, and cities and towns.

A review of past periods in American history where Federal Budget surpluses were familiar yields results which may be useful for analytical as well as for anecdotal purposes. By the objective standards--at least of some--"the good old days" occurred during the years 1825-1836.

These twelve fiscal years represent the longest period in American history in which the Federal Budget continuously registered a surplus. By and large, the revenue excesses, which resulted from tariff duties and land sales, were devoted to reducing the national debt. Apparently, the bureaucracy was not too resourceful in those days. Expenditures in 1832 were only a little higher than in 1825 (\$17 million versus \$16 million). The potentialities for debt reduction were soon exhausted--the debt was reduced from the burdensome total of \$81 million in 1825 to a more bearable \$7 million in 1832.¹³

Numerous proposals were made during this period for alternative methods of disposing of the excess Federal revenues. The one adopted was to distribute to the states, according to population, the surplus above \$5 million in the U.S. Treasury on January 1, 1837, which amounted to \$37 million. To overcome the constitutional objections of some, the payments were in the form of loans, but it was generally understood that the states would not be requested to make repayments. Historians argue over the deflationary effects of this large budgetary surplus. In any event, the distribution to the states was halted when it was three-quarters completed; the Panic of 1837 had turned the surplus into a deficit, and this "unique and curious measure", to use the terms of one historian, was allowed to lapse.¹⁴

The variety of uses to which the States devoted these windfall revenues is intriguing. Some used the funds to capitalize the state banks, others devoted the money to local debt repayment or public works construction. Some objected to the whole idea. The Georgia legislature, in their acceptance, stated that they would have refused the money had

it not been for the provision that the share of any refusing state should be divided among the other states. Although, according to one scholarly observer, some of the funds were "lost" or "wasted on improvements", the major portion was utilized for education and other "worthy purposes".^{/15}

IMPROVING THE ALLOCATION OF PUBLIC RESOURCES

Depending on which of the six approaches described above are selected, or some other, there may be great danger of not obtaining anything close to an optimum allocation of public resources. The possibility certainly exists that we, as a Nation, may use up potential increases in Federal revenues for relatively low-priority programs, while state and local governments are forced either to defer relatively more worthwhile projects for lack of funds, or to increase taxes which have adverse effects on economic stability or on distributional equity.

What may be required is the development of some methodology to allocate public resources on some more rational basis than at present. An examination of actual budget documents and appropriation hearings, at least at the Federal level, reveals no systematic attempt to appraise the desirability of the choices implicitly made in the allocation of government resources among the major alternative uses.

In practice, the actual allocation of funds among the major end-purposes of government is the accidental result of a myriad of independent budget decisions rather than the outcome of conscious choice. What is needed is a mechanism to permit the following types of choices to be made: between greater welfare and economic growth, between active and passive defense, between agriculture and education, between air and

surface transportation facilities, between direct federal operations and grants to state and local governments, and so forth. ¹⁶ Table 4 shows some of the kinds of implicit choices which have been made in the allocation of public funds among the major levels of government.

Basically, the horizons of budget reviewers need to be broadened by enabling cross-comparisons not currently made, such as a tradeoff between an extra billion dollars for Federal natural resources development or for grants to states for education and training programs, (or more general) purposes.

The current budgetary mechanisms do not answer or even raise such basic allocative questions. Yet, such types of decisions are no more novel than a family's choice to use the Christmas bonus for a new car or a vacation, or a company's desire to allocate an increase in earnings to raising the dividend rate or to embarking upon a new research program. The company or the family may use relatively crude analytical techniques in making such choices, but, at least for some of them, the alternatives are considered jointly. The recent development and extension of program budgeting and cost/benefit analyses for defense and water resources programs may have applicability to the broader questions involving the allocation of public resources. Without prejudging the question, such techniques might result in a more reasonable distribution of public resources to meet the needs of our urban areas.

We do have a major educational task ahead. At present, we may share William Henry Seward's lament concerning the uses of the potential Federal surpluses of the 1830's. The following appears in a letter he wrote in 1836, when he was a land officer:

"The public feeling is scarcely enlisted yet in support of our noble and just measure of distributing the public revenue. People seem, so far as they fall within my observation, to be unconcerned, as if entirely ignorant on the subject." ¹⁷

Table 4
Allocation of Public Funds Among Major Functions

Level of Government	Major Governmental Functions									
	National Defense	Educa-tion	Old Age Insurance	Health and Welfare	Natural Resources	High-ways	Unemployment Compensation	Police	Housing	Air and Water Transportation
Federal	X		X		X					X
State					X	X				
Local		X		X				X	X	

Notes: (1) "X" indicates level at which the largest portion of governmental funds is spent.
 (2) Functions listed in descending order of dollar magnitudes, from left to right, based on Fiscal Year 1963 relationships.

Source: Prepared from data in Facts and Figures on Government Finance, New York, Tax Foundation, Inc., 1965, p. 18.

Appendix A

FEDERAL SPENDING AND THE LOCALITY

This appendix focuses on a single city--Atlanta, Georgia--in order to examine the types of Federal Government funds that are available at the local level. Obviously, a great many cities and towns in the United States contain local representatives of various "old-line" federal departments, bureaus, and agencies, such as the FBI and the Bureau of Labor Statistics. However, there also are a great many federal programs of a "developmental" character. There are the programs relating to airports, flood control projects, post office buildings, highways, health research, and similar "investment" type projects.

The Atlanta, Georgia, metropolitan area presents an interesting case, not because of its uniqueness, but because of its typical position as a recipient of and beneficiary from federal programs and activities. It is singled out only because the information is available as the result of a special report by the U.S. Housing and Home Finance Agency.¹⁸ The HHFA lists 33 different federal "developmental" programs, of wide variety, in the Atlanta metropolitan area. The funds authorized for these programs in 1962, including grants as well as direct expenditures and loans as well as loan guarantees, totaled \$117,698,000.

Grants and Matching Funds. The Department of Commerce, the Department of Health, Education, and Welfare, the Housing and Home Finance Agency, and the Federal Aviation Agency each provided one or more types of grants and matching funds to the Atlanta area in 1962. These varied from secondary road construction (\$5,000) to air pollution

research (\$35,000). The \$35,841,000 in grants to Atlanta could be categorized as follows:

Transportation facilities--primary roads, secondary roads, urban roads, interstate highway, airport construction.

Education--payments to school districts.

Health--hospital construction, waste treatment works, air pollution research, water pollution research, health facility and construction.

Urban facilities--urban renewal, urban planning.

Direct Federal Expenditures. In addition to the above grants-in-aid, the Veterans Administration and the Departments of Agriculture, Defense, and Interior each conducted several developmental activities in Atlanta in 1962. These programs were mainly in various fields of natural resource development. The following is a classification of these various direct federal expenditure programs, which totaled \$2,296,000 in 1962.

Natural resource development--Altoona Dam recreation facilities, Buford Dam construction, flood prevention, watershed investigation, construction of park facilities, rehabilitation of park facilities, investigation of fish and wildlife, saline water research.

Health--veterans hospital alterations.

Agriculture--farm research.

Defense--construction of reserve, national guard, and other facilities.

Loans and Advances. Loans to individuals, business firms, and local governments in the Atlanta area were also made or planned for in 1962 by the Department of Agriculture, the Housing and Home Finance Agency, the Small Business Administration, and the Veterans Administration. These credit operations (totaling \$594,000) came within the following categories:

Urban facilities--direct housing loans, advances for public works planning.

Agriculture--farm loans, rural housing loans.

Business--loans to small business.

Insuring and Leaseback Programs. Finally, three different agencies provided loan insurance and guarantees to the Atlanta area in 1962--the Department of Agriculture, the Veterans Administration, and the Housing and Home Finance Agency. One agency--the Post Office Department--entered into "leaseback" agreements with private companies for the construction of post offices.

The loan insurance and guarantee programs do not involve any federal expenditure, other than for administration, except in the event of default. Under the "leaseback" program, the Post Office obtains the use of a building constructed to its specifications and makes payments on a lease over an extended period of time rather than paying the full cost of the facility in cash at the outset.

The Federal Government insured or entered into leaseback agreements in Atlanta in 1962 aggregating \$78,966,000. The programs may be classified as follows:

Urban facilities--insured housing loans, public housing construction,
guaranteed veterans housing loans.

Agriculture--insured farm ownership loans.

Government operations--post office building leaseback.

Comments. The above description of federal developmental programs in the Atlanta metropolitan area in 1962 shows the great variety of government projects in a single city in a single year. This sample of federal projects yielded programs covering transportation, education, health, urban development, agriculture, and business, as well as defense and government operations.

The federal agencies involved were the Departments of Agriculture, Commerce, Defense, Health, Education, and Welfare, and Post Office, the Federal Aviation Agency, the Housing and Home Finance Agency, the Small Business Administration, and the Veterans Administration.

The financial methods used include grants and matching funds, direct federal expenditures, loan and advance loan programs, and insuring and leaseback programs.

Note: Adapted from M.L. Weidenbaum, Federal Budgeting: The Choice of Government Programs, 1964 (reprinted in Congress and the Federal Budget, Washington, D.C., American Enterprise Institute, 1965, pp. 19-22).

FOOTNOTES

- L1 "Statement of John Kenneth Galbraith, Paul M. Warburg Professor of Economics, Harvard University", in January 1965 Economic Report of the President, Hearing before the Joint Economic Committee, Congress of the United States, 89th Congress, First Session, Part 2, p.14.
- L2 Murray L. Weidenbaum, Federal Government Budget Trends, 1965-1975, Working Paper 6502, Department of Economics, Washington University, February 26, 1965, 79 pp.
- L3 This section draws on some previous work on the economic impact of shifts in defense spending, e.g. M.L. Weidenbaum, "Adjusting to a Defense Cutback: Government Policy Toward Business," Quarterly Review of Economics and Business, Vol. 4, No. 1, Spring 1964, pp. 7-14 and "Defense Cutbacks and the Aerospace Industry", Aeronautics and Aeronautics, Journal of the American Institute of Aeronautics and Astronautics, Vol. 2, No. 6, June 1964, pp. 60-64.
- L4 See Norman F. Keiser, Macroeconomics, Fiscal Policy, and Economic Growth, New York, John Wiley and Sons, 1964, pp. 311-326.
- L5 Richard A. Musgrave, "The Incidence of the Tax Structure and Its Effects on Consumption," in Federal Tax Policy for Economic Growth and Stability. Papers submitted by Panelists before the Joint Committee on the Economic Report, U.S. Congress, 1955, pp. 96-113.
- L6 Estimates of income elasticity of various state and local taxes sources vary considerably. See especially, Otto Eckstein, Trends in Public Expenditures in the Next Decade, New York, Committee for Economic Development, April 1959, p. 44; Benjamin Bridges, "Income Elasticity of the Property Tax Base", National Tax Journal, Vol. XVII, No. 3, Sept. 1964, pp. 253-264; Jesse Burkhead, State and Local Taxes for Public Education, Syracuse University Press, 1963.
- L7 Facts and Figures on Government Finance, Thirteenth Edition, 1964-1965, New York, Tax Foundation, 1965, p. 15.
- L8 "Statement by Charles F. Conlon, Executive Secretary, The National Association of Tax Administrators", U.S. Congress, Joint Economic Committee, Fiscal Policy Issues of the Coming Decade, 1965, p.182.
- L9 Edward G. Bourne, The History of the Surplus Revenue of 1837, New York, G.P. Putnam's Sons, 1885, pp. 3-7.

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For a more pointed analysis of some of these proposals, emphasizing block grants, by the Chairman of President Johnson's Task Force on Intergovernmental Fiscal Relations, see Joseph A. Pechman, Financing State and Local Government. A paper prepared for the Symposium on Federal Taxation of the American Banking Association, March 26, 1965. For an earlier set of suggestions to deal with the same basic situation, see Gerhard Colm and Manuel Helzner, "Financial Needs and Resources Over the Next Decade: At all Levels of Government", in National Bureau of Economic Research, Public Finances: Needs, Sources and Utilization, Princeton, Princeton University Press, 1961, pp. 20-21.

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Bourne, op.cit., passim.

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For a more extensive treatment of the possibilities for utilizing the budgetary process for improving the allocation of public resources, see M.L. Weidenbaum, Federal Budgeting: The Choice of Government Programs, 1964 (reprinted in Congress and the Federal Budget, Washington, D.C., American Enterprise Institute, 1965, pp. 1-101.)

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Bourne, op.cit., p. 23.

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Testimony of Robert C. Weaver, Administrator, Housing and Home Finance Agency in U.S. Senate, Committee on Government Operations, Role of the Federal Government in Metropolitan Areas (Washington: U.S. Government Printing Office, 1963), pp. 82-83.