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REVENUE SHARING AND ITS ALTERNATIVES: WHAT FUTURE FOR FISCAL FEDERALISM?

PREPARED FOR THE

SUBCOMMITTEE ON FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

Volume III:
FEDERAL, STATE, LOCAL FISCAL PROJECTIONS

JULY 1967

Printed for the use of the Joint Economic Committee

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Part 1

STATE AND LOCAL: NEEDS, DEMANDS, AND RESOURCES

PUBLIC INVESTMENT AND CONSUMPTION: THE OUTLOOK IN STATES AND LOCALITIES

BY SELMA J. MUSHKIN, assisted by GABRIELLE C. LUPO and DAVID D. FRIEDMAN

Repeatedly the question is raised, "Can the States and localities afford to expand their public services? Do they have the fiscal capacity to do so? What is the outlook?"

These straightforward questions cannot be answered simply. What a State or community can afford to finance by way of public services depends upon a number of factors, including the following:

(1) The income in the community or State that is available for both public and private purposes.

(2) The share of that income that the citizen-consumer is willing to devote to public purposes, and his preference for publicly produced goods versus his preference for privately produced goods.

(3) The tax instruments available to the governments through which that share of income may be channeled into public use, having regard for comparative taxloads and burdens imposed by neighboring governments.

(4) The longrun growth and income that results from private uses versus public ones.

Fiscal capacity or, in other words, the amount of resources that can be devoted to public services, is not an absolute amount that can be quantified. The totality of needs for State and local expenditures is also not absolute. We may say that the capacity of one community exceeds that of another, or that the capacity of one State is larger than that of another. We can quantify *relative* measures, using one of several definitions of capacity. That is, we can say that the income available for tax payments is greater or lesser, or that the yield of some standard tax system would be greater in one State than in another. These measures of capacity change over time as the economy grows, as family income levels increase, as taxable wealth is enlarged by new investments in housing, industrial plants, and machinery.

Elsewhere in this volume the earlier studies and their findings on relative fiscal capacity of the States are presented. In the present chapter we are concerned with the outlook ahead. But even this brief statement of the factors to be considered may serve to put the problem of describing the outlook in perspective.

THE OUTLOOK FOR INCOME FLOWS

Growth has become the accepted characteristic of our economic system. The Nation's capacity to produce and to expand that productive capacity even further are accepted as ordinary routine. We expect ad-

vances in technology and acceleration of medical-scientific progress, and increasing volume and numbers of consumer goods.

As the economy grows the output is enlarged, more income is generated, demand is expanded, and provides the market for the goods and services produced. The gross national product is today almost seven times as large as it was prior to World War II; it is almost twice the peak reached 15 years ago. In the last 5 years it has grown $320 billion. We look forward to gross product of well over $1 trillion by 1975, with annual additions to the Nation's output each year of value equal to, or even in excess of, the total that was devoted to State and local expenditures in 1965.

State and local purchases of goods and services grew at an average annual rate of 15.2 percent between 1946 and 1952. This growth occurred as States and localities turned from the restraints on spending imposed by World War II requirements to the postwar problems of the backlog of accumulated neglect of construction and salary adjustments. They faced at the same time new problems of accommodating public services to population growth and migration. State and local expenditures have continued to rise at an annual rate of 8 percent or more per year, a rate substantially in excess of the annual rate of growth of the economy as a whole.

We project State and local purchases of goods and services at a $918 billion gross national product level to reach $103 billion by 1970, an amount that is almost 50 percent above the 1965 level of $69 billion and 26 percent above the annual rate reached in the first quarter of 1967 ($82 billion). Stated differently, State and local purchases of goods and services have been increasing some $5 to 6 billion per year in recent periods. This amount has been enlarged to $8 billion in the first quarter of 1967.

State and Local Share of Gross Product

The growth in State and local expenditures at a rate in excess of the growth in the Nation's output has enlarged the share of the gross national product represented by State and local purchases, and a further enlargement is in the offing. Even if the share of the gross national product devoted to State and local purchases of goods and services were to remain constant, the total amount of such purchases would reach $120 billion by 1975.

Demographic changes and higher standards of living have combined to increase the share of the Nation's output devoted to State and local activities. Goods and services that in a rural environment are purchased privately, in an urban environment are obtained through Government. Sewerage systems take the place of private septic tanks. Public refuse collection takes the place of privately burying the trash. Congestion produces its own public service requirements that have no rural counterpart. Sidewalks, street lighting, and traffic control become necessary. Dangers to health—infection and contagion—are created, requiring more emphasis on widespread use of known medical immunization procedures and health inspections of eating places and housing. Moreover, individuals who function fairly well within the

farm family require public support in the environment of the city, for example, the emotionally disturbed, the mentally retarded, the old, and the disabled. Public action is taken to provide public substitutes for the family; that is, to care for the sick and infirm and to watch over the children whose parents' work takes them away from home.

Prior to World War II there were about 6 million farms in the United States. Today the number of farms has been reduced by almost half. Concentration of population in urban centers is expected to continue, along with the commercialization of agriculture. This urbanization, and the technological advances which are partly responsible for it, make for changes in occupational patterns, raise the level of educational preparations for employment, and cause a high rate of educational obsolescence, creating new educational demands.

New public services are developed in response to demographic change, and some private services, as a consequence of urban living, have to be replaced by public expenditures. These changes enlarge State and local spending. The higher family income resulting from economic growth broadens the aspirations of people. More individuals grow concerned about whether most (or even all) can get what they need. Contrasts are sharpened between private frills among the absolute number of goods on the market that people may buy and the public problems that are neglected.

State and local purchases of goods and services as a percent of gross national product are set forth in summary form below for selected years.

	Percent GNP		*Percent GNP*
1970	11.3	1962	9.6
1967	10.9	1961	9.6
1966	10.4	1960	9.1
1965	10.2	1955	7.5
1964	10.0	1950	6.8
1963	9.9		

The growing share of the Nation's output represented by State and local governmental purchases of goods and services does not reflect in a precise way the scope of activity undertaken through collective action. In the complex of city living, public necessities are often provided through a mix of governmental and private activity in which what is public and what private is blurred. Adequate housing for low-income groups may be approached through "public" housing, or through rent subsidies to private owners. The renewal of our cities often takes the form of site clearance by the government and building by private contractors. Under the impact of "third party payments" both voluntary and public, hospitals earlier providing care for indigent patients open their doors on a "test of payability" to the community at large while private hospitals take on a larger share of responsibility for care to the needy. Voluntary agencies and public health departments cooperate in carrying out disease control and health education programs with complex flows of funds among these public and private agencies. Higher education for many years has been characterized by a mix of public and private institutions but increasingly public funds are going to finance construction, scholarships, and research in private colleges and universities. Mass transportation facilities may be provided publicly or through public fran-

chises by private companies. And important community action for the attack against poverty calls for coordinated or joint action by public and private agencies. Some uncertainty in statistical information about State and local expenditures is created by this mix of public and private. Small changes in definition rather than in activity may lead to differences in classification between public and private particularly in higher education and health and hospital outlays.

State and Local Tax Instruments and Loads

States and communities in their tax policies operate against two groups of restraints: (*a*) Those imposed by prevailing concepts of what is reasonable in terms of tax rates and combinations of taxes and (*b*) the magnitude of income flows out of which taxes are paid. While taxes are generally paid out of the income stream at some point, individual income is by no means the principal basis on which State and local taxes are assessed. Property taxes in the aggregate yield the largest amount of revenue to State and local governments, and these taxes are based on certain forms of wealth rather than income. Property, income, business transactions, consumption of a wide variety of products or of special commodities such as tobacco and gasoline are some of the major bases taxed under State and local tax laws.

While the 50 States generally use many of the same kinds of taxes, the same types of bases are not uniformly available to all the States. Kentucky, as the center of whisky production, derives considerable revenue from the taxation of liquor products. Delaware, which has for a long period been the center of industrial incorporation, derives a large amount of revenue from corporation franchise taxes. Texas and Oklahoma tax their petroleum and natural gas output.

Moreover, even when the same tax bases are available the States use them in different combinations. One-fifth of the States do not impose a general sales tax; one-third do not tax personal income. Some tax both sales and income, and one taxes neither. By and large, these variations in tax structure are the result of each State's accommodation to its own combination of economic, political, and social forces.

States are bound, not by Federal law but by tradition and circumstances, to heavy reliance on consumption taxation. Localities, however, are frequently limited by law in their tax bases to taxation of property values in support of public programs. Economic competition in a mobile free market limits the effective rates of State and local taxation.

Long Run Growth: Human Investment

In considering how much States and localities should and can spend, and how much they will be able to spend in the future, it is necessary to consider the effect of present spending on future resources and needs. While some kinds of spending by local governments are properly classified as consumption, other expenditures are really investment. This is widely recognized with regard to such physical investments as school buildings or sewerage plants. It should also be realized that expenditures on human beings, especially medical and educational expenditures, are to some degree investments, both for the governments and for the society as a whole. An obvious example is a retaining program, which, if successful, would enhance the trainees' earning ability. Other

forms of human investment may cause longrun benefits to the community as a whole, and benefit the local government itself indirectly, by increasing economic growth and thus future revenues.

Between 1929 and 1957 when the real national income or product increased at an average annual rate of 2.93 percent, increases in the quality of the work force due to education are estimated to have been responsible for over a fifth of the growth.[1] The contribution of education to growth is estimated to be more than four times that of physical capital investment. Thus States and localities over the decades have made large investments in education that enhanced the productivity of the work force and the Nation's output; they did this in a sense by enlarging the rate of saving through diverting current tax funds into investment. Accounting practices in the past have obscured the important role of governments in human investment activity. Funds devoted to education, health, human restoration, and rehabilitation have been labeled "spending"; private outlays for building and equipment, even for frills such as pool halls, have been labeled "investment."

Expenditures on schooling, health, halfway houses, may pay the locality back in higher economic activity, and future revenues. Of course, in making such calculations, one must also allow for the impact on tax rates and revenues of mobile taxpayers and businesses.

State-Local Fiscal Gaps

We have reviewed quickly the basic factors affecting the answer to the question as to whether the States and localities can afford to expand their public services: the health of the economy, the vigor with which it is growing, the mechanisms through which resources are diverted to public use, and the preferences of the citizen-consumer. We turn to assess the problem of fiscal outlook.

Economists have constructed useful schematic presentations of complex fiscal phenomena to illustrate major problems. Thus they have highlighted the problem of the inflationary gap when wartime military demands greatly enlarged the share of the gross national product required for wartime operations. The gap between potential and actual gross national product has been set forth to show the difference between what actually is occurring in the economy and the volume of goods and services that would be produced if unemployment were held down to 4 percent. The disparity or gap between potential and actual output represents the goods and services that are forgone because of the underutilization of economic resources. Such schematic presentations, although clearly simplifications, serve as important tools in policy formulation and in measuring progress toward the solution of economic problems.

A similiar gap analysis was developed for State-local financial problems. This gap analysis starts with empirical studies of economic responsiveness of State and local tax revenues to economic growth, assuming no change in tax rates or structure. In general terms (with some variations) the gross national product responsiveness to State and local taxes has been calculated to have an elasticity of unity. Stated differently, for every 1-percent growth in the Nation's output,

[1] Edward Denison, In *Residual Factor and Economic Growth*, OECD.

State and local tax revenues would grow by 1 percent. Thus with a 3½- or 4-percent growth in national product, at the same base or price level (constant or unchanging prices), State and local tax revenues would be expected to grow by 3½ or 4 percent without increased tax rates or the introduction of new taxes. When price increases are included along with the growth in real output, the average increase per year in the gross national product has been about 5 to 5.5 percent. Tax revenues have responded to the higher price levels resulting in a growth in taxes, apart from tax rate increases and new taxes, of 5 to 5.5 percent per year. While taxes have been increasing at this rate except for the new taxes imposed, expenditures of the States and localities have been growing, as indicated earlier, at about 8 or 8.5 percent per year or even more. The difference in the rates of growth between tax revenues and expenditures represents the gap, or disparity, in State and local finances. An example of this type of gap analysis is contained in the Advisory Commission on Governmental Relations report:

> We have determined that the GNP elasticity of State general revenues today is approximately 0.9 or, alternatively, that it lies somewhere in the range of 0.82 to 1.01. We have also seen that the elasticity figure has increased slightly since the end of World War II, when it was around 0.8, and that the gradual process of elasticity increase can be counted upon, in the absence of offsetting structural changes, to carry the figure to approximately 1.0 by 1970.
>
> The rate of growth of State general expenditures, on the other hand, has been nearly twice the rate of GNP rise during the postwar period. During the past decade the rates were, respectively, 9.2 and 5.5 percent. Strictly speaking the concept of GNP elasticity in its rigorous, scientific sense should not be applied to the expenditure side of the budget, but we do no great violence to the concept by employing the terminology to simplify this discussion. For the period since 1954, therefore, we may say that the GNP elasticity of State general expenditures has averaged approximately 1.7, and we have argued that there are no persuasive reasons why we should not anticipate an "elasticity" this large in the near future.
>
> An expenditure elasticity of 1.7 and a revenue elasticity of 0.9 or 1.0 leave a financing gap that is the perennial fiscal problem of the States.[2]

The gross national product elasticity of expenditures may be determined somewhat more rigorously than suggested by the Advisory Commission statement. We might ascertain the rate of increase in expenditures required just to hold the quantity of public services unchanged per person in the population at constant quality levels. During the decade 1954–64 the population that makes up the workload of the States and localities, as measured rather crudely, rose 2.4 percent per year. Salaries and other price increases required to maintain a constant quality rose 3.2 percent, indicating a total rise in public expenditures over this period of 5.7 percent per year without enlargement of the scope of public services or improvement of their quality. This growth in State and local spending was only slightly higher than the average increase in national output, suggesting a gross product elasticity of 1.0. Actual State and local spending, with increases in quality and scope of services, grew faster than 5.7 percent, or about 2.5 percent per year more than required to maintain a constant quality of public services for the larger numbers in the population.

The gap analysis that has received most attention was that developed for the task force on Federal revenue sharing. Joseph Pechman, chair-

[2] *Federal-State Coordination of Personal Income Taxes*, Advisory Commission on Intergovernmental Relations, October 1965. Pp. 45–46.

man of the task force, in a paper presented before the American Bankers Association's symposium on Federal taxation, March 26, 1965, restated the gap findings of his task force report. He illustrated the discrepancy between growth in needed State and local expenditures and the growth in gross national product and in State and local taxes: "Suppose gross national product grows at 5 percent per annum, and State and local receipts (including Federal grants) keeps pace with this growth. On these assumptions, State-local receipts would reach about $88 billion by 1970. But if needed State-local expenditures grow at 7 percent per annum—which seems conservative in the light of past experience—they would reach $103 billion by 1970, leaving a gap of $15 billion."

The gap analysis, while providing a useful tool for illustrating the problems of State-local finance, came into use during a period of rapid transition in both governmental and population patterns. The gap analysis essentially assumes for simplicity of presentation unchanging patterns of financing of State and local public services. It assumes an unchanged share of Federal, State, and local funds and a more or less unchanged distribution of expenditures functions. Application of the analysis to the fiscal situation in the States and localities in the mid-sixties failed to take account of the growth in Federal aids and to reflect the realinements of expenditures. Realinements were occurring both among governments—Federal, State, and local, but also among functions. Some of them are financed in part through public charges and fees, and others exclusively out of taxes. The projected gap, however, would be the same in this simplified analysis whether all the additions and expenditures of the States and localities were financed by Federal grants or none of these additions were so financed. The gap would not be altered if all the additions were in services financed through consumer charges or in the types of services that are exclusively financed by taxation.

During this transition a number of changes have taken place. New Federal grants-in-aid were enacted, many in number and substantial in amount. In 1964, for example, Federal payments to States and localities amounted to $10 billion. A careful assessment of legislative proposals that year suggested that this amount might reach $20 billion by 1970. Actual enactment of grant authority in the months following moved the Federal payments to State and local governments upward so that the potential 1970 figure became $22 billion or even higher.

Extensions were made in the social insurance system to include medicare, with its hospital benefits to those 65 years of age or over. Through this program State and local hospitals were relieved of "free" care of the indigent aged. Moreover, eligibility for old-age, survivors, and disability insurance benefits was relaxed, and a minimum payment was authorized for all aged 72 years or older, and disability was redefined to remove some of the restrictions that had existed. These additional changes in the national social insurance program could be expected to lower the number of indigent aged on the State and local welfare rolls.

New programs for the mentally ill shifted the emphasis away from long-term institutional care, financed primarily out of State funds, to community mental health centers. As a consequence, a larger part of

care of mental illness may be expected to be financed out of private patient fees, local tax funds, and Federal grants. Voluntary health insurance coverage of the risk of mental illness is increasingly helping to support patient charges, and the Medicare Program facilities the care of aged persons with mental illnesses in general hospitals.

The interstate highway program that had, since its enactment in 1956, accelerated highway construction in the States and localities, comes closer to the target date of completion with some drop off in the rate of highway expenditure growth in the interim years.

Shifts in governmental responsibility for some public services and the enlarged support by the Federal Government of others alters the fiscal outlook of the States and localities, reinforcing changes that are occurring as a consequence of population trends. The impact of the baby boom of post-World War II, that had enlarged school expenditures first at the elementary grades, then in the high schools, and more recently in the public colleges and universities, has abated. Realinements in expenditures expand the types of outlays for which governments impose charges; for example, higher education with its tuition and fees, mass transit with its fares, water and sewerage with their charges.

Charting the Fiscal Developments in States and Localities

During this period of fiscal transition, a more detailed approach to fiscal projection appears necessary than that provided by the gap analysis. Four recent studies of the fiscal situation of the States and localities in the period ahead have been made that seek to chart the changes in population composition and in program developments. These studies include the report by Dick Netzer undertaken for the Committee on Economic Development,[3] the staff study made for that Committee,[4] the work of the State-Local Finances Project of the George Washington University,[5] and the study by the National Tax Foundation.[6] (See table I.)

While each of these studies starts with somewhat different economic assumptions, the "gap" findings for 1970 are similar. They all suggest that for 1970, with Federal aids in the neighborhood of $20 billion, the "likely" State and local expenditures can be met over the Nation as a whole without appreciable changes in tax rates or introduction of new taxes. The Netzer study projects a gap of $4 billion between revenue needs and revenues available, including new long-term debt issues. But this figure is arrived at by assuming a grant amount of $16.5 billion for 1970, a figure that has been made obsolete by the President's budget request for grant funds for the current year.

For the year 1975, at least, the several projection studies are somewhat more divergent. The Committee for Economic Development finds that "the existing financial system will permit an increase, between 1965 and 1975, of 21 percent in the real per capita services provided by State and local governments." The Netzer study shows a deficit of $11 billion for 1975 assuming grants-in-aid just below $20 billion for that

[3] Dick Netzer, *State-Local Finance in the Next Decade*, a paper prepared for the Subcommittee on Federal-State-Local Fiscal Relations, Committee for Economic Development.
[4] *A Fiscal Program for a Balanced Federation*, Committee for Economic Development.
[5] See footnote 8, following.
[6] *Fiscal Outlook for State and Local Government to 1975*, Tax Foundation, Inc.

year, whereas the National Tax Foundation, with its projection of Federal payments to States and localities of $30 billion, assumes away Netzer's deficit.

PROJECT '70

Project '70, a Ford Foundation-financed study at the George Washington University, separately evaluated for the year 1970 approximately 100 expenditure components for each of the 50 States and the District of Columbia and approximately half as many revenue items, within a consistent set of economic and demographic assumptions.

The projections were made prior to the heating up of the Vietnam conflict within a set of economic and demographic assumptions generated by a macroeconomic growth model, chosen from among several preliminary models of the national economy developed for the Federal Inter-Agency Study of Economic Growth and Employment Opportunities. These structuring assumptions concern national economic and demographic developments, price movements, and productivity gains, and of course the general climate of the international scene. Some of the major components of the growth framework are—

1. A maximum rate of 4 percent unemployment throughout the period;
2. An average annual growth rate of GNP in constant prices of 4.1 percent;
3. A general price rise limited to 1.5 percent per year to derive estimates in 1970 current dollars with the growth in GNP at current prices of 5.7 percent per year; and
4. Labor force increases at an annual rate of 1.6 percent due to population rise and output per worker increases of 2 percent per year.

This combination of assumptions yields a GNP of $864 billion for 1970 and personal income of the residents of the States of $668 billion. The base year of the study was 1962.

Additional assumptions were made about the progress in each of the States in response to national economic growth patterns and to demographic changes. Federal aids and consumer-voter pressures were assumed to succeed in stimulating higher levels of State and local services, and judgments were made about the probable speed of program developments. The expenditures to provide additional or improved services in line with (assumed) national policy directions were then projected for the period.[7]

Within this growth framework, components of expenditures in current dollars in a variety of functional areas were projected from fiscal 1962 to calendar 1970 for the 51 jurisdictions. The detail projections

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[7] The following assumptions were made about Federal grants-in-aid in 1970, in measuring their effects on expenditures in each program in each State: (1) Existing grants will continue through 1970, including grants made under authorizations expiring before 1970. (2) New legislation enacted by the 89th Cong., first sess., will receive appropriations equal to authorizations, through 1970 (except vocational rehabilitation, whose offerings to States traditionally have much exceeded their "takings"). (3) Revision upward of grants authorized under the Elementary and Secondary School Act of 1965, and the National Defense Education Act. (4) Expansion of operations and appropriations under the Economic Opportunity Act of 1964. (5) Continued growth of Federal share of public assistance payments. (6) Increase in authorizations for grants for mass transportation facilities and for school health (an assumption made as a concomitant of the assumptions with respect to operation of the proposed medical assistance program). (7) No additional direct nationally administered programs that would either enlarge or reduce expenditure requirements in the States and localities.

were summed to derive an aggregate. As work progressed on components the aggregates were revised. Following is a summary description of the projections to 1970 of expenditures by functional area by State, and capital outlays by function by State. The details of the study findings and methods are available in separate manuscripts.[8]

General Expenditures.—General expenditures of States and localities are projected to grow at 7.1 percent per year, and within the assumptions of the macroeconomic framework to reach $108 to $109 billion in calendar year 1970 (in 1970 dollars).

The functional area projected to show the largest rate of increase in expenditures for the Nation as a whole is education. Projected to increase less rapidly than total general expenditures for the Nation are public welfare and expenditures on highways.

In table 2 the projected 1970 general expenditures, and expenditures for selected functional areas, are shown for each State.

Capital Outlays.—State and local capital outlays are projected at $30 billion for calendar 1970. This is over $9 billion more than actual State and local capital outlay expenditures in fiscal 1965; higher education capital outlays are projected for 1970 at $2 billion above the fiscal 1965 level; highway capital outlays at $2 billion more, sewerage at $1¼ billion more, and mass transit at $1 billion more in 1970 than in fiscal 1965.

For the Nation, capital outlay expenditures of State and local governments were projected to grow at an average annual rate of 7.1 percent per year from fiscal 1962 to calendar 1970. The average annual rate of growth of capital outlays from fiscal 1962 to fiscal 1965 has been 7.4 percent per year.

Analysis of historical data on capital expenditures indicates (1) a high degree of variability in expenditures among States for any given year and (2) a high degree of variability from year to year for each State. Construction programs are necessarily very lumpy; for any one year the level of capital outlay expenditures depends on the timing of individual major projects. Thus valid estimates for a given year in the future are not possible. The State-by-State estimates must be interpreted as a projected annual *average* for the period around 1970.

In table 3 the projected 1970 capital outlays for general government utilities, and for selected functional areas are shown for each State. Table 4 shows these capital outlays as a percentage of the combined total of general expenditures of States and localities and of utility expenditures.

The higher price increases experienced as a consequence of the Vietnam war and the achievement of an unemployment rate below 4 percent suggested a revision of assumptions and at least, on a summary national basis, a new set of projections related to the altered assumptions.

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[8] S. Mushkin and E. McLoone, *Public Spending for Higher Education in 1970*, The Council of State Governments, Research Memorandum 374; S. Mushkin and R. Harris, *Transportation Outlays of States and Cities: 1970 Projections*, RM 375; S. Mushkin, *State Programming and Economic Development*, RM 379; S. Mushkin and R. Harris, *Financing Public Welfare: 1970 Projections*, RM 380; S. Mushkin, *Property Taxes: The 1970 Outlook*, RM 381; S. Mushkin and E. McLoone, *Local School Expenditures: 1970 Projections*, RM 382; R. Harris, *Income and Sales Taxes: The 1970 Outlook for States and Localities*, RM 384; R. Rafuse, Jr., *Water-Supply and Sanitation Expenditures of State and Local Governments: Projections to 1970*, RM 389; S. Mushkin, *Health and Hospital Expenditures in State and Local Governments: 1970 Projections*, RM 390; S. Mushkin and G. Luno, "Project '70: Projecting the State-Local Sector," *Review of Economics and Statistics*, May 1967.

On the basis of a gross national product for 1970 of $918 billion, assuming a 2-percent rise in prices, and unemployment reduced to 3 percent from the earlier first-stage target of 4 percent, general expenditures of States and localities were projected at $115 billion or $6 to $7 billion above the earlier estimates.[9]

Charting the State-Local Fiscs in the Economy's Course

Project '70 was undertaken in part for the purpose of evaluating the effect of long-range State and local programs on the national economy. Other studies of the economy's course, principally those of the National Planning Association and the Joint Economic Committee, include State and local purchases of goods and services as a sector of national economic activity. Both of these studies are addressed to the challenge of the vast growth potential of the Nation, and the demand necessary to sustain the economy at these potential output levels without inflationary strain on the one hand or unemployment on the other. The study for the Joint Economic Committee states the problem in its preamble as follows:

> The U.S. economy has a potential for a rate of economic growth of between 4 and 4½ percent per year between 1965 and 1975. This is between one-third and one-half above the rate prevailing in the first two-thirds of this century, and is substantially above the 3.5 percent prevailing over the 17 years from 1948 to 1965. This higher rate of growth will not be achieved automatically, but will require improvements and adjustments in economic policies, both public and private, if it is to be achieved in a manner that does not generate undesirable inflationary byproducts.[10]

Both the National Planning Association's and the Joint Economic Committee's projections illustrate, among other components of economic activity, the revenues and expenditures of the States as they change in response to economic circumstances. Several projections are included in each of the reports. We have selected two of the several projections in the summary table presented below. The National Planning projection shown is the "judgment" projection, that which is viewed as "the most probable." It is defined as the projection that "exhausts neither the desirable ends nor the feasible means in the pursuit of economic growth; rather, it allows for slippage in the pursuit of ends and the use of means by policymakers, and allows for the response of consumers and producers to such slippage."

The Joint Economic Committee's projection selected illustrates the State and local sector at a gross national product level that comes closest to that used in the revised estimates made by the State-Local Finances Project of the George Washington University—namely, a gross national product level for 1970 of $920 billion compared to $918 billion as indicated in table 5.

On a gross national economic account basis the (several) projections show either a small surplus or a small deficit between State-local revenues and expenditures. Surpluses, where shown, are pri-

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[9] Selma J. Mushkin and Gabrielle C. Lupo, "State and Local Finances Projections: Another Dimension?" from *The Southern Economic Journal*, vol. XXXIII No. 3, January 1967.

[10] Joint Economic Committee, *U.S. Economic Growth to 1975: Potentials and Problems*, 1966.

marily attributable for the period ahead, as they have been in the past, to reserve accumulations in State-local retirement funds.

It hardly needs to be emphasized that the projections are not intended as predictions or forecasts. All of the figures shown are projected on the basis of sets of assumptions internally consistent and intended to illuminate emerging problems that would result from continuation of past relationships and trends. In juxtaposition, the several projections highlight the impact on State-local financing of (*a*) the cooling off of the fiscal heat generated by the rapid growth in school and college enrollments in the years past; (*b*) the changing composition of State and local expenditures and activities that results from urbanization and intensified concern with city blight; (*c*) the Federal grant-in-aid enlargement that is a concomitant of public action to meet city demands; and (*d*) the vast enlargement in total demand, private or public, that is required in the years ahead to achieve a balanced economic growth at a rate substantially above that which prevailed earlier—a rate which is essential if unemployment is not to reach large proportions due to the rapid growth of the population in the working-age group.

A review of the projection clearly points to the fact that workloads of State and local governments in the years ahead are not expected to grow at the same rate as they did earlier. During the 1950's State and local governments accommodated public services to the mounting child population, even though the numbers contributing to production of the income flow out of which taxes were paid was growing at a slower rate. An inverted pattern characterizes the period ahead, with the work force at full employment expected to grow more rapidly than the number of those in the dependent age groups.

In the decade past, despite the fiscal urgency of accommodation to mounting numbers, quality and scope of public services were enlarged. Each of the projections, in a somewhat different way, looks forward toward a further increase in the quality and scope of public services. Increases in line with past trends are projected in the National Tax Foundation, the Netzer, the Committee for Economic Development, and the George Washington University State-Local Finances Project studies. For the period ahead, however, the increased funds required to finance these gains in public services are matched by the expected enlargement in Federal aids. Such enlargement realistically quantifies the direction of Federal policy on the one hand, and the restraints on budget decisions in localities where the urgency for upgrading is most marked. A shortfall in Federal support might well result in expenditures below the levels projected. To illustrate, in the State-Local Finances Project estimates, extensions in quality and scope were assumed principally as a response to national policy directions—to the Headstart program, the Community Action program, the new medical assistance program, and the Appalachian program. These developments have their counterpart in new Federal categorical aids—aids that depart markedly from the historic dollar-for-dollar matching. Thus the growth points in State-local activities were essentially assumed in response to new Federal grant offerings. (In a reassessment of the highly disaggregated projection methods, it became clear that the assumptions of State and local responses to Federal grants were indeed reflected in the overall findings.)[11]

[11] Selma J. Mushkin and Gabrielle C. Lupo, *Measuring Capacity-Use Requirements of States and Localities.*

While the path was cleared by the 89th Congress for a substantial increase in Federal aids to State and local governments, appropriations for these grants do not come automatically; they wait upon an appropriation process. The budget submitted for fiscal year 1967–68 reflected some downward pressure as a consequence of inflationary forces in the economy. Reductions from what these aids would have been in the absence of limitations imposed by national economic policies are conjectural, but clearly the highway grants and regional economic development capital outlay programs were subjected to some curtailment, and some would assume that the funds made available to the Office of Economic Opportunity were less than they otherwise would have been.

More significantly, the juxtaposition of issues illuminated by the projections points to a defining of "standards" for public services and facilities in the period ahead. Economic growth potential is large. The Joint Economic Committee in its study of economic growth to 1975 suggests we can reach a gross national product of $1.2 or $1.3 trillion by 1975. The choice of levels rests with the policymakers. We can fall below these levels if a better equilibrium is not achieved than would occur by merely letting the economy continue into the future as it has in the past. A wide variety of choices are available in making the adjustments required to shift policy directions. To illustrate the complexities involved, and to show how maximum employment, rapid growth, and stable prices could be achieved, various models are set forth in the Joint Economic Committee study.[12] As an illustration, the committee report shows the consequences of tax reduction in the personal taxes and increases in Federal expenditures, mostly in the form of transfers and grants-in-aid to State and local governments. Both the reduction in taxes and increases in Federal aids to States and localities are assumed to achieve that increase in demand necessary to produce an equilibrium full employment position. In one such illustration, Federal grants-in-aid are projected at $37.7 billion by 1970, and in another at $51.4 billion.

The choice among alternative policy directions necessitates a documentation and quantification of demands for public services not reflected in the projections of "likely" State and local expenditures. A new scale of operations in State and local governments would be necessary in order to provide that range of governmental services which many think vital and that quality of services which may be desirable to give full support to private economic activity. Lack of provision for sufficient public services has its feedback on the private economy; it impairs private performance. For example, while technology permits a reduction in the workweek, inadequacies of transportation facilities for commuting to and from work lengthens effective work time on a portal-to-portal basis. Some of these actions are illustrated on the table below.

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[12] Joint Economic Committee, *U.S. Economic Growth to 1975: Potentials and Problems*, 1966.

Development in the Private Sector	*Complementary Activity in Public Sector*
1. Increased automation.	1. Increased demands for a skilled labor force requiring more education.
2. Increased industrial use of water.	2. Increased conservation of water resources through watershed development and antipollution programs.
3. Increased supply and use of automobiles.	3. More streets and highways, traffic control, parking spaces.
4. Increased volume of poisonous industrial byproducts.	4. More waste treatment works.
5. Increased concentration of populace in urban areas.	5. More mass transportation facilities, more protective police and health services.
6. Increased technological research and development.	6. More scientists and engineers trained by higher educational institutions.
7. Increased effectiveness of medicine, and enlarged demand for medical services.	7. More health manpower trained and made available and more health facilities.
8. Increased leisure.	8. More recreational opportunities, more parks and playgrounds.

It becomes increasingly evident that small changes in educational outlays will not overcome the cultural deficiencies of the poor home in the poor neighborhood. Technological change, as noted earlier, points to a massive program of worker reeducation to prevent educational obsolescence from creating unemployment and reducing productivity (below levels that could otherwise be achieved). As illustrative of some choices in expanding educational services, two sets of materials are given. The first is the tabulation of methods of encouraging additional manpower training that was set forth in the Joint Economic Committee study on *U.S. Economic Growth to 1975*: [13]

Governmental operation of training facilities:

1. Direct Federal operation of training facilities, including military training facilities.
2. Grants to States and local governments for their training programs.

Incentives to the private sector:

3. Expenditure subsidies for private industry training programs.
4. Tax incentives for private industry training programs.
5. Federal assistance to schools and other nonprofit institutions for specialized training.
6. Changes in regulatory programs (e.g., minimum wage legislation) to encourage on-the-job training.

The second, presented as part of a *Planning Chart Book on Education in the United States* by the National Committee for Support of the Public Schools, sets forth some options and national costs in improving educational programs. Building on the projected public education expenditures of the State-Local Finances Project for 1970, the National Committee for Support of the Public Schools illustrates the approximate costs of additional options as follows: [14]

[13] *Ibid.*
[14] National Committee for Support of the Public Schools, *Education in the States: A Planning Chart Book*, 1966.

Program improvement—approximate 1970 costs

	Billions
Maternal and child health care in low-income families to help prevent mental retardation	$1.5
Child day care centers for low-income families	1.4
Preprimary education for all 3- and 4-year-olds:	
Half-day	2.3
Full-day	5.1
Adding compulsory education 2 years beyond high school	1.7
Manpower training for 1 percent of the labor force without compensation for income loss	.9
With compensation for income loss	6.9
Further extension of school week through after-school-hour and weekend programs	1.0
To raise current expenditure per ADA to 80 percent of the U.S. average in all States spending less than this	.5
To raise current expenditure per ADA to $500, or 93 percent of the projected U.S. average in all States spending less than this	1.5

In order to guess at future developments in public expenditure during this period of fiscal transition, one should have some idea of how desirable various levels of public service are, and of how much they cost. Certain minimal levels can sometimes be set on the basis of professional standards; thus we are reasonably confident that the cost of providing people with such biological necessities of life as potable water and breathable air, or of maintaining public health services above a level where major epidemics are likely, is low compared to the value to the taxpayers of achieving these objectives. We can get some idea of the value of higher levels of public services from analysis by engineers of by how much it is possible to reduce time lost in the flow of people to places where they work, live, shop, go to school, and play, or by doctors of the rise in health which could result from various programs.

Changes in the demands of taxpayers for public services corresponding to changes in their economic circumstances can to some extent be predicted by comparing the public services provided in different States or communities. By seeing what services are demanded by higher income groups, whose income is less of a restraint on the services demanded, we can learn what sort of services are likely to be demanded in the future by those groups who are now limited by their low income.

Such an analysis, stated in terms of the relation between voter demands for public services and the cost of providing such services, avoids the commonly used concept of absolute public needs which must be satisfied at whatever cost. It thus comes closer than an analysis based on "needs" to describing the real world, a world in which State and local officials must decide what range of public services will give their constituents what they want at a price they are willing to pay, not what single set of decisions is the only way to avert imminent catastrophe.

Whatever the advantages of such an approach, we may be sure that the question of what public services are "needed" will still continue to be asked. As Kenneth Boulding states it, "Demand * * * implies autonomy of the individual, choice, and a tailoring of inputs of all

kinds to individual preferences. Only the slave has needs; the free man has demands." But Mr. Boulding continues, "In spite of the economist's uneasiness about it, a considerable demand exists for the concept of need." [15]

TABLE 1.—*Projections of State and local finances: U.S. Bureau of Census basis*

[In billions]

	1970			1975	
	GWU [1]	Netzer [2]	Tax foundation [3]	Netzer	Tax foundation
Total State and local expenditures	$121.8	$115.5	$117.8	$144.5	$157.9
Federal aid	$18.5-22.1	16.5	20.3	19.8	30.0
Borrowing	14.9	12.1	14.0	13.6	17.1
Other revenues	83.7-85.8	82.8	88.6	100.3	117.2
Total State and local revenues	115.6-121.2	111.4	122.9	133.7	164.2
Net surplus (or deficit)	−47-+1.0	−4.1	+5.1	−10.8	+6.4
GNP	864.0	762.0	902.0	916.3	1,178.0

[1] Selma J. Mushkin and Gabrielle C. Lupo, *"Project '70: Projecting the State-Local Sector"*, The George Washington University, State-local finances project.
[2] Dick Netzer, *"State-Local Finance in the Next Decade."*
[3] *"Fiscal Outlook for State and Local Government to 1975,"* Tax Foundation, Inc.

[15] Kenneth E. Boulding, "The Concept of Need for Health Services," *The Millbank Memorial Fund Quarterly*, vol. XLIV, No. 4, October 1966, pt. 2.

TABLE 2.—*General expenditures of State and local governments, total and selected functions, calendar year 1970 at $864,000,000,000 GNP*

[In millions]

State and region	General expenditures	Total education	Highways	Public welfare	Health and hospitals
United States	$108,967.4	$44,613.7	$16,168.8	$8,887.8	$8,025.5
New England	6,471.5	2,390.0	1,031.7	522.0	455.9
Maine	493.9	178.6	104.1	41.1	31.3
New Hampshire	338.0	129.8	76.9	18.9	21.9
Vermont	233.1	89.9	66.4	16.0	14.2
Massachusetts	3,179.6	1,130.6	438.4	279.5	239.0
Rhode Island	488.2	177.4	73.0	42.3	44.6
Connecticut	1,733.5	683.7	272.9	124.3	104.8
Mideast	24,699.9	9,325.6	3,164.7	2,033.9	1,932.6
New York	12,156.8	4,473.4	1,310.5	1,051.7	1,014.4
New Jersey	3,906.2	1,559.5	515.5	255.7	255.5
Pennsylvania	5,716.1	2,159.9	929.1	502.7	390.8
Delaware	318.4	151.9	40.3	22.9	18.8
Maryland	1,999.3	842.0	275.7	149.1	164.8
District of Columbia	603.7	138.9	93.6	51.9	88.5
Great Lakes	19,998.5	8,458.4	2,990.6	1,448.7	1,482.7
Michigan	4,691.7	2,032.0	576.4	308.3	429.6
Ohio	5,188.8	2,071.2	882.4	434.7	341.6
Indiana	2,345.5	1,102.1	373.9	112.8	198.9
Illinois	5,530.9	2,318.5	794.5	454.8	333.5
Wisconsin	2,241.2	934.6	363.4	138.0	179.1
Plains	8,247.1	3,590.5	1,490.9	654.8	547.0
Minnesota	2,148.6	976.1	347.8	179.7	138.7
Iowa	1,416.5	647.2	269.8	116.5	96.8
Missouri	2,017.5	808.8	338.0	193.2	148.4
North Dakota	391.8	168.3	74.7	21.8	18.4
South Dakota	396.0	160.9	104.2	21.0	15.1
Nebraska	710.8	313.1	143.5	38.7	44.8
Kansas	1,165.9	516.1	212.9	83.8	84.8
Southeast	19,268.8	7,475.1	3,462.3	1,667.0	1,681.2
Virginia	1,857.9	754.4	385.0	90.2	129.8
West Virginia	922.1	293.0	284.2	96.6	56.1
Kentucky	1,446.9	520.9	323.5	141.2	95.8
Tennessee	1,625.4	597.6	340.5	123.3	155.8
North Carolina	2,025.3	932.2	304.9	158.3	156.4
South Carolina	934.9	428.3	162.9	56.0	84.5
Georgia	1,950.0	744.9	294.8	168.0	217.2
Florida	3,129.6	1,185.1	413.6	186.9	351.0
Alabama	1,586.3	569.3	320.4	180.3	135.5
Mississippi	1,007.2	391.1	186.1	107.4	83.9
Louisiana	2,030.4	775.2	296.4	267.3	161.4
Arkansas	753.3	283.2	150.0	91.6	53.8
Southwest	7,821.7	3,547.7	1,271.0	673.9	446.8
Oklahoma	1,300.2	522.2	214.2	207.3	75.1
Texas	4,731.8	2,127.7	775.7	348.9	288.6
New Mexico	680.9	332.5	119.2	48.2	39.5
Arizona	1,108.6	565.3	161.9	69.5	43.5
Rocky Mountain	2,963.1	1,334.7	564.1	217.4	191.6
Montana	423.2	167.7	103.9	23.3	25.0
Idaho	378.0	146.2	79.6	25.0	27.7
Wyoming	258.4	94.8	72.8	10.0	23.2
Colorado	1,310.9	641.9	186.9	122.3	89.0
Utah	593.1	284.1	120.9	36.9	26.9
Far West	18,664.5	8,220.8	2,036.0	1,642.3	1,230.0
Washington	1,970.5	902.0	296.6	133.1	140.5
Oregon	1,194.2	497.1	211.8	76.8	77.3
Nevada	335.7	127.0	65.0	12.8	23.6
California	15,164.2	6,694.6	1,462.6	1,419.7	988.5
Alaska	321.8	100.6	80.7	11.6	16.9
Hawaii	510.4	170.0	76.9	16.1	40.9

NOTE.—Totals may not add due to rounding.

TABLE 3.—*Capital outlay expenditures of State and local governments, calendar year 1970, at $864 billion GNP*

[In millions]

State and region	Total	General government					Utilities
		Total	Education	Highways	Sewerage	Health and hospitals	
United States	$29,968.2	$26,439.8	$6,844.2	$10,452.6	$2,329.0	$681.7	$3,528.4
New England	1,803.6	1,621.3	392.0	600.1	152.0	39.4	182.3
Maine	137.1	122.0	24.5	48.2	22.3	1.9	15.1
New Hampshire	100.4	93.4	22.6	39.4	11.1	1.3	7.0
Vermont	77.1	72.6	13.6	39.8	7.7	1.1	4.5
Massachusetts	871.5	759.6	201.2	246.0	64.9	23.6	111.9
Rhode Island	141.9	132.8	29.4	49.8	12.8	3.7	9.1
Connecticut	475.8	441.0	100.7	176.9	33.3	7.8	34.8
Mideast	6,849.9	5,917.7	1,517.7	2,012.5	541.0	155.8	932.2
New York	3,146.7	2,633.6	692.5	782.4	233.5	80.0	513.1
New Jersey	1,069.4	987.0	280.4	324.4	88.9	18.0	82.4
Pennsylvania	1,716.9	1,541.3	344.9	601.7	159.7	44.3	175.6
Delaware	84.3	79.2	27.9	28.9	5.5	1.0	5.1
Maryland	541.8	500.9	148.8	196.5	30.4	10.0	40.9
District of Columbia	290.9	175.7	23.3	78.6	23.0	2.5	115.2
Great Lakes	5,198.4	4,666.9	1,200.8	1,926.4	415.9	111.4	531.5
Michigan	1,153.6	1,048.2	291.7	385.2	95.4	38.1	105.4
Ohio	1,378.2	1,263.2	273.5	584.8	102.4	23.0	115.0
Indiana	600.4	538.3	146.3	232.2	54.3	13.6	62.1
Illinois	1,544.6	1,359.1	362.6	558.0	115.7	23.4	185.5
Wisconsin	521.7	458.2	126.8	166.2	48.1	13.2	63.5
Plains	2,248.7	1,955.7	494.4	866.8	197.6	39.8	293.0
Minnesota	575.8	506.8	144.7	206.4	50.1	14.0	69.0
Iowa	332.6	295.6	69.5	137.0	37.2	3.8	37.0
Missouri	594.7	515.2	114.3	232.3	54.4	9.5	79.5
North Dakota	103.2	99.5	27.3	44.0	7.5	1.4	3.7
South Dakota	127.9	119.4	24.4	64.0	9.0	1.2	8.5
Nebraska	230.9	167.7	48.8	76.0	15.3	2.1	63.2
Kansas	283.8	251.6	65.5	107.1	24.2	7.8	32.2
Southeast	5,794.4	5,188.2	1,130.2	2,325.3	488.1	186.7	606.2
Virginia	552.5	517.5	102.7	262.7	37.6	11.6	35.0
West Virginia	355.7	329.2	28.3	207.2	35.0	9.9	26.5
Kentucky	484.3	452.3	80.8	235.8	38.8	14.4	32.0
Tennessee	599.6	491.6	92.5	236.9	39.5	20.1	108.0
North Carolina	570.3	510.6	148.0	194.4	63.0	19.7	59.7
South Carolina	292.1	260.9	70.0	112.2	32.0	10.9	31.2
Georgia	575.1	502.3	109.0	192.6	49.1	28.0	72.8
Florida	854.4	739.1	198.3	277.9	68.5	21.9	115.3
Alabama	495.4	448.9	77.1	222.4	36.6	16.9	46.5
Mississippi	276.2	255.6	69.6	105.0	20.8	10.2	20.6
Louisiana	513.8	476.3	106.4	193.6	40.9	16.0	37.5
Arkansas	225.3	204.2	47.5	84.6	26.2	7.3	21.1
Southwest	2,175.2	1,928.9	525.4	830.7	176.8	41.6	246.3
Oklahoma	312.1	286.7	71.9	120.8	31.7	6.4	25.4
Texas	1,334.0	1,157.7	294.9	506.1	109.8	27.2	176.3
New Mexico	193.4	180.7	41.8	86.9	17.7	4.8	12.7
Arizona	335.6	303.7	116.9	116.9	17.7	3.2	31.9
Rocky Mountain	836.4	778.0	196.5	384.4	62.8	16.8	58.4
Montana	129.5	123.9	21.0	72.1	8.0	2.4	5.6
Idaho	118.3	108.3	27.4	49.5	9.9	3.4	10.0
Wyoming	86.2	82.3	11.1	55.0	3.6	1.8	3.9
Colorado	321.6	294.7	96.9	117.0	30.2	5.7	26.9
Utah	180.6	168.6	40.0	90.8	11.0	3.4	12.0
Far West	4,788.6	4,121.5	1,346.9	1,392.1	279.1	82.9	667.1
Washington	561.2	449.1	131.6	190.7	37.4	8.4	112.1
Oregon	286.1	261.0	50.8	130.7	27.4	4.8	25.1
Nevada	105.6	98.8	24.9	46.5	8.3	2.3	6.8
California	3,836.0	3,312.9	1,139.6	1,024.2	206.1	67.4	523.1
Other:							
Alaska	128.3	121.3	13.6	58.7	7.2	5.0	7.0
Hawaii	144.9	140.5	26.5	55.6	8.4	2.3	4.4

TABLE 4.—*Capital outlay as percent of State and local expenditures—General expenditures and utility expenditures combined, fiscal year 1962 and calendar year 1970*

[In millions]

State and region	Capital outlay	Capital outlay as percent of general and utility expenditures	
		Calendar year 1970	Fiscal year 1962
United States	$29,968.2	25.5	26.0
New England	1,803.6	26.3	22.6
Maine	137.1	26.5	23.8
New Hampshire	100.4	28.7	27.0
Vermont	77.1	30.9	31.2
Massachusetts	871.5	25.2	18.5
Rhode Island	141.9	28.1	20.4
Connecticut	475.8	26.5	29.0
Mideast	6,849.9	25.9	23.9
New York	3,146.7	23.7	23.6
New Jersey	1,069.4	26.4	22.6
Pennsylvania	1,716.9	28.7	22.7
Delaware	84.3	25.4	28.7
Maryland	541.8	26.2	30.0
District of Columbia	290.9	39.4	29.9
Great Lakes	5,198.4	24.3	26.0
Michigan	1,153.6	23.4	26.9
Ohio	1,378.2	25.1	26.1
Indiana	600.4	23.7	25.0
Illinois	1,544.6	25.7	24.8
Wisconsin	521.7	22.0	27.7
Plains	2,248.7	25.0	25.9
Minnesota	575.8	25.1	26.5
Iowa	332.6	22.1	24.7
Missouri	594.7	27.5	24.1
North Dakota	103.2	25.8	27.9
South Dakota	127.9	30.6	31.6
Nebraska	230.9	24.1	28.7
Kansas	283.8	22.4	24.5
Southeast	5,794.4	27.7	27.0
Virginia	552.5	28.4	31.3
West Virginia	355.7	37.2	19.5
Kentucky	484.3	37.8	31.6
Tennessee	599.6	29.3	30.5
North Carolina	570.3	26.2	24.3
South Carolina	292.1	28.2	24.5
Georgia	575.1	27.5	26.2
Florida	854.4	24.9	26.0
Alabama	495.4	28.5	27.3
Mississippi	276.2	26.1	29.9
Louisiana	513.8	24.3	23.9
Arkansas	225.3	28.2	25.8
Southwest	2,175.2	25.8	27.8
Oklahoma	312.1	22.9	22.9
Texas	1,334.0	26.0	29.0
New Mexico	103.4	27.2	24.5
Arizona	335.6	27.7	30.6
Rocky Mountain	836.4	26.8	27.0
Montana	129.5	29.8	29.6
Idaho	118.3	29.6	26.9
Wyoming	86.2	32.2	34.8
Colorado	321.6	23.2	23.2
Utah	180.6	28.7	29.5
Far West	4,788.6	23.5	27.6
Washington	561.2	24.1	28.6
Oregon	286.1	22.7	24.9
Nevada	105.6	30.1	34.8
California	3,836.0	23.5	27.5
Alaska	128.3	37.8	32.2
Hawaii	144.9	27.6	33.8

TABLE 5.—*Projections of State and local government receipts and expenditures on national economic account basis*

[In billions of dollars]

	1970					1975	
	NPA [1]	JEC [2]	GWUI [3] (high revenue projection)	GWUII (low revenue projection)	GWU918 (high growth rate projection)	NPA	JEC
State and local purchases of goods and services	110.5	107.1	97.3	97.2	103.2	166.3	149.7
Transfer payments	9.5	8.7	8.0	8.0	7.9	66.4	10.5
Net interest	1.8	.6	1.1	1.1	1.1	3.0	.6
Less current surplus of government enterprises	5.3	4.2	5.1	5.1	5.1	9.5	5.2
Total State and local expenditures	116.5	112.2	101.4	101.4	106.8	172.2	155.6
Federal grants	19.5	17.5	21.8	18.1	21.8	31.0	25.0
Other revenue sources	94.6	93.5	83.7	81.7	88.9	140.6	131.0
Total State and local revenues	114.1	111.0	105.5	99.8	110.7	171.6	156.0
Surplus (or deficit)	−2.4	−1.2	+4.1	−1.6	+3.9	−0.6	+0.4
GNP	883.8	920.0	864.0	864.0	918.0	1,167.1	1,205.0

[1] National Planning Association, Center for Economic Projections, "National Economic Projections to 1975–76."
[2] Joint Economic Committee, "U.S. Economic Growth to 1975: Potentials and Problems, 1966."
[3] Selma J. Mushkin and Gabriello C. Lupo, "Project 70: Projecting the State Local Sector, the George Washington University," State local finances project.

FISCAL TRENDS IN THE FEDERAL SYSTEM*

BY RESEARCH AND POLICY COMMITTEE OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT

The United States is a Federal system operating under a written Constitution which divides the functions of government between the National Government and the States.

A primary reason for calling the Federal Convention was "to form a more perfect union," with a National Government strong enough to provide effectively for certain public services of benefit to all the people of the Nation. The first powers enumerated in the Constitution are the fiscal powers of the National Government. Congress is given "the power to lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common defense and general welfare of the United States. * * *"

The powers of the National Government, including its fiscal powers, are substantial, but they are not unlimited. The 10th amendment specifically provides that all powers not delegated to the National Government or prohibited to the States be reserved "to the States or to the people." Both the States and the National Government have constitutional powers to tax.

Strictly speaking, the Federal principle refers to the relationship between the National Government and the States. But it has wider implications for the whole of society. Cities and counties are not directly provided for in the Constitution but are creatures of the States. As such they must depend upon the States for the solution of many of their problems.

Basic to the Federal principle is the view that power should be plural rather than centralized. A Federal system is valued because it permits wider choices in the pursuit of general welfare, greater freedom to develop different public values in different localities, and more opportunities for innovation by individual communities that may set standards for the rest of the country.

SHIFT OF POWER TO THE NATIONAL GOVERNMENT

Federalism has not stood still. As a result of technological, economic, social, and international changes since the ratification of the Constitution in 1789, the Federal system has undergone a continuous change and the division of responsibility among the levels of government has become much less distinct.

During this century the balance of power has been shifting to the National Government. The adoption of the Federal income tax was a major factor in this shift. The 16th amendment to the Constitution, by granting Congress power "to lay and collect taxes on incomes,"

*Reprinted from: Committee for Economic Development, *A Fiscal Program for a Balanced Federalism*, New York, 1967, chs. 2, 3, 4, 5, p. 50–54, 60–61.

provides the National Government with the most productive of all revenue sources.

The implied powers in the "general welfare" clause of the Constitution also provide wide flexibility for the National Government to expand the size and scope of its activities in the civilian sector. This was clearly demonstrated in the decade of the 1930's which brought a substantial increase in National Government spending and a dramatic change in the Federal structure. Judicial interpretations lifted some limits on the National Government's regulation of economic affairs and on the amounts and purposes of its expenditures.

Government policies to combat depression and to meet the needs of two world wars and a continuing cold war have resulted in high federal income tax rates. The national government has achieved fiscal dominance in this field. It was responsible in 1965 for 93 percent of all income tax collections in the country, even after the 1964 Federal income tax cut.[1]

Although anti-depression and defense requirements are major reasons for the growth of national government expenditures, another cause has been the marked increase in social and economic interdependence of American society, particularly since the end of World War II. This interdependence is a product of rapid population growth, industrialization, urbanization, and the increased mobility of our population. Problems that in earlier times were seen as purely local in character have taken on regional or national significance.

The growth of social and economic interdependence has not been matched by the evolution of political structures to cope with it. Problems created by interdependence frequently are aggravated by the substantial fragmentation and overlapping of about 80,000 local governments with authority to spend or tax. Because legal jurisdictions often do not coincide with natural economic boundaries, it has become more difficult to assess benefits and costs on a communitywide basis. In the language of the economist, the typical community is a nest of "spillovers." The effects of economic activities undertaken locally spill over beyond legal jurisdictional boundaries, enlarging the area of benefits and costs and greatly complicating the task of determining where and how to raise and distribute public revenue.

Today more than ever before there is need for cooperation among individual communities in supplying public services and in coordinating revenue systems on a fiscally sound basis. But there are serious political obstacles to cooperation and coordination. As a result, it appears easier to seek funds from higher levels of government—States or the National Government—with larger legal revenue basis. Given superior revenue resources and a concern for "the general welfare" of the people, the National Government tends to take over more and more responsibility for the problems of the States and cities.

National Government expenditures on goods and services have grown from a modest 2 percent of gross national product (GNP) in 1930 to 10 percent in 1965. The relative shares of such Government expenditures have shifted from about one-fifth National, four-fifths State and local in 1930 to about 50–50 today, as shown in chart I.

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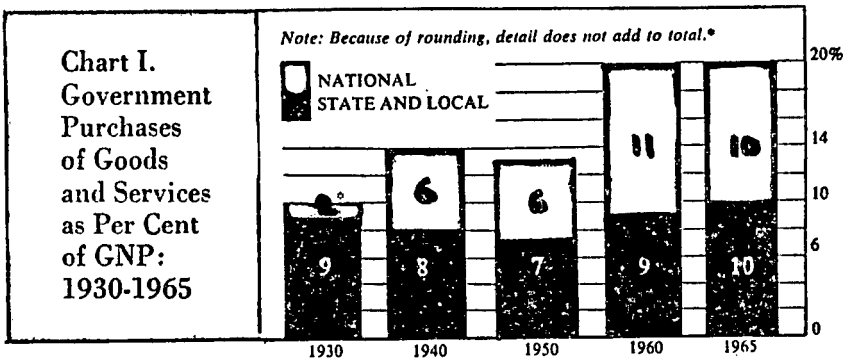
[1] See Appendix I.



STATE-LOCAL EXPENDITURE GROWTH

Despite these developments the State-local government sector has recently been a most dynamic element in the Nation's fiscal system. From 1955 to 1965 State and local general expenditures increased by 121 percent, more than twice as rapidly as general expenditures of the National Government. State and local government employment increased 58 percent in the same period compared to 9 percent for National Government civilian employment. The portion of gross national product taxed away by State and local governments has shown a rather steady increase while Federal taxes have declined relative to gross national product since 1952.

Although the National Government has increased its financial aid to lower levels of government, expenditures by State and local governments based on their own revenues still play the major role in meeting the cost of civilian public services. Combined general revenues of State and local governments from their own sources provide the funds for two-thirds of all outlays for general civilian public services, as shown in table 1.

TABLE 1.—*Financing of general civilian expenditures, by level of government, 1965*

[Dollar amounts in billions]

Level of government	General civilian expenditures	Intergovernmental revenue	Expenditures financed by own sources	
			Amount	Percent
National	[1] $34.6		$34.6	35
State-local	74.5	$11.0	63.5	65

[1] Total general expenditures, less expenditures for national defense, international relations, space, veterans' benefits, and interest on the general debt.

The rapid growth of State and local expenditures reflects the large burdens placed on State and local governments in the postwar years, some of which resulted from abnormally low expenditures during the depression (when both private incomes and public revenues were low) and during the war (when both materials and manpower were scarce). The acceleration in State and local spending is largely due to three major factors:

1. *Population changes.* While population as a whole increased 18 percent between 1955 and 1965, school-age population grew 35 percent

and over-65 population rose 25 percent. These two age groups create demands for the most costly public services. Additional demands were created by the greater concentration of population in the metropolitan areas. The "population workload"—derived by weighting the relative expenditure importance of these groups—increased 27 percent in the last decade.

2. *Price increases.* Prices of goods and services purchased by State and local governments grew 40 percent between 1955 and 1965, although prices in the economy as a whole rose by only 22 percent. The difference is largely due to the greater importance of services and more modest increases in productivity in State and local government than in the private sector.

3. *Expansion of scope and quality of public services.* The postwar rise in the standard of living of a more mobile and urbanized population brought demands for more and better public services, particularly in education, highways, health, and welfare. Additional demands were created by an increasing awareness of the plight of those groups that did not share in the benefits of rising living standards.

Population changes and price increases combined account for $26.2 billion of the total rise of $40.8 billion in State and local government general expenditures in 1965 over 1955. The residual increase of $14.6 billion can be viewed as an estimate of the expansion of scope and quality of public services, assuming no significant change in the efficiency with which they were provided. On this basis, the expansion of scope and quality of services performed by State and local governments amounted to 24 percent in the decade 1955–65. The effects of the three factors combined are summarized below.

1955 General Expenditures	×	Population Factor	×	Price Factor	×	Scope and Quality Factor	=	1965 General Expenditures
$33.7 billion	×	1.27	×	1.40	×	1.24	=	$74.5 billion

In addition to general expenditures, State and local government application of funds includes supplementary contributions to employee retirement systems, other net expenditures, including profits on liquor stores and a deficit in utility operations, and additions to working capital and sinking funds, as shown in table 2. Total application of funds rose from $36.3 billion in 1955 to $81.9 billion in 1965, an increase of 126 percent.

TABLE 2.—*State and local government outlays of funds, 1955 and 1965*

[In billions of dollars]

Item	1955	1965
General expenditures	33.7	74.5
Supplementary government contributions to retirement funds	.7	1.8
Other expenditures (net)	.2	.8
Additions to working capital and sinking funds	1.7	4.8
Total outlays	36.3	81.9

Financing State-Local Expenditures

State and local governments obtained their funds from taxes, charges and miscellaneous general revenue, Federal aids, and increases in debt. The distribution by revenue sources is shown in table 3.

The revenue from each major tax source, property taxes, sales and gross receipts taxes, and income taxes more than doubled from 1955 to 1965.

The yield of the property tax rose by about $12 billion. It is the most important revenue source at the State and local level, accounting for 44 percent of tax revenue. However, it is almost entirely a local tax and accounts for about 90 percent of local tax revenue. Although the demise of the property tax has long been predicted, it produced almost $23 billion in fiscal 1965, more than the revenues from any other local, State, or Federal levy except the Federal income tax. Most of this increase came from the unanticipated responsiveness of the property tax to economic growth associated with growth in the tax base from new construction, higher real property values, and improved assessment administration.

The second largest State and local revenue source is taxes on sales and gross receipts. These include general retail sales taxes and selective taxes levied on motor fuel, tobacco products, and liquor. They rose by nearly $10 billion from 1955 to 1965 and accounted for 33 percent of total tax revenue in 1965. The general retail sales tax, now in use in 42 States, is the largest single source of State tax revenue.

Thirty-three States have broad-based individual income taxes; 38 States have corporate income taxes. Revenues from these taxes grew by $4 billion during the period. Income tax revenues showed the greatest proportion of gain of all taxes, but since they started from a relatively low level they remained less important to State and local governments than property and sales taxes, accounting for only 12 percent of total tax revenues in 1965.

Table 3.—*State and local general revenue and increase in debt, 1955 and 1965*

[Dollars in billions]

Item	Amount		Percentage increase, 1955–65
	1955	1965	
Taxes	$23.5	$51.2	118
Property	10.7	22.6	111
Sales and gross receipts	7.6	17.1	125
Income	2.0	6.0	200
Other	3.1	5.5	78
Charges and miscellaneous general revenue	4.5	11.7	160
Federal aids	3.1	11.0	255
General revenue	31.1	74.0	138
Increase in debt during year	5.3	7.3	38
Total	36.4	81.3	123

Note.—Because of rounding, detail may not add to totals.

Charges and miscellaneous general revenue contributed $11.7 billion in 1965, a growth of more than $7 billion from 1955 to 1965.

Total State and local general revenues amounted to $74 billion in 1965. Of this amount $11 billion was received from the National Gov-

ernment. Thus State and local governments proved themselves capable of raising $63 billion in general revenues from their own sources in 1965, an increase of $35 billion over the 1955 level, or 125 percent.

Up to now State and local finances have been considered as if they were uniform throughout the Federal system. But there are, in fact, substantial differences in the financial patterns among and within States. These differences result from variations in taxable capacity and needs for public service, and also from different views of the public policy choices involved in the use of tax sources and in the level and composition of public expenditures.[2]

THE OUTLOOK FOR STATE AND LOCAL FINANCE

Although State and local governments have sharply expanded their expenditures in the postwar period, unmet public needs still exist. New needs will be created by continued population growth, increased urbanization, and rising prosperity. But the ability of State and local revenue systems to meet these needs has been questioned because of the common belief that property and sales taxes are relatively unresponsive to economic growth.

There are varying appraisals of the outlook, each of which can influence fiscal decisions in a different direction and affect the future of American federalism in a different way. Those who foresee a serious crisis in financing State and local needs will want a greater role for the National Government and a sizable increase in national support. On the other hand, those who anticipate a rise in State and local revenues sufficient for future needs see a less important role for the National Government.

In the following pages we assess the potential for increases in State and local revenues over the decade 1965–75, assuming no broadening of the tax base or increases in tax rates. The present State and local tax structure will yield increased revenues in future years in amounts that depend on the responsiveness of State and local taxes to economic growth and the rate of economic growth itself.

Recent experience suggests that State and local taxes are more responsive to economic growth than previously assumed. We estimate that the existing structure of State and local taxes will yield increases in revenues approximately in proportion to the rise in gross national product.[3]

The annual growth rate of gross national product averaged 3.5 percent in real terms between 1955–65. Real growth in 1965–75 is projected at the higher rate of 4 percent a year because of an anticipated increase in the rate of growth of the labor force. On this basis, gross national product is projected to increase 48 percent [3] over 1965.

If there is no change in State and local tax rates as they appeared in the statutes in 1965, their revenues from taxes are projected at about $78 billion [3] in 1975. This total includes $3 billion [3] from new sales taxes enacted in five States which were scheduled to take effect after fiscal 1965.

General nontax revenues from State and local sources are drawn primarily from user charges made for Government services. For the

[3] See app. II.
[3] See app. III.

most part expenditures associated with current charges tend to generate their own revenue. If this revenue rises according to the estimated changes in the population groups which use such services and the rise in prices of goods and services purchased by State and local governments, charges and miscellaneous revenues are projected to increase from $11.7 billion in 1965 to about $16 billion [3] in 1975.

Federal grants-in-aid to States and localities will total about $15 billion in fiscal 1967. But if currently enacted programs continue, they will reach an estimated $26 billion [3] in 1975.

In 1965 the increase in State and local government debt was $7.3 billion and the total debt was $99.5 billion. The total debt was 1.6 times general revenue from own sources, a relationship which remained stable over the 1955–65 decade. If the total debt continues to remain a constant proportion of revenue from our sources, about $6 billion [3] in additional funds would be provided from this source in 1975.

On the basis of these projections the total yield in 1975 to State and local governments of an unchanged revenue structure plus net additions to debt would be about $126 billion.[4] *

State-Local Expenditure Needs

The factors that pushed up State and local expenditures between 1955 and 1965 will continue to operate in the decade 1965–75. The three major factors, already identified, are changes in population-workload, prices, and the demand for improvement in scope and quality.

1. *Population-workload* depends upon the structure as well as the size of population. The growth rate of age groups that significantly influence the demands for public education, welfare, health, and hospitals will decline. The increase of the age group (5 to 17) that determines enrollment in public elementary and secondary schools will fall from 35 percent in 1955–65 to 7 percent in 1965–75. There will be a decline, from 25 percent in 1955–65 to 17 percent in 1965–75, in the growth rate of older citizens, who are relatively heavy beneficiaries of health and welfare services. Total weighted population workload is projected to increase 15 percent from 1965 to 1975 compared with 27 percent in the decade 1955–65.

2. The *price level of goods and services* purchased by State and local governments has consistently risen at a higher rate than that for output as a whole, 15 percent higher in the 1955–65 period. Although the productivity of government services can and should be improved, we have assumed a continuation of the 15-percent differential rate of increase in their costs for the period 1965–75.

These assumed changes in population workload and prices of government goods and services would require an increase of about $24 billion [5] in general expenditures of State and local governments between 1965 and 1975 simply to maintain the 1965 overall level of scope and quality, as shown below.

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[3] See app. III.
[4] At 1965 prices.
[5] See memorandum by Mr. Robert R. Nathan.

1965 General Expenditures	×	Population Factor	×	Price Factor	×	Scope and Quality Factor	=	1975 General Expenditures Needs with 1965 Scope and Quality and Prices
$74.5 billion	×	1.15	×	1.15	×	1.00	=	$98.5 billion

The total yield to State and local governments with an unchanged tax structure plus additions to debt in 1975 was projected at $126 billion.[5] Of this total an estimated $6 billion would be required for supplementary contributions to government retirement systems and additions to working capital and sinking funds, and about $1 billion for other net expenditures.[6]

Thus an estimated $119 billion[7] would be available for general expenditures in 1975. This would provide in 1975 an additional $20.5 billion[7] for improvement in the scope and quality of State and local governmental services, or about 21 percent over the year 1965, as shown below.

1965 General Expenditures	×	Population Factor	×	Price Factor	×	Scope and Quality Factor	=	1975 Available Revenues for General Expenditures with 1965 Revenue Structure and Prices
$74.5 billion	×	1.15	×	1.15	×	1.21	=	$119 billion

These calculations suggest that through 1975 State and local governments can secure the funds to finance expansions in expenditures incorporating significant improvements in scope and quality without increases in tax rates or broadening of the tax base.

An increase in the overall price level of the economy would not materially affect improvement in scope and quality. Each 1-percent increase in the price level would increase revenues by about $1.2 billion and expenditures by almost $1 billion.

3. Unlike changes in population and prices, *improvements in scope and quality* are subject to policy choices. With foreseeable economic growth, the existing financial system will permit an increase, between 1965 and 1975, of 21 percent in the real per capita services provided by State and local governments. Is this enough? Obviously, a large quantity of services would not be provided, although they would be good to have if the public could afford them. But this is always true, not only of State and local services but also of national services and of private goods and services that we obtain through purchase with our own incomes.

[5] At 1965 prices.
[6] These outlays are not included in "general expenditures" as defined by the Bureau of the Census.
[7] At 1965 prices.

How much change in scope and quality of public services takes place depends on political decisions made by people acting in their role as voters and government officials. Improvements in scope and quality of public services are limited by the willingness of citizens to give up private claims for public claims, by their willingness to accept increasing redistribution of economic resources, and by limits on the speed with which real resources can be efficiently directed to new uses.

If the electorate is willing to pay for an even more rapid improvement in scope and quality of State and local government services than that indicated as possible with an unchanged tax structure, and if real resources can be provided for such improvements, then additional funds must be made available from State and local government sources or from the National Government.

If additional funds are sought, what is the desirable direction for the revenue systems to follow, and to what extent can State and local governments provide for their own increased expenditures? Possible changes in the revenue-raising structure of State and local governments present major areas of policy choice governing their fiscal future. These choices involve judgments concerning the responsibility of State and local governments in financing their own requirements and the role of the National Government in support of such steps.

A FISCAL PROGRAM FOR STATE AND LOCAL GOVERNMENTS

Although State and local governments can secure the funds necessary to provide substantial increases in scope and quality of public services between now and 1975, there is no room for complacency with regard to the adequacy of the system. General revenues of State and local governments from their own sources now account for 10 percent of gross national product and may account for an even greater percentage in the future.

If the public demands faster improvement in scope and quality of services, additional funds will be needed beyond those available from the present tax structure, which increases revenues no faster than economic growth. The States have not sufficiently developed revenue sources that raise funds most equitably and with least injury to their economic health. Partly because State governments are not truly representative, they have failed to respond adequately to the statewide interest in, and responsibility for, the provision of services by their localities.

Moreover, "poor" States and some central cities may provide greater than average increases in revenues. In particular their own resources may be inadequate to provide for large numbers of disadvantaged persons.

State and local governments should not simply turn to the National Government to meet demands made on them for more and better services. Continuation of the sharp expansion of Federal grants-in-aid is vulnerable to political factors and may be restrained by other commitments of the National Government. Furthermore, these grants are not always aimed where they will do the most good. As a result, there is unnecessary waste and a reduction in funds available for high-priority programs of the States.

A balanced federalism calls for a strong fiscal partnership among all levels of government—National, State, and local. The extent to which State and local governments assume responsibility for handling their own problems will significantly determine the role of the National Government in their fiscal affairs. The more equitable and responsive the State and local revenue systems become, the greater will be the ability of these governments to play an effective role in the Federal system. This requires leadership and assumption of responsibility by State governments, because local governments derive their fiscal powers from the States which have a wider revenue base and a greater fiscal potential.

But money without reform would simply aggravate the problems created by the present fragmentation and overlapping of local governments. For this reason this Committee in *Modernizing Local Government* recommended a program of State constitutional revision "to modernize the forms and powers of local government." These recommendations will be extended in a forthcoming statement calling for modernizing State governments.

The following sections assess some major actions by State governments to provide a better fiscal structure.

State Aids to Local Governments

Revenues from their own sources do not meet the full public service costs of local governments, particularly the larger central cities. Supplemental funds are obtained from State grants-in-aid as well as from direct Federal grants. In 1965 State general expenditures totaled $40 billion. Direct expenditures were $26 billion; State aids to local governments were $14 billion. Of the latter, 59 percent went for education and 17 percent for welfare. A portion of this aid was a pass-through of Federal aid to the States.

States play an important role in the Federal system today. In 1965 they raised about a third of total general revenue from civilian domestic public purposes. Nevertheless there has been much criticism of State initiative in finding solutions to modern public problems. The States have been attacked for failure to act on urban problems, especially in metropolitan areas where local government fragmentation severely hampers the attack on social ills and programs designed to aid the poor.

Because of the increasing interdependence of local jurisdictions, the role of the States must grow if they are to be strong and effective partners in the Federal system. The States should encourage greater cooperation and coordination among local governments in solving metropolitan problems. In many areas taxpaying ability is greatest in the suburbs but needs are greatest in the central cities. The States should do more to equalize resources available to individual local governments to combat social ills.

Since public schools are generally the most costly item in local budgets, school funds should be distributed to local districts through a program that insures each district within the State the financial ability to support its schools. In its policy statement, *Paying for Better Public Schools*, this Committee outlined a "foundation" program to provide such support. It called for "specification of the type and quality of school services that should, as a minimum, be available to students

throughout the State, * * * determination of the costs of providing these services, and establishment of a method for distributing State funds in such a way as to make it possible for every school district to provide at least the foundation level of education from these and its own funds."[8] Such aid should reflect the rise in school costs over time and the high cost of special programs for the disadvantaged.

In addition, this Committee, in its policy statement, *Raising Low Incomes Through Improved Education*, has called for greater State effort particularly in the areas of prekindergarten schooling, higher education, adult retraining and literacy instruction, and training for the physically handicapped.

Public welfare and relief costs also are a heavy burden on local budgets. Because some of the causes of poverty are regional and national in origin, and since poor persons, as well as others, move freely from place to place, a substantial sharing of welfare costs by higher levels of government is justified.

Cities with a high concentration of poor and disadvantaged are particularly burdened, and presently pay more than a reasonable share of the costs to support these groups through welfare programs. If not assisted, they may be obliged to impose taxes that may drive out business, reduce employment, and accentuate the welfare problem. For these reasons States should assume greater financial responsibility for public welfare costs.

States should take greater responsibility for paying for education and welfare, either through direct expenditures or grants-in-aid, in order to help equalize and improve the financial ability of local governments to meet their needs in these fields.

Property Tax Administration

The fiscal capacity of local governments is largely dependent on the property tax. It is the source of almost 90 percent of local tax revenue. It has several advantages for local governments. The limited mobility of real property restricts the possibility of an exodus of the base of taxation because of differing rates among neighboring communities. Property tax rates can be subjected to small incremental changes. The property tax provides appreciable financial independence for local governments and is the tool which permits local citizens to compare the costs of many public services against benefits.

The present local administration of the property tax is generally inadequate. The legal responsibility for assessing property for tax purposes rests with officials in about 18,000 primary assessment jurisdictions, many of which are too small to permit the employment of professional assessors.[9] Assessors are often elected officials who lack technical competence. Because of inadequate staffing, reassessments are made infrequently and inaccurately.

Improper assessment procedures have led to gross inequities. (1) Within individual assessment jurisdictions individual properties of a like category are often assessed at widely varying ratios of market

[8] *Paying for Better Public Schools*, a Statement on National Policy by the Research and Policy Committee of the Committee for Economic Development, New York, December 1959, p. 53.

[9] For a more detailed discussion of the problem, see the recently issued CED policy statement, *Modernizing Local Governments, op. cit.*

value. (2) Within individual jurisdictions inequities exist in the treatment of different categories of property. Inequities resulting from poor assessment administration are frequently compounded by attempts to assess property on the basis of current earnings rather than market value. (3) Although the distribution of State grants-in-aid and shared taxes is frequently based upon the assessed value of property, the average ratio of assessment to market value in different local jurisdictions varies widely. (4) State constitutions frequently place limits on property tax rates and on indebtedness of State or local governments based upon the assessed value of property. The common procedure of underassessment relative to market value unduly limits local tax revenues and debt potentials.

Although the property tax is essentially a local tax, improved property tax administration requires leadership and direction by State governments. The very power to tax is conferred on local governments by State constitutions and legislative enactments.

If inequities in property assessment are to be remedied, the States must assume responsibility in order that property be assessed uniformily throughout each State. Where there is effective county government, States may choose to delegate assessment to counties under State supervision and standards. Property assessment by States or counties need not interfere with local governments determining the amount of funds to be raised or setting the necessary tax rates to raise them (within limits imposed by State legislation.)

States should take full responsibility for assuring statewide equitable and uniform assessment of real property.

It is common practice to assess improvements more heavily than land in relation to market value, business property more heavily than residential property, and new property more heavily than old property. Thus the property tax is not proportional to the value of the property as intended by law. These practices reduce incentives to rehabilitate property and to use urban land efficiently.

*Assessment ratios of all classes of real property, including land. should be equalized on the basis of market value.**

There are cases where local communities want to ease the tax burden on certain types of property. For example, property tax easement may be desired to achieve the rehabilitation of slum areas or to maintain open spaces. But these purposes should not be accomplished through reductions of assessment which unduly complicate assessment administration and conceal the extent of subsidy. Where such easements are justified they should be accomplished by abatement of tax liability rather than reduced assessment.

States frequently place constitutional restrictions upon local taxing and borrowing powers in the form of maximums allowable in relation to assessed value of taxable property. These limitations have impaired the ability of local officials to tax, borrow, and plan effectively. Constitutional property tax and debt restrictions are incompatible with governments responsive to the needs of our rapidly growing and shifting population.

Limitations on local powers over property taxes and debts should be removed from State constitutions and, where desirable, should be imposed only by statute.

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*See memorandum by Mr. Charles Keller, Jr.

State legislative actions have eroded the property tax base. Exclusion of certain major classes of property—intangibles and some types of tangible personal property—has been a welcome step in the reform of the property tax because it is difficult to discover and assess the value of such property. Religious, educational, and charitable organizations are also excluded because it is believed that these nonprofit institutions promote social welfare.

But further exemptions are given by many States to certain classes of property owners—for example, homesteaders and veterans. Local units in 32 States lost an estimated $3 billion in assessed value in 1961 as a result of veterans' exemptions alone. In four of the 14 homestead States, homestead exemptions covered more than 30 percent of the value of locally assessed real property.

These exemptions tend to shift the tax burden among groups without regard for generally held principles of tax equity. For example, homestead exemptions may aid relatively wealthy homeowners at the expense of relatively low-income renters. The exemption procedure is also a poor method of subsidization. Such subsidies are not identified in State or local budgets and do not get the public scrutiny and regular review they deserve.

Although States generally provide the exemptions, local governments sustain the major portion of the resulting revenue loss, despite substantial local government costs incurred in providing public services for these properties. This loss is capriciously unequal among individual local jurisdictions. The greatest losses are likely to be sustained by central cities which can ill afford them.

*Property tax exemptions for special private interest groups such as homesteaders and veterans should be abolished. If States continue to require such subsidies through property tax exemptions they should reimburse local governments for the revenue losses incurred. States and local governments should also negotiate with private tax-exempt organizations to pay for direct services rendered.**

States, the National Government, and other public bodies own tax-exempt property, resulting in revenue losses to the local governments where such property is located. Losses are inequitably distributed among these jurisdictions and are often highest among those with the highest public service costs.

States, the National Government, and other public bodies should pay local governments a fair share of the local public service costs applicable to their properties.

Our recommendations concerning the property tax recognize that it will remain of great importance to local governments. But it falls heavily on only one type of expenditure. And even under the best administration proper assessment is difficult. Since communities differ in the size and character of their property base, some local governments may not be able to find enough property revenues to finance basic public services. There should be relatively less emphasis on the property tax, and we are proposing additional measures for broadening the State-local revenue base.**

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*See memorandum by Mr. Charles Keller, Jr.
**See memorandum by Mr. Robert R. Nathan.

General Retail Sales Tax

The general retail sales tax is growing in importance because it yields substantial revenues even at low rates and because it is relatively easy to administer.

However, the exemption in many States of a wide range of consumer services results in unnecessary tax losses. It reduces responsiveness to economic growth because personal expenditure on services increase in relative importance as incomes rise. Taxation of certain kinds of retail transactions and exemptions of others produce inequities among persons with different expenditure patterns as well as administrative difficulties.

A more broadly based general retail sales tax, particularly covering more services, can provide large amounts of revenue at a relatively low tax rate. Such a tax would be more equitable and responsive to growth in incomes, it would diminish unwarranted distortions, and it would reduce administrative problems.

*If they need more revenue, State governments should broaden the coverage of consumer services under a general retail sales tax and make more effective use of such a broad sales tax.**

Local retail sales taxes provide escape from excessive dependence of local governments on the property tax. This is appealing from the standpoint of tax equity because sales taxes reach income untouched by the property tax. They make each citizen-consumer more aware of the cost of increasing the supply and improving the quality of local public services. However, economic competition among taxing jurisdictions due to the mobility of people often discourages local governments from taxing retail sales.

In some States, local governments are prohibited from imposing general retail sales taxes. In others, some local governments, particularly large cities, impose retail sales taxes to meet increasing demands for public services and yet maintain some degree of fiscal and political autonomy. The result is a multiplicity of local retail sales taxes with varying coverage and rates.

A tax supplement is a logical administrative device for avoiding these complications. Under such a procedure a local rate is added at the option of the local government to the State rate. Both local and State taxes are collected by the State governments which allocate the local share to the account of the local taxing jurisdiction. This device provides identical coverage for State and local purposes, eliminates duplicate administration, and alleviates the burdens of compliance.

States should permit local governments to impose general retail sales taxes only in the form of supplements to State taxes.

Personal Income Tax

The personal income tax is the last major source of relatively untapped State revenue. Seventeen States have no broad-based personal income taxes. About three-fourths of the States with the personal income tax have effective rates of less than 2 percent of personal income.

A compelling argument for a State personal income tax is its flexibility and potential equity. Tax liability under the personal income tax can be closely related to income levels, family size, and other factors which influence the ability to pay.

*See memorandum by Mr. Robert R. Nathan.

This revenue is also collected with relatively little cost and difficulty. States taxing personal incomes have been increasingly defining taxable personal incomes in much the same manner as does the National Government, making compliance easier. Furthermore, States have increasingly been availing themselves of the opportunity to exchange tax information with the National Government. Both of these developments improve the administration of State income taxation and should be encouraged.

The personal income tax has a striking growth potential. It is estimated that revenues from current State personal income taxes grow by about 1.7 percent for each 1-percent gain in gross national product. This is considerably greater than the response of sales and property taxes. Because State government expenditures are expanding at rates higher than gross national product, this characteristic makes it a most important fiscal tool.

If they need more revenue, State governments should make greater use of the personal income tax

Local government personal income taxes are in effect in eight States. Such taxes raise difficulties. Income tax liability of nonresidents must be calculated on a different basis than that used for Federal and State tax returns. Even taxing the earnings of nonresidents at full rates is unfair to the extent that they do not fully use local public services paid for by such taxes. Those who reside in one community and earn income in another may be subject to double taxation.

In some States local governments are prohibited from using the personal income tax. When a local government is allowed to impose the tax the State should provide that such taxes be collected as a supplement to the State income tax. Some of the inequity of local personal income taxes may be reduced if earnings of nonresidents are taxed at lower rates than the earnings of residents, and such taxes could be credited against personal income taxes imposed in the jurisdiction of residence.

States should permit local governments to impose personal income taxes only in the form of supplements to State taxes.

Outlook With Strengthened Tax Structure

In this chapter we have proposed a number of fiscal measures whereby States and local governments can increase their revenue if needed, and at the same time improve the responsiveness and equity of their tax structure. A broader tax base would help reduce financial difficulties in meeting future State-local expenditure needs. The administration of the local property tax should be improved. Its relative importance can be reduced by effective use of broad-based sales taxes and State personal income taxes. Where there are local sales and personal income taxes they should be supplements to State taxes.

Professional property tax assessment with regular peridoic reassessment and the abolition of special property tax exemptions could result in an increased yield of about $2 billion [10] in 1975.

If all States which have no sales tax or which have a relatively low rate or narrow coverage were to adopt a broad-based sales tax with

[10] At 1965 prices.

the 1965 average rate and coverage, the additional yield is estimated at $2 billion [10] in 1975.

The possibilities for increases in State personal income tax yields are considerable because many large industrial States do not use this tax effectively. If all States with no personal income tax or with a relatively low rate or narrow coverage were to adopt a personal income tax with the 1965 average rate and coverage, the estimated additional yield would be $6 billion* in 1975.

1965 General Expenditures	×	Population Factor	×	Price Factor	×	Scope and Quality Factor	=	1975 Receipts Available for General Expenditures, with Strengthened Revenue Structure
$74.5 billion	×	1.15	×	1.15	×	1.33	=	$131 billion

In sum, all these measures could result in additional tax revenues of $10 billion. Since total debt maintains a stable relationship to revenues from own sources, then additional tax revenues would probably be accompanied by an additional increase in debt of $2 billion over the $6 billion projected with a fixed tax revenue structure. Thus receipts available for State and local general expenditures would total $131 billion in fiscal 1975 (based on the assumptions in ch. 3).

As a result, about $32.5 billion would be available for improvement of scope and quality beyond the 1965 level, or about 33 percent, as shown in the following table. This expansion in State and local general expenditures over those required to meet the projected rise in population and prices would exceed the 24-percent increase in the 1955–65 decade.

It is important to be clear about the significance of these calculations. They are not predictions of things to come or of revenue requirements necessary to meet future expenditures by State and local governments. They simply establish that taxing and spending choices of State-local government officials are wider than is commonly supposed. They suggest that State and local governments can reduce the burden of inequity and achieve a better balance in their tax systems by taking measures which improve their ability to raise revenue from their own sources.

State and local governments can in the aggregate speed the rate of improvement in the scope and quality of public services if they are willing to pay the price in higher taxes. But due to population mobility and to our increasingly interdependent society, the benefits of public services of one State extend into other States. Thus they serve regional and national interests, not merely their own. The National Government therefore has a responsibiltiy for assisting the States to attain greater fiscal strength. Some ways this can be done are discussed in the next chapter.

THE ROLE OF THE NATIONAL GOVERNMENT

Over the decade 1955 to 1965 State and local governments have been able to finance a vast increase in public expenditures largely from their

*At 1965 prices.

own resources. In looking ahead to 1975 we have found that, with the expected increase in Federal grant-in-aid funds implicit in existing legislation, they will be able to finance further increases in their expenditures to meet future needs arising from population and price changes, and to make significant improvements in scope and quality, without an increase in their tax rates or broadening of their tax structure. Further we have seen that States and localities can finance an acceleration in the recent rate of improvement in scope and quality of public services if they take steps to improve the productivity and equity of their revenue systems.

The National Government has a responsibility to help State and local governments become stronger members of the Federal system. National decisions on fiscal policy have a great impact on State and local revenues and expenditures as well as on intergovernmental relations. We believe that the National Government should not only encourage and give financial aid to State and local governments to provide public services required by the national interest which these governments might be unable or unwilling to provide alone, but it should help strengthen State and local government revenue structures through its fiscal policies.

In our view, the National Government can help most effectively by establishing or supporting new regulations for State taxation of interstate commerce; by setting up a regular review of Federal grant-in-aid programs; and by sharing Federal income tax resources with the States through a partial income tax credit for individuals.

National Responsibility for Interstate Commerce

State taxing power needs not only to be strengthened but to be restrained from reaching outside State boundaries at the expense of other States. The National Government can play an important role in correcting serious faults of State taxation of business that have property or operations in two or more States. At the start of 1965, 38 States imposed corporate income taxes, 38 imposed general sales taxes, eight imposed gross receipts taxes, and 27 imposed taxes on capital stocks. State taxation of business occurs under different and sometimes conflicting rules and regulations which hamper interstate commercial activity. States tend to use tax formulas that will make their share of revenue from such activity as big as possible. The result frequently has been double taxation and taxation by States in which activity is minimal.

Although the diverse system of State taxation of interstate commerce produces widespread inequities, taxation of business income produced outside the jurisdiction continues to broaden and grow more complex. Yet jurisdictional claims are unclear and guidelines for determining the amount of tax due are often imprecise. In many cases even the determination of whether or not liability exists is difficult, if not impossible. The cumulative handicaps for businesses arising from these many taxes are severe.

To remedy the defects of the present system, simple, clear, and equitable jurisdictional regulations must be provided for State taxation of interstate business. Otherwise the increase in the number of jurisdictions imposing each kind of tax will increase the confusion,

inequity, and administrative difficulties already hampering interstate commerce.

Either the States must enter into voluntary compacts or the National Government should use its power and responsibilty under the interstate commerce clause of the Constitution to reduce tax interference by the States upon the free flow of commerce across State lines.

The Council of State Governments has recently proposed an interstate compact which deals with the jurisdictional aspects of State taxation of multistate businesses and this has already been introduced in eight State legislatures. But if most of the States do not voluntarily enter into agreements of this kind the Congress should undertake action.

A system of uniform regulations establishing equitable and clear limits of tax jurisdiction upon interstate businesses by individual States should be enacted by Congress if not assured by a compact of the States.

Federal Categorical Grants-in-Aid

Federal categorical grants-in-aid are made to State or local governments under specific conditions and for specific programs to be carried out at the State or local level usually with State or local financial participation. These categorical grants are made to encourage public services which involve the national interest, but which some State and local governments cannot or will not undertake on their own initiative at levels desirable by the National Government.

The recent expansion of Federal categorical grant-in-aid programs reflects the growing role of the National Government in the fiscal affairs of State and local governments. Expenditures for categorical Federal grants-in-aid advanced from $7 billion in 1960 to nearly $15 billion in fiscal 1967. The 89th Congress alone passed 21 new health programs, 17 new education programs, 15 new economic development programs, 12 new programs for the cities, 17 new resource development programs, and four new manpower training programs. Between April 1964 and January 1966, the number of authorized Federal aids expanded from 116 to 162 major programs and specific authorizations rose from 239 to 399. Today categorical Federal grants-in-aid affect nearly every State and local public service.[11]

It is always difficult and sometimes impossible for States and localities where the proportion of poor persons is much above the average to finance adequate public services without outside assistance. Although the need for services in these areas is relatively great, the resources to provide them may be relatively small. Furthermore, extensive public programs for low-income groups may lead to an influx of poor persons and an exodus of higher income groups, making it even more difficult for a community to take care of its own needs.

Increasing interdependence in our society has made poverty a problem of national concern. We believe that the allocation of Federal categorical grants-in-aid should be increasingly based on need, as indicated by the location of poor individuals and families and by the shortage of resources from which to raise funds for minimum levels of public services in "poor" State or local jurisdictions.

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[11] See app. IV.

But we cannot ignore weaknesses in the present methods of providing Federal grants-in-aid. Some programs have been adopted without knowledge of their cost or scope. Others compete, overlap, and contain complex and sometimes contradictory provisions. Personnel at all levels of government are preoccupied with promoting their individual programs. They often ignore the broader intergovernmental implications of these programs because their mandate does not require it.

Grants-in-aid are used to influence State and local expenditure decisions in the national interest. But they are sometimes made without sufficient consideration of State and local laws, government structures, financial and administrative capabilities, and on-going programs. They often tend to reduce the freedom of action of State and local officials in policy matters which need plural decisionmaking.

The National Government has tried to do a great deal in a relatively short time through a rapid expansion of grant-in-aid programs. The range of activities covered is now so vast and the volume of pooled local, State, and National tax funds so large that the Federal system has been hard put to manage the grant-in-aid programs effectively and efficiently.

Some efforts at better coordination among the levels of government in administration of grants-in-aid have recently been made. Under the Comprehensive Health Services Act of 1966, for example, the funds for a number of health programs have been consolidated, giving lower levels of government greater flexibility in these programs. Such efforts should be intensified.

But there has been no regular review of either individual programs or the entire grant-in-aid system. We believe that good management requires that the National Government review the entire system to determine whether there is continued need for individual programs, whether present patterns and formulas are justified, whether the desired results are being attained efficiently, whether there are harmful byproducts in such programs that should be eliminated, and whether the programs promote healthy State and local governments.

The National Government through the Congress and the Bureau of the Budget should appraise the grant-in-aid system and establish procedures for a regular review of individual grant-in-aid programs. The goal of the review should be to promote efficient use of public funds, to further beneficial participation by State and local governments, and increasingly to distribute funds according to the location of poor persons and the shortage of resources in poor jurisdictions.

Reducing Federal Personal Income Taxes

A major longrun fiscal policy issue is how the National Government can make the most profitable use of the rapid growth of Federal income tax revenues. The normal growth of the economy currently increases the annual yield of the existing Federal income tax system by about $7 billion, and this would rise to about $11 billion [12] by 1975. This increase in the annual yield of Federal income tax receipts is greater than the increase in National Government expenditures for domestic civilian services.

[12] At 1965 prices.

Because of the stepped-up military requirements for Vietnam, this increase is far below the recent rate of increase in National Government expenditures. But under normal peacetime conditions the national fiscal system generates such fast-growing revenues that the objectives of rapid economic growth, high employment, and price stability might be threatened by fiscal drag. Such conditions call for some combination of Federal income tax reduction, debt reduction, and increased spending for desirable public needs. We believe that the national budget could also be used to support the revenue and expenditure efforts of State and local governments.

There has been much discussion recently of the need for, and possibility of, sharing income tax resources among all levels of government. This discussion has arisen partly because high Federal personal income tax rates tend to make it difficult for State and local governments to obtain greater personal income tax revenues, even though State and local government expenditures grow more rapidly than national government civilian expenditures.

Evidence of this is suggested by the history of the State income tax movement. Thirty-two States instituted broad-based personal income taxes between 1911 and 1937 when Federal personal income taxation was nonexistent or low. But during the past 30 years of high Federal personal income taxation there was a new adoption by only one State. Seventeen States do not have broad-based personal income taxes. Twenty-four States had broad-based personal income taxes with an effective rate of less than 2 percent of personal income in 1965. It is probable that high Federal income tax rates have significantly deterred State legislators from using this tax source effectively.

Yet the income tax is more responsive to economic growth than other tax sources and the potential for State personal income taxation is relatively untapped compared with other tax sources. A Federal income tax reduction would reduce the restraints on State use of personal income taxes. We believe the National Government should, when the budgetary situation permits, reduce Federal personal income tax rates.

Alternatives for Strengthening State Finances

But we expect Federal personal income tax rates to remain relatively high even after any likely reduction, and therefore the National Government would continue to be a strong income tax competitor of the States. From the point of view of lower levels of government, this is most unfortunate because retail sales and property taxes, the major sources available to them, have limited responsiveness to increases in personal incomes associated with economic growth. Revenues from personal income taxes, on the other hand, increase more than proportionately with economic growth.

Two other factors make it unduly difficult for States to finance increases in the level of public services which their citizens deem worthwhile. Tax competition makes it difficult for one State (or other governmental jurisdiction) to maintain a tax level much greater than that of a neighboring jurisdiction, for this could discourage business and persons with higher incomes from locating or remaining in the relatively high tax area. And a growing portion of the benefits of public services produced by one tax jurisdiction accrues to individuals resid-

ing, or businesses operating, in other jurisdictions, with the result that public services whose benefits exceed their costs are too often not undertaken.

These three factors—Federal competition for personal income tax funds, tax competition among governmental jurisdictions, and the spread of public service benefits beyond the taxing jurisdiction—not only limit the ability of the States to finance increases in services which their citizens deem worthwhile; they have created the conditions under which the National Government has tried to bridge the gap through categorical grants-in-aid. But, as we have seen, there are weaknesses in the present method of providing Federal grants-in-aid, and therefore, if we are to strengthen fiscal federalism, other ways of assisting the States should be found.

Two major plans have been advanced to deal with a potential Federal budget surplus and to overcome restraints on State finance. One is a plan for the National Government to provide general assistance grants to the States. Essentially, this plan would transfer funds from the National Government to the States primarily on the basis of population with practically no restrictions as to their use. The other plan would provide Federal income tax reduction in the form of a partial tax credit—on top of the deductibility provisions in the present Federal income tax—allowing individual taxpayers to offset a portion of their payments of State income taxes against their Federal income tax liability.[13] Such a partial tax credit would make the payment of State income taxes less burdensome. But States would have to take positive action to secure more revenue from this source; the tax credit would be for individual taxpayers.

The amount of funds that would be made available to the States under either plan would depend on the terms involved. In the case of general assistant grants, the amount of funds transferred could be about 1 to 2 percent of the Federal personal income tax base on one proposal or about 3 to 5 percent of Federal personal income tax receipts on another proposal. These would have totaled about $1.5 to $5 billion in 1965. In the case of a partial tax credit, the degree of encouragement of State personal income taxation, and the resulting loss to the Federal Treasury, would depend on the size of the credit. At the extreme, a 100-percent credit would permit a State to raise income tax revenues entirely at the expense of the U.S. Treasury with no direct burden accruing to that State's taxpayers. At the other extreme, a credit of only 5 or 10 percent would have little effect. But a credit somewhere between would help to reduce the limitations imposed upon the effective use of personal income taxation by the States. It is estimated that a 25-percent credit would have reduced Federal income tax receipts by about $2.5 billion in 1965 if all States taxed personal incomes as heavily as Oregon, the State which taxed personal incomes at the highest rate in 1965.

Both plans indicate a preference for personal income taxation over other forms of taxation. Both could provide increased funds over time because they relate to sources of revenue which would automatically grow with economic growth. But they do this in different ways. The general assistance plan makes use of Federal income tax revenues and would be at the expense mainly of future Federal income tax reduc-

[13] For examples of how a partial tax credit could work, see app. V.

tions. The partial tax credit plan would reduce future Federal income tax revenues but encourage State income taxation. In the long run, the general assistance plan would delay or greatly limit the potential for future tax reductions. Therefore, the funding of a general assistance plan would not reduce Federal tax competition with the States. The partial tax credit plan, on the other hand, would result in lower Federal income tax payments.

A general assistance grant based on population would provide some equalization of fiscal resources among the States because the residents of high-income States pay more Federal income taxes per capita than those in low-income States. If this allocation by population is deemed to make an insufficient allowance for the low fiscal capacity of poor States, the general assistance plan could be modified to provide more per capita funds to poor States and less per capita funds to rich States. A partial tax credit, on the other hand, would not bring about any redistribution of funds between poor and rich States. Other methods, such as categorical grants, would be needed to achieve equalization.

In evaluating the equalization effect of the general assistance grant, a number of considerations should be kept in mind. First, if account is taken of the contribution made by the citizens of poor States to Federal personal income tax receipts, the funds gained from the equalizing effects of the various proposals for general assistance grants made to date would generally be small, amounting to about 4 to 8 percent of the outlays of State and local general expenditures in the poorest 17 States. Second, some of the major poverty areas and some of the most explosive poverty problems exist in the large urban centers. Those centers are in the relatively rich States which would lose fiscal resources in any State redistribution, thereby reducing their own fiscal capacity to deal with these problems. This effect raises a serious question of whether the problems of poverty are best attacked by helping poor persons or poor States. Third, the redistribution of income from richer to poorer States may not result in the redistribution of income from richer to poorer persons. The basically unconditional character of general assistance grants provides no assurance that the funds would be used by these poor States to help poor persons. We believe that the responsibility to bring adequate public services to poor persons, whether in relatively poor States or not, can be most effectively met through categorical grant-in-aid programs designed specifically to deal with these problems.

Both the general assistance and the tax credit plans are designed to strengthen the fiscal position of State governments, but they try to do this in different ways. Since the general assistance plan would transfer funds to the States basically without conditions, they may be used to add to State expenditures or to reduce State and local taxes, or some combination of the two. There is evidence that funds transferred from higher levels of government to lower levels which are not restricted in usage and which do not require matching funds by the lower level may substitute for revenue-raising efforts at the lower level. Studies of State aid to local education confirm this tendency on the part of local governments. Furthermore, a field study of relatively poor States made for CED indicates that there are States which can and probably should increase their tax effort but which might be deterred from doing so by a program of general assistance.

Competition among governmental jurisdictions, which also serves to restrain State taxation, would remain unaffected by a general assistance grant, adding to the likelihood that the general assistance funds would merely substitute for State revenue efforts. But by reducing the direct burden from State personal income taxation, a tax credit reduces the differential tax costs of individuals living in relatively high and relatively low-income tax States. Further, a reduction in the direct cost of State taxation to the State income taxpayers would in itself create incentive for greater State reliance on its own sources by encouraging the use of the personal income tax.

Since a general assistance plan would result in reduced tax responsibility by the States, it would tend to reduce State efforts to improve their own revenue systems and particularly, if more money is needed, to promote a more equitable and responsive tax structure. To overcome this, advocates of general assistance grants have suggested a tax effort formula designed to penalize those States which make below average fiscal efforts or which cut their taxes in response to general assistance funds. If a workable formula could be devised, it would leave little fiscal discretion to the States and would destroy one of the objects sought by the plan for general assistance grants.

Unrestricted general assistance funds from the National Government to State governments would reduce pressures for desirable State and local reforms. They would permit the States to spend greater amounts of funds without being accountable for raising them. An income tax credit, on the other hand, would keep the responsibility for raising taxes with State legislatures and continue to maintain the accountability of the State to the people from whom tax funds are drawn. The partial tax credit plan would put funds in the States' hands to be used as they see fit only to the extent that they use State income taxation. It would reduce the substantial limiting effect of high Federal income taxes on State use of this first-rate revenue source. States which already impose income taxes would have to raise their rates to secure increased revenue and they might be encouraged to do so since this could be done without substantially raising the total taxes paid by their citizens.

However, there might be a problem for those 17 States without broad-based individual income taxes because they would benefit from the credit only if they imposed an income tax. They might regard a partial credit limited to income taxes as Federal coercion. They might want a partial credit to include sales and perhaps property taxes as well.

There are a number of reasons for limiting a partial tax credit to the payment of State personal income taxes only. As we have noted above, the greatest restraint to State taxation is on the use of personal income taxes. National tax policy discourages State income taxes because of high Federal income tax rates, but encourages State general retail sales taxes because the National Government does not use this tax source. As a result, national tax policy is not now neutral, and 42 States have general retail sales taxes. If the credit were to include sales taxes, we would perpetuate the present unneutral situation. Limiting the credit to the personal income tax would tend to correct the present imbalance.

There is another important disadvantage in allowing a partial credit for sales and property taxes. All consumers pay sales taxes but mil-

lions of people with low incomes pay no Federal income tax. As a result, these people would have to pay a higher effective rate of sales tax than others. A credit against property taxes would also be unfair because millions of both renters and property taxpayers do not pay Federal income taxes. Furthermore, those renters who pay Federal income taxes would receive no credit for property taxes which they do not pay directly, although their rent payments reflect these costs.

Thus on grounds of equity, practicality, and because the purpose of a credit would be to overcome restraints upon State taxation, we believe that a credit should be limited as a partial offset to State personal income taxation. In order to give States with no personal income taxes the opportunity of taking advantage of the credit, it could become effective 2 or 3 years after enabling legislation is passed by Congress. Once such legislation is passed, State legislatures might be expected to look upon the State income tax with more favor if more money is needed because it represents the last major untapped source of revenue, has economic revenue growth potential, and enjoys important advantages from the standpoint of tax equity.

Any evaluation of the two plans—the general assistance grant and the partial tax credit—must consider the goals to be achieved. This Committee believes it desirable to reduce Federal income taxes as soon as budget conditions permit. It believes further that using part of the Federal income tax cut to give partial credit for State income taxes would reduce restraints upon the ability of the States to finance services with an equitable tax structure and would permit the States to be more effective partners within a dynamic Federal system.*

On balance, we believe the partial tax credit plan is the preferable method to strengthen the fiscal resources and responsibility of State governments and to secure a more equitable and responsible Federal revenue system. Therefore:

*When the budgetary situation permits a reduction in Federal taxes, it should be accomplished in part by giving individual taxpayers a partial credit against their Federal personal income tax liability for their personal income payments to the States.***

MEMORANDUMS OF COMMENT, RESERVATION, OR DISSENT

FRED J. BORCH:

I approve this statement, but I believe that too little attention is given to the fact that the States have worked very hard and diligently on the problems they have faced and that many of the States should be given great credit for the efforts they have made in the light of the great many obstacles that are brought forth in the report.

C. WREDE PETERSMEYER, with which CHARLES KELLER, JR., has asked to be associated:

I believe that each State should be free to decide which type of taxation best suits its particular fiscal requirements. The proposal herein made that would give individual taxpayers a partial credit against their Federal personal income tax liability *only* for personal

*See memorandum by Mr. Robert R. Nathan.
**See memorandum by Mr. C. Wrede Petersmeyer.

income tax payments to the States would discriminate against taxpayers in such States that, for their own reasons, now prefer and may continue to prefer types of revenue-producing taxes other than income taxes.

It is one thing for CED to suggest that an income tax is a desirable form of tax for States to consider, but a far different matter for CED to insist on this type of taxation by recommending that only State income taxes qualify for Federal income tax credit. I suggest that the credit be applied to any State-imposed taxes, whether they be income, sales, or property.

GEORGE RUSSELL, with which THOMAS ROY JONES and HOWARD C. PETERSEN have asked to be associated:

The recommendation that the benefits of a Federal income tax reduction be tied to a State income tax credit is unnecessarily restrictive. Seventeen States, according to this statement, do not have broad-based personal income taxes. The tax approach now being recommended, with which I do not agree, would tend to coerce all States into imposing an income tax (in lieu of other taxes) in order to qualify their residents for Federal income tax credits.

If Federal budgetary considerations support a reduction in Federal income taxes, this action should be given a high priority. Such an action would enlarge the tax base for all State and local governments using tax measures most appropriate to their needs.

ROBERT B. SEMPLE:

While I concur with most of the recommendations and approve of this statement in general, I must dissent from the provision which advocates giving taxpayers a partial credit against their Federal income tax liability for personal income tax payments to the States. I am not persuaded by the arguments in chapter 5 that either of the plans for sharing the projected Federal income "bounty" with the States are equitable or desirable. The partial credit plan and the arguments used to support it would seem to reflect undue Federal influence on the States' tax prerogatives. A tax credit would create a gross inequity between taxpayers in those States with an income tax and those in States which do not choose to enact one.

The individual State tax structures now in existence have come about through a long and delicate process involving repeated adjustments through the legislative process to arrive at a semblance of balance, recognizing the economic characteristics of each State. I am not convinced that the States cannot solve their own tax problems and reject the idea that the Federal Government must take on even added responsibility at the State level, even though it may be through an income tax incentive plan rather than direct subsidy. I feel that the present deductibility provisions in the present Federal income tax law are good and sufficient reasons for the States that find a need for additional revenue through the State income tax route to pass the necessary legislation.

An additional credit of 25 percent would be an impractical if not unacceptable proposal and I would advocate the most acceptable incentive would be reduction in the Federal income tax to the greatest extent possible at the earliest opportunity.

PHILIP SPORN, with which J. WILSON NEWMAN has asked to be associated.

While I strongly endorse the need for strengthening State fiscal responsibility, I question the desirability of giving individual taxpayers a partial credit against their personal Federal income tax liability for income tax payments to the States for the following four reasons:

1. I do not believe it will solve the problem of providing funds to those States and for those purposes that have the greatest need.

2. It seems to me that such a program would lead to undermining the Federal income tax as a major element in financing the social-economic requirements of a modern society. Rather than the beginning of a process of erosion of the Federal income tax, we need a further simplification of the tax and a tightening of existing areas of tax deductions.

3. Such a credit would reduce the countercyclical potentialities of the Federal income tax, since to the extent that such a credit is provided, countercyclical changes in tax rates would be reduced by the extent to which such credits are provided.

4. I believe that a straightforward reduction in Federal income taxes to eliminate fiscal drag on the economy would itself reduce public resistance to and thus make possible extending State and local taxes to bring about increased fiscal responsibility on the part of the States, and it would do this in a much simpler and more straightforward manner without danger of eroding or complicating the Federal income tax and reducing its flexibility.

THEODORE O. YNTEMA, with which JOSEPH L. BLOCK and CHARLES KELLER, Jr. have asked to be associated:

I concur in most of the general observations in this paper, but I disagree with its major policy recommendation.

This statement recommends action by the Federal Government intended to coerce the States into adopting income taxation. I am not opposed to State income taxes, but I am opposed to such Federal coercion. This statement does not establish the need or justification for such coercion. States can now levy income taxes just as well as other taxes. Since all such State taxes are deductible from income taxed at the Federal level, there is no need to go further and establish a tax credit available only to persons paying State income taxes. Unless decisions on State taxes are to be taken over by the Federal Government, the decisions on income taxes should not be forced on the individual States.

ROBERT R. NATHAN:

It should be noted that included in this total of $126 billion is the $26 billion of Federal grants-in-aid. This also should be taken into consideration explicitly in later discussing the resources available for improving the scope and quality of State and local government services. Without this being noted explicitly there may be some complacency about the adequacy of internal State and local financing.

CHARLES KELLER, Jr.:

Market value should of course be related, amongst other things, to income-producing capabilities. Slum properties being old and dilapidated, generally receive low assessments, which in effect subsidizes

them and makes them more attractive from an investment return basis. This is a situation which should be promptly reversed.

CHARLES KELLER, Jr.:

While I agree with the statement, it does not go far enough. Property tax exemption for new industrial facilities, now available in many States, should also be abolished. Even where States reimburse local governments for the taxes lost through all of the listed exemptions, other evils and imbalances are created thereby, and in some instances not all units of local government such as special districts are included in such reimbursement.

CHARLES KELLER, Jr.:

The matter of the assessment of personal and intangible property is not discussed. The assessment of these classes of property is also inequitable, and their taxing, including stocks of goods in inventory, and machinery and equipment should be abolished.

ROBERT R. NATHAN:

Some prevailing exemptions from sales taxes may be producing inequities, but broadening the coverage will increase inequities far more than any conceivable elimination of present inequities. To the extent that highly essential items important in low-income family expenditures are taken from exempt categories and subjected to a general sales tax, the adverse impact on poverty and on equity issues can be serious.

ROBERT R. NATHAN:

The tax credit device for State income taxes, in principle, warrants full support. But it is uncertain how effective it will be in stimulating States to rely more heavily on graduated income taxes if the credit is as small as the examples presented in this report. The $700 million figure sited in appendix V is not likely to encourage much action among the States toward raising more revenues through income taxes. For this reason I would favor both the general assistance grants and the tax credit until such time as the States develop more responsive and equitable fiscal systems which are adequate to their needs, at which time general assistance grants may be reduced or eliminated.

I strongly favor a credit against Federal income taxes for State income taxes limited to a given dollar level of tax credit or as a given percentage of the Federal personal income tax liability. Such a method assures that the Federal Government will retain control over the size of the loss in Federal revenue that can or will result from the tax credit. The methods offered in appendix V will require the Congress to give a degree of open-ended access to Federal revenues. The drop in Federal revenues would be based on State legislation. Further, my method will greatly strengthen the inducement to States to adopt at least that level of taxation on incomes which will be allowed as a credit against Federal income taxes. States can set higher levels as they see fit. If we really believe that the States need more responsive tax systems or else the Federal Government will have to assume more and more financial and perhaps operating responsibilities for functions that have traditionally been handled by States and localities, then the proposed tax credit device should be one that will yield positive results.

Appendix III[1]: ESTIMATE OF RESPONSIVENESS OF STATE-LOCAL TAX RECEIPTS TO ECONOMIC GROWTH

Many studies of the responsiveness of State and local taxes to economic growth have been made in recent years. The calculations of the CED staff have drawn from these materials. Table A shows the range of estimates of responsiveness of individual taxes in 11 independent studies as compiled by the Advisory Commission on Intergovernmental Relations and published in *Federal-State Coordination of Personal Income Taxes*, 1965. Some results of three of the most recent and most thorough studies are also shown. These studies are: Dick Netzer, *State-Local Finance in the Next Decade*, unpublished paper prepared for the CED, 1965; *Project '70*, a study directed by Selma Mushkin to project State-local finances in 1970 for the Department of Labor and the Interagency Project on Economic Growth and Employment Opportunities and to be reported by Selma J. Mushkin and Gabrielle C. Lupo, "Project '70: Projecting the State-Local Sector," in *Review of Economics and Statistics*, May 1967; and Tax Foundation, Inc., *Fiscal Outlook for State and Local Government to 1975*, New York, 1966. The final column indicates the responsiveness assumed by the CED staff, based on the studies noted.

The calculations leading to the estimate of 1975 tax revenues, which are based on the assumed responsiveness of individual taxes, the assumed real increase in national output of 48 percent between 1965 and 1975, and 1965 State and local tax revenues, are shown in table B.

Tax	Advisory Commission compilation [1]	Netzer	Tax foundation	Project '70	CED
Property	0.7–1.1	1.0	0.9	[2] 1.0	1.0
General sales and gross receipts	.9–1.05	1.0	1.1	1.0	1.0
Selective sales and gross receipts	[3] .5– .7	([4])	[3] .7	.7	.7
Personal income	1.5–1.8	1.75	1.7	1.7	1.7
Corporate income	1.1–1.3	1.15	1.2	1.3	1.2
Other	[3] .5– .6	([5])	[3] .7	[3] .7	.7

[1] Gross national product except for tax foundation study, which uses growth in personal income.
[2] Assuming continuation of the lag in reassessment observable between 1956 and 1961. The growth of the market value of property was projected as 1.2 times the growth in gross national product.
[3] Computed by CED staff based on greater breakdown of individual taxes published by author and weighted by 1965 revenues.
[4] Alcoholic beverage tax, including excess of revenue over expenditure of liquor monopoly systems, 0.6; tobacco products, 0.75; other selective sales and gross receipts, excluding motor fuel taxes, 1.4.
[5] Death and gift taxes, 1.8; other, excluding motor vehicle and operators licenses, 1.1.

Tax	1965 revenue	Responsiveness	Percentage growth in revenue—1965–75 [1]	Increase in revenue—1965–75	1975 revenue
Property	$22,583	1.0	48	$10,840	$33,423
General sales and gross receipts	7,981	1.0	48	3,831	11,812
Selected sales and gross receipts	9,136	.7	34	3,106	12,242
Personal income	4,090	1.7	82	3,354	7,444
Corporate income	1,929	1.2	58	1,119	3,048
Other	5,521	.7	34	1,477	7,398
Total	51,243			24,127	75,367

[1] Responsiveness ratio (elasticity) times projected 48 percent real increase in GNP.

NOTE.—Because of rounding, detail may not add up to totals.

[1] This appendix is the product of the Research Staff of CED and does not necessarily represent the views of the Research and Policy Committee.

FISCAL OUTLOOK FOR STATE AND LOCAL GOVERNMENT TO 1975 *

BY THE TAX FOUNDATION

I. SUMMARY AND CONCLUSIONS

Under the impetus of developments in both government and the private sector, State and local government spending has risen rapidly in the postwar period. General expenditures in 1965, at $75 billion, had more than quadrupled since 1948. The expanded outlays provided more and better services to growing numbers of persons, in an economy where incomes, living standards, costs, and prices were all moving upward. Over two-thirds of the increase was spent for education, highways and streets, and health and welfare, but all major State and local functions were substantially enlarged.

Confronting the financial challenge posed by these developments, State and local units adopted new taxes, raised the rates of old taxes, and put higher price tags on services sold. These efforts, along with concurrent economic growth, raised annual revenues from State and local sources to levels now $48 billion higher than in 1948. Simultaneously, the expansion of Federal grant programs added another $9 billion to annual general revenues. Thus it was that general revenues grew apace with general expenditures. To pay for large capital investments, especially in school buildings and road construction—not all of which are financed from current revenues—the States and localities borrowed in amounts which increased their total outstanding debt from $19 billion in 1948 to $100 billion at the end of fiscal 1965.

Can State and local governments continue to finance growing programs in the next decade without further extensive tax-raising measures? Will there by any abatement in the thrust of the basic forces which have fashioned postwar trends? The findings in this study suggest affirmative answers to both questions.

Under the conditions assumed, aggregate general revenues will grow somewhat more rapidly than spending in the decade ahead, without an increase in overall tax rates. A key factor in the projected surplus and the improved fiscal outlook is the indicated slowing in the growth rate of the automatic or built-in forces which have accelerated expenditure increases throughout the postwar years.

In recent years it has become almost commonplace to assume that all State and local governments are in financial straits and will be increasingly hard pressed to meet their future responsibilities on their own. While some jurisdictions may be so afflicted, the conclusions of this study suggest that they will be in the minority.

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* Reprinted from: *Fiscal Outlook for State and Local Government to 1975*, Tax Foundation, Inc., New York, 1966, chs. I, II, VII, VIII, IX, app. A and B.

This conclusion results from a projection of the outlook for State and local government finance under specificed assumptions, as presented below, and is thus not a prediction or forecast. Apart from the underlying assumptions as to general economic and demographic conditions, which are largely outside the control of State and local governments, the actual course of events will depend heavily on future policy decisions at all levels of government.

Expenditures

General expenditures are projected to rise from $75 billion in fiscal 1965 to $142 billion in 1975. This pattern represents continued high growth, but at a relative pace more nearly consistent with that of the first half of the 1960's than with the faster rate recorded in earlier postwar years. For the next decade, the indicated rise is 89 percent, in comparison with a 122-percent advance in the decade ending in 1965.

Many of the variables influencing the postwar expenditure upsurge will continue to operate with approximately the same force as in the past. Others will tend to accelerate spending, and some will act as decelerators. A major restraining element is the outlook for population trends, influenced by the declining birth rate since the late 1950's. This development will hold rates of growth in total population below those of the 1950's, thus tending to reduce pressures on spending. More important, however, is the concomitant effect of the resulting population age distribution on expenditure levels, notably in the areas of public school education and public welfare.

Policy decisions, as distinct from automatic or built-in forces, have the predominant role among factors tending to accelerate spending rates for some functions, notably public welfare.

Some reallocation of funds among the major functions is foretold in the projections. In particular, further growth in local school spending will be tempered by a slackening in enrollments. The two largest functions—education and highways—are expected to grow at an appreciably less rapid pace, giving way to larger rates of increase in the remaining functions. The most dynamic growth areas for the decade ahead appear to be public welfare, health and hospitals, and a variety of functions grouped under miscellaneous general activities. As before, education will remain the most costly function of State and local units, and will continue to call for the largest dollar increases.

Projections of expenditures for major functions, with comparative historical data, are shown in table I–2.

EDUCATION

Education is the dominant function of State and local governments and is second only to national defense in all government spending. Schools and colleges now enroll more than a quarter of the nation's population. The vast majority—45 million—are in State and local institutions. These institutions made notable achievements in the postwar period, and costs mounted rapidly. A relaxation in enrollment pressures in the next decade is expected to exert a moderating influence on future spending trends. Total State and local outlays for education are projected at $52.9 billion in 1975, an increase of 83 percent in the next 10 years, in comparison with a 144-percent rise during the past decade.

Relatively slow increases in enrollments in local schools are in prospect between 1965 and 1970; thereafter a decline of some 1.2 million students is anticipated by 1975. For the decade, enrollment gains will average out at 162,000 per year, in contrast with the experience of the 1955–65 period, when additions averaged 1,187,000 a year. With per pupil standards rising as in the first half of the 1960's, operating costs per pupil would reach $852 by 1975, about three-quarters higher than in 1965. Declining numbers, however, would restrain growth in expenditures for both current and capital purposes. In total, local school spending is projected at $37.1 billion in 1975, up 66 percent over the decade, in contrast to a rate of growth almost twice that rapid (121 percent) in the decade ending in 1965.

Expenditures for institutions of higher education are projected to grow more rapidly than for public schools, but also at rates below those of the past decade. Outlays are projected at $14 billion by 1975, or about 139 percent above 1965. Current expenditures per full-time student are estimated to increase by about three-fifths in the next decade—from $1,593 in 1965 to $2,557 by 1975. While large increases in numbers enrolled will continue, it is significant that the biggest proportionate gain in college students (a 60-percent increase in a 5-year period) was absorbed in the first half of the 1960's. Succeeding enrollment gains for the next two 5-year intervals are estimated at 45 and 28 percent, respectively.

PUBLIC WELFARE

Public welfare is the third ranking category among State and local government functions, but welfare spending in the postwar period has proceeded at a slower pace than that for other major activities. Most State and local welfare falls under the federally shared program of public assistance, which has been in effect for over three decades. Assistance takes two forms: cash payments to the needy in support of living allowances, and medical payments.

A significant increase in the velocity of public welfare spending is envisioned in the projections. Total welfare outlays in 1975 are estimated at $17.1 billion, or 170 percent more than in 1965, in comparison with the previous decade's advance of 99 percent. The higher rates of increase reflect the assumption of widespread response on the part of the States to 1965 Federal legislation in the field of medical care for the "medically indigent." Emphasis in the welfare field promises to shift in three ways: (1) from financial aid for living support to payments for medical care; (2) from programs for the elderly to those for younger persons; and (3) from aid to the very poor to assistance to those with higher living standards. Projections in this study, assuming all States will implement the new Federal law, indicate that medical costs under public assistance programs will rise by $7.5 billion from 1965 to 1975.

In the other major sector of public welfare—cash living allowances to the needy—only moderate rates of increase are indicated. The slackening reflects expected declines in the rate of growth of members of the population under 18 years old, and those 65 years old and over. These two groups receive more welfare aids than others, and in the postwar period have tended to increase more rapidly than other age categories. Further downward biases in the outlook for State and local welfare spending are due to the continued increase in the role of social insurance programs in the care of elderly persons.

HEALTH AND HOSPITALS

State and local governments own and operate 2,041 hospitals and administer a variety of public health programs. They have a predominant role in caring for patients with long-term illnesses, especially mental diseases. The projections of future spending indicate that outlays will rise by 97 percent in the decade ahead, to a level of $10.6 billion in 1975. The rate is just slightly below that experienced from 1955 to 1965.

Since 1948 expenditures for State-local health and hospital services have more than quadrupled. The growth in outlays due to productivity or quality changes is difficult to separate from that due solely to rising prices. Recent Federal legislation affecting the overall financing of national health services will have an indirect influence on the State-local health and hospitals sector; in particular, State-local hospitals may become more self-sustaining. These new programs will serve to reduce the role of State and local hospitals in the care of the sick poor, and hospitals which serve primarily the poor may become obsolescent in their present form. While the overall financial responsibility of State and localities for hospital and health services may decline in relation to the Nation's total health expenditures, their administrative role in the broader field of health services, which includes medical vendor payments under public welfare, seems likely to expand. Medical care costs and prices are expected to continue to mount rapidly.

HIGHWAYS

The management of the Nation's 3.6 million miles of highways and streets rests largely in the hands of State and local governments. This job ranks second to education in financial requirements. Federal highway policy has been a major guiding force in capital spending since 1956. But State and local units have a more extensive responsibility for the 2.8 million miles of city streets and local roads which are outside the federally aided systems. Land, construction, maintenance, and other highway costs have risen rapidly as a result of both price inflation and improvements in the quality of roads and streets. Such increases are estimated to continue at a similar pace throughout the propection period. The volume of highway construction, however, is projected to drop somewhat following the completion of the presently designated 41,000-mile Federal-State Interstate Highway System before 1975. Total highway outlays in 1975 are projected at $16.6 billion, 36 percent above 1965. Future Federal legislation will have an important bearing on actual highway outlays beyond 1972.

OTHER FUNCTIONS

The remaining services provided by the States and localities cover a wide range of activities. In total the costs of these heterogeneous services are projected to rise to slightly over twice the 1965 cost, but at a rate somewhat under that experienced in the previous decade.

TABLE I-1.—*State and local general expenditures, actual and projected, fiscal years 1955–75*

Function	Amount (billions)			Percent change	
	Actual		Projected, 1975	1955–65	1965–75
	1955	1965			
Total, general expenditures	$33.7	$75.0	$142.0	+122	+89
Education	11.9	29.0	52.9	+144	+83
Highways	6.5	12.2	16.6	+89	+36
Public welfare	3.2	6.3	17.1	+99	+170
Health and hospitals	2.5	5.4	10.6	+112	+97
All other	9.7	22.1	44.8	+128	+103

Source: Table VII-2.

Table I-2 sketches the indicated future pattern of per capita expenditures for selected functions, in comparison with the 1955 and 1965 levels.

TABLE I-2.—*Per capita expenditures for selected State and local functions, actual and projected, fiscal years 1955–75*

Function	Amount (billions)			Percent change	
	Actual		Projected, 1975	1955–65	1965–75
	1955	1965			
Total general expenditures	$205	$387	$655	+89	+69
Education	72	150	244	+108	+63
Highways	39	63	76	+62	+21
Public welfare	20	33	79	+65	+139
Health and hospitals	15	28	49	+87	+75
Sanitation and sewerage	7	12	20	+71	+67
Police and fire	12	20	33	+67	+65
Housing and urban renewal	3	6	12	+100	+100
General control	9	14	22	+56	+57
Interest on debt	5	13	24	+160	+85
Other general	23	48	96	+109	+100

Source: Computed from data in tables VII-1 and VII-2.

COMPOSITION OF EXPENDITURES

The indicated slackening in overall expenditure growth stems largely from expected lower rates of increase in capital outlays, principally for education and highways. Capital outlays for general functions, $18.6 billion in 1965, are projected to rise by only 43 percent in the next 10 years, as compared with a 95-percent increase in the previous decade. All other general expenditures are projected to rise at rates slightly under those of the 1955–65 decade to a level in 1975 more than twice that of 1965.

The overall projections also envisage some reduction in the rate of growth in State and local government employment and payrolls. Under the assumptions here, the number of full-time employees would rise from 6.9 million in 1965 to 9 million by 1975. If average earnings continue to grow as in the first half of the sixties, total payrolls would reach $76 billion by 1975, almost double those of 1965. The increase would compare with a 141-percent rise in the 1955–65 decade.

Revenue

In the postwar period the yields of all major revenue sources of State and local governments have increased substantially, more than matching expenditure gains. With the advent of new Federal grant-in-aid programs and liberalization of other programs, revenues from that source have exhibited the most resounding proportionate increases. Federal aids more than tripled in the last decade and accounted for almost one-fifth of the rise in all general revenues. State and locally imposed taxes, however, made up the lion's share of the increase.

Despite the record of extensive tax-raising measures throughout the postwar period, the overall tax structure of State and local governments has been quite stable. One of the most surprising developments was the resurgence of the property tax and its relative stability as a source of funds, in sharp contrast to the declining role of the tax over a long period of years up until the end of World War II.

The findings in this study indicate that general revenues in the next decade will rise somewhat more rapidly than general spending, without any increase in overall effective tax rates. Conservative estimates of the automatic response of taxes to rising incomes point to a 75-percent rise in yields from existing taxes in the decade ahead. Funds from present Federal grant-in-aid programs are estimated to rise to $30 billion by 1975, for a large but relatively lower rate of increase than has characterized the past decade. It is estimated that rates charged to users of specific State and local services will continue to grow proportionately with expenditures for the associated functions.

General revenues from all sources are projected at $146.9 billion in 1975, an increase of 98 percent for the decade. Table I–3 presents the projections, by major sources, with historical comparisons.

Table I–3.—*State and local general revenue, actual and projected, fiscal years 1955–75*

Source	Amount (billions)			Percent change	
	Actual		Projected 1975	1955–65	1965–75
	1955	1965			
Total, general revenue	$31.1	$74.3	$146.9	+139	+98
Total from State and local sources	27.9	63.3	116.9	+127	+85
Taxes	23.5	51.6	90.2	+120	+75
Current charges	3.0	8.4	18.8	+183	+124
Miscellaneous	1.5	3.3	7.8	+124	+134
From Federal grants	3.1	11.0	30.0	+252	+172

Source: Table VIII-13.

Overall Finances

General revenues are thus estimated to exceed general expenditures by about $5 billion in 1975. When account is taken of the still broader financial operations of State and local governments—for example, borrowing and debt servicing—the overall financial position is further strengthened. Table I–4 presents relevant data.

TABLE I-4.—*Source and use of major State and local government funds,*[1] *actual and projected, fiscal years 1965 and 1975*

[In billions]

	Actual, 1965	Projected, 1975
Source of funds:		
General revenue	$74.3	$146.9
Profit on liquor stores	.3	.3
New long-term borrowing	11.2	16.1
Other borrowing [2]	1.1	1.0
Total funds available	86.9	164.2
Use of funds:		
General expenditures	75.0	142.0
Long-term debt retirement	5.0	8.8
Employee retirement systems	1.8	3.0
Deficit on utility operations	1.0	.5
Additions to liquid assets	4.8	3.6
Total funds required	87.5	157.9
Funds available less funds required	−.6	+6.4

[1] Excludes transactions of social insurance systems. Utility and liquor store operations are entered on a net basis.
[2] Net increase in total debt outstanding minus difference between long-term debt issued and retired.

Source: Table IX-11.

If State and local units continue to borrow about one-half the amounts they spend for capital investment, as they have in recent years, total debt for all functions would rise from $100 billion in 1965 to $169 billion by 1975, an average of about $7 billion a year. This would represent a slackening in the relative growth rate in debt, as well as a decline in the outstanding volume of net long-term debt in relation to revenues from State and local sources (see table I-5).

TABLE I-5.—*Total debt and net long-term debt of State and local governments, actual and projected, fiscal years 1955–75* [1]

[Dollar amounts in billions]

Total	Actual		Projected 1975
	1955	1965	
Total debt outstanding	$44.3	$99.5	$169.4
Net long-term debt [2]	$38.5	$85.9	$145.1
As a percent of—			
State and local revenues from own sources [3]	126	126	115
Personal income	12	16	16

[1] Debt as of the end of fiscal years in comparison to revenue for fiscal years and personal income for calendar years.
[2] Total long-term debt less cash and securities held as debt offsets.
[3] General revenue from own sources plus utility revenue, since net long-term debt includes utility debt.

Source: Tables IX-7 and IX-9.

The projected surplus of available funds over those required suggests that, if receipts and outlays on current accounts materialize as indicated, State and local units may not be required to resort to borrowing from capital purposes to the same extent as in recent years, and that the levels of debt projected here may be overstated. On the other hand, the indicated levels of debt do not appear to exhaust the potential recourse to new debt financing if needed.

Indeed the outlook suggests that there will be room for greater discretion on the part of State and local officials in shaping taxation and debt policies—the opportunity to choose among alternative means of financing to perhaps a greater extent than ever before in the postwar period.

Assumptions and Methods

The detailed assumptions underlying these projections of State and local finance are spelled out in the study. In general, they envisage rates of economic growth and general prices similar to the experience of the first half of the 1960's, and no worsening of international tensions involving the United States. The projections are consistent with a rise of about 4 percent annually in real gross national product and an annual increase of 1.6 percent in general prices. Under the assumptions, current dollar gross national product would amount to $1.2 trillion by 1975, and per capita personal incomes would rise to $4,239, about 54 percent higher than in 1965.

The population projections assume that the birth rate will continue downward until 1967 and thereafter will gradually rise throughout the projection period. The estimates are based on the revised series C of the Bureau of the Census. Total population, according to this series, would rise by about 23.7 million during the next decade, from 194.6 million in 1965 to 218.3 million in 1975.

Expenditures are projected for the several functions by building up estimates of caseloads, unit costs, and prices, under legislative programs already in effect—or in a few instances where it is noted—on anticipatory legislative policy changes. It is a basic assumption that standards per service unit will advance in the future at the real rate of improvement experienced during the period 1960–65. Tax revenues are projected on the basis of the present tax structure; and the increases shown reflect gains accruing solely from expected future economic growth. Nontax revenues and revenues from Federal grants are based on projected expenditure levels for the several functions.

The implicit policy factors in these assumptions deserve emphasis. Unlike most elements of the projections, they cannot be viewed as fully automatic or built in.

On the expenditure side, the projected results would materialize only if current operating expenditures for improvements in the scope and quality of services—through both new and expanded programs—are introduced at rates comparable to those of the first half of the 1960's. (Rates of growth for capital spending are projected at somewhat less than in this period.) From 1960 through 1965 per capita operating expenditures, adjusted for the rise in consumer prices, rose by just over 5 percent per year. The projections are based on similar rates of improvement. Since the *per capita* growth rate associated with local school spending will be reduced through smaller future enrollment increases, the projections allow somewhat higher rates of improvement in nonschool functions than those of the early 1960's.[1]

[1] The concept of improvement is difficult to measure, because no satisfactory index of productivity of government outlays is available. It has been estimated that the quality and scope of State and local government services were improved at a rate close to 2 percent per year in the past decade; that is, about one-fifth of the total expenditure growth represented improvements, as distinct from sums added because of growing population, caseloads, prices, and costs. Selma J. Mushkin and Gabrielle C. Lupo, "Project '70, Projecting the State-Local Sector," advance manuscript to be published in *Review of Economics and Statistics*.

Whether these limits on spending can actually take effect is another question. The very appearance of financial surpluses may provide an irresistible temptation to spend the additional funds, rather than to reduce taxes or retire debt.

The key policy factors involved in the revenue projections are: (1) tax rates within separate jurisdictions and States will be flexible, rising or falling in accordance with projected spending; thus school district tax rates might decline, while municipal, county, or State tax rates would rise simultaneously, depending upon intergovernmental financing arrangements; (2) taxing officials will act to keep the legal base of property taxes—assessed valuation—adjusted proportionately to rising market values, as well as the schedule of user charges and fees rising at rates commensurate with those of the first half of the 1960's; and (3) there will be some further implementation of Federal grant-in-aid programs enacted through 1966, and grants for programs now in effect will by 1975 finance $30 billion of the projected direct State and local government outlays.

The year-by-year record of tax-raising legislation in the States over the past two decades does not suggest that an abrupt end to tax rate increases will occur. Thus higher tax revenues than those projected here under 1965 tax structures seem very likely to materialize.[2] Potential tax revenues, as opposed to yields under constant 1965 rates, could rise by an additional $8 billion a year by 1975 through the adoption of general sales and income taxes in the States not employing them in 1965. Further, the raising of effective tax rates to the highest levels (in relation to personal income) prevailing in any State in 1965 could bring in annual increases totaling more than $25 billion by 1975. There are, moreover, reasons to believe that Federal grants in the next decade will expand more rapidly than the rates projected here. Additional fiscal strength could no doubt result from improvements in State and local government organization and procedures; but no attempt has been made here to estimate the amount of such potential savings.

The actual course of economic events—as compared to the assumptions—will also have important bearing on the future of State and local government finance. Projected tax revenues, for instance, would be reduced by between $3 and $4 billion by a reduction of one-half of 1 percent in the assumed annual growth in personal income. Further, if prices rise by one percentage point per year more than assumed in this study, general expenditures would increase by an additional $15 billion a year by 1975,[3] but tax collections would rise by only $10 billion more. On the other hand, higher rates of economic growth and slower increases in prices and costs than those assumed here would further strengthen the financial position of State and local governments.

It should be reemphasized that the projections set forth in the study are in no sense predictions or a statement of future "needs," based on value judgments, and the assumptions do not constitute recommendations. The projections are rather a true statement of the

[2] In fact, the projections do not include a billion dollars or more which would result by 1975 from new taxes and higher rates already imposed in some localities since 1965.

[3] Moreover, if the rate of growth in prices experienced since the beginning of 1966 (3 percent annually) were to be substituted for the rise assumed here, general expenditures by 1975 would be $20 billion higher than projected.

levels of State and local government activity which would prevail in 1970 and 1975 if the assumptions prove accurate.

As is the case in any aggregative study involving national totals, the conclusions do not apply with equal validity to all States or to all of the more than 80,000 local taxing jurisdictions in the Nation.

II. BACKGROUND

The aim of this study is to set forth projections of the level of State and local government activity which will prevail in 1970 and 1975 under a specified set of assumptions. This is a very different sort of task from making predictions or from setting forth the amounts needed on the basis of some set of value judgments. It is thus a truism that if the underlying assumptions of this study materialize, the projections themselves will be completely accurate. If the results are to be meaningful, it becomes of great importance to employ assumptions which are as realistic as possible, based on present knowledge.

Further, the study is not designed to recommend improvements in government affairs—taxation, expenditure procedures, or administration—which could solve problems which may develop or which could lead to levels of operation conforming to the preferences of individual observers and their varying philosophical notions with respect to the role of government in a society.

It should also be made explicit that the emphasis is on overall national levels of activity, not individual government units. Since all of the component parts will not function precisely as the whole, the conclusions will not apply with equal validity to all areas.

This background section describes the approach and general methodology, the underlying assumptions, and the content and organization of the entire study.

The size of the State and local government sector of the economy by 1965 had reached a magnitude which even a decade earlier some observers had considered improbably high. At around $75 billion in fiscal 1965, general revenues and expenditures were more than four times their 1948 levels, having grown by an annual rate of about 9 percent over the 17-year period (table II–1). Expansion in the scale of operations prevailed throughout every major category of expenditures and every major revenue source.

Some of this growth was induced by circumstances largely outside the control of State and local units. Table II–2 illustrates some of the underlying demographic and economic forces. Included were: (1) an expansion of one-third in total population, accompanied by far greater rates of increase in subcomponents of the total for whom government costs tend to be high—young people of school age, elderly persons seeking public aid, and urban dwellers; (2) a more than doubling of vehicular traffic on the streets and highways, as measured by motor vehicle registrations; (3) construction costs rising by more than two-thirds; (4) consumer prices increasing almost one-third; (5) average salaries in the private sector doubling, as State-local rates of pay rose even more rapidly; and (6) rapidly rising income, tending to raise standards sought for government, as well as private, services. Added to those more or less external or environmental forces were numerous

policy decisions by public officials, creating new programs or raising the quality of services rendered under old programs.[1]

TABLE II-1.—*Selected measures of change in State and local government finance, fiscal year 1948 to 1965*

Series	Amount (millions)		Percentage change, 1948 to 1965	
	1948	1965	Total	Annual average [1]
General expenditures, total	$17,684	$74,954	+324	+8.9
Education	5,379	28,971	+438	+10.4
Highways	3,036	12,221	+303	+8.5
Public welfare	2,099	6,315	+201	+6.7
Health and hospitals	1,229	5,362	+336	+9.1
Police and fire	1,050	3,855	+267	+8.0
Sewerage and sanitation	670	2,360	+252	+7.7
Natural resources	496	1,730	+249	+7.6
Housing and urban renewal	176	1,250	+610	+12.2
General control and financial administration	880	2,773	+215	+7.0
Interest on general debt	399	2,490	+524	+11.4
All other	2,270	7,627	+236	+7.4
General revenues, total	17,250	74,341	+331	+9.0
From own sources, total	15,389	63,312	+311	+8.7
Taxes	13,342	51,578	+287	+8.3
Other general revenue	2,047	11,735	+473	+10.8
From Federal grants	1,861	11,029	+493	+11.0
Gross debt outstanding	18,656	99,512	+433	+10.3

[1] Initial to terminal year, compound interest formula.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations by Tax Foundation.

Few sources of available receipts were left untapped in supporting the extended financial requirements generated by such circumstances. While the existing revenue structure automatically produced additional funds as the economy expanded, the amounts so produced were not as large as the growth in spending, and other sources of funds were sought. New taxes were adopted, rates of existing taxes were repeatedly increased, and higher user charges and fees were put into effect. Thus from their own sources, State and local units provided $48 billion, 84 percent, of the $57 billion rise in the annual level of spending that took place between fiscal 1948 and 1965 (see table II-1). During the same interval, Federal grant-in-aid programs for State and local governments were enlarged substantially. As a result, Federal aid funds increased by $9 billion, making up the remaining 16 percent of the total addition to general revenue. Moreover, to pay for large capital outlays, not all of which are financed from general revenues, State and local units continued to borrow in amounts which added about 10 percent a year to their outstanding indebtedness. Their gross-debt at the end of fiscal 1965 approached the $100 billion level, over five times its size in 1948.

[1] Such policy changes do not lend themselves readily to summarization, but examples will be brought out in the sections of the text dealing with expenditures for specific functions.

TABLE II-2.—*Selected measures of demographic and economic change affecting State and local finance*

Measure	Percentage change, 1948 to 1965	
	Total	Annual average [1]
Total population	+33	+1.7
Elementary and secondary school age	+69	+3.2
Age 65 and over	+57	+2.7
Urban population [2]	+54	+2.6
Motor vehicle registrations [2]	+118	+4.7
Construction costs [3]	+68	+3.1
Consumer prices	+31	+1.6
Average annual salary per state-local employee	+121	+4.8
Average annual salary per employee in private industry	+104	+4.3
Personal income	+155	+5.7

[1] Initial to terminal year, compound interest formula.
[2] Partly estimated.
[3] American Appraisal Co. index, average of 30 cities.

Source: Computed from data published by the U.S. Department of Commerce, Bureau of the Census Office of Business Economics, and Bureau of Public Roads; and the U.S. Department of Labor, Bureau of Labor Statistics.

Still further perspective on the size and growth of the State-local sector can be gained through comparisons of the rates of growth in purchases of goods and service by the major sectors of the economy (table II-3). Between 1948 and 1965 State and local government purchases expanded more rapidly than those of any other major sector of the economy, except national defense.[2] The 9.4-percent annual rise in State-local government purchases may be compared with growth of 5.9 percent in gross national product, 5.5 percent in personal consumption expenditures, 5.1 percent in net business investment, and 8.6 percent in total Federal spending—but 6.4 percent in Federal nondefense expenditures.

What is the outlook for the State and local sector in the future?

TABLE II-3.—*Annual rates of change in purchases of goods and services by major sectors, calendar year, 1948-65*

Sector	*Annual percentage increase* [1]
All sectors [2]	5.9
Personal consumption expenditures	5.5
Gross private domestic investment	5.1
Net exports	.5
Government purchases, total	8.9
Federal	8.6
National defense	9.5
All other	6.4
State and local	9.4

[1] Initial to terminal year; compound interest formula.
[2] Equivalent to gross national product.

Source: Computed from data of the U.S. Department of Commerce, Office of Business Economics.

APPROACH

Taxing and spending decisions in State and local governments are intimately related, and are often made simultaneously. Property tax rates, for example, are typically set by local officials at the same

[2] The 9.5-percent annual increase in national defense outlays was only slightly in excess of the growth rate for State and local general spending.

time the expenditure budget is approved. Obviously some expenditure decisions lead to the necessity for subsequent tax increases if programs authorized are to be continued. Conversely, taxing decisions may influence the course of expenditures. Although the relationships are intertwined, the link between decisions to tax and to spend is dimmed somewhat by the availability of other revenues—notably intergovernmental payments and user charges and fees—and borrowed funds. Even so, the affinity between expenditures and available receipts from all sources is unmistakable.

The task of protecting State and local finances thus poses a dilemma at the outset. Is one to project the amount of tax and other funds which might be available, as limiting value for future expenditures, and then divide up the proceeds among competing functions? Or is one to project expenditure levels without regard to the manner in which they are to be financed?

A pragmatic solution is applied in this study. Tax revenues are projected on the basis of the present tax structure, assuming no new taxes and no increase in rates of existing taxes. Under this assumption, tax levels will be determined solely by future levels of real growth in the economy and in prices. Expenditures are projected, for each major function separately, without regard to the means of financing, by building up estimates of caseloads, unit costs, and prices, based on legislation already in effect—or in the few instances where it is so noted—on anticipatory legislative changes. Revenues from user charges and fees and from Federal grants are estimated on the basis of projected expenditure levels for the several functions.

Finally, the outlook for debt financing is considered to be a function of projected levels of capital expenditures. Estimates are then made for future borrowing levels, to round out the picture for total receipts. On the expenditure side, the projected levels of general expenditures are adjusted upward for additional financial requirements, such as increases in liquid assets commensurate with growth in debt and scale of operations.

Underlying Assumptions

In large measure the financial outlook for State and local governments will be responsive to the same set of circumstances and events which will influence the course of development of the general economy and the individual business concern. These determinants run the gamut of the natural, social, economic, and political elements—domestic and international. The fundamental assumption behind the projections of this study is that there will be no revolutionary changes in any of these forces by 1975 and that the pattern existing then will be more similar to that of the first half of the 1960's than to any other period in history.

In particular, the state of U.S. involvement in any international military conflicts is held constant at the 1965 level. Although no serious depression is assumed, the projections are consistent with alternating cyclical changes such as those which have characterized the postwar period.

GENERAL ECONOMY

The major economic assumptions underlying the projections are presented in table II–4, with comparative data for the postwar period. (The implicit annual rates of gain are shown in appendix table A–1.)

Under the assumptions, current dollar gross national product would rise to $902 billion by 1970 and to $1,178 billion by 1975, approximately 4 percent per year in real terms, with an assumed increment of 1.6 percent per year as a result of rising prices. The level of output results from the assumption that, with a slight increase in the labor force participation rate, the number seeking jobs in 1975 will increase by about 15.4 million in the decade ahead, that longrun reductions in the work week will continue at past rates, and that productivity (output per man-hour in constant dollars) will grow at 2.6 percent per year, compared with 1960–65 rates of 3.2 percent.[3] If these assumptions materialize, per capita personal income would increase from $2,750 in 1965 to $4,239 by 1975, about 54 percent.

TABLE II-4.—*Actual and projected levels of population and economic activity, selected years, 1948–75*

Series	Unit	Actual			Projected	
		1948	1960	1965	1970	1975
Total population as of July 1	Million	146.6	180.7	194.6	205.5	218.3
Population age 14 and over	do	108.6	127.3	138.3	150.1	162.9
Labor force participation rate	Percent	57.9	57.4	56.7	57.5	57.8
Labor force, annual average	Million	62.9	73.1	78.4	86.3	94.1
Armed forces	do	1.4	2.5	2.7	2.7	2.7
Civilian employment	do	59.1	66.6	72.2	79.7	87.2
Unemployment	do	2.3	3.9	3.5	3.9	4.2
Unemployment rate	Percent	3.8	5.6	4.5	4.5	4.5
Average weekly hours	Number	41.3	38.9	38.4	37.5	36.7
Productivity [1]	Dollar	2.724	3.875	4.549	5.170	5.868
Gross national product (in 1965 dollars)	Billion	358.8	541.1	681.2	830.6	1,006.8
Gross national product price deflator (1965=100).	Percent	71.8	93.2	100.0	108.6	117.0
Gross national product (in current dollars).	Billion	257.6	503.8	681.2	902.0	1,178.0
Personal income (in current dollars)	do	210.2	401.0	535.1	708.5	925.3
Personal income per capita (in current dollars).	Dollar	1,433	2,219	2,750	3,448	4,239

[1] Gross national income per man-hour, in 1965 dollars.

Source: Basic data from U.S. Department of Commerce and U.S. Department of Labor.

POPULATION

The numbers of persons State and local units are to serve will exert a significant influence on the general scale of government operations. Further, the age distribution has specific implications for some particular functional categories, such as education and welfare.

A factor of some consequence in the outlook for government services is the recent downward revision in the estimates of future population growth. The revised projections of the Bureau of the Census point to a population ranging from 214.1 to 227.5 million persons by 1975, as compared with the 1964 projections which ranged from 218.9 to 230.4 million for 1975. Among the four alternative series, reflecting differing levels of fertility, the new series C is used in this study, since it appears to conform closely to recent trends in the birth rate. This series assumes a continuation of the decline in birth rates (which began in 1957) until January 1, 1967, and thereafter a gradual increase

[3] This reduction in productivity is assumed on two bases: (1) the 1960–65 record was achieved through the fuller utilization of existing capacity, whereas the economy in 1965 was approaching a capacity level of operation; and (2) as more young people, born in the postwar period, enter the labor force relative to the experienced work force, the rate of growth in output per man-hour can be expected to diminish somewhat.

to 1975, back to a level approximately equal to that prevailing in 1965. The actual number of births would increase from 3.9 million a year in 1965 to 4.5 million a year by 1975. Total population, under projection C, will rise by about 23.7 million during the next decade, from 194.6 million in 1965 to 218.3 million in 1975.

When compared to the Census Bureau's earlier projections for 1975, the revised figures anticipate far greater reductions than appeared likely just 2 years ago. Table II–5 shows the projections in total and for selected age groups under the new series C in comparison with actual experience in the past decade and with earlier projections under the old series B, which have heretofore been the most widely accepted among the alternative estimates of future population. These projections disclose reductions in both the relative and absolute growth of total population, the school age population, and those 65 or older in the next decade, as compared to the 1955–65 period, but somewhat faster growth in the numbers of college age.

TABLE II–5.—*Population of selected age groups, actual and projected, 1955–75* [1]

Year and series	Total population	Elementary and secondary school age [2]	College age [3]	65 and over	Under 18
	Number in thousands				
Actual:					
1955	165,931	37,173	14,968	14,527	55,739
1965	194,583	50,006	20,186	18,156	70,440
Projected, 1975:					
New series C	218,263	51,666	27,537	21,160	72,321
Old series B	225,870	55,312	27,178	21,171	80,504
	Numerical change, selected intervals (thousands)				
1955–65	+28,652	+12,833	+5,218	+3,629	+14,701
1965–75:					
New series C	+23,680	+1,660	+7,351	+3,004	+1,881
Old series B	+31,287	+5,306	+6,992	+3,015	+10,064
	Percentage change, selected intervals				
1955–65	+17.3	+34.5	+34.9	+25.0	+26.8
1965–75:					
New series C	+12.2	+3.3	+36.4	+16.5	+2.7
Old series B	+16.1	+10.6	+34.6	+16.6	+14.3

[1] As of July 1. Except for total, and population aged 65 and over, numbers by age groups are estimated.
[2] Age 5–17.
[3] Age 18–24.

Source: U.S. Department of Commerce, Bureau of the Census, supplemented by Tax Foundation estimates.

Trends in other attributes of the population—mobility, urbanization, density, income and ethnic distribution, etc.—are assumed to continue to change at rates experienced over the past decade.

OTHER CONSIDERATIONS

The use of alternative assumptions as to the changes in population, prices, costs, general economic growth, and other factors would lead to an agglomeration of different projections more likely to confuse than to enlighten. For that reason, little use is made in this study of

the low-medium-high technique of presenting projections. Care has been taken throughout, however, to make the assumptions sufficiently explicit and detailed so that the observer who wishes to build his own set of projections can do so by plugging in alternatives for specific factors.

Content and Organization

Throughout the study, principal emphasis is on general revenues and general expenditures.[4] Section I of the study contains the summary of all sections, together with concluding observations. Sections III through VI deal almost exclusively with expenditures for major functional groupings. In particular, separate attention is devoted to education, welfare, health and hospitals, and highways, with a summary treatment of the remaining functions. In section VII expenditure projections are assembled for all functions, and some consistency checks are developed for employment, wages and capital outlays. Per capita expenditures for major functions, actual and projected, are compared with the 1948–61 computed trend. Section VIII reviews past trends in revenue and examines the outlook for future funds from State and local sources and from Federal aid. Finally, section IX presents projections of other financial magnitudes not included in general revenues and expenditures, and the outlook for debt financing, and discusses the potential adequacy of funds available in the light of projected expenditure levels.

In treating each major subject, an attempt is made to define the concept of activity under consideration, to analyze historical trends with a view to indentifying the underlying causal factors and gaining better perspective on future trends, and to present the assumptions behind the projections, along with the projections themselves. An attempt is made to strike a balance as between the inclusion of highly aggregative and overly detailed material. Background material of limited interest to the general reader, and detailed assumptions utilized in the study are contained in appendix A. Projections developed in other studies are summarized in appendix B.

VII. SUMMARY OF EXPENDITURE PROJECTIONS AND RELATED CONSIDERATIONS

Sections III through VI have given emphasis to education, public welfare, health and hospitals, and highways among all the functions of State and local governments. This preeminence reflects dual considerations—the absolute magnitude of expenditures for those functions and the presence of some elements which, in the future, will modify past trend patterns. In total, the four largest categories account for about 70 percent of general spending.

It is the aim of this section to bring together expenditure projections for all general categories of State and local services and to scrutinize them in relation to past expenditure trends, population, and other measures. To round out the totals for all general functions, projections for the remaining functions are first presented.

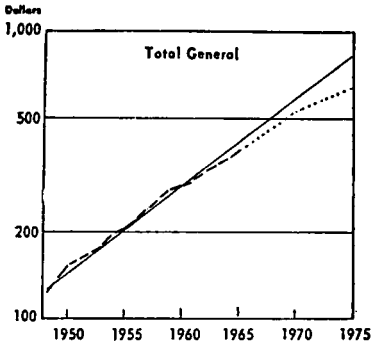
[4] The "general" classifications excludes finances of insurance trust systems, utilities (water, gas, and transit), and liquor store operations. For the most part these operations are self-financing and do not draw heavily upon general revenues. Attention is given in sec. IX to the portions of these operations which require partial support from general funds.

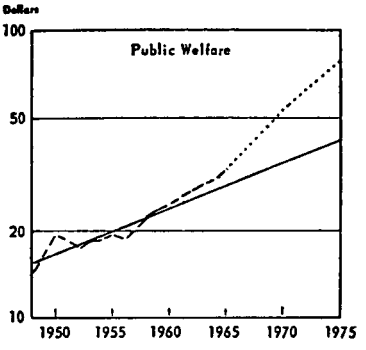
Miscellaneous General Expenditures

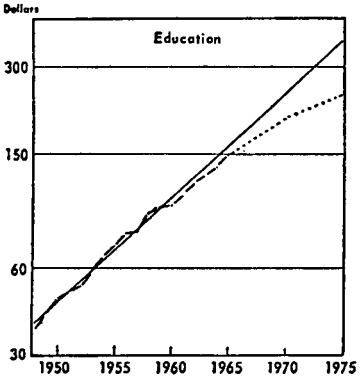
Other services provided by the States and localities cover a wide range of somewhat heterogeneous activities. A thorough examination of the factors behind the fluctuations in each category has not been undertaken. The underlying forces, however, are not dissimilar to those already reviewed under the major functional groupings. Since 1960 expenditures for these activities have grown at the annual rate of 7.7 percent per year, as compared to 9.5 percent annually in the preceding 5-year period. They have risen from 3.8 percent of personal income in 1960 to 4.2 percent in 1965.

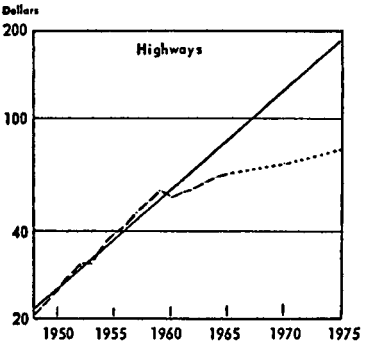
Estimates for the six separable classifications of these miscellaneous functions, and for the combination of all other functions, appear in table VII–1. Sizable growth is depicted in all categories in the decade ending in 1975, ranging from 72 percent for general control and financial administration to 121 percent for the diversity of activities comprising the large category of remaining services ("all other"). This latter classification includes local parks and recreation, natural resources, airports, water transport and terminals, parking facilities, correction, libraries, employment security administration, and general public buildings. Ranking next to this "all other" category in growth rate are interest on general debt and expenditures for housing and urban renewal, both projected at more than twice their 1965 level. Outlays for police and fire protection, the largest of the segregable categories in the miscellaneous group, would rise by 84 percent. A similar advance is projected for the sanitation and sewerage function. In all of these miscellaneous categories, the 1965–75 decade growth is shown to be less than that of the previous decade, but the rate is close to the actual experience in the first half of the 1960's.

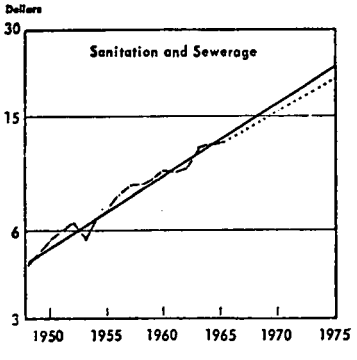
PER CAPITA GENERAL EXPENDITURES FOR
Actual and Projected,

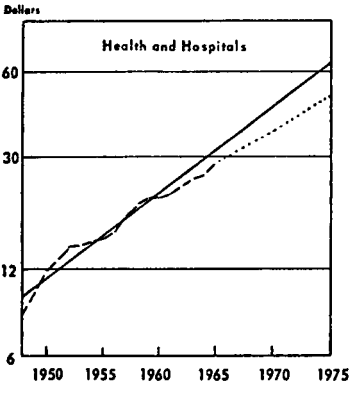






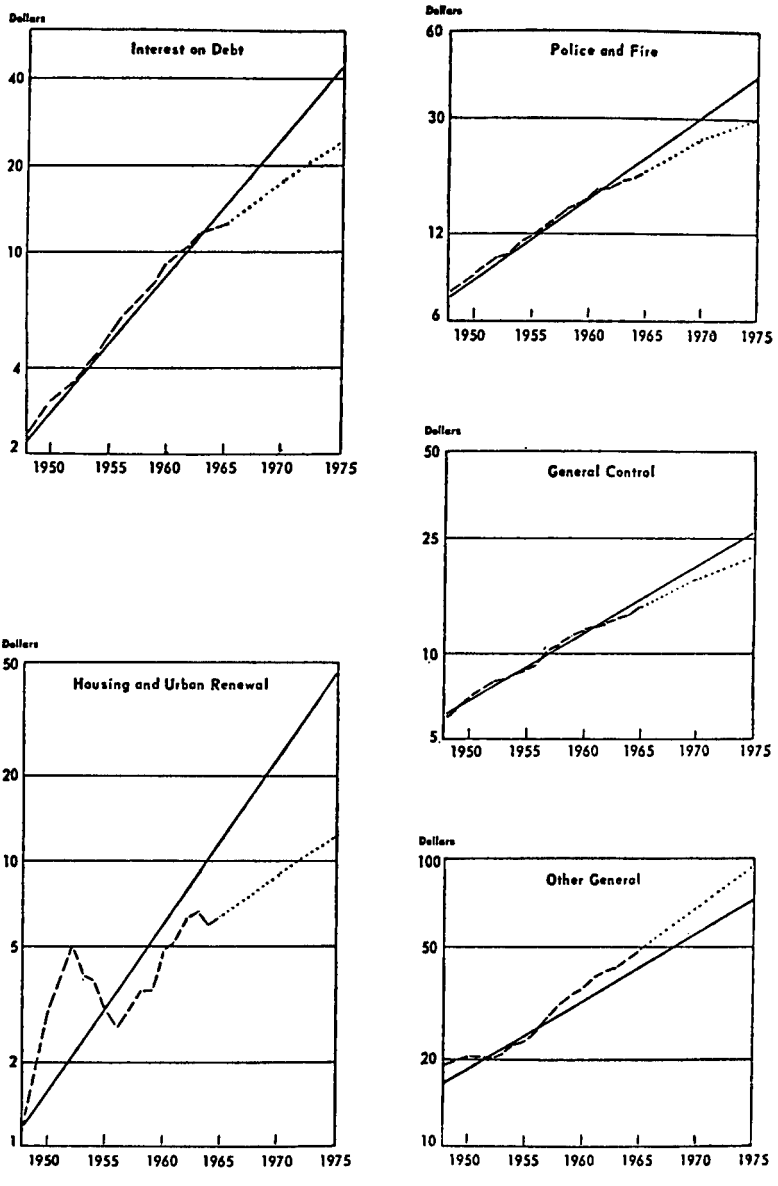






_____ Computed least-squares trend, 1948-1961. – – – – – Actual. - - - - - - - - Projected.

SELECTED STATE AND LOCAL FUNCTIONS
and 1948-1961 Trend



Ratio scales: Equal vertical distances represent equal percentage changes

TABLE VII-1.—*Detail of State and local general expenditures for miscellaneous functions* [1]—*Actual and projected, selected fiscal years, 1950–75*

Fiscal year	Function					
	Police and fire	General control [2]	Interest on general debt	Sanitation and sewerage	Housing and urban renewal	All other [3]
	Amount (millions)					
Actual:						
1950	$1,264	$1,041	$458	$834	$452	$3,070
1955	1,923	1,452	838	1,142	499	3,819
1960	2,850	2,113	1,670	1,727	858	6,313
1965	3,855	2,773	2,490	2,360	1,250	9,358
Projected:						
1970	5,274	3,667	3,688	3,254	1,824	14,221
1975	7,072	4,767	5,304	4,398	2,586	20,706
	Percentage change, selected intervals					
1950–55	+52.1	+39.5	+83.0	+36.9	+10.4	+24.4
1955–60	+48.2	+45.5	+99.3	+51.2	+71.9	+65.3
1960–65	+35.3	+31.2	+49.1	+36.7	+45.7	+48.2
1965–70	+36.8	+32.2	+48.1	+37.9	+45.9	+52.0
1970–75	+34.1	+30.0	+43.8	+35.2	+41.8	+45.6
1955–65	+100.5	+91.0	+197.1	+106.7	+150.5	+145.0
1965–75	+83.5	+71.9	+113.0	+86.4	+106.9	+121.3
	Annual rates of change, selected intervals					
1950–55	+8.8	+6.9	+12.8	+6.5	+2.0	+4.5
1955–60	+8.2	+7.8	+14.8	+8.6	+11.4	+10.6
1960–65	+6.2	+5.6	+8.3	+6.5	+7.8	+8.2
1965–70	+6.5	+5.7	+8.2	+6.6	+7.9	+8.7
1970–75	+6.1	+5.4	+7.5	+6.2	+7.2	+7.8
1955–65	+7.2	+6.6	+11.5	+7.5	+9.6	+9.4
1965–75	+6.3	+5.6	+7.7	+6.4	+7.5	+8.3

[1] Totals appear in last column of table VII-2.
[2] Includes financial administration.
[3] Excludes education, highways, public welfare, and health and hospitals.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations and projections by Tax Foundation.

EXPENDITURES FOR ALL GENERAL FUNCTIONS

The overall outlook for expenditures emerges in table VII-2, which summarizes the projections by major functions, with comparative historical trends. Under the assumptions underlying this study, State and local general expenditures would rise from $75 billion in fiscal 1965 to $142 billion in 1975. The broad pattern sketched by the projections is that of continued high growth in State and local government outlays, but at a relative pace more nearly consistent with that of the first half of the 1960's than with the faster rate recorded in earlier postwar years. For the 1965–75 decade, the indicated rise is 89 percent; in the previous decade, spending increased 123 percent. In dollars and cents, however, the projected increment for the next decade far overshadows the advance in the previous 10 years. The estimated 1975 outlays are $67 billion above 1965, in comparison with the $41 billion rise from 1955 to 1965.

TABLE VII-2.—*Summary of State and local general expenditures by major function—Actual and projected, selected fiscal years, 1950–75*

Fiscal year	Total general	Major function				
		Education	Highways	Public welfare	Health and hospitals	All other [1]
	Amount (millions)					
Actual:						
1950	$22,787	$7,177	$3,803	$2,940	$1,748	$7,119
1955	33,724	11,907	6,452	3,168	2,524	9,673
1960	51,876	18,719	9,428	4,404	3,794	15,531
1965	74,954	28,971	12,221	6,315	5,361	22,086
Projected:						
1970	105,882	41,499	14,069	10,861	7,525	31,928
1975	141,984	52,944	16,567	17,070	10,570	44,833
	Percentage change, selected intervals					
1950–55	+48.0	+65.9	+69.7	+7.8	+44.4	+35.9
1955–60	+53.8	+57.2	+46.1	+39.0	+50.3	+60.6
1960–65	+44.5	+54.8	+29.6	+43.4	+41.3	+42.2
1965–70	+41.3	+43.2	+15.1	+72.0	+40.4	+44.6
1970–75	+34.1	+27.6	+17.8	+57.2	+40.5	+40.4
1955–65	+122.6	+143.8	+89.4	+99.3	+112.4	+128.3
1965–75	+89.4	+82.7	+35.6	+170.3	+97.2	+103.0
	Annual rates of change, selected intervals					
1950–55	+8.2	+10.7	+11.2	+1.5	+7.6	+6.3
1955–60	+9.0	+9.5	+7.9	+6.8	+8.5	+9.9
1960–65	+7.6	+9.1	+5.3	+7.5	+7.2	+7.3
1965–70	+7.2	+7.4	+2.9	+11.5	+7.0	+7.7
1970–75	+6.0	+5.0	+3.3	+9.5	+7.0	+7.0
1955–65	+8.3	+9.3	+6.6	+7.1	+7.8	+8.6
1965–75	+6.6	+6.2	+3.1	+10.5	+7.0	+7.3

[1] See detail in table VII-1.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations and projections by Tax Foundation.

FUNCTIONAL SHIFTS

Some reallocation of funds among the major functions is foretold in the projections, as the rates of increase for the largest spending areas—education and highways—slacken significantly from previous experience in the postwar period, and the larger rates of gain occur in the remaining functions. The most dynamic growth areas for the next decade appear to be public welfare, health and hospitals, and miscellaneous general functions. As before, however, education will continue to call for the largest dollar increases (36 percent of the total rise in the next 10 years).

The results of the differential growth rates among the major functions are reflected in the functional distribution of general expenditures (table VII-3).

TABLE VII-3.—*Functional distribution of State and local general expenditures' actual and projected, selected fiscal years, 1955–75*

Function	Percent of total		
	Actual		Projected, 1975
	1955	1965	
Total general	100.00	100.00	100.00
Education	35.31	39.65	37.29
Highways	19.13	16.30	11.74
Public welfare	9.39	8.42	12.02
Health and hospitals	7.48	7.15	7.44
Police and fire	5.70	5.14	4.98
General control [1]	4.30	3.70	3.36
Interest on general debt	2.48	3.22	3.74
Sanitation and sewerage	3.39	3.15	3.10
Housing and urban renewal	1.48	1.67	1.82
Other general	11.32	12.48	14.58

[1] Includes financial administration.

Source: Computed from data in table VII-2.

RELATION TO INCOME

It has been noted that State and local expenditures are sensitive to changes in personal income. Table VII-4 directs attention to the relationship between expenditures and income. From 1955 to 1965 State-local general outlays rose from $112 to $145 per $1,000 of personal income. The 1975 projections of expenditures amount to $157.50 per $1,000 of the assumed levels of personal income. All major functions except two—highways and general control (including financial administration)—would continue to rise at rates slightly faster than personal income, although at a slower comparative pace than in the past.

TABLE VII-4.—*State and local general expenditures for selected functions in relation to personal income, actual and projected, selected fiscal years, 1955–75*

Function	Expenditures per $1,000 of personal income		
	Actual		Projected 1975
	1955	1965	
Total general	$112.22	$145.40	$157.50
Education	39.62	56.20	58.73
Highways	21.47	23.71	18.39
Public welfare	10.54	12.25	18.94
Health and hospitals	8.40	10.40	11.72
Police and fire	6.40	7.48	7.84
General control [1]	4.83	5.38	5.29
Interest on general debt	2.79	4.83	5.88
Sanitation and sewerage	3.80	4.58	4.88
Housing and urban renewal	1.66	2.42	2.87
Other general	12.71	18.15	22.97

[1] Includes financial administration.

Source: Computed from data in tables II-4, VII-1, and VII-2.

PER CAPITA CHANGES

In the preliminary stages of work on this study, some experimental least-squares trend computations were made for per capita general expenditures, by selected function, for the fiscal years 1948 through 1961. The results indicated, in retrospect, that the "best guess" for per capita expenditure growth in any fiscal year during that 14-year period would have been 7.3 percent per capita, about 10 percent for total spending. It is of some interest to compare the actual course of expenditures since 1961, and the projections developed in this study, with the estimates suggested by a mechanical extension of the computed trends.

Table VII–5 and the accompanying charts bring out these comparisons. The 1975 trend extensions portray per capita expenditures by 1975 of $841, over one-fourth higher than the $655 per capita derived by the more detailed methods followed in this study. For eight of the spending categories studied, the earlier trend computations point to 1975 activity levels far higher than now appear likely. In the remaining categories—public welfare and miscellaneous general—the trend levels appear understated by large amounts, according to the assumptions of the present study.

TABLE VII–5.—*Trends in per capita general expenditures by function, 1948–61 trend projected to 1975 (fiscal years)*

Function	Computed trend [1]		Amount per capita			
	1948 level (amount per capita)	Annual rate of increase (percent)	Indicated by 1948-61 trend		Actual, 1965	In this 1975 projected study
			1965	1975		
Total general	$125.5	7.3	$415.8	$841.1	$387.4	$654.6
Education	38.6	8.8	161.8	376.1	149.7	244.1
Highways	21.6	8.2	82.5	181.4	63.2	76.4
Public welfare	15.3	3.7	28.4	41.0	32.6	78.7
Health and hospitals	9.6	7.2	31.4	62.9	27.7	48.7
Police and fire	7.4	6.7	22.3	42.6	19.9	32.6
General control [2]	6.1	5.6	15.4	26.6	14.3	22.0
Interest on general debt	2.4	11.3	15.1	44.1	12.9	24.4
Sanitation and sewerage	4.7	6.1	12.9	23.4	12.2	20.3
Housing and urban renewal	1.2	14.5	11.8	45.7	6.5	11.9
Other general	16.6	6.0	44.8	72.5	48.4	95.5

[1] Trend equations are of the simple exponential type derived by the least-squares method. Computations were based on logarithms but for simplicity the results here are presented as antilogarithms.
[2] Includes financial administration.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census, Computations and projections by Tax Foundation.

As the charts reveal, reductions in the rate of growth began to become apparent by the early 1960's, earlier for some functions. Further declines in these rates for most functions are projected for the years following 1965.

OBJECT OF EXPENDITURE

The indicated slackening in overall expenditure growth stems largely from the projected slowing of growth in capital outlays, principally for education and highways. For all other spending, the shift in the future trend pattern is far less pronounced. Table VII–6 presents past

and projected capital outlays for all government functions, general and other.[1] The dollar and percentage changes over selected periods for current and capital expenditure separately are shown in table VII–7. Current operating costs are projected to rise by 105 percent and capital costs by only 43 percent in the decade ending in 1975.

TABLE VII–6.—*Capital outlay of State and local governments for all functions, actual and projected, selected fiscal years, 1955–75*

Fiscal year	Capital outlay		
	Total	General	Utility
	Amount (millions)		
Actual:			
1955	$10,706	$9,544	$1,162
1960	15,104	13,697	1,407
1955	20,771	18,581	2,190
Projected:			
1970	26,131	22,683	3,448
1975	31,568	26,502	5,066
	Percentage change, selected intervals		
1955 to 1960	+41.1	+43.5	+21.1
1960 to 1965	+37.5	+35.7	+55.6
1965 to 1970	+25.8	+22.1	+57.4
1970 to 1975	+20.8	+16.8	+46.9
1955 to 1965	+94.0	+94.7	+88.5
1965 to 1975	+52.0	+42.6	+131.3

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations and projections by Tax Foundation.

TABLE VII–7.—*Changes in current versus capital expenditure for State and local general functions, actual and projected, selected intervals, 1955–75*

Interval	Current operations [1]		Capital outlays	
	Amount (millions)	Percent	Amount (millions)	Percent
1955–60	+$13,999	+57.9	+$4,153	+43.5
1960–65	+18,194	+47.7	+4,884	+35.7
1965–70	+26,826	+47.6	+4,102	+22.1
1970–75	+32,283	+38.8	+3,819	+16.8
1955–65	+32,193	+133.1	+9,037	+94.7
1965–75	+59,109	+104.9	+7,921	+42.6

[1] Includes all general expenditures except capital.

Source: Computed from data in tables VII–2 and VII–6.

Still another dimension of the revised growth pattern is reflected by a conversion of the dollar expenditure projections into implicit levels of employment and payrolls. (See table VII–8.) The number of employees of State and local units, according to these projections, would rise from 6.9 million in 1965 to 9 million in 1975, or 31 percent, as compared to the 55-percent increase in the 1955–65 decade.[2] If rates of increase in average earnings conform to the 1960–65 experience

[1] Utility spending is included in the totals shown in table VII–6. Althought utilities fall outside the scope of the present discussion, they are relevant to overall financing arrangements, discussed in sec. IX.

[2] These estimates cover employees in general and other State-local functions.

(4.2 percent per year, in current prices) total annual wages and salaries would reach $76 billion by 1975, about 98 percent above 1965—far less than the 141-percent rise in the previous 10 years.

TABLE VII-8.—*Employment and payrolls of State and local governments* [1]—*Actual and projected, selected calendar years, 1950–75*

Calendar year	Number of full-time equivalent employees (thousands)	Average annual earnings per employee	Total wages and salaries (millions)
	Number or amount		
Actual:			
1950	3,722	$2,786	$10,368
1955	4,443	3,599	15,992
1960	5,530	4,550	25,162
1965	6,878	5,592	38,465
Projected:			
1970	8,116	6,872	55,774
1975	9,000	8,447	76,020
	Percentage change, selected intervals		
1950–55	+19.4	+29.2	+54.2
1955–60	+24.5	+26.4	+57.3
1960–65	+24.4	+22.9	+52.9
1965–70	+18.0	+22.9	+45.0
1970–75	+10.9	+22.9	+36.3
1955–65	+54.8	+55.4	+140.5
1965–75	+30.9	+51.1	+97.6

[1] Includes all functions—general and other.

Source: Actual data from U.S. Department of Commerce, Office of Business Economics. Computations and projections by Tax Foundation.

VIII. GENERAL REVENUES

For the most part the preceding sections have dealt with questions associated with spending—how much has been spent, and for which functions, what factors have played a leading role in shaping postwar trends, and what the outlook is under the conditions assumed. This section will explore related questions on the revenue side: How were funds raised to support spending increases? What sources of revenue contributed the largest amounts? What is the outlook for future receipts?

A broad view of postwar trends in general revenue sources is given in table VIII-1. General revenues in 1965 were 4.3 times their size in 1948. The increase corresponded closely to the expenditure gain.[1] All major revenue sources helped to augment the total—State and local taxes, current charges and fees, nontax revenues, and Federal grants-in-aid. Throughout the period State and locally imposed taxes remained by far the major source of funds. Their fraction of the total, however, declined perceptibly in the postwar period—from 77 percent in 1948 to 69 percent in 1965, as the other major sources grew in importance. Charges and other nontax revenues from State and local sources rose from 12 to 16 percent of total general revenues, and Federal grants climbed at a similar pace—from 11 to 15 percent.

[1] Not all general expenditures are financed from current revenues. See sec. IX for a discussion of other financing arrangements.

TABLE VIII-1.—*General revenue of State and local governments by major source, selected fiscal years, 1948–65*

Fiscal year	Total-all sources	From own sources			From Federal grants
		Total-own sources	Taxes	Other [1]	
	Amount (millions)				
1948	$17,250	$15,389	$13,342	$2,047	$1,861
1950	20,911	18,425	15,914	2,511	2,486
1955	31,073	27,942	23,483	4,459	3,131
1960	50,504	43,530	36,117	7,414	6,974
1965	74,341	63,312	51,578	11,735	11,029
	Percent of total				
1948	100	89.2	77.3	11.9	10.8
1950	100	88.1	76.1	12.0	11.9
1955	100	89.9	75.6	14.4	10.1
1960	100	86.2	71.5	14.7	13.8
1965	100	85.2	69.4	15.8	14.8

[1] Charges and fees and miscellaneous.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations by Tax Foundation.

The allocation of the revenue-raising responsibility as between the States and their political subdivisions has remained almost unchanged in the period since 1948. Table VIII-2 presents relevant data. Local governments raised $32.7 billion from local sources in 1965, and State governments $30.6 billion from their sources. The increase in yields over the 17-year period was 315 percent for local revenues and 307 percent for State revenues. Further, there has been no major change in the degree of dependence of local governments on State aid during the postwar period. State aids have continued to furnish about 29 percent of total general revenues of local governments. In State budgets, however, there was a slight decline in the portions turned over to local governments, as the States spent proportionately more of their total revenues (including receipts from Federal aids) directly for their own purposes.

TABLE VIII-2.—*State versus local general revenues from own sources, selected fiscal years, 1948–65*

[In millions of dollars]

Fiscal year	General revenue from own resources		Local revenue from State aid [1]		
	State	Local	Amount	Percent of local revenue [2]	Percent of State revenue [2]
1948	7,517	7,872	3,283	28.9	35.5
1950	8,839	9,586	4,217	30.1	37.4
1955	13,205	14,737	5,987	28.4	37.0
1960	20,618	22,912	9,522	28.8	34.8
1965	30,610	32,703	14,077	29.4	34.4

[1] Includes amounts initially received by States from Federal Government and turned over by States to local governments.

[2] Percentages apply to local revenue from State aid in relation to total general revenue (from own sources plus intergovernmental receipts.)

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations by Tax Foundation.

The outlook for future general revenues can best be explored through separate analysis of the three major components: State and locally imposed taxes, charges, fees, and other miscellaneous revenues, and Federal grants-in-aid.

State and Local Taxes

In the period from 1948 to 1965, annual State and local tax yields rose from $13.3 to $51.6 billion, or by 8.3 percent per year on the average, just slightly under the 8.9 percent annual growth in general expenditures. Table VIII-3 indicates how the major types of taxes contributed to the overall advance. In contrast to the very large change in the total tax yields, there was a remarkable degree of stability in the relative shares of the several types of taxes.

Table VIII-3.—*Yields of major State and local taxes by type of tax, selected fiscal years, 1948–65*

Fiscal year	Type of tax				
	Individual income	Corporate income	Sales [1]	Property	All other
	Amount (millions)				
1948	$543	$592	$4,442	$6,126	$1,638
1950	788	593	5,154	7,349	2,030
1955	1,237	744	7,643	10,735	3,125
1960	2,463	1,180	11,849	16,405	4,220
1965	4,090	1,929	17,118	22,918	5,521
	Percent of total [2]				
1948	4.1	4.4	33.3	45.9	12.3
1950	5.0	3.7	32.4	46.2	12.8
1955	5.3	3.2	32.5	45.7	13.3
1960	6.8	3.3	32.8	45.4	11.7
1965	7.9	3.7	33.2	44.4	10.7

[1] General and selective. In 1965 general sales tax yields were over $7,981,000,000, and selective, $9,136,000,000. This breakdown is not available for years prior to 1952.
[2] Total tax yields appear in table VIII-1.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations by Tax Foundation.

Property taxes, though declining slightly in their fraction of all taxes (from 46 to 44 percent of the total), remained the largest source of tax funds and provided a greater portion of the 1948–65 increase than any other tax. In view of the previous longrun decline in the importance of the property tax as a revenue source, the resurgence of the tax, represented by its relative stability as a fraction of total tax revenues, was one of the most surprising developments in State and local finance in the postwar period.[2]

General and selective sales taxes contributed a rather stable 33 percent of the total. The only significant gain in relative importance among tax sources was registered in individual income tax yields, which grew from 4 percent to almost 8 percent of total taxes over the 17-year period. Corporate income and miscellaneous taxes accordingly declined somewhat in their share of the total.

[2] At the turn of the century the property tax contributed 82 percent of all State and local general revenues.

Increases in tax collections far outstripped concurrent gains in population and personal income (table VIII–4). Per capita State and local taxes rose from $92 in 1948 to $267 in 1965, or 190 percent. Per $1,000 of personal income, tax yields increased from $66 in 1948 to $100 in 1965, more than 50 percent. From one year to another, the changes for each major tax were highly variable in relation to changes in personal income (table VIII–5). Taking every year in the interim from 1953 through 1964 into consideration, total tax yields each year increased by more than the corresponding rise in income. For every 5-percent increase in income, tax collections rose by percentages ranging from 5.75 to 8.95. In half the years the annual tax increments were above 6.85 percent for a 5-percent income rise. As exhibited in table VIII–5, the several types of taxes did not respond with equal vigor, year by year, to changes in personal income. Corporate and personal income tax fluctuations were quite volatile in relation to income; sales and property taxes were less sensitive.

TABLE VIII–4.—*State and local tax collections in relation to population and income,*[1] *selected fiscal years, 1948–65*

Fiscal year	Tax collections	
	Per capita [2]	Per $1,000 of personal income
1948	$91.77	$66.46
1950	105.78	73.21
1955	142.68	78.14
1960	201.34	92.08
1965	266.58	100.05

[1] Excludes social insurance taxes.
[2] Based on estimated total population, including Armed Forces abroad, at the middle of the fiscal year.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census and Office of Business Economics. Computations by tax foundation.

TABLE VIII–5.—*Sensitivity of State-local revenues from own sources to changes in personal income, fiscal years 1953–65*

Revenue source	Sensitivity coefficient [1]		
	Low year	High year	Median year
Total revenue, own sources	1.21	2.09	1.47
Total taxes	1.15	1.79	1.37
Individual income	.07	3.41	2.25
Corporation income	[2] −1.51	2.75	1.69
General sales	.98	2.36	1.51
Selective sales	.82	2.04	1.27
Property	.96	2.29	1.32
Other taxes	[2] −.15	2.27	1.21
Charges and miscellaneous	1.17	4.05	1.91

[1] Average annual change in revenue per 1 percent change in personal income. Revenues are not adjusted for tax rate and base changes.
[2] Tax yield declined as personal income rose.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census and Office of Business Economics. Computations by Tax Foundation.

A longer range view of the performance of the major State and local taxes in relation to personal income is given in table VIII-6. Overall, the effective rate in relation to income increased 51 percent in the period from 1948 to 1965. For the largest tax sources, property and sales, effective rates advanced 46 and 51 percent, respectively. The sharpest rise occurred for individual income—with a rate hike of almost 200 percent.

TABLE VIII-6.—*Yields of major State and local taxes in relation to personal income, fiscal years 1948 and 1965*

Tax	Tax yields per $1,000 of personal income		
	1948	1965	Percent change, 1955-65 [1]
Total taxes	$66.46	$100.05	+51.3
Individual income	2.70	7.97	+195.2
Corporate income	2.95	3.76	+27.5
Sales [2]	22.13	33.37	+50.8
Property	30.52	44.68	+46.4
All other	8.16	10.76	+31.9

[1] Represents change in tax yields adjusted for income change.
[2] General and selective. In 1965 the breakdown was as follows: general, $15.56, and selective, $17.81.

Source: Basic data from U.S. Department, Bureau of the Census and Office of Business Economics. Computations by Tax Foundation.

The postwar pattern of growth in tax collections, and the year-to-year fluctuations described above, came about through a combination of forces: (1) extensive legislative changes in the types of taxes imposed, their bases, and rate structures; (2) automatic swelling of tax revenues from the structure of taxes and rates in effect at the beginning of the period, as a result of growth in the taxable base; and (3) revisions in procedures for administering and collecting taxes, including changes in timing, such as the introduction of current withholding. Little information of a comprehensive sort is available to measure the effect on yields of the third factor—changes in administrative procedures. On the whole, it is probably correct to assume that there were improvements in these methods which in time have served to raise the amounts obtained from a given tax structure. The first two forces are, however, of overriding importance in explaining the postwar performance of State and local tax systems. Each deserves consideration—policy changes versus automatic or "built-in" factors.

TAX LEGISLATION

The financial surpluses which had developed in State and local budgets during World War II disappeared rapidly as spending pressures mounted in the postwar period.[3] Since that time, the State governments—and to some extent local units—have adopted new taxes, and have repeatedly raised the rates of taxes already in effect.

[3] State and local total current revenues were well in excess of expenditures throughout the period from 1940 through 1946. The resultant surpluses served to reduce outstanding debt from $20.3 billion at the end of 1940 to $15.9 billion at the end of 1946. *Facts and Figures on Government Finance, 1964–65, Tax Foundation,* New York, 1965, p. 131.

The volume of tax-raising legislation was typically uneven from year to year, with peaks recurring during the last year of a 4-year interval.[4] Thus in 1947, 1951, 1955, 1959, and 1963 a very large amount of tax legislation took place. Partly in response to these changes, tax collections rose sharply in years following the legislation.

New Taxes. In the period since 1946, there have been 46 adoptions among the States of one of the six major taxes (table VIII–7). Most frequently, legislative decisions showed a preference for general sales taxes; but new cigarette taxes were levied almost as often. Eighteen States have levied new sales taxes in the postwar period, 16 have adopted taxes on cigarettes, and all States not taxing gasoline and distilled spirits at the end of the war had decided to do so by 1966. In contrast to the widespread adoption of general sales taxes, now imposed in all but eight States, income taxes have been levied far less frequently. There have been only three adoptions of individual income taxes and five of corporation income taxes in the entire postwar period. As of 1966, 17 States were without a comprehensive personal income tax and 13 without the corporate income tax.

To relieve the pressure on property taxation, there were also in the postwar period some adoptions of nonproperty taxes by local governments, particularly sales and income taxes. Prior to World War II, sales taxes were imposed by only two major cities, New York City and New Orleans.[5] After the war a local sales tax movement began in California and spread to localities in other States, especially Illinois, Mississippi, and Utah. By 1964, sales taxes were being levied by over 2,000 local governments in 14 States, and six of the 15 largest cities in the United States imposed a sales tax.[6]

TABLE VIII–7.—*Dates of adoption of major State taxes*

Tax	Number of States adopting tax			States using tax, 1966
	Before 1931	1931–46 [1]	1947–66	
Income:				
Individual	15	15	3	[2] 33
Corporation	17	15	5	37
General sales	0	24	18	42
Selective sales:				
Gasoline	48	1	1	50
Cigarette	8	25	16	49
Distilled spirits	0	30	3	[3] 33

[1] Most of these adoptions occurred during the 1930's; from 1941 through 1946 the only adoptions of major State taxes were: cigarette taxes in 6 States; and distilled spirits and gasoline taxes in 1 State.
[2] Excludes 3 States in which only a very limited portion of income is taxed.
[3] In the 17 remaining States, liquor stores are owned and operated by State or local government; some impose excises in addition to the profit markup.
Source: Advisory Commission on Intergovernmental Relations and Tax Foundation records.

[4] This phenomenon, first revealed in a 1958 Tax Foundation study, has been predictably regular. See *The Financial Challenge to the States,* Tax Foundations, March 1958, p. 19.
[5] *Tax Overlapping in the United States, 1964,* Advisory Commission on Intergovernmental Relations, Washington, July 1964, p. 107.
[6] New York, Chicago, Los Angeles, Washington, D.C., San Francisco, and New Orleans. Since 1964, there have been further adoptions, notably in many localities in New York and Virginia. *Ibid.,* updated by Tax Foundation records.

Local income taxes, though not as widespread as local sales taxes, are also for the most part a postwar development. Local income taxes are levied to some extent in seven States and the District of Columbia. The most intensive use of the tax occurs in Pennsylvania, where several thousand local units, including schools districts, levy the tax—and in Ohio, where it is imposed by 85 municipalities. In both instances, the extensive use of local income taxes occurred in the postwar period. Eleven of the cities with population over 300,000 use this tax as a source of revenue.[7]

The record of rate increases in State taxes is far longer (table VIII-8) than that of new tax adoptions.[8] Tobacco and alcoholic products were the most frequent targets for increased rates, but general sales and motor fuels were not far behind. There appeared to be somewhat more reluctance to raise personal and corporate income tax rates. Rate reductions, in contrast, were almost inconsequential. The effect of these revisions on the rates for general sales, cigarette, and motor fuels taxes is shown in Table VIII-9. The most prevalent rate for general sales taxes rose from 2 to 3 percent; for cigarettes from 3 to 8 cents per pack; and for motor fuels from 4 to 7 cents a gallon.The highest rates in effect in any State were similarly extended. It is of interest to note that in the case of each of these three taxes the maximum rate in effect in 1948 had become by 1965 the most popular rate in effect, with 20 or more of the states taxing at that rate.

TABLE VIII-8.—*Number of States changing rates of major State taxes in postwar period*

[Selected periods, 1950-65]

Tax	1946-50	1951-55	1956-60	1961-65 [1]
Number increasing rates:				
Individual income	11	10	12	16
Corporate income	11	11	8	9
General sales	4	8	12	19
Motor fuels	24	25	16	17
Cigarette and tobacco	19	21	32	39
Alcoholic beverages	24	16	17	28
Number reducing rates:				
Individual income	3	4	1	1
Corporate income	1	2	2	1
General sales	0	1	2	0
Motor fuels	0	3	1	1
Cigarette and tobacco	1	1	2	0
Alcoholic beverages	0	4	0	1

[1] Includes changes up to September 1965.

Source: Tobacco Foundation publications and records.

[7] Detroit, Philadelphia, Pittsburgh, St. Louis, Kansas City (Missouri), Cincinnati, Columbus, Toledo, Louisville, New York City, and Washington, D.C.

[8] No record of legislative changes in the bases of specific taxes is available.

TABLE VIII-9.—*Trends in rates of selected State taxes, 1948–65*

Year	General sales	Cigarettes (per pack)	Motor fuels (per gallon)
Rate:	*Percent*	*Cents*	*Cents*
Modal rate:			
1948	2	3	4
1965	3	8	7
Maximum rate:			
1948	3	8	7
1965	5	11	11
Number of States levying at modal rate:			
1948	19	18	20
1965	20	20	24

Source: Tax Foundation records.

A full record of changes inproperty tax rates over the postwar period is not available. The rise in the effective rate of property taxes in relation to income (table VIII-6) suggests that on the average property tax rates were raised almost 50 percent in the postwar period.

Altogether these policy decisions—new taxes and rate increases—accounted for approximately half of the rise in tax collections from 1948 to 1965—for about $19 billion a year of the actual $38 billion annual increase in total state and local collections.

Automatic Response to Income. The search for a tenable relationship between changes in tax yields and some measure of income has occupied the attention of economists for some years. The standard technique for estimating yields from a given tax at a specified rate is the income elasticity of the tax, usually defined as the percentage change in tax yield per 1-percent change in income.[9] Early studies of this relationship identified income taxes as being highly sensitive to income change (highly elastic); general sales taxes as responding in proportion to income change (having unit elasticity); and selective sales taxes on such items as cigarettes, motor fuels, and alcoholic beverages as relative unresponsive to income change (relatively inelastic).[10]

The empirical results derived from such studies conform to established theoretical views. As personal income rises, both the tax base—taxable income as defined under existing laws—and the effective rate of the tax rise more rapidly. The faster rise in taxable income is due to the fact that exemptions, in the form of flat amounts per person, tend to rise more slowly in conformity to population growth; hence more personal income moves into the taxable base. Since most States have some degree of graduation in their rate scales, the effective rate of the tax

[9] Elasticity is sometimes measured in relation to gross national product, but personal income is usually the income concept utilized in State studies, because of its availability on a State basis. Elasticity may be computed in several ways. One which may provide interesting by-product information is that of dividing the marginal yield per unit of income in a given period by the average yield-income ratio in the previous period.

$$e=\frac{T_1-T_0}{T_0}\Big/\frac{Y_1-Y_0}{Y_0}=\frac{T_1-T_0}{Y_1-Y_0}\Big/\frac{T_0}{Y_0}$$

where e=elasticity or percent change in yield per 1 percent change in income; T=tax yield; Y=personal income, and the subscripts indicate given year (1) and base year (0). It is obvious that as the marginal yield-income ratio rises in relation to the initial average yield-income ratio, the elasticity increases. In other words, as long as the marginal yield-income ratio exceeds the average, the elasticity of the tax will be greater than 1. Similarly, the larger the average yield of a tax in relation to income, the less the elasticity coefficient of a given marginal ratio.

[10] See, for instance, Harold M. Groves and C. Harry Khan, "The Stability of State and Local Tax Yields," *American Economic Review*, vol. XLII, No. 2 (March 1952), pp. 87–102.

also tends to move upward over time as the income distribution shifts upward and more taxpayers move into higher taxable brackets.

General sales taxes, levied at a fixed percentage, tend to increase in relation to personal income because the taxable base (comodities and, to an increasing degree, some services constituting personal consumption expenditures) tends to grow in step with personal income. The coverage of a particular State tax, nature of the exemptions, etc., will cause some variations in the elasticity from state to state. On the other hand, selective excise taxes, typically levied at a specific rate for a fixed unit (e.g., cigarette taxes at 8 cents per package) will not rise as rapidly as the dollar volume of sales of the commodity taxed, or as personal income.

One of the most controversial areas in studies of income elasticity of taxes has involved the property tax. To a large extent, the dispute stems from ambiguous concepts of the taxable base. The nominal or legal base of the tax is assessed valuation of taxable property. The economic base, however, is the market value of taxable property. The actual response of tax *yields* in relation to income change depends upon the two bases—market value of property and assessed values—and the nominal rate, and the two bases do not necessarily rise in unison. Early studies examined the response of assessment values to income change and found low elasticity coefficients.[11] This result was attributed in part to lags in assessment practices of getting new property on the rolls and keeping properties on the rolls reassessed in accordance with market values.

More recent studies have emphasized the responsiveness of the economic base of the property tax to income change, and have held that this is the most relevant measure for measuring the influence of economic change on property tax revenues.[12] It has also been found that in the postwar period there has been an increase in the elasticity of the market values of taxable property in relation to income, and that the elasticity coefficient has been close to 1.0.[13] This postwar performance of the tax base is attributed to an increase in the capital-output ratio in the general economy, with the interruption in this period of the previous longrun decline in the relationship of national wealth to gross national product.

It is the latter concept of elasticity which is utilized in this study. The projections presented below reflect property tax yields at present rates of the tax in relation to marketable property values. Since it is assumed that the economic base of the tax will rise almost as rapidly as income, the resulting revenues—levied as a percentage of value—would increase proportionately. Realization of the results indicated thus requires that assessment practices will keep the legal base adjusted in step with changes in market values.

PROJECTIONS

As a guide to the projection of tax yields from the major sources in the next decade, the empirical evidence available from the other studies was supplemented by research on the performance of State

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[11] *Ibid.*, p. 90.

[12] For a thorough analysis of the property tax, and a detailed discussion of elasticity studies, see Dick Netzer, *Economics of the Property Tax*, The Brookings Institution, Washington, 1966. Elasticity measures are discussed on pp. 184–190.

[13] *Ibid.*, p. 187.

taxes in the period since 1959. To eliminate the effects of changes in tax structures, only those States were included in which there were no changes in the particular tax analyzed. The results are shown in table VIII–10, along with the results from other investigations, and the coefficients used in the projections. In general, the answers obtained were similar to those reported by others. One exception, however, was the extremely volatile response of the corporation income tax, and the high elasticity recorded during the 1959–64 period for the 17 States in which no changes in corporate tax rates occurred.[14]

TABLE VIII–10.—*Personal income elasticity of major State and local taxes* [1]

Tax	Range in other studies [2]	This study	
		Actual 1959–64 [3]	Projected, 1965–75
Individual income	1.5–1.8	1.67	1.7
Corporate income	1.1–1.3	1.71	1.2
Property	.7–1.1		.9
General sales	.9–1.05	1.19	1.1
Motor fuels	.4–.6	.76	.6
Tobacco	.3–.4	.71	.5
Alcoholic beverages	.4–.6	.53	.5
Other selective sales	.9–1.1		1.0
Motor vehicle licenses	.2–.4		.3
All other	.6–1.2		1.0

[1] Percent change in tax yield per 1 percent change in personal income.
[2] These are gross national product, rather than personal income, elasticities, as derived in more than a dozen studies. See Federal-State Coordination of Personal Income Taxes, Advisory Commission on Intergovernmental Relations, Washington, October 1965, p. 42, for a list of authors.
[3] Computations for each tax based on income and State tax yields in only those States where no legislative changes took place in the tax rate or base.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census and Office of Business Economics. Computations by Tax Foundation.

Although there is now a consensus as to the range of elasticity measures for each of the major taxes, there are disparities from year to year and State to State in actual yields in relation to income.[15]

Since the aim of the projections here is to reveal the amounts that existing tax systems would yield in the next decade, with no change in tax rates, the future estimates of yields depend solely upon present yields by type of tax, the assumed growth in income, and the responsiveness of each tax to income change.[16] With some adjustments suggested by other research, the elasticity coefficients derived from the period 1959–64 have been used in this study (table VIII–10). The results, presented in table VIII–11, indicate total tax revenues of $69.6 billion in 1970 and $90.2 billion in 1975. The advance for the decade would be 75 percent, as compared to 120 percent in the previous decade. The amounts and fractions of the total increase may be compared with the present distribution of revenues among the major taxes in table VIII–3. While sales and property taxes would contribute about two-thirds of the total increment in the next decade, the share of income taxes would continue to rise in overall importance.

[14] In part, this phenomenon is associated with the timing problem noted earlier. Since corporate profits rose rapidly in this period, lags in collections beyond the fiscal year in which profits accrued could easily lead to the high elasticities reported.
[15] Some of these disparities reflect timing differences—a change in the timing of the receipt of personal income and the collection of the tax. Others are undoubtedly associated with collection procedures.
[16] The 1965 yields were adjusted for new sales taxes added in 1966, and for increases in tax rates during 1965 which were not reflected in collections data for fiscal 1965.

TABLE VIII-11.—*State and local tax collections by type of tax* [1]—*Actual and projected, selected fiscal years, 1965–75*

[In millions]

Type of tax	Collections			Increase in collections, 1965–75	
	Actual, 1965	Projected		Amount	Percent of total increase
		1970	1975		
Taxes, total	$51,578	$69,589	$90,218	$38,640	100.0
Individual income	4,090	6,303	9,524	5,434	14.1
Corporation income	1,929	2,679	3,662	1,733	4.5
Property	22,918	29,610	37,753	14,835	38.4
Sales and gross receipts, total	17,118	21,883	27,902	10,784	27.9
General	7,981	10,822	14,469	6,488	16.8
Selective, total	9,136	11,061	13,433	4,297	11.1
Motor fuel	4,331	5,206	6,200	1,869	4.8
Tobacco	1,386	1,604	1,841	455	1.2
Alcoholic beverage	949	1,112	1,292	343	.9
Other	2,471	3,139	4,100	1,629	4.2
Motor vehicle and operators' licenses	2,145	2,353	2,569	424	1.1
All other	3,376	4,470	5,838	2,462	6.4
Additions since 1965 [2]	----------	2,291	2,970	2,970	7.7

[1] Excludes social insurance collections.
[2] For State taxes only, includes rate changes and new taxes adopted in 1965; and new taxes only in 1966.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations and projections by Tax Foundation.

CHARGES AND FEES AND MISCELLANEOUS GENERAL REVENUE

As previously noted, charges and fees and miscellaneous general revenues have constituted a rising portion of State and local general revenues. In 1965, receipts of this nature made up 16 percent of general revenues.

The major services for which charges are made to users fall in the categories of education, highways, hospitals, housing and urban renewal, and sanitation. Table VIII-12 presents data on 1955–65 trends in the amounts of charges and fees, by function, together with the portions of associated expenditures which emanated from this source. For most functions it is clear that users of specific services paid increasingly larger fractions of the associated costs.

TABLE VIII–12.—*State and local revenues from charges and fees, by major function—Selected fiscal years, 1955–65*

Fiscal year	Total, all functions	Education	Highways	Hospitals	Housing and urban renewal	All other [1]
	Amount (millions)					
1955	$2,927	$939	$274	$453	$269	$1,037
1960	5,319	1,769	568	883	339	1,760
1965	8,402	3,193	[2] 700	1,372	458	2,679
	Percent of expenditures for associated function					
1955	8.8	7.9	4.2	22.1	53.9	8.1
1960	10.3	9.4	6.0	27.3	39.5	9.0
1965	11.2	11.0	6.0	30.3	36.6	9.5

[1] Estimated. Data are available for toll facilities only.
[2] The largest sources of charges and fees not shown separately here are sanitation and nonhighway transportation.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations by Tax Foundation.

The projections (table VIII–14) assume continued increases in the share of spending supported by user charges for major functions, as in the period since 1960. For miscellaneous general revenues, the estimates assume a continutaion of comparative growth rates in relation to personal income as in the 1960–65 period.

FEDERAL GRANTS-IN-AID

Federal grants have increased in importance in State-local general revenues in the postwar period. In 1948, they totaled about $1.9 billion, 11 percent of State and local general revenues. By 1965 they had reached $11 billion, almost 15 percent of all revenues (table VIII–1). Total grants in selected years beginning in 1950, and their functional distribution, are shown in table VIII–13. State and local government activities which have received especially large portions of their total support from the Federal Government are public welfare, highways, and housing and urban renewal.

TABLE VIII–13.—*State and local revenues from Federal grants, by major function, selected fiscal years, 1950–65*

Fiscal year	Total, all functions	Education	Highways	Public welfare	Housing and urban renewal	Health and hospitals	Other
	Amount (millions)						
Actual:							
1950	$2,371	$369	$429	$1,131	(1)	(1)	$442
1955	3,099	521	589	1,429	(1)	$73	487
1960	6,994	950	2,905	2,070	$226	135	708
1965	11,062	1,677	3,977	3,098	676	292	1,342
	Percent of State-local expenditures for aided function						
1950	10.0	5.1	11.3	38.5	(1)	(1)	4.9
1955	9.2	4.4	9.1	45.1	(1)	2.9	6.1
1960	13.5	5.1	30.8	47.0	26.3	3.6	4.8
1965	14.8	5.8	32.7	49.1	54.1	5.4	6.3

[1] Not available; included in "other."

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations by Tax Foundation.

Federal aid programs have been discussed in the foregoing sections on expenditures, especially under education, public welfare, health and hospitals, and highways. No attempt has been made, however, to catalog and evaluate separately the trends in all the varied programs in effect. The projections (table VIII–14) represent middle-of-the-road estimates based on legislation for the most part already in effect.[17] According to some observers, these projections are lower than the levels which can reasonably be expected to result from existing programs. The future magnitude of Federal grants is of course uncertain. Actual amounts will depend in part upon domestic and international political factors not now foreseeable. It has been estimated that the adoption and implementation of the Great Society program in full would add increases of over $3 billion annually to Federal expenditures (largely grants-in-aid) above the built-in increases of similar size which automatically would occur under existing programs.[18] In that case, Federal grants by 1975 would be in the neighborhood of $45 billion. Other estimates run as high as $60 billion.[19]

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[17] One exception is that it has been assumed that the Federal Government will extend its sharing under title XIX programs for the medically indigent to all able-bodied persons aged 18 through 64.

[18] Gerhard Colm and Peter Wagner, *Federal Budget Projections,* The Brookings Institution, Washington, D.C., 1966, p. 12.

[19] In hearings before the Senate Government Operations Committee's Subcommittee on Intergovernmental Relations, Senator Edmund S. Muskie indicated that Federal grants-in-aid are expected to reach $60 billion annually by 1975, four times the present figure. *Washington News,* Tax Foundation, Nov. 25, 1966, p. 2.

TABLE VIII-14.—*Summary of State and local general revenue by major function, actual and projected, selected fiscal years, 1950–75*

Fiscal year	Total general revenue	General revenue from own sources				Federal grants-in-aid
		Total	Taxes	Current charges	Miscellaneous general revenue	
	Amount (millions)					
Actual:						
1950	$20,911	$18,425	$15,914	(1)	(1)	$2,486
1955	31,073	27,942	23,482	$2,972	$1,487	3,131
1960	50,504	43,530	36,117	5,319	2,095	6,974
1965	74,341	63,312	51,578	8,402	3,333	11,029
Projected:						
1970	108,603	88,292	69,589	13,557	5,146	20,311
1975	146,865	116,855	90,218	18,846	7,791	30,010
	Percentage change, selected intervals					
1950 to 1955	+48.6	+51.6	+47.6	----------	----------	+25.9
1955 to 1960	+62.5	+55.8	+53.8	+79.0	+40.9	+122.7
1960 to 1965	+47.2	+45.4	+42.8	+58.0	+59.1	+58.1
1965 to 1970	+46.1	+39.4	+34.9	+61.4	+54.4	+84.2
1970 to 1975	+35.2	+32.4	+29.6	+39.0	+51.4	+47.8
1955 to 1965	+139.2	+126.6	+119.6	+182.7	+124.1	+252.2
1965 to 1975	+97.6	+84.6	+74.9	+124.3	+133.8	+172.1
	Annual rates of change, selected intervals					
1950 to 1955	+8.3	+8.7	+8.1	----------	----------	+4.7
1955 to 1960	+10.2	+9.3	+9.0	+12.3	+7.1	+17.4
1960 to 1965	+8.1	+7.8	+7.4	+9.6	+9.7	+9.6
1965 to 1970	+7.9	+6.9	+6.2	+10.0	+9.1	+13.0
1970 to 1975	+6.2	+5.8	+5.3	+6.8	+8.6	+8.1
1955 to 1965	+9.1	+8.5	+8.2	+11.0	+8.4	+13.4
1965 to 1975	+7.1	+6.3	+5.7	+8.4	+8.9	+10.5

[1] Detail not available. Total for current charges and miscellaneous general revenue was $2,511,000,000

Source: Basic data from U.S. Department of Commerce, Bureau of the Census. Computations and projections by Tax Foundation.

The projections presented here, as well as the related expenditure levels previously discussed, do not take full account of Federal grants which may be funneled through State or local governments, but which seem likely to raise State-local direct outlays without requiring more non-Federal funds. According to the assumptions, these Federal aids would reach $30 billion by 1975, an increase of 172 percent in the next decade, as compared to a 252 percent rise in the 1955–65 period.

The future estimates assume some decline in the portion of State and local highway outlays financed through Federal aid, a rise in the Federal share of welfare spending, some liberalization of the recently enacted education measures which would raise the Federal Government's share of the total education bill somewhat, and an approximate tripling of the fraction of Federal aid going to miscellaneous or presently unclassifiable functions.

SUMMARY

Responding to several major influences, State and local revenues in the postwar period rose somewhat faster than general expenditures. Taxes, the mainstay of State and local revenue systems, financed the largest part of the rise, but their share in general revenues declined

somewhat with the fivefold expansion in Federal grants and the sizable increase in charges imposed upon users of specific services sold by State and local units. About half of the increase in tax revenues was due to decisions by State and local officials to impose new taxes or raise the rates of old taxes. The remaining half represented the automatic response of tax yields to expanding economic growth.

Projections of future revenues, based on the present system of taxes and rates, indicate that general revenues will rise from $74.3 billion in 1965 by 98 percent to $146.9 billion in 1975. The projected rise is smaller proportionately than that of the previous decade (139 percent) largely because the tax projections do not include the effect of any future tax rate increases and Federal grants are assumed to grow at a less rapid rate in the decade ahead than in the 1955–65 period.

IX. OVERALL FINANCES

Comparison of the general revenue and expenditure projections developed in preceding sections indicates that, under the conditions assumed, aggregate revenues will grow somewhat more rapidly than spending in the decade ahead, without an increase in tax rates. Table IX–1 presents data on the state of balance on general State and local transactions as projected, with past comparisons. Revenues are estimated to exceed expenditures by $2.7 billion in 1970 and $4.9 billion in 1975.

TABLE IX–1.—*Comparison of State and local general revenues and general expenditures, actual and projected, selected fiscal years, 1950–75*

[In millions]

Fiscal year	General revenue	General expenditures	Deficit (−) or surplus (+) on general transactions
Actual:			
1950	20,911	22,787	−1,876
1955	33,724	31,073	+2,651
1960	50,504	51,876	−1,372
1965	74,341	74,954	−613
Projected:			
1970	108,603	105,882	+2,721
1975	146,865	141,984	+4,881

Source: Tables VII-1 and VIII-14.

For several reasons, it is necessary to delve further into the financial operations of State and local governments before evaluating the adequacy of funds for financing general functions. The main factors are: (1) not all general spending is financed on a pay-as-you-go basis, and the outlook for debt transactions must be examined; (2) State and local governments can be expected to increase their holdings of liquid assets both as offsets to debt and as working capital, as their scale of operations expands; and (3) general revenues (and/or borrowing) pay for some activities not covered under general expenditures.

This section will explore the broader outlook for State and local finance, taking into account fund requirements in addition to those for general expenditures. Particular attention will be given the largest of these sources of demand for added funds—debt transactions.

Debt Transactions

Gross debt of State and local governments more than quadrupled in the period from 1950 to 1965, and approached the $100 billion level as 1965 ended (table IX–2). What is the outlook for the next decade?

Table IX–2.—*Gross outstanding debt of State and local governments* [1]—*Selected periods, 1950–65*

Year [2]	Total debt outstanding	Long term			Short term
		Total	Full faith and credit	Non-guaranteed	
	Amount (millions)				
1950	$24,115	$23,056	$19,779	$3,275	$1,060
1955	44,267	42,272	30,539	11,733	1,995
1960	69,955	66,801	41,650	25,151	3,154
1965	99,512	94,204	56,417	37,786	5,309
	Percent of total				
1950	100.0	95.6	82.0	13.6	4.4
1955	100.0	95.5	69.0	26.5	4.5
1960	100.0	95.5	59.5	36.0	4.5
1965	100.0	94.7	56.7	38.0	5.3

[1] Data represent debt for all functions, general and nongeneral.
[2] End of fiscal years.

Source: Basic data from U.S. Department of Commerce, Bureau of the Census, Computations by Tax Foundation.

There are no universally accepted answers to questions concerning the propriety or sustainability of a given level of debt. For States and political subdivisions, the level of general obligation debt is limited by constitutional or statutory provisions. Other borrowing, however, is not so restricted and has been resorted to with increasing frequency in the postwar period. Nonguaranteed debt has risen significantly in proportion to total debt, from 13.6 percent in 1950 to 38 in 1965 (table IX–2). For practical purposes, it would thus appear that the existing strictures setting maximum limits to general obligation debt do not serve as a realistic guide to the future course of total debt.

Most borrowing of State and local units is for the purpose of financing capital expenditures. There are strong traditions against incurring long-term debt to pay current operating bills, and the practice is often forbidden by law. The future demand for credit on the part of the States and localities may thus be expected to reflect prevailing judgments by those who make the decisions as to the need for capital funds measured against the cost of carrying credit.[1]

[1] Research by Michael D. Tanzer lends support to the widely held notion that the volume of new debt issues for all State and local governments is negatively correlated with the interest rate and positively associated with capital expenditures. He found the interest to be considerably more pronounced for State issues, however, than for local. For States, his findings, for the period 1953 through 1960, also reveal that the volume of new debt financing was inversely related to the lagged stock of liquid assets. Michael D. Tanzer, "State and Local Government Debt in the Postwar Period," *The Review of Economics and Statistics*, vol. XLVI, No. 3 (August 1964), pp. 237–244.

COST OF CREDIT

Forces largely outside the control of these governments determine the supply of loanable funds in the capital market and the terms and conditions under which they may be available to borrowers at large. State and local government bonds (so-called municipals) in general receive a preferential rate in the market because of their tax exempt status under the Federal income tax.[2] Despite the combination of a rising level of borrowing during the postwar period and great diversity in the concentration of debt, there appears to have been no significant deterioration in the quality of new offerings in general, at least up to 1960. Research by Roland I. Robinson, based on an analysis of new offerings in the postwar period up to 1960, indicated that Moody's ratings for these securities were about as high near the end of the decade as at the beginning.[3]

No similar analysis of new security offerings is available since 1960. It is clear, however, that State and local bonds have maintained a favorable interest differential in relation to U.S. Government and corporation bonds (table IX–3).

TABLE IX–3.—*Government and corporate bond yields,*[1] *calendar years 1960–66*

[Percent per year]

Year	Government bonds		Corporate bonds
	State and local	United States (long-term)	
1960	3.69	4.01	4.73
1961	3.60	3.90	4.66
1962	3.30	3.95	4.61
1963	3.28	4.15	4.57
1964	3.28	4.15	4.57
1965	3.34	4.21	4.64
1966 [2]	3.84	4.63	5.28

[1] Annual yields are averages of monthly or quarterly data Monthly yields are computed as follows: State and local bonds, general obligations only, based on Thursday figures; U.S. Government bonds, averages of daily figures for bonds maturing or callable in 10 years or more.
[2] Month of June 1966.

Source: Board of Governors of the Federal Reserve System.

Another criterion in evaluating the cost of credit is the annual interest cost which must be paid from State and local funds—both in relation to total personal income (one measure of ability to "afford" credit) and to total State-local budgets. As the data in table IX–4 reveal, interest costs have moved upward in both respects in the postwar period. The $2.5 billion annual interest costs in 1965 amounted to $4.65 per $1,000 of personal income, compared to $1.90 in 1948; and to 2.86 percent of total State-local expenditures, up from 1.88 percent in 1948. In relation to both income and total expenditures, however, the cost was substantially lower than in 1940, despite rising per capita costs.

[2] For particular units, financial position is also an important factor in the cost of credit, as witnessed by the spread in prices of bond issues according to investment service ratings. As of June 1966, yields were 3.60 percent on State and local bonds rated Aaa as compared to 4.16 percent for Baa bonds. *Federal Reserve Bulletin*, July 1966, p. 1010.

[3] Roland I. Robinson, *Postwar Market for State and Local Government Securities*, a Study by the National Bureau of Economic Research, Princeton University Press, 1960, p. 65. The author does not attribute this phenomenon to an improvement in general State and local credit, however, but to the fact that government units with the highest credit ratings borrowed infrequently in the early postwar years but entered the market more frequently toward the end of the decade.

TABLE IX-4.—*Selected measures of the cost of interest on State-local debt,*[1] *selected fiscal years, 1940–65*

Year	Amount			Percent of State-local total expenditures
	Total (millions)	Per capita [2]	Per $1,000 of personal income [3]	
1940	$653	$4.94	$8.34	5.81
1948	399	2.72	1.90	1.88
1950	458	3.02	2.01	1.64
1955	838	5.07	2.70	2.08
1960	1,670	9.24	4.16	2.74
1965	2,490	12.80	4.65	2.86

[1] Includes interest on all debt, general and utility.
[2] Based on population at the middle of the fiscal year.
[3] Based on personal income during the calendar year.

Source: U.S. Department of Commerce, Bureau of the Census.

CAPITAL OUTLAYS AND DEBT FINANCING

Capital outlays of State and local units rose virtually without interruption from $7.4 billion in 1952 to $20.8 billion in 1965. Annual averages in the first half of the 1960's of $18.1 billion were approximately twice those of the early 1950's.

Table IX-5 indicates the extent to which borrowing financed these outlays, as well as the major functions giving rise to security offerings. Since 1955, slightly more than half of all capital outlays have been financed through borrowing. Earlier in the 1950's, the portion exceeded three-fifths.[4] As indicated in table IX-5, the major broad functions for which debt is occurred are education, utilities (water and sewer, etc.), roads and bridges, and housing.

TABLE IX-5.—*Proceeds of new issues of State and local securities, by purpose, and capital outlays, annual averages, selected periods, 1952–65*

[Dollar figures in millions]

Purpose	Average per year		
	1952–55	1956–60	1961–65
NEW SECURITY PROCEEDS			
New capital, total	$5,568	$6,907	$9,371
Education	1,309	2,264	3,165
Roads and bridges	1,506	950	936
Utilities	899	1,526	2,023
Housing	489	290	571
Veterans' aid	143	268	155
Other purposes	1,222	1,610	2,522
Refunding, total	135	70	644
CAPITAL EXPENDITURES			
Total, all functions	8,793	13,693	18,137
New security issues as a percent of capital expenditures	63.3	50.4	51.7

Source: Basic data from Board of Governors of the Federal Reserve System and U.S. Department of Commerce, Bureau of the Census. Computations by Tax Foundation.

[4] The reduction reflects the declining role of borrowed funds in financing roads and bridges, following the system of extended Federal highway grants in 1956.

PROJECTIONS

Given the demand for borrowed funds on the part of State and local governments, and in the absence of undue stringency in the capital markets, there is no indication on the horizon to suggest that the market will not absorb high-grade State-local securities by amounts growing proportionately with the income from State and local sources. Since new borrowing is closely related to the volume of capital expenditures, it appears reasonable to assume that the demand for new long-term credit will depend upon future capital outlays. Based on relationships existing in the first half of the 1960's, and projected capital outlays, long-term borrowing for new capital (excluding refunding) would rise from $10.5 billion in 1965 to $12.7 billion in 1970 and $15.5 billion in 1975 (table IX–6).

TABLE IX–6.—*Capital outlays and proceeds of new State and local security issues,*[1] *actual and projected, selected fiscal years, 1960–75*

Year	Amount (millions) all functions		Percentage of capital outlays financed by borrowing			
	Capital outlay	Security issues(1)	All functions	Education	Highways	Other
Actual:						
1960	$15,104	$7,247	48.0	65.3	15.9	75.5
1961	16,071	8,463	52.6	73.2	18.0	77.7
1962	16,791	8,568	51.0	73.9	16.0	77.8
1963	17,946	9,151	51.0	74.5	10.8	83.8
1964	19,087	10,201	53.4	74.2	8.6	93.4
1965	20,771	10,471	50.4	71.5	10.8	80.6
Projected: [2]						
1970	26,131	12,652	48.4	73.4	12.6	82.8
1975	31,568	15,536	49.2	73.4	12.6	82.8

[1] Excludes refunding issues.
[2] Projections assume new security proceeds will finance the same portion of capital outlays for major functions as in the average year for the period 1961–65.

Source: Capital outlays from table VII–6; new security issues from Board of Governors of the Federal Reserve System. Computations and projections by Tax Foundation.

The implications of the foregoing assumptions on total debt outstanding are shown in table IX–7. Total debt would rise from $99.5 billion in 1965 to $169.4 billion by 1975, or by an average of about $7 billion a year. Data in this table are based on the assumed continuation of recent practices with respect to long-term debt retirement, refinancing, the use of short-term borrowing, and the holding of funds as long-term debt offsets, as well as the borrowing-capital expenditure relationship. (Further attention will be given to these practices, and the corresponding fund requirements, in the following section.)

TABLE IX-7.—*Debt transactions of State and local governments, actual and projected, selected fiscal years, 1950–75* [1]

[In millions of dollars]

Period	Total debt outstanding	Long-term debt			Net long-term debt [4]
		Outstanding	Issued [2]	Retired [3]	
Actual:					
1955	$44,267	$42,272	$7,221	$2,351	$38,502
1960	69,955	66,801	7,955	3,458	61,596
1965	99,512	94,204	11,249	5,040	85,942
Projected:					
1970	132,257	124,668	13,124	6,851	113,691
1975	169,352	159,126	16,116	8,759	145,070

[1] Outstanding debt as of the end of the fiscal year.
[2] Includes refunding issues.
[3] Includes refinancing.
[4] Total long-term debt less cash and securities held as debt offsets.

Source: Actual data from U.S. Department of Commerce, Bureau of the Census. Projections by Tax Foundation.

Net long-term debt (long-term debt minus assets held as offsets) would thus rise from $85.9 billion in 1965 to $145.1 billion by 1975. Although average annual growth would continue to mount in actual size (from $4.9 billion in the 1960–65 period to $6.3 billion in the years 1970–75) the relative growth rate would slacken. This pattern reflects an extension of trends that have been underway since the midfifties (table IX-8). Under these assumptions, the size of the net debt would decline somewhat in relation both to the revenues from State-local sources and to personal income (table IX-9).

TABLE IX-8.—*Changes in net long term debt of State and local governments, actual and projected, selected intervals, 1940–75* [1]

Interval	Average annual increase	
	Amount (millions)	Percent
Actual:		
1940–50	$266	1.5
1950–55	3,731	14.2
1955–60	4,619	9.8
1960–65	4,866	6.8
Projected:		
1965–70	5,553	5.7
1970–75	6,276	4.9

[1] Computations based on debt outstanding at the end of fiscal years.

Source: Computed from data in table IX-7, and earlier data from the same source.

TABLE IX-9.—*State and local net long term debt in relation to revenues and personal income, actual and projected, selected fiscal years, 1940–75* [1]

Year	Net long term debt as a percent of—	
	State-local revenues (own sources) [2]	Personal income
Actual:		
1940	183.4	21.9
1950	98.1	8.7
1955	126.0	12.4
1960	125.3	15.4
1965	126.0	16.1
Projected:		
1970	119.7	16.0
1975	115.2	15.7

[1] Debt as of the end of fiscal years in comparison to revenue for fiscal years and personal income for calendar years.
[2] General revenue from own sources plus utility revenue, since net long term debt includes utility debt. Utility revenue is projected according to the rate of increase in 1960–65; general revenues are from table VIII-14.

Source; Basic data from U.S. Department of Commerce, Bureau of the Census and Office of Business Economics. Computations and projections by Tax Foundation.

OTHER FINANCIAL CONSIDERATIONS

Thus it appears in general that the projected levels of debt financing would be within the borrowing capacity of State and local governments, on the basis of their expected revenues and total personal income. Would new security issues in the volume indicated, and the associated annual requirements for retiring debt, place a financial strain on State and local governments? Before answering this question, there are several additional factors to be considered.

CASH AND SECURITY HOLDINGS

State and local governments typically hold large sums in the form of liquid assets—cash and security holdings—as offsets to long-term debt, in bond funds pending the completion of construction, and as working capital. These funds have risen from $29.3 billion in 1960 to $44 billion in 1965, an average increase of almost $3 billion per year. Reserves held against long-term debt have been increased from 7.4 percent of outstanding debt in 1960 to 8.3 percent in 1965, and bond funds from 8.4 to 9.8 percent of total debt. Other cash and security holdings have been quite constant in relation to the scale of operations, amounting to 32 percent of total expenditures (exclusive of social insurance systems). If these practices continue, total holdings of cash and securities would rise to $54 and $70.6 billion in 1970 and 1975, respectively. Table IX-10 presents these projections, by purpose, in comparison with data for earlier years.

TABLE IX-10.—*Cash and security holdings of State and local governments, by purpose, excluding insurance trust systems, actual and projected, 1960–75* [1]

[In millions]

Purpose	Actual		Projected [2]	
	1960	1965	1970	1975
Total	$29,313	$44,041	$54,040	$70,566
Long-term debt offsets	5,205	8,261	10,977	14,056
Bond funds	5,892	9,764	12,961	16,596
All other	18,216	26,016	30,102	39,914

[1] End of fiscal years.
[2] Long-term debt offsets and bond funds are projected at the same ratio to total debt outstanding as in 1965. All other holdings are projected to maintain their 1965 ratio to estimated expenditures for general plus utility purposes.

Source: Actual data from U.S. Department of Commerce, Bureau of the Census. Projections by Tax Foundation.

OTHER OPERATIONS

Some other transactions of government do not enter directly into Bureau of the Census tabulations of general expenditures, but occasionally augment or draw upon funds derived from general revenues or borrowing. In particular, there are typical deficits in the operation of some utility systems—notably water and transit services, profits on monopoly liquor stores operated in 16 States and a few localities, and government contributions to employee retirement systems made to their own systems on behalf of their own employees.[5] Projected requirements for each of these functions are included in the summary table below.

SUMMARY OF OVERALL FINANCES

Under the assumptions discussed, total requirements for funds versus available funds are projected as indicated in table IX-11. The sums available would exceed requirements by $5.1 billion in 1970 and $6.4 billion in 1975.

[5] That is, State government employer contributions to State systems on behalf of State employees, and local employer contributions to local systems for local employees. Employer contributions from local to State systems (and vice versa) are included in general expenditures. These transactions are excluded from general expenditures because they represent interfund transactions; i.e., payments from general funds to retirement systems, for which separate accounts are kept.

TABLE IX-11.—*Summary of source and use of major State and local government funds,*[1] *actual and projected, selected fiscal years, 1965–75*

[In millions]

	Actual 1965	Projected	
		1970	1975
Source of funds:			
General revenue	$74,341	$108,603	$146,865
Profit on liquor stores	275	275	275
New long-term security issues	11,249	13,124	16,116
Other borrowing [2]	1,081	884	981
Total funds available	86,946	122,886	164,237
Use of funds:			
General expenditures	74,954	105,882	141,984
Long-term debt retired	5,040	6,815	8,759
Employee retirement	1,794	2,384	2,974
Deficit on utility operations	978	500	500
Additions to liquid assets	4,769	2,174	3,642
Total funds required	87,535	117,755	157,859
Funds available less funds required	−589	+5,131	+6,378

[1] Excludes receipts, expenditures, and liquid assets of social insurance systems; utility and liquor store operations are entered on a net basis. Also excludes some interfund and other transactions not detailed separately in Bureau of the Census reports.

[2] Net increase in total debt outstanding minus the difference between long-term debt issued and retired; presumably represents changes in short-term debt and some timing differences as between refinancing issues and refunding transactions.

Source: Actual data from U.S. Department of Commerce, Bureau of the Census. Projections by Tax Foundation.

These indicated "surpluses" suggest that, if receipts and outlays on current accounts materialize at projected levels, State and local units may not be required to resort to borrowing for capital purposes at the same rate as in the first half of the 1960's. On the other hand, the indicated levels of debt do not appear to exhaust the potential recourse to new debt financing if needed (i.e., on the basis of projected revenues and personal income).

Moreover, the projections of tax collections are based on taxes currently in effect, with no change in overall rates. Such an assumption does not rule out the imposition of new taxes and the raising of rates in some areas, so long as they are counterbalanced by corresponding reductions elsewhere. Nor does the general assumption of a constant tax structure necessarily preclude a change in the mix of taxes; i.e., reducing some taxes and increasing others, so long as the effective rate in relation to income remains relatively constant.

Indeed the outlook in all respects indicates room for greater discretion on the part of State and local officials in shaping taxation and debt policies—the opportunity to choose among alternative means of financing to perhaps a greater extent than ever before in the postwar period.

Appendix A: ASSUMPTIONS AND METHODOLOGY

Assumptions as to the major institutional, economic, and demographic forces underlying the projections presented in this study are discussed in sections I and II of the text, and the corresponding levels of population, employment, prices, and output appear in table II–4. Table A–1 below provides data on the rates of change in the projected levels of activity, in comparison with previous periods in the postwar years. This particular combination of growth rates for the several components of output—labor force participation rate, employment, pro-

ductivity, and average weekly hours is not an essential factor in the assumptions, but illustrates one way in which the assumed overall growth rate could materialize. The basic assumption is that gross national output will rise about 4 percent per year in real terms. Since unemployment is held constant in this model at the rate prevailing in 1965 (4.5 percent), the projected levels of activity are less than the potential under a full capacity, or full employment, model.

TABLE A-1.—*Implicit annual rates of change in projected series compared with postwar changes, selected intervals, 1948–75*

Series	Annual percent change over interval [1]			
	Actual		Projected	
	1948–60	1960–65	1965–70	1970–75
Population	1.76	1.50	1.10	1.21
Labor force	1.26	1.40	1.94	1.75
Civilian employment	1.00	1.60	2.00	1.81
Unemployment	4.50	−2.89	2.19	1.49
Productivity	3.0	3.3	2.6	2.6
GNP in constant dollars	3.5	4.7	4.0	3.9
GNP price deflator	2.2	1.4	1.7	1.5
GNP in current dollars	5.8	6.2	5.8	5.5
Personal income in current dollars	5.5	5.9	5.8	5.5
Personal income per capita	3.7	4.4	4.6	4.2

[1] Initial to terminal year; compound interest formula. Changes are all positive, except as noted.

Source: Computed from data in table II-4.

Among several alternative projections of population available in the new series of the Bureau of the Census, U.S. Department of Commerce, series C has been selected for this study, since birth rates through mid-1966 appear to have conformed best to indicated trends for this series. Table A-2 below indicates what the actual future population levels would be under other assumptions, as well as how the 1966 revised projections compare with those published 2 years earlier. The range of growth in the revised series for the decade, 1965 to 1975, is from 10 to 16.9 percent, about two percentage points below the 1964 projections.

TABLE A-2.—*Alternative projections of total population, 1970–75* [1]

Series	Number (in millions) [2]		Percent change		
			Annual rate		Total, 1965–75
	1970	1975	1965–70	1970–75	
New series:					
A	208.9	227.5	+1.4	+1.7	+16.9
B	207.1	223.0	+1.3	+1.5	+14.6
C	205.5	218.3	+1.1	+1.2	+12.2
D	204.1	214.1	+1.0	+1.0	+10.0
Old series:					
A	221.4	230.4	+1.7	+1.7	+18.4
B	209.0	225.9	+1.4	+1.6	+16.1
C	206.1	220.1	+1.2	+1.3	+13.1
D	205.9	218.9	+1.1	+1.2	+12.5

[1] As of July 1. Includes armed forces abroad. The range of projections reflect primarily different assumptions concerning fertility rates.
[2] Population as of July 1, 1965, estimated at 194,600,000.

Source: U.S. Department of Commerce, Bureau of the Census; revised series from Current Population Reports, series P-25, No. 329, March 1966; old series from series P-25, No. 286, July 1964.

EXPENDITURE PROJECTIONS

Projection techniques differ somewhat for the several functional categories, depending upon the nature of programs and the availability of specific measuring devices. In the fields of education and public welfare, the approach has been to estimate caseloads based on age, income, or other classifications of population; to project expenditures per case, with separate adjustment for costs and for prices per case. Total expenditures reflect the product of estimated caseloads and expenditures per case. All expenditure projections have been constructed according to the respective functional definitions of the Bureau of the Census, although the original source material was often derived from, or supplemented by, data of other agencies.

EDUCATION

Projections for local schools, higher education, and other education were developed separately, and different methods were used in projecting capital and current operating costs.

Local Schools. Enrollment estimates were adapted from data published by the U.S. Office of Education, adjusted by Tax Foundation according to the 1966 revisions in population projections (series C) of the Bureau of the Census. The basic assumptions are: 98 percent of the population aged 5 through 17 will attend school; 85 percent of them will enroll in public schools, and there will be no change in the portion of enrolled students attending daily (now about 93 percent).

Current expenditures per pupil in average daily attendance are projected according to assumption III, in table III–10; i.e., per pupil expenditures in constant dollars will increase at the same rate as in the period from 1959 to 1964 (4 percent annually). Current dollar equivalents were obtained by adjusting the resulting data for the assumed rise in general prices (1.8 percent per year, 1965–70, and 1.5 percent, 1970–75). Total current operating expenditures represent the number of students in average daily attendance times projected current dollar costs per student.

Capital outlay projections were adapted from projections of the U.S. Office of Education, adjusted by Tax Foundation for recent population revisions and for the general assumptions of this study regarding future capital costs. Details are shown in table III–11. The projections envisage the construction of an average of 58,600 new classrooms a year throughout the period 1965–75. The large majority—47,400—represent additions associated with current replacement (abandonments), migration, consolidation of school districts, and reduction of crowded and unsatisfactory rooms; this is a substantial increase over the previous 10 years, when construction for these purposes averaged only 26,200 a year. In view of declining enrollment growth, the Office of Education estimate of the number of classrooms to be constructed for enrollment increases during the 1965–69 period is reduced to about one-half that of the previous 5-year period. Since this study projects an absolute decline in numbers enrolled between 1970 and 1975, the Office of Education projections associated with enrollment increases—19,000 per year—have not been included in the Tax Foundation projections. In arriving at the current dollar totals, the adjusted Office of Education constant dollar expenditures have been raised to allow for an assumed rise in capital and construction costs of 3 percent per year throughout the 1965–75 period.

Higher Education. Enrollment estimates are those of the U.S. Office of Education, as shown in table III–16. Projections by that agency are based on the continuation of the 1954–64 (linear) trends in (*a*) attendance rates of population aged 18 to 21 years, and (*b*) entrance rates of the 18-year-old population—all projected separately by sex and by type and control of institution. Full-time equivalents are based on the 1964 ratios of full time to total enrollments by type of institution, control, etc. (Under these assumptions full-time equivalent enrollment would constitute 83.1 percent of total enrollment in 1969 and 78.9 percent in 1974.)

Current expenditures per student, full-time equivalent, are projected according to assumption III, table III–14; i.e., the real costs per full-time equivalent will increase at the rate experienced in 1959–64 (3.2 percent annually). Total current expenditures for higher education represent the product of cost per full-time student and the number of students.

Capital outlay projections are those of the U.S. Office of Education, adjusted by Tax Foundation for the assumed construction cost increase of 3 percent annually. The Office of Education assumptions are: (1) For increased capacity, based on the experience of school years 1954–64, average capital outlay from all sources will increase by $6,363 (1963–64 dollars) per increase in full-time equivalent students in publicly controlled institutions (2) For replacement and rehabilitation, capital outlay is projected at 1 percent of the value of plant to be replaced or rehabilitated each year.

Projections for other education assume that both current operation and capital outlay will grow at rates slightly higher than higher education in the decade from 1965 to 1975, as a result of increasing emphasis on adult education and retraining largely under Federal-State programs.

PUBLIC WELFARE

Different procedures were used in the projection of the major components of public welfare expenditures, principally cash payments for income maintenance under the categorical public assistance programs and medical vendor payments.

Cash Payments. Total payments (table IV–6 are derived as the product of the projected number of recipients in each categorical program and estimated average money payments to each recipient. The number of recipients (table IV–5) is based on the assumed continuation of the 1960–65 trend in recipient rates (recipients in each program per 1,000 population in the age group aided), adjusted to eliminate the effect of program and policy factors influencing the 1960–65 trend. Average payments per recipient are projected by adding $2.50 to the 1965 average monthly payments for OAA, APTD, and AB, and $1.25 to average monthly payments for AFDC recipients (reflecting the increase in the Federal share in these programs beginning January 1, 1966). The adjusted amounts were then raised on the assumption that further increases would correspond to the rise in consumer prices. The resulting averages by category were adjusted to an annual basis, and summed.

Medical Vendor Payments. The assumptions behind the projections of medical payments (table IV–10) are discussed in the text, page 64. Estimates were derived separately for the estimated recipients of cash payments (the indigent, by category) and for the medically indigent. For the former category, the number of recipients was computed as described above. For the medically indigent, it was assumed that 19 million of the poor and near poor under age 65 would be eligible by 1970 and all in that group (30.9 million) by 1975. (Note that additional legislation at both the Federal and State levels would be required for this assumption to materialize, since present laws do not permit Federal participation in aid to ablebodied persons in the ages 18 through 64.)

For all except those receiving OAA and APTD money living allowances, medical payments per recipient are based on a projection of 1964 per capita medical costs, adjusted in two ways: (*a*) to bring medical outlays for the poorest one-fourth of the population up to the level of the remainder and (*b*) for the assumed continuation of past trends in per capita medical costs (5.5 percent per year). With these adjustments, costs per eligible member of the population (under 65) would rise to approximately $300 annually by 1975.

For those receiving APTD cash allowances, medical payments are already higher than the average for the population at large. For that group, 1964 medical payments per recipient were increased to allow for rising medical prices in the next decade. Vendor payments for OAA recipients were projected separately, taking account of the new hospital and medical insurance program; the amounts projected include only the estimated deductible items and insurance premiums under the new system.

HIGHWAYS

Projections for current and capital highway outlays were developed by different techniques, utilizing detailed information by type of road system published by the Bureau of Public Roads. Estimates so developed were adjusted to a Bureau of Census basis. (See Table IV–7.)

Current Expenditures. The largest component of current expenditures—maintenance outlays—are projected to rise by about three-fifths from 1964 to 1975, with an estimated 8-percent increase in total mileage and a 50-percent rise in maintenance costs per mile. These estimates project experience in the period 1959–65, when maintenance costs per mile (in current dollars) rose at the rate of 3.8 percent annually. The 1975 projection assumes per mile maintenance costs of

$1,271, as compared with $845 in 1964. Estimates of other current expenditures—primarily administration and research—assume an annual rate of increase of 6 percent per year, somewhat higher than the recent rate of 5.6 percent, in view of increasing emphasis on research in highway planning. In total, current operating expenditures are projected to rise by an annual rate of 4.8 percent per year, 1964–75, as compared with 4.6 percent per year, 1958–64.

Capital Outlays. The projections foresee a level of spending on either the presently designated interstate system, or additions to the system, roughly equivalent to 1964 spending levels in current dollars (about $3.4 billion). In view of expected future price increases, the physical volume of construction, land acquisition, etc., on this particular system would, under these assumptions, decline somewhat. For all other roads—the Federal-state ABC system, other State, and other local roads—capital outlays are projected to rise more rapidly than in the 1958–64 period—3.8 percent per year from 1964 to 1975, in comparison with 2.4 percent per year in the period 1958–64.

HEALTH AND HOSPITALS

Expenditures for health (table V–11) are projected on the assumption that per capita constant dollar expenditures will continue to rise as in the period 1960–65, population will rise at rates of 1.1 and 1.2 percent per year in the succeeding 5-year intervals following 1965, medical care prices will increase by 3 percent per year (as compared with 2.6 percent in the 1960–65 period), and factors other than population and prices will exert the same weight as in the first half of the 1960's (rising at the rate of 2.9 percent per year).

For hospitals, projections are based on an extension of recent trends in expenditures for current operations of general hospitals and psychiatric and tuberculosis hospitals separately, taking account of population, prices, and other factors. For current expenditures of general hospitals, projected rates of growth are 7.5 percent per year; for psychiatric and tuberculosis institutions, 8.1 percent per year. Since there has been no perceptible direction in the trend of capital outlays, capital spending is held constant in 1970 and 1975 at 1965 levels, adjusted for an assumed increase of 3 percent annually in construction costs throughout the projection period.

OTHER EXPENDITURES

Expenditures for other general functions (table VII–1) are projected by extrapolating the income elasticity of expenditures for each function according to the 1960–65 experience; that is, the trend in the ratio of spending to personal income is assumed to continue as in that base period.

Capital outlays for nongeneral functions (table VII–6) are projected at rates of constant-dollar increase experienced in 1960–65, adjusted for the general assumptions of the study concerning future construction cost increases.

Estimates of employment and payrolls of State and local governments (table VII–8) assume that salaries and wages will continue to rise at the same rate as current operating expenditures for education and other functions separately; and that average earnings per full-time equivalent worker will rise at the same rate as in 1960 through 1965.

GENERAL REVENUES

Tax receipts (table VIII–11) are projected by holding constant the overall structure of taxes imposed and stipulated rates at their 1965 levels, adjusted for changes enacted in State taxes by early 1966. Revenues were projected for each tax according to the personal income elasticity experienced in recent years (table VIII–10).

Revenues from current charges and fees, in general, are assumed to increase in proportion to associated expenditures as in the period from 1960 through 1965; the total would rise from 11.2 percent of expenditures in 1965 to 13.3 percent by 1975. Ratios for some functions would increase, others remain constant or decline. The ratios of receipts to expenditures are as follows for 1965 and 1975 respectively (in percent): total, 11.2 and 13.3; education, 11 and 13; highways, 6 in both years; hospitals, 30.3 and 55.5; housing and urban renewal, 36.6 in both periods; and all other, 9.5 and 8.3. The large increase in hospitals reflects projected increases in receipts from paying patients under 1965 amendments to the Social Security Act.

Any estimates of future Federal grants are to a large extent arbitrary. As noted in the text, pages 109–111, projections of Federal aid in other studies indicate grant-in-aid levels of $45 to $60 billion by 1975. In this study projected

amounts are $20.3 billion in 1970 and $30 billion in 1975 (table VIII–14). These amounts are those which are directly associated with expenditure projections. The projections assume that Federal grants will rise from 14.8 percent of State-local general expenditures in 1965 (and an estimated 17.1 percent in 1967) to 19.2 and 21.1 percent, respectively of projected expenditures in 1970 and 1975. The ratio of grants to expenditures for the major functions for 1965 and 1975 respectively are (in percent): education, 5.8 and 15.4; highways, 32.7 and 27.5; public welfare, 49.1 and 55; housing and urban renewal, 54.1 and 60; health and hospitals, 5.4 and 16.5 (primarily as a result of future Federal participation in State-local payments for mental and tuberculosis hospital patients); and aids under miscellaneous (or presently unclassifiable) functions, 6.3 and 15.

Overall Finance

New security issues are projected on the assumption that borrowing will finance the same portion of capital outlays for each major function as in the period 1961–65. (See table IX-6).

Short-term debt outstanding is projected to rise by $456 million annually, which is the average increase experienced in the period 1961–65. Long-term debt issued is the total of projected new security issues and refunding issues. The amount of long-term debt retired is assumed to be 5.758 percent of long-term debt outstanding in the previous year, according to recent practices. The annual difference between debt issued and debt retired is added to debt outstanding in the succeeding year.

The amounts to be added annually to liquid assets are interpolated from data in table IX–10. Footnote "b" in that table furnishes the basis for computation.

Projections of other sources and uses of funds (table IX–11) are based on recent experience. Profits on liquor stores are held constant at 1965 levels. Deficit on utility operations is assumed at $500 million for both 1970 and 1975, since experience reveals that relatively large deficits (e.g., $978 million in 1965) are generally followed by sharp downward adjustments. Contributions to employee retirement systems (out of general funds) are estimated to increase by $118 million annually, based on recent trends.

Appendix B: COMPARISON WITH OTHER STUDIES

Recent comprehensive studies of the outlook for State and local government finance to 1970 have been prepared under the auspices of the Council of State Governments.[1] Further, the outlook for educational expenditures to 1970 and 1975 has been examined by the Office of Education, U.S. Department of Health, Education, and Welfare.[2] Material presented below provides a comparison of the projections in these two studies with those of the Tax Foundation. Since all three sets of projections involve numerous detailed and explicit assumptions, no thorough discussion of the differences can be attempted here. Nevertheless, this summary treatment illustrates the effect on projected levels of activity of several alternate sets of assumptions.

Council of State Governments. Table B–1 presents a comparison of the Council's expenditure projections for 1970 with those of the Tax Foundation. Although there is variation among functional groups, the Council's total estimates for calendar year 1970 ($108.3 billion) are virtually identical to those of the Tax Foundation, when the latter are adjusted to a calendar year basis. In both instances, the overall growth rate in current prices is 7.2 percent per year from the base year to 1970. The greatest differences are in higher education (discussed below) and highways and streets, for which the Council's projections are significantly higher than those of the Tax Foundation, and in public welfare and miscellaneous general functions, for which the Tax Foundation's projections are substantially higher than those of the Council.

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[1] Published in a series of separate reports, and summarized in Selma Mushkin and Gabrielle C. Lupo, "Project '70: Projecting the State-Local Sector," for publication in a forthcoming issue of *Review of Economics and Statistics.*

[2] Published in *Projections of Educational Statistics to 1974–75,* 1965 edition, Washington, 1965.

TABLE B-1.—*Comparison of projected levels of State and local government general expenditures, 1970* [1]

[In billions]

Function	Council of State governments	Tax foundation
Total, general expenditures	$108.3	$105.9
Education, total	44.6	41.5
Local schools	31.0	30.4
Higher education	12.1	9.8
Highways, total	16.2	14.1
Current	5.7	4.8
Capital	10.4	9.2
Public welfare	7.1	10.9
Cash assistance	4.4	4.6
Medical vendor payments	1.8	4.5
Other	.8	1.8
Health	1.6	1.2
Hospitals	6.4	6.3
Police and fire	5.1	5.3
Interest on general debt	3.6	3.7
Sewerage and sanitation	3.5	3.3
All other general [2]	18.5	19.7

[1] Projections of the Council of State Governments are for calendar year 1970; those of Tax Foundation are for fiscal year 1970.
[2] Includes general control, housing and urban renewal, natural resources and parks, and other general.
Source: See text.

Projections of tax collections (table B-2) in the two studies are also very similar in total. Since the Tax Foundation projections are based on 1965 tax structures, and include new major State tax changes, enacted through calendar 1965, the Council's projections from a 1963 base year indicate a somewhat higher automatic response of taxes to general economic growth than do those of the Tax Foundation. The difference is most evident in the case of the property tax, for which the Council's calendar 1970 projections are $3.4 billion higher than Tax Foundation's fiscal 1970 estimates.

TABLE B-2.—*Comparison of projected levels of State and local government tax collections, 1970* [1]

[In billions]

Tax	Council of State governments	Tax foundation
Total taxes	$70.3	$69.6
Individual income	6.6	6.3
Corporation income	2.3	2.7
Property	33.0	29.6
Sales and gross receipts, total	21.9	21.9
General	10.7	10.8
Selective, total	11.2	11.1
Motor fuel	5.2	5.2
Tobacco	1.7	1.6
Alcoholic beverage	1.3	1.1
Other	3.0	3.1
Motor vehicle and operators' licenses	2.4	2.4
All other	4.2	4.5
Additions since 1965	----------	2.3

[1] For notes and sources, see table B-1.

The treatment of the overall financial state of balance in the two studies differs somewhat. (See table B–3.) The Council's estimates treat the amount of borrowing as a residual, depending upon the outcome of revenues under a range of high and low assumptions for general revenues from own sources and from Federal grants-in-aid. Under the "high revenue" illustration, balance could be attained, according to these estimates, with borrowing equal to $13.9 billion. Under the "low revenue" illustration, borrowing would reach $19.6 billion. Tax Foundation procedures did not include a range of estimates—for either revenues or expenditures; further, the estimates of borrowing were computed directly as a function of projected capital expenditures and not on the basis of a projected gap in general income and outgo.

TABLE B–3.—*Comparison of projected levels of overall State and local government finance, 1970* [1]

[In billions]

	Council of State governments	Tax foundation
Source of funds:		
General revenue, own sources, including net liquor store profits:		
Illustration I	86.4	88.6
Illustration II	84.3	
Revenues from Federal Government:		
Illustration I	22.1	20.3
Illustration II	18.5	
Total borrowing:		
High revenue illustration	13.9	14.0
Low revenue illustration	19.6	
Total funds available	122.4	122.9
Use of funds:		
General expenditures	108.3	105.9
Debt retired	7.5	6.8
Contribution to employee retirement	2.5	2.4
Deficit on utility operations	.6	.5
Additions to liquid assets	3.5	2.2
Total funds required	122.4	117.8
Funds available less funds required		5.1

[1] For notes and source, see table B–1.

Expenditures for Education. Table B–4 provides a comparison of the major elements of projected expenditures for education by the Council of State Governments to 1970 and by the U.S. Office of Education for both 1970 and 1975 with those of the Tax Foundation.

TABLE B-4.—*Comparison of projected expenditures for education in several studies, 1970 and 1975* [1]

Series	Unit	1970			1975	
		CSG	HEW	TF	HEW	TF
	Local schools					
School age population	Millions	53.0	53.0	53.0	55.3	51.7
Enrollments	do	44.8	44.8	44.2	47.1	43.0
Average daily attendance	do	41.2	41.4	41.1	43.8	40.0
Current expenditures per pupil in ADA	Dollars	672	659	650	806	852
Total current expenditures	Billion dollars	27.7	27.3	26.7	35.3	34.1
Capital expenditure	do	3.3	3.7	3.7	4.2	3.0
Total expenditures	do	31.0	31.0	30.4	39.5	37.1
Additional classroom construction	Thousand rooms	65.3	68.8	68.8	67.4	48.4
	Higher education					
Enrollments [2]	Millions	5.4	4.6	4.6	5.9	5.9
Full-time equivalent [3]	do	[4] 4.5	3.8	3.8	4.7	4.7
Current expenditure per full-time equivalent.	Dollars	1,900	2,400	2,033	2,900	2,557
Total current expenditures	Billion dollars	8.6	9.2	7.8	13.4	11.9
Capital expenditures	do	3.5	2.0	2.0	2.1	2.1
Total expenditures	do	12.1	11.2	9.8	15.5	14.0

[1] Initials in column headings refer to Council of States Governments (CSG); U.S. Department of Health Education, and Welfare (HEW); and Tax Foundation (TF). Projections published by HEW in constant 1963–64 dollars have been converted to current dollars according to the assumptions of the TF study. Calendar year for CSG; school year for HEW and TF. HEW data are on a different basis from the Bureau of the Census concept used in the other 2 studies. For local schools the differences are small. For higher education, there are large disparities; e.g., 1965 current expenditures as defined by HEW were some 27 percent higher than the census data.

[2] Degree-credit fall enrollment.

[3] Degree-credit, full-time equivalent.

[4] Estimated by Tax Foundation. Based on the relationship of total fall enrollments and full-time equivalents in HEW projection.

Source: See table B-1.

For local schools, there is relatively little difference between the three sets of projections in 1970. For 1975, the Tax Foundation projections are lower than those of the Office of Education primarily because of Tax Foundation's use of the recently revised population projections of the Bureau of the Census (see text, pp. 26–27), which would lead to a decline in public school enrollments between 1970 and 1975. Despite the assumption of substantially higher per student current outlays in the Tax Foundation estimates, this decline in numbers reduces total current expenditure projections by $1.2 billion below those of the Office of Education. As noted in the text, page 44, Tax Foundation has incorporated the Office of Education projections of capital outlays, except that the additional needs associated with growing enrollments were subtracted for the period 1970 through 1975.

Projections in the three studies are at somewhat greater variance for higher education. For 1970, the Council of State Governments foresees higher levels of enrollment than those indicated in the Office of Education estimates (also used in the Tax Foundation projections), somewhat lower current costs per enrollee but more capital construction than the other studies. For 1975, the Office of Education current outlays exceed those of the Tax Foundation by about $1.5 billion. This divergence, however, reflects the use of different definitional concepts (see note "e," table B–4). The Office of Education estimates, based on 1955–65 trends, indicate a 107-percent constant dollar increase in current expenditures from 1965 to 1975; the Tax Foundation projections—on the Census basis—foresee a 130-percent constant dollar increase in the same period.

STATE-LOCAL FINANCE IN THE NEXT DECADE

BY DICK NETZER*

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I. The Objectives of This Study and Its Main Findings

The fundamental problem of Federal-State-local fiscal relations today is the apparent disparity between the budgetary outlook of the Federal Government on the one hand and that of State and local governments (both individually and in the aggregate) on the other. That is, the Federal Government operates with a highly responsive and productive revenue system combined with limited responsibilities for civilian public expenditures. This combination has permitted the Federal Government to substantially cut tax rates in a variety of ways, but massively in total, while gradually expanding its program activities, in the past 5 years.

State and local governments, in contrast, bear the initial and continuing responsibility for providing the public services and facilities closely associated with a growing population, increasing urbanization, and the rising standards to be expected of an affluent society. As Table I shows, in the past decade, State-local expenditures have increased roughly twice as fast as the national economy has grown (even after allowance for greatly increased Federal aid[1]), and this rate of increase shows no sign of abating. At the same time, State-local revenue sources on balance are far less responsive to the economy's growth than are Federal revenue sources; substantial increases in tax rates and the widespread adoption of new taxes have been necessary to finance the rise in State-local expenditures.

Table 1.—*State-local expenditures in 1963–64 and change since 1954*[1]

[Dollar amounts in billions]

Function	Fiscal years ending July 1, 1963, to June 30, 1964		Percent increase over fiscal years ending in 1954	
	State-local expenditures	Federal aid	State-local expenditures	Expenditures less Federal aid
Education	26.5	1.7	151	147
Health, hospitals, and welfare	10.7	3.3	95	89
Highways	11.7	3.6	111	61
Services essentially urban in character [2]	12.2	.7	104	93
All other	13.3	.8	132	133
Total, general and utility expenditures [3]	74.4	10.0	123	112
Exhibit: Increase in GNP, 1953–63 [4]			60	

[1] From U.S. Bureau of the Census, Government Finances in 1963–64 (May 1965) and 1962 Census of Governments, vol. VI, No. 4, Historical Statistics on Governmental Finances and Employment (1964). A change in the period covered by Census Bureau reports explains the 1954 and 1963–64 comparison. It appears that, in dollar terms, 1963–64 is roughly 9.8 years later than 1954 for State-local finance overall magnitudes.
[2] Police and fire protection, water supply and sanitation, local parks and recreation, housing and urban renewal, transportation except highways (transit, airports, port facilities, parking), and gas supply utilities.
[3] Excluding expenditures for liquor monopolies and social insurance trust funds.
[4] Survey of Current Business, July 1964.

[1] Half of the increase in Federal aid in the 1954–64 decade was for highway purposes.

Does this apparent contrast between the Federal and State-local sector outlooks require new arrangements for large-scale sharing of plentiful Federal revenues with hard up State-local governments? The primary objective of this study is to provide some guidance on this question by analyzing the capacity of State and local governments to finance the perspective increase in their expenditures over the next decade from their own fiscal resources, that is, without major changes in the existing structure of Federal-State-local fiscal relations.

In reality, of course, State and local governments will strike a financial balance at *some* level, whatever is done about Federal aid or tax sharing. That is, if the revenue bind is a severe one, State-local expenditures will be lower a decade hence than they might otherwise be, an outcome which some perhaps might welcome. A repetition of the past decade's experience appears more likely, however, with State-local expenditures rising rapidly compared to the productivity of present State-local revenue systems, and the gap filled by substantial and widespread tax increases. The problem with this solution is that present State-local revenue systems are poor ones in many respects, with adverse effects on the level, composition, and geographic location of investment and consumption.

This then suggests a second objective for this study: an examination of the kinds of State-local tax increases which are conceivable, a forecast of which of these are most likely to occur, and an appraisal of which of these are most desirable from the standpoint of national and local economic development. The "fiscal drag" argument aside, much of the case for Federal tax sharing or unconditional grants rests on the well-founded suspicion that the most likely State-local increases are relatively undesirable ones.

THE SETTING FOR THE PROJECTIONS

The projections in this study assume overall price level stability, prosperity in the actual years used as "target" dates (1970 and 1975), and continued moderately rapid economic growth. Specifically, the 3.75-percent average annual growth rate used by Murray Weidenbaum in his paper on the Federal budget outlook, prepared for CED, is utilized here as well. In addition, some attention is paid to the effect on State-local finance of somewhat faster and slower rates of growth.

A fair degree of institutional stability is also assumed. That is, trends in expenditures are based on the evidence of the recent past, trends in such underlying factors as population, and the maturing of programs now in their early stages. No large wholly new programs, not now in view, are provided for in these projections; the global nature of the projections, however, allows for new programs with low expenditures in the next decade. This is not a wildly unrealistic assumption; the huge increase in State-local expenditures since the end of World War II has involved few large wholly new activities, but instead is explained largely by increasing costs and workloads and by expansion and enrichment of programs readily discernible as of the late 1940's.

Similarly, it is assumed that Federal programs, and grants to State-local governments in particular, will consist almost entirely of those expected to be on the statute books by the end of this session of Congress. In view of the large amount of new legislation recently, it seems

reasonable to expect that, while Federal aids will grow substantially, this growth will largely reflect the expansion of existing and recently adopted programs, rather than wholly new ones.

THE MAIN FINDINGS

1. If State-local expenditures continue to increase as rapidly as they have in the recent years of overall price level stability, expenditures in 1975 will be more than double the level of 1963–64. However, expenditures for education and highways, which account for more than half State-local expenditures, should increase less rapidly than in the recent past. In education, the reason for this is that the rate of increase in enrollments—at all levels—is expected to taper off. As for highways, the overall magnitude of the program is more or less set, since the Federal program heavily influences expenditures and the latter is unlikely to change greatly before 1975. On balance, therefore, a slower rate of growth is a reasonable expectation for State-local expenditures in total. The "most likely" projection, shown in table 2, provides for an increase of $54 billion from 1963–64 levels, or 75 percent.

TABLE 2.—*Summary of "most likely" projections for 1975*

[In billions of dollars]

Item	1963–64 actual [1]	1974–75 projected
Revenues:		
Tax revenues [2]	41.9	[3] 67.2
Federal aid	10.0	19.9
Program-associated receipts [4]	19.7	31.1
Other	1.7	2.0
Total	73.3	120.1
Expenditures:		
Program expenditures [5]	71.5	[6] 125.6
Additional requirements [7]	12.6	19.0
Total	84.1	144.5
Long-term debt issued	11.2	[8] 13.6
Net deficit		10.8

[1] Based on Census Bureau data; partly estimated.
[2] Excludes highway-user taxes; includes net liquor profits.
[3] At constant tax rates, with 3.75 percent GNP growth rate.
[4] User taxes, charges, fees, special assessments, etc.
[5] Excludes debt service transactions.
[6] "Model" providing for some improvement.
[7] Debt service, additions to balances, and Government contributions to employee retirement funds.
[8] Assumes market absorbs net increase of $6,000,000,000 a year in State-local indebtedness.

NOTE.—Detail may not add to totals, because of rounding.

2. At a 3.75-percent average annual rate of growth in the economy, revenues from existing State-local general taxes are likely to rise by 60 percent, or $25 billion, by 1975. Alternative reasonable assumptions on the GNP growth rate do not affect this outlook greatly. A one-fourth percentage point difference in the assumed growth rate changes the 1975 projection by $1.7 billion; a one-half percentage point difference, by $3.4 billion. Thus even a 4.25-percent growth rate, which is historically very high for long periods, results in an increase in tax revenues of less than 70 percent.

3. Federal aid and receipts associated with particular programs—highway user taxes and charges and other user fees and charges—currently provide large revenues in addition to general taxes. It is likely that these will continue to increase rapidly, and that Federal aid for specific programs will double by 1975.

4. *However*, increases in tax revenues at constant rates *plus* substantial increases in both user charges and conditional Federal grants will not be sufficient to cover expenditures, despite the marked slackening in the growth rate of the latter. As table 2 shows, a gap of nearly $11 billion remains, to be filled either by brandnew Federal grant arrangements or by increased State-local tax rates and the adoption of new forms of taxation.

5. In the postwar period, the most popular form of new and increased taxation at the State-local level has been the general sales tax. With the adoption of a statewide sales tax in New York this year, sales taxation now applies in areas accounting for more than 85 percent of personal income in the United States. Thus, even if the sales tax becomes universal (as is likely), the anticipated gap will not be closed.

6. State (and local) income taxation is less widespread than sales taxation but does apply to more than half the income generated in the country. Moreover, in recent years, there have been few new adoptions of State income taxes and rate increases have also not been widespread. Apparently, heavier use of both corporate and individual income taxation has been inhibited by fears of the impact on the location of economic activity, in part because the high income tax rate States have not been among the most rapidly growing ones.

7. If all States did in fact use both sales and income taxation at rates somewhat above the average now prevailing, the revenue gap shown in table 2 would be closed for the country as a whole (although not necessarily for all States). However, this does *not* appear to be the most likely outcome. Instead, the path of least resistance politically seems likely to be isolated adoptions of various types of new taxes and tax rate increases plus substantial and general increases in property tax rates nearly everywhere. The defects in the property tax are many; not the least of these are its deterrent effects on investment in general in a capitalist society and its noxious effects on the fortunes of the Nation's large older cities. These defects will be worse in their consequences as the rates of tax rise.

8. Therefore, it does seem that the fiscal problems of State-local governments, under existing arrangements, will be resolved by means which are far from optimal. In contrast, Federal tax sharing or unconditional grants, if considered perhaps as a new form of State-local tax (rather than as a traditional type of outside aid) measure up well as a "gap filler," having a high degree of responsiveness to economic growth, no effects on the location of economic activity among parts of the country, and general acceptance as roughly equitable among individual taxpayers.

II. The Outlook for State-Local Expenditures

FACTORS AFFECTING STATE-LOCAL EXPENDITURES

The evidence of the past suggests strongly that the most important determinant of trends in State-local expenditure is the change in what might be called the underlying workload—principally numbers of people, especially in places and age groups which are heavy consumers of particular kinds of public services. Some obvious examples are these:

—the numbers of people of school and college ages clearly have a direct and powerful impact on education costs;

—the number of people in older age groups seems to affect hospital requirements;

—the proportion of people living in urban areas has a bearing on the overall costs of public services which are essentially urban in character, such as police and fire protection, water supply and sewerage, refuse disposal, local parks and recreation, transport facilities other than highways (which are present in rural as well as urban areas), and the like;

—the rate at which land on the outer edges of urban concentrations becomes urbanized affects the total size of public capital costs for all sorts of community facilities or "intrastructure."

The Census Bureau, the U.S. Office of Education, and other public and private agencies have published projections of these basic demographic trends. The most recent Census Bureau projections of the U.S. population suggest that, between mid-1964 and mid-1975: the total population will increase by 18 percent; the elementary school-age population (5 to 13) will increase more slowly—by 10 percent; the high school-age population will increase by 21 percent; and the college-age population will increase much more rapidly—by 38 percent.[2] These projections, of course, reflect largely persons now living and are influenced by birth rates in the past two decades. The rate of increase in the elementary school-age population is projected to be much more modest than in the recent past, but recent high birth rates are reflected in "bulges" in the high school and college age groups. Even here, the rate of increase will be slowing as 1975 approaches, under these projections.

The U.S. Office of Education has converted these demographic projections into enrollment projections at public and private institutions.[3] These enrollment figures reflect recent trends in the percentages of the respective age groups attending school or college, and equally important, the mix between public and private institutions. As the following percentage increases in enrollments show, public institutions of higher education are expected to serve a much higher fraction of a rapidly growing age group than at present (the figures apply to the fall, since this is the beginning of the respective school years):

---

[2] U.S. Census Bureau, *Current Population Reports*, series P-25, No. 286, "Projections of the Population of the United States by Age and Sex: 1964–85" (July 1964). The series B projections is used here; in this series, which is a moderately high one, the fertility rates of recent years have been scaled down somewhat.

[3] U.S. Office of Education, *Projections of Educational Statistics to 1973–74* (1964 edition), table 1. The Office of Education projections have been extrapolated to 1974–75 by the author.

Percent increases in enrollments at public institutions, fall 1963 to fall 1969, and fall 1974

	Fall 1969	Fall 1974
Elementary school	7.0	10.4
High school	18.8	32.6
Higher education (degree-credit only)	63.6	115.9

What of the location of this larger population, totaling 225 million by 1975? There seems to be every reason to expect the major migrations to continue: from the older sections of the country in the Northeast and Midwest, following the sun to the West, Southwest, and Florida; from rural and low-income areas (especially in the South) to the urban concentrations all over the country; and from the central cities of older metropolitan areas to their outer portions. To be sure, these migrations may not continue at exactly the same rates. For example, the population of the rural South has already been greatly affected by migration and no longer provides such a huge pool of potential migrants. Also, central city populations have actually been rising in the 1960's; the large net migration to the suburbs of the 1950's may not be renewed until the 1970's.

Nevertheless, it is reasonable to expect that the entire population increase expected by 1970 will occur in areas defined by the Census as urban (as in the 1950's), in which case the urban population in 1970 will be 12 percent larger than in 1964 and 25 percent larger by 1975. In short, from the standpoint of State-local finance, the most important population factors in the decade ahead will be, first, the very large percentage increase in urban population, especially the outer parts of metropolitan areas, and second, the very large increase in enrollments at public institutions of higher education.

State-local government services have expanded far more, in quantity and quality, than population increases and shifts alone can explain, both in the recent past and throughout this century. This expansion is related in various ways to the growth of the economy and the increase in incomes. For one thing, some public services are necessary complements to the growth of the private sector of the economy—highway expenditures became significant only with the advent of the automobile; modern industrial processes and standards of living continually increase per capita water use; and while the relation between growth and education is something of a chicken-and-egg proposition, at least part of the demand for enrichment of educational programs is derived from the requirements of the modern economy.

In addition, with rising incomes, a higher standard of performance is expected from the public sector: governments are expected to do more things and do them better. This income elasticity of demand for public service is a highly uneven affair, which never has been quantified satisfactorily, but there is much fragmentary evidence that it is real. One of the strongest pieces of evidence relates to public school programs in suburban areas. Within a number of individual States, there appears to be a strong correlation between income levels and expenditures per school child, with high income suburban areas showing up strikingly.

The assumption here is that the country will have a generally growing and prosperous economy over the next decade. Thus, it is sensible

also to assume that there will be continued pressure for State and local governments to expand their outlays beyond the increases needed simply to accommodate a larger population at the same standards of performance. Quantifying this is, of course, a highly subjective matter. In general, the inclination here is to avoid building into the projections very large wholly new programs not foreshadowed by developments already in train but to make allowances for all sorts of marginal extensions of the quantity and quality of public services.

THE PROJECTIONS

Table 3 summarizes one set of views as to the likely magnitude of State-local expenditures in 1970 and 1975 (excluding debt service). Three "models" are indicated. The level of expenditures required to match population and enrollment increases, with no increase in per capita or per pupil outlays, is labeled the "constant costs model." This is highly unrealistic, in part because the standards and scope of public programs change over time, but also for another reason.

TABLE 3.—*Projections of State-local government general and utility expenditures (excluding interest), 1970 and 1975* [1]

[In millions of dollars]

Fiscal year and "model"	Local schools	Higher education	Highways [2]	All other	Total
1963–64 [3]	20,399	5,525	11,664	33,955	71,543
1969–70:					
"Constant costs model" [4]	22,025	8,000	13,700	37,525	81,250
"Competitive model" [5]	25,150	8,200	13,700	43,500	90,550
"Improvement model" [6]	28,525	8,625	13,700	48,750	99,600
1974–75:					
"Constant costs model" [4]	23,150	10,025	14,700	40,925	88,800
"Competitive model" [5]	29,950	10,425	14,700	53,675	108,750
"Improvement model" [6]	36,850	10,700	14,700	62,325	125,575
Continuation of 1957–64 rate of increase [7]	45,600	19,225	21,100	66,675	152,600

[1] All projections assume general prosperity in the economy, overall price level stability, and a satisfactory rate of economic growth. It is assumed that the accompanying increase in productivity will result in steady increases in the average levels of employee compensation in the private sector.

[2] Highway expenditures, which are now largely determined by the scale of the Federal program are projected under only a single "most likely" alternative.

[3] Expenditures for fiscal years ending between July 1, 1963, and June 30, 1964; from U.S. Bureau of the Census, Governmental Finances in 1963–64 (May 1965).

[4] In this "model" (except for highways), increased expenditures reflect only the increase in population or (for education, enrollment):

(i) Local schools—constant per pupil operating costs, adjusted for the more rapid increase in the higher cost secondary school enrollment expected.

(ii) Higher education—constant per student overall operating costs.

(iii) In both education categories, capital outlays are the same in all 3 alternatives and reflect the estimated cost of accommodating the increased enrollment (at current standards) plus minor replacement costs.

(iv) "All other"—constant per capita costs, adjusted to reflect the facts that expenditures are twice as high in urban areas as in rural areas and that all the population increase is expected to be in urban areas.

[5] In this "model" (except for highways), the projections have been increased to reflect the fact that, if State-local governments are to command resources, they must match wage and salary increases and the like which take place in the private sector, with few if any offsetting productivity gains. The education projections here are adapted from the U.S. Office of Education projections based on a continuation of 1953–63 increases in per pupil or per student current operating expenditures, expressed in constant dollars. The "all other" projections reflect a projected 2.5-percent average annual rise in overall costs, based on a much larger expected rise in personnel costs.

[6] In this "model," unlike the previous ones, an allowance is made for significant improvements in the standards of public services, in general based on expenditure levels in places where standards are known to be high:

(i) Local schools—current expenditures are 15 and 25 percent higher than in the previous "model" in 1970 and 1975, respectively. Per pupil operating expenditures average $850 in 1975, versus less than $450 currently.

(ii) Higher education—current expenditures are 10 and 20 percent higher than in the previous "model" in 1970 and 1975, respectively.

(iii) "All other"—current expenditures are 15 and 20 percent higher than in the previous "model" in 1970 and 1975, respectively. Capital outlays are unchanged from the previous "model."

[7] The level of expenditures which would result if expenditures increased as rapidly between 1964 and 1975 as they did between 1957 and 1964.

In an environment of overall price level stability, the prices of factor inputs in the productive process are likely to rise, but—in the private sector of the economy—to be offset by improvements in productivity. Specifically, wage and salary rates are likely to rise substantially in a prosperous atmosphere, as in the past few years. If State-local governments are to command resources, manpower in particular, they must at least match the wage and salary increases in the private sector. If they are to *bid away* resources from the private sector, as they must if their share of GNP is increasing as projected (see table 4), they must do even better. However, experience suggests that there are relatively few offsets to these salary increases in the form of improved productivity, for the most costly State-local functions, notably education and health and welfare services.[4]

TABLE 4.—*Projected State-local expenditures and gross national product, 1970 and 1975*

[Dollar amounts in billions]

Item	1963–64	1969–70	1974–75
State-local general and utility expenditures (excluding interest) [1]	$71.5	$99.6	$125.6
Percent increase over 1963–64		39.2	75.5
Gross national product [2]	$603.4	$762.2	$916.3
Percent increase over 1963–64		26.3	51.9
State-local expenditures as percent of GNP	11.8	13.1	13.7

[1] From table 3; "improvement model" expenditures.
[2] GNP projected to increase at average annual rate of 3.75 percent, from calendar 1964 level of $622,400,000,000. Data shown are for year ending June 30.

Therefore, a second "model," labeled the "competitive model" is shown, with attempts to measure the probable costs of State-local programs of constant quality (but expanded to serve the larger workload) in view of the higher salary and other costs which State-local governments will confront. This may be considered the minimum level of expenditures which are at all likely.

The third or "improvement model" is more likely still. This allows for improving the quality or expanding the scope of State-local services, but at a relatively modest rate, surely less rapidly than in recent years. As table 4 shows, under this "improvement model," State-local expenditures will increase significantly as a share of GNP.

Local schools—The "constant costs" projections for local schools are simply a reflection of the anticipated increase in enrollments, with an adjustment reflecting the much more rapid increase in high school than elementary school enrollments. It appears that per pupil operating costs in high schools are roughly twice as high as in the elementary schools.

The "competitive model" involves increases in per pupil costs equivalent to those experienced in the 1953–63 period, expressed in dollars of constant purchasing power. There is a rationale for this, however. Office of Education estimates indicate that the demand for new teachers

[4] This is not to say that major improvements in productivity are impossible in State-local governments. Rather, we are saying, first, that major improvements have not been the actual experience; second, that in highly individualized personal and professional activities—public or private—improved productivity is not readily discernible; and third, that productivity improvements which take the form of better service at higher costs (which may very well occur in State-local government) are almost impossible to measure.

will equal 10 percent of the number of teachers on the average year in the decade ahead, with net additions to the number of teachers of 2 to 2½ percent each year. Attracting these teachers will require steady increases in the salaries paid, at a rate greater than the increase in salaries in the economy generally. Even if all other costs of education remain constant, since salaries of instructional personnel amount to more than two-thirds of total current school costs, per pupil costs are likely to rise by 35 to 40 percent by 1975. In reality, the "competitive model" projection here may *understate* the probable increase in expenditures for school programs of constant quality.

The "improvement model" similarly may involve understatement. It allows for flat increases of 15 and 25 percent above the "competitive model" in 1970 and 1975, respectively, increasing average per pupil costs from about $450 currently to $850 in 1975. Numerous high-income suburban school districts provide high quality school systems today at per pupil costs well in excess of $1,000, and some large central city school systems are approaching the $1,000 per pupil level. If the nationwide average per pupil cost in 1975 were to reach $1,000, total school expenditures would be $6.5 billion greater than in the "improvement model" in table 3.

Nevertheless, because of the expected slowing in enrollment increases, expenditures for schools are most unlikely to increase as rapidly as in recent years, as the bottom line of table 3 suggests.

Higher education—Here the large expected increase in enrollments is clearly the most important factor in the projections. In part, this is because the aggregates hide some important considerations. As higher education has expanded in recent years, faculty salaries and similar costs have risen steeply and per student costs at institutions maintaining essentially constant programs have also risen very steeply. But a large part of the increase in enrollments has been absorbed by institutions with relatively low costs, such as junior colleges, and this is expected to continue. Moreover, class sizes in colleges have increased significantly. Thus the "competitive model" reflects a very small amount of cost increase per student, for all public institutions in the country as a whole. In effect, then, public higher educational institutions are expected to achieve a form of productivity increase, to offset rising salary costs.

This could be very wide of the mark, if as some developments suggest, attempts are made to match cost and quality levels in the most prestigious institutions on a very widespread scale. But even so, here again the rate of increase in expenditures in the 1957–64 period is not likely to be matched.

Highways—A single set of projections of highway expenditures is offered in table 3, indicating a very slow rate of increase from current levels. This is because the Federal highway program is the major determinant of the overall scale of highway expenditure, and the Federal program is very largely "set" by the basic legislation, the 1956 act as amended. The projection here is that federally aided highway *capital* expenditure, which now account for about 80 percent of total highway capital outlays, will remain at current levels through 1975, and that other highway capital outlays as well as maintenance and similar costs will rise gradually as in the past few years. Since the Federal program is designed to meet the major needs of traffic well

into the 1970's, it is difficult to conceive of any major upward movement in highway expenditures.

All other activities—The projections shown in table 3 were made across the board, for all other functions taken as a group. They reflect, first, the increase in the urban population, with high expenditure requirements; second, the salary increases necessary to remain "competitive" for resources; and third (in the "improvement model"), flat percentage increases representing program enrichment. The overall result suggests a continued rate of increase in expenditures not far below recent rates.

Examination of developments in particular programs suggests that this is a reasonable expectation. For example, the projections are consistent with substantially increased activities in the field of urban renewal, mass transportation, and local parks and recreation, which now seem likely. They also are consistent with a prospective slackened rate of investment in new airport and port facilities, some diminution of the State-local social welfare burden in connection with the transfer of some medical care costs to the Federal Social Security program via Medicare, and some economizing on housekeeping services through greater utilization of automated equipment and techniques. But here, too, wholly new programs could change prospects considerably; however, such wholly new programs seem unlikely without Federal stimulation, in which case Federal funds will finance much of the costs (as in the poverty program).

Additional financial requirements—The program expenditure projections in table 3 are not a complete picture of State-local financial requirements. Some additional requirements, which give rise to additional taxation or borrowing, are shown in table 5. State and local government contributions to retirement systems for their employees now exceed $2 billion a year and are increasing at least as fast as other types of expenditure.

TABLE 5.—*Projections of additional financial requirements of State-local governments, 1970 and 1975* [1]

[In millions of dollars]

Type of requirement	Actual, 1963–64 [2]	Projected	
		1969–70	1974–75
Government contributions for employee retirement not included in general and utility expenditures [3]	1,715	2,700	3,300
Addition to operating balances, sinking funds, and bond funds [4]	(5)	3,000	3,000
Interest on total debt	2,826	[6] 4,100	[6] 5,050
Retirement of long-term debt	5,045	[7] 6,100	[7] 7,600
Total of above	(5)	15,900	18,950

[1] These are requirements above the expenditure projections shown elsewhere.
[2] Based on Census Bureau data.
[3] Although these amounts do not appear as expenditures in Census Bureau data, they do increase revenue requirements; projections reflect the expansion in State-local expenditures overall, excluding capital outlays. Local government contributions to State-administered retirement systems are included in general and utility expenditures.
[4] The recent rate of increase has been nearly $3,000,000,000 a year; substantial economies in balances are conceivable, although not likely.
[5] Not available.
[6] Equals 3.2 percent of total debt, assuming a net increase in indebtedness of $6,000,000,000 a year.
[7] Equals 5 percent of projected long-term debt.

In addition, the expanding scale of State-local government operations results in steady additions to financial assets held as required offsets to debt (e.g., between the time bonds are sold for a major construction project and the time the proceeds are disbursed), or ordinary working balances. The State-local sector as a whole is profligate in its ratio of balances to transactions (roughly a 1-to-2 ratio) compared with business and the Federal Government (close to a 1-to-20 ratio), and very large economies could be achieved, in theory. However, a variety of institutional arrangements conspire to prevent this economizing, and it is therefore not projected to occur.[5]

In addition, debt service requirements are included in table 5, on the assumption that indebtedness continues to increase at the rate of $6 billion a year net, which is more or less the recent rate of increase in debt. At present, borrowing finances very nearly 100 percent of State-local capital outlays not receiving Federal aid, except for highways which are largely financed from State highway-user taxes with minor borrowing. The "improvement model" is a low capital outlay model, involving only modest increases in capital expenditures from the current high rates. The rate of increase in debt in table 5 would continue the present pattern of debt financing of nearly all nonhighway capital outlays. If the rate of capital spending were to increase sharply, and if capital market conditions permitted, indebtedness and debt service charges might increase more rapidly than indicated in table 5. But it is highly unlikely that the long precedents which largely prevent State-local governments from financing current operating costs by borrowing will be upset.

ON THE RELIABILITY OF EXPENDITURE PROJECTIONS

If earlier experience means anything, there is a built-in conservative bias in overall projections such as those presented above. That is, somehow such projections seem incapable of reflecting all the pressures for increased expenditures which the thousands of State and local governments individually feel and respond to. At any rate, this appears to be the explanation for the repeated tendency of the overall projections made in recent years to understate the expenditure increases actually occurring.

Table 6 presents three such sets of projections published in 1959, with base years of 1957 or 1958 and projections for 10- to 13-year periods. These projections are expressed in terms of average annual percent increases, and compared with the actual 1957–63 experience. It can be seen that all of the projections are on the low side, with the exception of the Colm-Helzner projections for urban renewal and health and hospitals, which however anticipated wholly new types of programs not now in view. It is true that the costs of State-local government, as expressed by the implicit GNP price deflator for State-local purchases of goods and services, rose rapidly in an atmosphere of general price stability, but this explains only a small part of the difference—1 to 1.5 percentage points a year, depending on the set of projections in question.

[5] If such economizing were to take place, balances might be *reduced* by as much as $2 billion a year, instead of increasing at $3 billion a year, thus reducing total financial requirements by as much as $5 billion a year below the figures shown in tables 3 and 5.

TABLE 6.—*Comparison of previous State-local expenditure projections with actual experience, 1957–63*

[Average annual percent increases in expenditures projected and realized]

Function	Eckstein, 1957–68 projections [1]	Colm-Helzner, 1958–70 projections [2]	Netzer, 1957–70 projections [3]	Actual increase, 1957–63 [4]
Education	5.4	5.8	6.1	9.3
Highways	2.8	3.8	4.7	6.1
Health and hospitals	2.9	9.5	4.5	7.0
Housing and renewal	6.5	25.8	6.3	16.3
Other	3.7	4.8	3.7	7.4
Total	4.3	6.1	4.8	7.9

[1] Otto Eckstein, "Trends in Public Expenditures in the Next Decade," CED Supplementary Paper (April 1959). Calendar year projections on a national income accounts basis.
[2] Gerhard Colm and Manuel Helzner in "Public Finances: Needs, Sources, and Utilization," National Bureau of Economic Research (1961). Calendar year projections on a national income accounts basis, "judgment model" projections.
[3] Dick Netzer in "Public Finances: Needs, Sources, and Utilization." Fiscal year projections on the basis of Census Bureau concepts; "substantial improvement" model, with allowances for relative price shifts.
[4] Census Bureau data and concepts, for fiscal years ending during the calendar years 1957 and 1963.

The consistent understatement for education and the catchall "other" category suggests that the difficulty is, indeed, a failure to reflect widespread increases in the quality and scope of public services. In light of this, the projections in table 3 must be viewed with caution, and considered not maximums but minimums. *The likelihood, therefore, is that the fiscal problem of State-local governments will in fact be more serious than this paper suggests*, and that the pressure for additional taxation will be greater.

III. STATE-LOCAL FISCAL RESOURCES

NONTAX RESOURCES

The main focus of this paper is on State-local taxation: the productivity of State-local tax systems relative to likely financial requirements and the types of tax increases possible, likely, and/or desirable. However, State-local tax revenues cover only about one-half of total financial requirements at present (see table 2). Substantial additional funds are provided by borrowing, Federal aid, and what are here designated "program-associated receipts"—taxes, charges, and similar payments by users of specific public services and facilities related to the nature and extent of specific uses.

These nontax resources will be discussed first, before turning to tax revenues, because it is felt that the possibility or likelihood of major policy changes here, on the initiative of State-local governments themselves, is limited. The volume of State-local *borrowing* is affected by the level of capital outlays and by the capacity of the capital market to absorb increases in State-local debt obligations. While debt limits in State laws and constitutions frequently restrict the freedom of action of State and local agencies, all sorts of devices for avoiding the limits have been developed and it is likely that, in the aggregate, debt limits have not worked to limit the overall growth in State-local debt. Thus, easing of debt limits by itself would not lead to a large rise in borrowing, and thus relieve the pressure on tax sources of funds.

Between 1953 and 1963–64, State-local long-term borrowing increased from less than $5 billion to more than $11 billion. This paralleled almost exactly the increase in State-local capital outlays for other than highway purposes. As indicated earlier, it is considered highly unlikely that the link between the level of capital outlays and the volume of borrowing will be served, by the truly radical change of permitting State-local governments to finance current operating costs by borrowing (except on a very short-term, seasonal basis). Therefore, the following is projected:

[In billions of dollars]

	1963–64	1969–70	1974–75
Nonhighway capital expenditures ("improvement model")	11.1	12.6	14.5
Long-term debt issued	11.2	12.1	13.6

The actual borrowing projection technique was to assume a net increase in indebtedness (debt issued less debt retired) of $6 billion a year, approximately the recent level. The capacity of the market for State-local obligations to absorb much larger amounts is limited by the changing nature of the principal investor forces in the Nation's capital markets. State-local obligations, whose interest is exempt from Federal income taxation, are sold primarily to investors with a taxable status, particularly at the higher marginal tax rates—the corporate rate and the upper bracket personal rates. But major classes of investors—pension funds, mutual funds, the various funds of State and local governments themselves, and most mutual financial institutions—are not concerned with Federal income taxation and hence not interested in tax-exempt securities, unless the return on them is much higher than it is generally. And these are the investor groups of growing importance. High-income individuals, casualty insurance companies, and commercial banks (in periods of low private credit demand), are the mainstays of the market for municipals, and they do not seem likely to absorb very much larger offerings than in recent years, especially in view of the reductions in the highest marginal tax rates under the Federal income tax.

Federal aid and program-associated receipts.—To some extent, at least, the increased fiscal requirements projected in the preceding section will generate their own finance, in the form of Federal aid or user charge revenue. To be sure, very often the causative relationship is the reverse: that is, the additional Federal aid or gasoline tax collections permit an increase in expenditure. The point, however, is that these earmarked receipts and expenditures are inextricably linked and that, therefore, the net additional burden on general revenue sources is less than the rise in expenditure would indicate.

The projections of expenditure in table 3 have implications for Federal aid and other program-associated revenue which are shown in table 7. Both sets of projections assume that under the specified economic and demographic conditions, recent trends will continue without radical new departures. Thus, as in the recent past, there will be a slowly increasing reliance on both Federal aid and user charges for certain key programs, for example education with regard to Federal aid and water and sewerage with regard to user charges. As the scale of expenditure rises, under these asumptions, more Federal aid under

existing programs, expansions of the scope of these programs, and modest new programs can be expected within the span of one decade. Regarding user charges, for some activities revenue will automatically rise with the scale of operations; in others, higher rates for the charges can be anticipated; and in still others, there are obvious possibilities for emulation by some governments of successful introduction of new types of user charges by others (e.g., sewer service charges). But, to repeat, nothing really radically different is expected—such as, for example, a wholesale shift of the burden of health and welfare costs to the Federal Government, or shifting of fire protection costs from tax support to financing by service charges levied on a square footage, front footage, fire insurance premium basis, or something of this sort.

TABLE 7.—*Projected Federal aid and State-local "program-associated" receipts in relation to expenditure projections, 1970 and 1975*

[In millions of dollars]

Fiscal year and item	Education	Highways	All other	Total
1963–64 [1]				
Expenditures	25,924	11,664	33,955	71,543
Federal aid [2]	[2] 1,654	[2] 3,628	4,720	10,002
Program-associated receipts [3]	2,811	7,400	9,500	19,700
1969–70				
"Improvement model" expenditures [4]	37,150	13,700	48,750	99,600
Federal aid	4,950	4,300	7,250	16,500
Program-associated receipts [3]	4,150	8,900	12,800	25,850
1974–75				
"Improvement model" expenditures [4]	48,550	14,700	62,325	125,575
Federal aid	5,950	4,000	9,900	19,850
Program-associated receipts [3]	5,450	10,250	15,375	31,075

[1] For fiscal years ending between July 1, 1963, and June 30, 1964; from U.S. Bureau of the Census, Governmental Finances in 1963–64 (May 1965).
[2] Total equals State-local revenue from Federal Government; amounts for education and highways equal Federal intergovernmental expenditures for these purposes.
[3] Includes highway-user tax revenues, utility revenues, charges for other services, special assessments, and minor other program revenues. Partly estimated for 1963–64.
[4] From table 3.

In table 7, very large increases in Federal aid for education are projected, reflecting the expected workings of recent legislation over the decade. Federal aid for highways, in contrast, is "pegged" at the levels suggested by the current highway legislation, with some stretchout of the current program beyond the formal termination date of 1972. This is to account for highway costs in excess of those anticipated when the present financial arrangements were established (this conforms with the Weidenbaum projections). Within the "all other" category, large percentage increases in Federal aid are projected for housing and renewal, health, and water pollution control (sewerage) activities; large dollar increases are projected for welfare. This, too, reflects recent and pending legislation.

The large increase projected for program-associated receipts in education is mainly a consequence of increased enrollment in public higher educational institutions, with higher student fees and auxiliary revenues. Another notable feature of the projections for program revenues is in connection with State-local hospitals: a large part of the fiscal effect of the Medicare program is expected to take the form of the payment of hospital charges in behalf of formerly indigent patients from social security funds.

PROJECTED TAX REVENUES UNDER PRESENT ARRANGEMENTS

The first step in examining the capacity of State-local tax systems to finance the expected requirements is to project the revenues likely to accrue automatically from the growth in the Nation's economy. That is, if GNP increases by 3.75 percent annually, how rapidly will State-local tax revenues grow, without any further changes in tax rates, the use of new taxes, or the coverage (or similar provisions) of existing taxes?

This requires an analysis of the changes in the bases of the respective major taxes associated with a given change in GNP. For the property tax, the issue is the responsiveness of the market value [6] of taxable property to economic growth. For taxes with a progressive rate structure—individual income taxes and death and gift taxes—the issue is the change in the base adjusted for the average degree of progressivity. For taxes based on the quantity or dollar value of goods or services purchased, the issue is how these increase with economic growth.

The usual method of attacking the problem is to look at the experience of the recent past, and try to distinguish two aspects of the increase in tax revenues actually realized: the increase due to expansion of the tax base and the increase due to increases in tax rates, adoption of new taxes, and the like (all designated here as "changes in effective rates," for short).[7] Tables 8 and 9 present the results of such an effort for the period 1946–63. Table 8 indicates the magnitude of estimated changes in effective rates (that is, in the tax laws and rates themselves), which have been large and widespread throughout the period since the ending of World War II. Overall, State-local effective tax rates are estimated to have been 41 percent higher in 1963 than in 1946, and non-property taxes 82 percent higher. Since the early 1950's, effective rates have increased by about one-third.

TABLE 8.—*Estimated changes in effective rates of major classes of State-local taxes (excluding highway user taxes), fiscal 1946–63*

Tax	Percent change in effective tax rates		
	1946–52	1952–57	1957–63
Property	−9	+15	+11
Income	+5	+16	+17
Sales and gross receipts [1]	+44	+18	+22
All other [2]	+34	+24	+6
Total	+7	+16	+14
Total, excluding property taxes	+31	+18	+18

[1] Includes excess of revenue over expenditure of liquor monopoly systems; excludes motor fuel taxes.
[2] Including death and gift taxes and licenses and permits; excludes motor vehicle and operators' licenses.

[6] Market, rather than assessed, value is used here, to free the analysis from unpredictable changes in local assessment practices. If property value is considered evidence of taxable capacity, then market value, rather than the assessor's guess, is surely the appropriate measure.

[7] The basic approach used is that described in an earlier study by the author. In *Public Finances: Needs, Sources, and Utilization*, National Bureau of Economic Research (1961) The 1946–57 data in tables 8 and 9 come from that study.

TABLE 9.—*GNP elasticity of State-local tax bases (excluding highway-user taxes), estimated 1946–63 and assumed for projections*

Tax	Percentage change in tax bases associated with 1-percent rise in GNP		
	Estimated, 1946–57	Estimated, 1957–63	Assumed for projections
Property	[1] 1.00	1.25	1.00
Income	1.40	1.49	1.55
Individual	1.53	1.70	1.75
Corporation	1.28	1.10	1.15
Sales and gross receipts: [2] [3]	(4)	(4)	1.00
General	.92	1.00	1.00
Alcoholic beverage [2]	[1] .19	.60	.60
Tobacco products	[1] .62	.80	.75
Other [3]	1.45	1.40	1.40
Death and gift	1.98	1.80	1.80
All other, including licenses and permits [5]	[1] 1.09	1.10	1.10

[1] Change based on constant prices for these taxes, because of rapid change in price level during this per od
[2] Includes excess of revenue over expenditure of liquor monopoly systems.
[3] Excludes motor fuel taxes.
[4] Not computed because of differences in bases.
[5] Excludes motor vehicle and operators' licenses.

Table 9 indicates the "GNP elasticity" of State-local tax bases, that is, the percent change in tax bases associated with a 1-percent increase in GNP. In order to abstract from the postwar inflation, some of the 1946–57 estimates are shown in terms of constant dollars. This was felt to be unnecessary for the 1957–63 period and for the projection period, because of the relatively stable overall price level experienced or assumed.

The elasticities assumed for the projection period are rather similar to those experienced, with adjustment for tax structure changes in recent years which affect elasticity (e.g., the 1959 income tax revisions in New York State have increased the elasticity of the individual income tax). There are two changes worth noting. An elasticity of 1.00 for the property tax (that is, the market value of taxable property is expected to increase in proportion to GNP) is assumed for the coming decade, a figure which seems equal to the 1946–57 experience but is below the 1957–63 experience. Over the long pull (since 1900, for example), the value of investment in forms commonly subject to the property tax has increased *much* less rapidly than national income or output. That is, the ratio of capital to output has declined considerably, as is to be expected with rising efficiency of productive assets. Moreover, a number of careful studies of the elasticity of the property tax base suggest that elasticity figures of 0.8 or less are appropriate for the coming decade. The 1.0 figure used here is a compromise between recent experience, which cannot be ignored, and this other evidence.

The second change is the reduction of the figure for tobacco products, a reduction reflecting some allowance for changes in smoking habits in response to concerns over the impact on health.

The application of the assumed elasticity figures and the assumed increase in GNP result in the projections shown in table 10: an increase in total tax revenue of 60 percent (or $25 billion) between 1963–64 and

1974–75, while GNP is increasing by 52 percent. That is, overall tax revenues are expected to increase 15 to 20 percent faster than GNP, under these assumptions. In 1957, if existing tax structures remain as they were in 1963–64 in all respects, the forces of economic growth will increase the relative importance of income taxes significantly, and will marginally reduce the relative importance of other State-local tax sources.

TABLE 10.—*Projected revenue from State-local taxes, 1970 and 1975, assuming no change in tax rates, usage, or other provisions* [1]

[In millions of dollars]

Tax	Actual, 1963–64 [2]	Projected at 3.75-percent growth rate [3]	
		1969–70	1974–75
Property [4]	21,241	27,725	33,325
Income	5,486	7,925	10,175
Individual [4]	3,791	5,650	7,400
Corporation	1,695	2,275	2,775
Sales and gross receipts [5] [6]	11,912	15,150	18,250
General [4]	7,254	9,450	11,350
Alcoholic beverage [5]	1,135	1,325	1,525
Tobacco products	1,280	1,475	1,725
Other [6]	2,243	2,900	3,650
Death and gift	658	950	1,275
All other, including licenses and permits [7]	2,589	3,400	4,150
Total	41,886	55,150	67,175
Total, excluding property taxes	20,645	27,425	33,850

[1] That is, taking into account only the effect of the projected increases in GNP, as applied to 1963 and 1964 tax provisions.
[2] From U.S. Bureau of the Census, Governmental Finances in 1963-64 (May 1965).
[3] Assumed average annual GNP growth rate.
[4] Projected on the basis of calendar 1964 tax collections data, using fiscal 1964 GNP as the starting point. Other taxes were projected from fiscal 1963 tax data, using calendar 1962 GNP as the starting point.
[5] Includes excess of revenue over expenditure of liquor monopoly systems.
[6] Excludes motor fuel taxes.
[7] Excludes motor vehicle and operators' licenses.

The use of alternative assumptions as to the expected rate of economic growth makes only a small difference in the projections, as table 11 shows. If a growth rate of 4 percent is assumed, total tax revenues in 1975 will be $1.7 billion above the projected levels of table 10, a difference of only 2.5 percent. A growth rate of 3.5 percent yields a reduction of similar magnitude. If GNP were to increase by 4.25 percent over the period, which is a very high rate indeed, total tax revenue would increase by 68 percent between 1963–64 and 1974–75, which is still less than the expenditure increase expected (see table 4).

TABLE 11.—*Projected State-local tax revenue, 1970 and 1975, at constant rates under alternative economic growth assumptions* [1]

[In millions of dollars]

Tax	1969-70			1974-75		
	3.5 percent [2]	3.75 percent [2]	4 percent [2]	3.5 percent [2]	3.75 percent [2]	4 percent [2]
Property	27,375	27,725	28,050	32,525	33,325	34,125
Income	7,775	7,925	8,050	9,850	10,175	10,500
Sales and gross receipts [3]	14,975	15,150	15,350	17,800	18,250	18,700
Other [4]	4,300	4,350	4,425	5,275	5,425	5,550
Total	54,425	55,150	55,875	65,450	67,175	68,875
Total, excluding property taxes	27,050	27,425	27,825	32,925	33,850	34,750

[1] Projected on the same basis as table 10.
[2] Assumed average annual GNP growth rates.
[3] Includes excess of revenue over expenditures of liquor monopoly systems; excludes motor fuel taxes.
[4] Excludes motor vehicle and operators' license.

THE NEED FOR HEAVIER TAXATION

How does anticipated revenue from nontax sources and from current State-local tax systems compare with anticipated financial requirements? Table 12 presents the results: a need for additional tax revenue (or entirely new types of Federal aid or tax sharing arrangements) of $4 billion in 1970 and nearly $11 billion in 1975. It must be kept in mind that *this is likely to be an understatement* of the size of the problem. The expenditure projections, as noted earlier, have a built-in conservative bias and are likely to be on the low side.[8] There is no parallel offsetting bias in the revenue projections; they may in fact to be too high.

TABLE 12.—*Projected need for additional State-local tax revenues, 1970 and 1975*

[In millions of dollars]

Item	1969-70	1974-75
Program expenditures (table 3) [1]	99,600	125,575
Additional requirements (table 5)	15,900	18,950
Total financial needs	115,500	144,525
Less:		
Nontax resources:		
Long-term debt issued [2]	12,100	13,600
Federal aid (table 7)[1]	16,500	19,850
Program-associated receipts (table 7)[1]	25,850	31,075
Other [3]	1,850	2,000
Subtotal	56,300	66,525
Tax revenues under current laws (table 10)	55,150	67,175
Total	111,450	133,700
Equals additional tax needs	4,050	10,825

[1] "Improvement model" expenditures and associated receipts.
[2] Assuming net increase in indebtedness of $6 billion a year.
[3] Sale of property, interest on balances, etc.

[8] For example, a set of State-by-State projections of expenditures for higher education for 1970, which have been criticized themselves as too low in particular States, forecasts higher education expenditures one-third greater than those shown in table 3. Selma J. Mushkin and Eugene P. McLoone, *Public Spending for Higher Education in 1970*, Council of State Governments (February 1965).

Accepting table 12 as the most likely picture, the indication is that State-local effective tax rates must be raised by 14 percent by 1975. Now, this is not a very large increase in tax rates (or in adoptions of new taxes and the like) by recent standards: table 8 indicates an increase of similar proportions in the 6 years, 1957–63. But it does present a number of problems. First, there appears to be increasing public resistance to State-local tax increases, in many places, after nearly 20 years of tax rate increases. Second, the increasingly widespread use of new types of taxes in recent years mean that, in many places, a full range of tax devices is in use and increased revenue can come only from increasing the rates of existing taxes, not the adoption of new ones. Third, the defects in State-local tax devices, which are many, become steadily more pronounced as the rates at which they are applied rise.

The issue, then, is this: which types of taxes can in fact be used to fill the gap? Which are most likely to be used? And which are most desirable, or least undesirable, from the standpoint of national economic and social objectives?

THE PROPERTY TAX

Although the property tax remains much the most important State-local tax, with approximately stable relative importance in recent years, and is universally used by local governments, its importance and the composition of the property tax base varies widely from place to place. In the late 19th century, the classic age of the tax, it was truly general in application, and at a uniform rate, to all forms of privately owned wealth. By now, however, exemption and special treatment (meaning lower tax rates, in effect) have resulted in a tax base overwhelmingly composed of real property, with business equipment and inventories included in the base in most places, and motor vehicles in some places, but household goods and intangible property excluded almost universally in practice if not in law.

As table 8 indicates, effective property tax rates increased nearly 30 precent between 1952 and 1963. Were property tax rates to continue to increase at this rate over the projection period, property tax revenues in 1974–75 would be $10 billion higher than the constant rate figure shown in table 10, and the indicated revenue gap would be closed by this alone.

Perhaps another indication of the theoretical potential for increases in property tax rates is suggested by the very considerable variation in effective property tax rates, even among the large urban States. The following is the Census of Governments evidence, for some selected States, as to the statewide average effective rates on locally assessed real property (local general property tax revenue from such property divided by its estimated market value):[9]

[9] From U.S. Bureau of the Census, *Property Taxation in 1962*, Special Study No. 47 (November 1964), table 7.

[In percent]

	1957	1962
Massachusetts	2.8	2.7
New York	2.7	2.5
New Jersey	2.3	2.6
Wisconsin	1.9	2.1
Illinois	1.4	1.7
Michigan	1.3	1.7
California	1.2	1.3
Indiana	.9	1.2
Texas	.8	1.0
United States	1.3	1.4

If effective rates were to rise so rapidly that the average for the country in 1974–75 equaled the rates used in a moderately high-rate State in 1962—say, Connecticut or Minnesota, with a 1.9-percent rates—revenues would be roughly $11.9 billion higher than the figure shown in table 10.

It is questionable whether rates will indeed rise quite so rapidly. For one thing, as table 8 shows, overall effective rates have risen a good deal less rapidly since 1957 than they did between 1952 and 1957. For another, the State figures cited immediately above suggest some resistance to effective rate increases in the high-rate States. For example, the two highest rate States in 1957, Massachusetts and New York, experienced *declines* between 1957 and 1962 for the States as a whole.

Yet another factor casting some doubt on the likelihood of so large an increase in property tax revenue is the continued pressure for narrowing the tax base, which surely is increased by rising effective tax rates. The chances are better than ever that the next decade will witness exemption of at least some classes of personal property (e.g., inventories, household goods, motor vehicles) in some of those States, principally in the Midwest, where the coverage of the property tax is still quite broad. And as has been noted earlier, when the property tax is confined to real property, its revenue responsiveness to economic growth is reduced.

There are other forces for narrowing the tax base as well. Public efforts in housing and urban renewal frequently end up with significant additions to the roll of tax-exempt property; if the large-scale New York program of tax abatement for middle-income housing is emulated elsewhere, it is conceivable that very large proportions of the new housing built in the developed portions of metropolitan areas might be taxed on a reduced basis by the end of the decade. In addition, other expansions of the activities of the public sector of the economy—building new roads and airports in particular—remove property from the tax rolls, and the expanding role of nonprofit, tax-exempt organizations has a similar effect.

As tax rates rise, concern over the impact on a community's competitive attractiveness is also heightened, and can have a restraining influence on the tax increases themselves. Location of new plants in an industrial "tax haven" with few schoolchildren becomes a good deal more alluring when school property tax rates reach 3 percent of the market value of real property, as they have in a considerable number of suburban New York and New Jersey school districts.

Perhaps the best indicator of the likely increase in rates is the national experience since 1957; on a comparable basis, this would sug-

gest a 20-percent increase in effective rates by 1974–75, or revenues $6.7 billion above te table 10 level. In conclusion, then, the guess here is that property tax rates will *not* rise sufficiently to obviate other kinds of tax increases, although a significant increase in the burden of the property tax can be expected.

But even this increase can hardly be considered a desirable one. Heavy reliance on the property tax has all sorts of noxious influences on both the economy in general and the pattern of urban development. One obvious such influence is what has been called fiscal mercantilism, the incentive that small local governments relying on the property tax have to plan land use not on the basis of larger notions of suitability but for fiscal ends. That is, they try to zone out public service costs—mainly moderate-income families with school-age children—and zone in tax base—industry and high-income families living in expensive houses. This tends to produce a highly dispersed pattern of homes and jobs, and in the eastern half of the country, at least, very can be a deterrent to modernization and rehabilitation efforts which add substantially to needed transportation investment. Moreover, this fiscal mercantilism is both a product of and tends to perpetuate a fragmented structure of government in metropolitan areas and parochial attitudes toward areawide public problems.

Within the older, already developed portions of metropolitan areas—particularly central cities—heavier reliance on the property tax tends to have unfortunate results as well. Heavier taxation of industrial property—important in the tax bases of many older central cities—tends to speed the flight of industry to the outer areas. High property tax rates do little to discourage ownership of slum properties which typically have a very high ratio of net income to value, but can be a deterrent to modernization and reabilitation efforts which often increase value a great deal more than they increase the income from the property.

In addition, the long-recognized general defects of the property tax are most apparent in the central cities. The tax is for the most part very badly administered with wide deviations from the legal standard of uniform assessment of properties of all types, ages, and values. Compared to, say, income or sales taxation, the degree of unequal treatment of similarly situated taxpayers—even in places which do a relatively good job of assessment administration—is shocking, and perhaps inherent. While big city tax agencies can afford professional assessment methods and personnel, the variety of property types, ages, and conditions tends to produce glaring inequities, which sap confidence in the performance of local government.

Insofar as the tax falls on housing, it is regressive with respect to income in most places, and in any event, it is doubtful that most people would deliberately choose to tax housing heavily as a conscious social policy. Finally, the portion of the tax on industrial and commercial property is certainly not neutral in its impact. It discriminates against capital-intensive activities in favor of labor-intensive ones (and the latter are often those for which the central city already has a competitive edge and therefore need not favor by lower taxation relative to gross receipts or value added). And when considered in conjunction with our high Federal corporate tax, it produces a rather anti-capitalistic tax structure for a capitalist economy.

All this suggests that even if heavier reliance on the property tax were to prove the path of least resistance for local governments, it is very much a primrose one for our urban society.

INDIVIDUAL INCOME TAXES

Although State income taxation antedates the 16th amendment and the present Federal income tax, it has not had a parallel development. It provides only about one-seventh of State government tax revenues, and is used in only 34 States, having less than two-thirds of the Nation's population.[10] Of the States directly astride the Nation's main industrial belt, from Boston to the Mississippi, seven do *not* use the tax.[11] Texas, Florida, and Washington are the other major nonincome tax States. One measure of coverage is afforded by Federal income tax data: the States without the tax account for 42 percent of adjusted gross income on 1962 Federal income tax returns.[12]

State individual income tax collections in 1963–64 amounted to about 7 percent of Federal tax collections, but this includes the States not using the tax. Data for 1959–61 indicate that the average ratio of State to Federal collections, for the States using the tax, was about 10 percent—far below the average for California, around the average for Massachusetts, well above for New York and Minnesota, and far above for Oregon and Wisconsin, to give some idea of the regional variation.

Because State income taxes are, without exception, progressive in structure (with rising marginal rates and personal exemptions or credits), revenues from them is very responsive to growth in GNP. The characteristic State income tax structure appears to be one under which a 1-percent rise in personal incomes in the State will be accompanied by a 1.8-percent rise in income tax receipts.

Because so many large States do not now use the tax, the possibilities for very large increases in aggregate income tax revenues through new adoptions are considerable. If all States were to adopt the tax at the average rates prevailing in 1964, total revenues would be nearly $4.8 billion higher in 1974–75 than shown in table 10. If the tax were to be universally used, but at appreciably higher rates, with today's low rate States using rates comparable to those of today's higher rate States, and overall effective rates averaging one-fifth higher than at present, revenues would be $7 billion higher in 1974–75 than the table 10 figure.

The obstacles to more widespread use of the tax and at higher rates are largely internal political ones, within each State, with the struggle focusing on questions of equity and the distribution of the State-local tax burden. Since State income tax payments are deductible in computing Federal income tax liability, at least for high bracket taxpayers the net burden is a small one and cannot have much of an impact on locational decisions among competitive States, except insofar as the existence of an income tax is taken as an indicator of an "un-

[10] Much information on the tax is in Advisory Commission on Intergovernmental Relations, *Tax Overlapping in the United States*, 1964, especially ch. 8. The 34 States include the District of Columbia but exclude 3 States with income taxes applying only to limited types of income.

[11] Illinois, Michigan, Ohio, Pennsylvania, New Jersey, Connecticut, and Rhode Island.

[12] U.S. Treasury Department, Internal Revenue Service, *Statistics of Income—1962, Individual Income Tax Returns* (1965).

friendly climate" for business of high-income individuals. Moreover, there are no serious obstacles in administration or compliance considerations which would preclude any large State from adopting the tax.

To be sure, the large States traditionally are either "income tax States" or "sales tax States." Both taxes are used by 24 States, but most of these are less urban, lower income areas—10 in the South (broadly defined) and eight in the mountain and plains parts of the country. Only California, Indiana, Maryland, Wisconsin, and now New York, among the high-income urban States, use both types of taxes on the State level. But given Federal deductibility and the resulting minor importance of interstate competition, it is hard to argue with the proposition that moderate rate State income taxes (even without a progressive rate structure) in the States not now using them, would be a sensible move in the decade ahead.

The same cannot be said for use of income taxes by local governments. Currently local income taxes, typically a 1-percent flat rate tax with no exemptions, produce about $375 million in revenue and are used in six States by nearly 30 cities over 50,000 in population including nine large cities, and by several hundred smaller places. The six States are Alabama, Kentucky, Michigan, Missouri, Ohio, and Pennsylvania; the nine large cities are Philadelphia, Pittsburgh, Detroit, St. Louis, Cincinnati, Columbus, Dayton, Toledo, and Louisville. Neither Ohio, Michigan, nor Pennsylvania have State individual income taxes. This information is as of 1964. These places in all contain about 8 percent of the urban population of the country, and probably a somewhat smaller share of the income usually taxed. Where the local income tax is used, it typically provides a very substantial share of local government revenues—in the Ohio cities using the tax, it generally produces more revenue than the property tax.

Obviously, with such limited usage of the tax today, the revenue possibilities from more widespread use are considerable. But there are major obstacles and objections to this. For one thing, small local governments cannot effectively administer anything except a narrowly based income tax, and local income taxes in practice do not tax property income. The very smallest units are virtually confined—insofar as the well-administered part of the tax is concerned—to payroll taxes collected from large employers. Naturally, so narrow an income tax raises bitter equity controversies.

For another, intrametropolitan area conflicts are inherent in this, for the very purpose of a local income tax is often to enable central cities to tax commuters in the face of the unwillingness of State legislatures to give them a "fair" proportion of State aid funds. But this too can encourage migration of activity from the central city; moreover, it can result in legislation giving the community of residence priority (as in Pennsylvania, except for Philadelphia), which may negate the purpose for which the tax was proposed to begin with.

In short, it appears that if income is considered an appropriate base for taxation, it can best be tapped at the State level, with the State distributing all or part of the proceeds to local governments on the basis of the taxpayers' residence or the location of their employment, to achieve a specified measure of property tax relief, to support local government in general, or to support specific public services. All

of these things have been done (directly or indirectly) heretofore, in some part of the country, and it seems the preferred course in most cases. (Some of the very largest cities may be the exceptions here.)

CONSUMPTION TAXES

The bulk of the revenue from consumption taxes is derived from general sales taxes—usually retail sales taxes imposed on a wide range of goods and a more limited range of services. The States adopted sales taxes in two bursts, mostly in the mid-1930's, but also since 1946. By 1964, 37 States and the District of Columbia had imposed the tax, and in 1965 New York adopted a statewide sales tax. New Jersey, Massachusetts, Minnesota, and Virginia are now the only States having a population of more than 3 million not using the tax; State sales taxes thus cover close to 86 percent of the country's personal income, far more than the coverage of State income taxes. Most of the bigger States exempt food from the tax, and some partially exempt clothing and medicines. Rates range from 2 to 5 percent, with 3 percent by far the most common rate. Since the low rates are mostly in smaller States, the weighted average rate probably is 3.2 to 3.3 percent.

The potential for additional revenue from the general sales tax is less than in the case of the individual income tax because of the greater usage of the tax at the present time, and is lesser responsiveness to economic growth. Were the tax to be used in all States, revenues in 1974–75 might be $3.3 billion more at the prevailing average rates, and $6.5 billion more if the average rate rose one-fourth to 4 percent.

A sales tax which exempts food and most housing expenditures (by definition, since few of the latter involve retail trade) is for the most part proportional rather than regressive with respect to income. Given a progressive Federal tax structure, it is difficult to object strenously on equity grounds to such a State tax. Moreover, the tax has little bearing on the location of economic activity; even if it did, the interstate competitive problem would be small since so many States now use the tax. Thus, it is a fair guess that, by 1975, State use of general sales taxes will be nearly universal.

Although sales taxes are used by a large number of local governments and produce nearly $1.2 billion a year in revenue, they are mostly low rate (½ or 1 percent) supplements to State sales taxes. In two States (plus New York prior to August 1, 1965), there are no State taxes but local taxes with rates as high as 3 percent. Virtually all municipalities and most counties in California and Illinois—nearly 1,700 local governments in all—impose low rate supplements to the State taxes, and low-rate sales taxes are used by about 450 local units in eight other States.

If local sales taxes were universally used at prevailing rates by all urban local governments, then sales tax revenues in 1974–75 might be $2.3 billion higher than shown in table 10. Were State legislatures to make it as easy for local governments to adopt local sales tax supplements (that is, only a resolution of the governing body) as they have in California and Illinois, it is highly likely that such universal use would actually develop. And if universally used by local governments, but administered by the States, this tax device is not ob-

jectionable on either administrative or intra-area competitive grounds. But, by the same token, the identical fiscal ends could be achieved by simply raising the State sales tax by ½ or 1 percent and distributing the added proceeds to the local units where the sales take place. So, in effect here we are talking about an across-the-board increase in State sales tax rates.

Liquor and tobacco have worldwide popularity as subjects of taxation, and generally produce substantial revenues whenever used because of willingness to employ very high tax rates, relative to the value of the product. In the United States, State and local agencies are somewhat inhibited from using high tax rates because the Federal Government already does so. However, the rates of State taxation have been rising in the postwar period, and can be expected to continue in the future, given the relatively minor impact on consumption of sizable rate increases. Moreover, there is a wide range in existing rates of taxes of various kinds on alcoholic beverages; an overall average rate increase of 30 percent or more over the decade could easily occur, if the bigger States raise their rates to the levels used by the high-rate States today.

Even this, however, would not produce large amounts of additional revenue; the problem is that these taxes are rather unresponsive to economic growth. For one thing, both liquor and tobacco taxes are levied mainly on a specific physical basis—cents per package or per gallon—rather than an ad valorem basis, which means that the tax collector does not share in the uptrading that accompanies rising incomes (from beer to champagne). For another, physical consumption of both liquor and tobacco products is rising less rapidly than income, especially in the former case. With liquor taxes universal and tobacco taxes in 47 States, even sharply higher rates would not yield more than $2 billion above the amounts shown in table 10, for the two types of taxes.

Local revenues from alcoholic beverage taxation are minor, mostly in the form of licenses, and very sluggish in their response to growth; they appear to have little potential and make little sense. Local cigarette taxes are more widespread—they are quite general in Alabama, Colorado, Florida, and Missouri, thus amounting to a supplement to the State tax (in Florida, a substitute for the State tax) in fact if not in name. A handful of other, mostly larger, cities also use the tax. The ease of avoidance—except where all other surrounding communities use the tax or where the city is a very large one (like New York)—clearly is a dampening influence on heavier local government reliance on the tax source.

The remaining taxes classed here as consumption taxes include taxes on insurance company premiums, taxes on pari-mutuels, admissions, and other amusements, miscellaneous selective sales taxes producing rather modest amounts, and miscellaneous license taxes and permits fees, notably hunting and fishing licenses and building permits. Insurance company premiums have been rising faster than GNP, and the other taxes included here have bases which seem to increase almost proportionately with GNP. But more widespread use at higher rates is unlikely to produce as much as an additional $1 billion by 1974–75.

BUSINESS TAXES

Corporation net income taxes are imposed by 37 States currently; in addition, minor amounts are collected from low-rate companion taxes imposed by some of the cities using individual income taxes. It appears that the States using the tax account for about 70 percent of total corporate income, considering the data on U.S. corporate income tax returns, the distribution of personal income, and other indicators. This is considerably greater coverage than exists for State individual income taxes, due largely to the fact that New Jersey, Connecticut, and Pennsylvania, which do not use the individual income tax, impose the corporate tax. There is only a very modest degree of progression in State income tax structures. Only eight States have graduated rates (the largest of which is Wisconsin).

Were all States to use the tax at the average rates now prevailing, revenues would be about $1.2 billion higher in 1974–75. The most popular tax rate today is a 5-percent one, but the larger States generally have somewhat higher rates, so that the weighted average rate is probably about 5½ percent. Were all States to use the tax at average rates 20 percent higher—say, at the level now existing in Massachusetts or Wisconsin—revenues would be $2 billion higher than in table 10.

Since State income taxes are deductible in computing Federal income tax liability, for a corporation paying the Federal rate, State corporate income taxes in practice absorb no more than 4½ percent of corporate profits before taxes; on the average, the figure is less than 3 percent. In view of this, and of the experience of the States using the tax, it is doubtful whether State corporate income taxes in the present range have a discernible impact on industrial location. Thus it is conceivable that the use of the tax will spread in the years ahead.

Whether this is particularly sensible or desirable is another question. Few public finance experts are very much enamored of the corporate income tax, and its principal virtues (such as enhancing the contracyclical built-in flexibility of the fiscal structure), are, in the main, virtues of a Federal rather than a subnational tax. Among the criticisms are that the corporate income tax has an incidence which is not only unknown but perhaps unknowable (and therefore highly suspect), that the tax discriminates against profitable and presumably therefore growing businesses (thus acting as a drag on economic growth) although unprofitable businesses are at least as likely to benefit from government services and give rise to public costs, and that the tax discriminates, with no justification save administrative convenience, against the corporate form of organization, in favor of noncorporate business.

It has been argued at times that it makes some sense to include, as a cost of doing business in a particular place, some portion of the costs of State-local government. However, corporate profits seem an imperfect basis for measuring these "social overhead costs." Some more gross measure, more nearly reflecting the volume of productive activity without regard to profitability or the form of business organization, seems desirable.

The States all do use a variety of franchise, privilege, and occupational taxes on business, measured in many different ways, often, for corporations, by capital stock authorized or issued. These license taxes

on corporations and on businesses and occupations yield about $850 million a year currently. But these taxes are for the most part far too crude and eratic in impact to be acceptable as appropriate substitutes for a broadgage "social overhead tax" on business activity.

Perhaps the most logical basis for such a tax is the value added by each enterprise. Value added taxation exists in other countries and, in a much modified form, in Michigan where the tax yields about 7 percent of State tax revenue. The advantage of the value added tax is its complete coverage and therefore neutrality among differing industries, forms of business organization, and the various factors of production. It is entirely conceivable that the tax could be applied on a metropolitan areawide basis, given the appropriate form of political organization, to finance metropolitan areawide services. It could also be levied by State governments, with proceeds returned to local governments on any basis that seems desirable. Ideally, it might even be a substitute for most if not all other State-local taxes on business, including taxation of business property.

SUMMARY: TAX POLICY "MODELS"

In the preceding sections, the focus has been on the revenue potential of various kinds of *conceivable* State-local tax rates increases or adoptions of new taxes, with some side comments on the probability of their occurring and their desirability. "Conceivable" tax changes are defined as universal utilization of tax forms now in wide usage and rate increases such that average rates in 1974–75 parallel the rates now applicable in higher tax rate States, for individual types of taxes. A summary of these conceivable tax increases, in terms of revenue impact, is presented in table 13 as a "maximum model." This is not to say that this is the absolute maximum revenue which State-local tax systems can produce; rather, it appears to reflect the outside limits, assuming that legislatures and voters behave in general as they have been doing in recent years.

As table 13 shows, the "maximum model" would yield revenues totaling $27 billion more than the "constant rate model" presented in table 10, which is far more than is required to meet the prospective fiscal gap. Since the conceivable tax policy measures differ in likelihood, and since not all these measures will be required, what is a "likely model"?

TABLE 13.—*"Maximum model": Additional tax revenues from wider usage and higher rates of major State-local taxes, 1974–75*

[In billions of dollars]

Tax [1]	Increase over constant rate projection in table 10, due to—	
	Wider usage [2]	Wider usage plus higher rates [3]
Property		6.7
State individual income	4.8	7.1
Local individual income	[4] .6	([5])
Corporate income	1.2	2.0
State general sales	3.3	6.5
Local sales	2.3	([5])
Liquor and tobacco	.1	2.0

[1] Highway user taxes excluded as program-associated receipts.
[2] Except where otherwise indicated, universal usage assumed.
[3] Average rate increases over the decade assumed as follows:

	Percent
Property	20
State individual income	20
Corporate income	20
State general sales	25
Liquor	35
Tobacco	90

[4] Doubled use assumed to be a "maximum likely" result.
[5] Not computed; the essence of these taxes is that they are low-rate taxes, for the most part.

To put it most boldly, the highest order to probability by far attaches to higher property tax rates and universal State use of the general sales tax. As table 13 indicates, these two measures together could very nearly close the gap, by producing an additional $10 billion.

If expenditure pressures appear to exceed fiscal resources at the local government level, increased property tax rates are likely simply because, for most local governments, the property tax rate is determined as a residual, to balance the accounts. That is, expenditure budgets are set, and State aid and nonproperty tax revenues estimated; the difference is the amount which must be raised from the property tax. The official property tax rate is this amount divided by the assessed value of taxable property in that jurisdiction. And unlike other taxes whose rates must be changed in large jumps—such as increasing a sales tax from 3 to 4 percent—the property tax rate can be increased almost continuously by small fractional amounts. All this tends to make property tax rate increases the path of least resistance.

As noted earlier, the only major form of State-local taxation to increase significantly in popularity in the last 20 years is the sales tax, and universal usage at the State level seems not far off. Income taxation has not spread widely, although there have been some new adoptions, particularly of corporation income taxes, and some rate increases in major States (such as New York in 1959).

To some extent at least, this has been because of concern about the impact of State taxes on the location of economic activity. The argument has been that the corporation income tax (and other business taxes) actually increases the cost of doing business in a State, and that income taxation in general is a sign of an adverse "business climate," unlike the sales tax which is mainly a consumer tax. Whether State-local taxes do in fact affect business location decisions is open to question, but the fear that this does occur is often a sufficient in-

hibition. Therefore, if recent experience is any guide, increased usage and higher rates of income taxation are likely to be isolated rather than common phenomena.

Largely because increases in property tax rates are so large a component of the "likely model" of State-local tax policy, it hardly seems to comprise the preferred, or "desirable model" of tax policy for the future. The preferred package of policies is one which is conducive to an optimal pattern of regional economic growth and to improvement of the quality of urban living in America. In fact, the probable pattern of finance can offset in part the substantial improvements in metropolitan communities which the large State-local expenditures anticipated are designed to achieve. Urban sprawl in newly developed sections, sick central cities, and acute financial strain for many cities and suburbs amidst relative financial ease for some other State and local governments will persist and in fact be fostered by relying heavily on property tax increases.

An optimal package of revenue-increasing arrangements would be one which deemphasizes the property tax, encourages metropolitan areawide solutions to metropolitan problems, provides central cities with finance adequate to greatly improve the quality of public services they provide as a concomitant of urban renewal, and minimizes the obstacles posed by interregional competition for economic activity.

Increased reliance on user charges clearly would be consistent with these goals, especially to the extent that this is a substitute for property tax financing of the service. As for taxes per se, a "desirable model" would provide for use by all 50 States of the sales and individual income taxes; at average prevailing rates, this would increase State revenues in the aggregate by $8.1 billion over the table 10 projection for 1974–75. In States where the revenue problem may be most severe—for example, in the rapidly growing parts of the country—use of the broad-based taxes at somewhat higher rates than now prevail is obviously indicated.

But, as has been said, this does not appear to be the most likely outcome. Moreover, if the gap has been understated—if the added tax revenue needed will be closer to $20 billion than to $10 billion by 1975—very large rate increases in sales and personal income taxes would be required, which are even less likely.

The case for new forms of Federal tax sharing or unconditional grants is bolstered by the prospect that the probable types of State-local tax measures are not the desirable ones. Consider the proposed unconditional grants not as a traditional form of Federal aid, but instead as a new type of State-local taxation, the revenues from which States estimate in their budgetmaking and dispose of as they would the revenues from any new tax. How does this type of "new tax" measure up to the appropriate criteria for State-local tax policy?

1. Since the aggregate revenue from this source, in the proposal, would depend on the Federal individual income tax base, it will increase with the Nation's economic growth appreciably more rapidly than most existing State-local taxes.

2. As a nationwide tax, it will have minimal effects on the location of economic activity, both among regions and within metropolitan areas.

3. As far as equity among individuals is concerned, the Federal tax structure as of 1965 is generally considered to be at least as

fair as State-local *nonproperty* taxes in general, and surely more equitable than the total State-local tax system in which property taxes play so large a part.

In summary, then, the proposed new Federal tax-sharing plan is good public policy not because State-local governments are unable to finance themselves, but because it is superior to the relatively undesirable State-local tax measures which are most likely to occur in the absence of these new arrangements.

IV. A Note on Geographic Differentials in State-Local Finances

The preceding sections of this paper deal with State-local finances over the next decade in the aggregate, as if there were substantial uniformity throughout the Nation. However, this is very far from being the case. Instead, patterns of State-local finance differ markedly among the States and there are some major differences within many of the States. In part, these differences relate to fundamental underlying factors such as taxable capacity and needs for public services. That is, poorer States are likely to have relatively smaller public sector activities than richer ones; mountainous States are likely to spend relatively more for highways; urban States are likely to spend relatively more for police and fire protection; to name just a few such factors. But such underlying differences, there seem to be real differences in public policy choices, regarding the kinds of taxes in use and the level and composition of public expenditures.

In the following paragraphs, some evidence is presented on interstate differentials in Sate-local finance, treating the combined total of State-local finances in each State as a single system. This is a reasonably reliable approach, since State laws govern the fiscal patterns of both State and local governments. Moreover, by contrasting State-local finances in largely urban States with those in less urban States, urban-rural differences can be brought to light.

The evidence examined here concerns 1962 and changes between 1957 and 1962. The reason for this choice of years is that a Census of Governments was conducted in each of these years, providing extensive data not available for other years. No Census of Governments was conducted between 1942 and 1957, thus limiting the time series comparisons possible for the postwar period to the 1957–62 ones.

In table 14, some comparisons of State-local tax systems for 1962 are made for a dozen selected States in different parts of the country, divided into one group of large, high-income, highly urbanized States and a second group of smaller, poorer, and much less urbanized ones. It is apparent that the fiscal effort made by the poorer, more sparsely populated States is as great as or greater than that made by the big, rich, urban States, that is, State and local taxes per $1,000 of personal income. The poorest States tax themselves, relative to personal income, more heavily than do most of the rich ones, and States such as Mississippi and Vermont tax themselves a good deal more heavily than even New York and California.

TABLE 14.—*Interstate differences: State and local government tax systems, 1962*[1]

State	Property taxes				Other taxes		
	Percent of general revenue excluding Federal aid	Amount per $1,000 of personal income	Per capita	Estimated effective rate (percent)[2]	Percent of general revenue excluding Federal aid	Amount per $1,000 of personal income	Per capita
Selected large, high-income urban States:[3]							
New York	38	$47	$138	2.5	47	$60	$173
California	42	52	151	1.3	42	52	151
Illinois	46	46	130	1.7	40	40	114
Ohio	42	42	102	1.0	39	40	95
New Jersey	55	54	153	2.6	30	30	84
Massachusetts	54	60	166	2.7	35	39	108
Selected smaller, low-income less urban States:[4]							
Mississippi	23	33	42	.5	55	77	98
West Virginia	23	26	47	.6	61	69	124
Arkansas	23	26	39	.6	57	67	99
Idaho	39	49	95	1.7	53	52	100
North Dakota	38	49	113	1.4	34	44	101
Vermont	40	53	108	2.2	48	65	131
U.S. average	38	43	103	1.4	45	51	121

[1] Based on combined State and local government revenue totals in each State; data from 1962 Census of Governments, U.S. Census Bureau.
[2] The estimated effective rate figures are based on property tax revenues, the composition of assessed values, and the estimated market value of taxable real property. The rates shown are the statewide averages estimated to apply only to real property assessed by local assessors for general property taxation.
[3] States selected are among the 9 largest in population in 1960 (all over 5,000,000), the 11 highest in per capita income (over $2,300), and the 14 most urbanized (over 73 percent, under the census definition).
[4] States selected are among the 22 smallest in population (none over 2,200,000), the 17 lowest in per capita income (none over $1,900) and the 11 least urbanized (none over 48 percent urban).

The effects of high income show up in the per capita results. Even the rather low overall effort in New Jersey and Illinois produces total per capita tax receipts very substantially in excess of those for poor Southern States. And the higher effort rich States—New York and California—have per capita tax receipts which are far higher than those elsewhere. These income effects occur despite Federal-aid programs, which in general are designed to aid poorer (e.g., public assistance) and more sparsely populated (e.g., highways) States disporportionately. Federal aid per $1,000 of personal income is generally three to four times as great in poorer nonurban States as it is in the big rich States. The disparity is large even on a per capita basis. However, since Federal aid, even in poor States, rarely amounts to more than one-fourth of total revenues, it cannot overcome disparities in income.

It is also clear that there are considerable differences even among States with similar characteristics with regard to income and urbanization, for example, New York, California, and Massachusetts versus Illinois, Ohio, and New Jersey in regard to tax effort. In part, this is related to some broad sectional tendencies. The level of State-local government activity in general is relatively high in New England, New York, and the Pacific Coast States, and relatively low in the Midwest. The property tax is a much less important part of the revenue system in the South, where the role of State governments which use nonproperty sources is a considerable one and where in addition local nonproperty tax and nontax revenues are important. But even within the same parts of the country there are many exceptions—for example, the very heavy reliance on the property tax in New Jersey and Massachusetts.

Table 15 compares per capita State-local expenditure for the same groups of States, for four activities responsible for 75 percent of State-local general expenditures. It also indicates wide and not entirely systematic regional variations. It is no surprise to find that the poorer Southern States spend less per capita on education than the richer States, in view of their fiscal capacity. Underlying needs are differently distributed, reflecting the number of school-age children per capital (high in rapidly growing States such as California and Arizona), the proportion of schoolchildren attending nonpublic schools (relatively high in the big eastern and Great Lakes cities), and the high costs of education of a given quality in a very sparsely populated area (e.g., North Dakota).

TABLE 15.—*Interstate differences: Per capita State and local government expenditures, 1962* [1]

State	Total general expenditures [2]	Education	Highways	Health and welfare	Police and fire protection
Selected large, high-income urban States: [3]					
New York	$403	$123	$53	$70	$28
California	437	171	55	68	25
Illinois	322	118	50	50	21
Ohio	287	108	54	43	15
New Jersey	310	114	42	37	25
Massachusetts	344	102	48	71	28
Selected smaller, low-income, less urban States: [4]					
Mississippi	252	89	55	47	7
West Virginia	254	96	54	48	8
Arkansas	220	80	51	43	7
Idaho	317	108	85	44	13
North Dakota	377	142	91	38	9
Vermont	378	128	131	46	10
U.S. average	324	120	56	51	18

[1] Based on combined unduplicated State and local government expenditure totals in each State; data from U.S. Census Bureau, 1962 Census of Governments.
[2] Excludes expenditures of government-owned utilities and liquor stores, and expenditures of insurance trust systems such as unemployment insurance and employee retirement.
[3] See footnote 3, table 14.
[4] See footnote 4, table 14.

Beyond this, there are important differences arising from tradition and differences in tastes. For example, the main reason for the higher per capita outlays for education in California compared to New York is found in the fact that California spends nearly four times as much per capita as does New York for public colleges and universities. Tastes, too, surely must explain why current operating expenditure per capita for local schools is nearly 15 percent higher in New York than in Illinois.

The next two tables (16 and 17) compare the same set of States with regard to trends between 1957 and 1967. The recent trends in State-local taxes are not very systematic, although the high-income States appear to have been increasing their taxes more rapidly than the low-income ones (the final column of table 16), despite the more rapid increase in personal income per capita in most of the poorer States. This perhaps is a reflection of the rather large increases in the estimated market value of taxable real property in the large urban States (a consequence of high rates of construction of housing and office buildings in and near the larger cities), which presumably makes it somewhat easier to increase property tax revenues.

TABLE 16.—*Interstate differences: Trends in State-local taexs, 1957–62*

[Percent increases, 1957–62] [1]

State	The economic base			Property taxes	Property taxes per per capita	General sales taxes per capita	Individual income taxes per capita	All State-local taxes per capita
	Personal income	Personal income per capita	Market value of taxable real property [2]					
Selected large, high-income urban States: [3]								
New York	24	16	52	36	27	[4] 29	[4] 92	37
California	38	16	59	65	38	7	[4] 70	30
Illinois	21	15	28	47	41	[4] 46	(5)	36
Ohio	16	8	60	52	42	5	(5)	32
New Jersey	27	15	38	54	39	(5)	(5)	37
Massachusetts	26	20	45	46	39	(5)	49	33
Selected smaller, low-income, less urban States: [6]								
Mississippi	37	26	59	47	36	39	30	25
West Virginia	4	7	38	49	53	[4] 26	(5)	43
Arkansas	33	25	36	52	43	[4] 64	[4] 118	34
Idaho	26	16	3	32	21	(5)	[4] 97	25
North Dakota	55	50	15	25	21	1	91	21
Vermont	25	21	33	43	39	(5)	34	38
U.S. Average	26	16	41	48	36	38	59	32

[1] Based on data in U.S. Census Bureau, 1957 and 1962 Census of Governments.
[2] Estimated market value of real property assessed by local assessors for general property taxation. Excludes State-assessed and personal property.
[3] See footnote 3, table 14.
[4] Indicates that a major tax rate change occurred in this period.
[5] This form of taxation was not used in this State in either 1957 or 1962 or both.
[6] See footnote 4, table 14.

TABLE 17.—*Interstate differences: Trends in State-local expenditures, 1957–62*

[Percent increases, 1957–62] [1]

State	Local schools, per pupil	Per capita				
		Local schools	Higher education	Highways	Public welfare	Total, general expenditures [2]
Selected large, high-income urban States: [3]						
New York	18.7	37	85	34	41	37
California	24.1	39	84	19	33	39
Illinois	23.9	45	80	17	64	42
Ohio	14.9	34	55	20	41	32
New Jersey	23.3	39	124	11	64	33
Massachusetts	29.1	44	101	−19	26	20
Selected smaller, low-income, less urban states: [4]						
Mississippi	50.3	64	109	36	46	61
West Virginia	35.4	36	68	69	78	54
Arkansas	49.1	48	51	46	38	45
Idaho	20.9	30	43	41	35	36
North Dakota	48.3	58	84	19	21	39
Vermont	34.6	41	110	81	33	57
U.S. average	26.2	40	68	22	34	37

[1] Based on data in U.S. Census Bureau, 1957 and 1962 Census of Governments.
[2] Excludes expenditures of government-owned utilities and liquor stores, and expenditures of insurance trust systems such as unemployment insurance and employee retirement.
[3] See footnote 3, table 14.
[4] See footnote 4, table 14.

The upward movement of expenditures (table 17) was pervasive. Very large rates of increase in spending for higher education were recorded in this 5-year period nearly everywhere. Largely because of high rates of increase in per pupil expenditures for local schools in the poorer States, the poorer States on balance increased their overall spending more rapidly than did the richer ones. In part, the rich/poor State disparities in the movements of taxes and of expenditures is explained by the rapid increase in Federal aid in this period, which is of greater importance for the poorer States. Increases in Federal aid were of particular significance in financing highways and welfare expenditures.

Table 18 deals with all the States (except Alaska and Hawaii), rather than the 12 selected States of the preceding tables. It bears out the implication of table 16, that: (1) State-local tax effort (taxes relative to personal income) has been increasing sharply nearly everywhere; and (2) tax effort has been increasing somewhat more in the relatively better off States. In only five States did total State-local taxes decline as a percentage of personal income in this period: the Dakotas and Oregon (which are high tax-effort States nonetheless); and Nevada and Virginia. In addition, in Georgia and South Carolina, there was only a negligible increase in tax effort.

TABLE 18.—*Changes in State-local tax revenue relative to personal income, 1957–62*

Percentage change in tax revenues per $1,000 of personal income, 1957–62	Numbers of States with per capita personal income—			
	Above the median		Below the median	
	And indicated tax/income changes in—			
	Property	Other taxes	Property	Other taxes
Decline of:				
10 percent or more	1	1	1	2
0 to 10 percent		1	2	6
Increase of:				
0 to 10 percent	6	8	9	9
10 to 20 percent	9	9	9	4
20 to 30 percent	6	4	2	3
30 percent or more	2	1	1	
Total	24	24	24	24

[1] Based on data in 1957 and 1962 census of Governments.

In short, the pressures for increased State-local spending and increased State-local taxes have been very general. Very few States, indeed, have failed to respond to these pressures, or can be said to be failing to pull their own weight. The proposal for a larger financial contribution from Federal revenues cannot be answered by pointing to great disparities in the needs for public services among the States: the needs are quite general. Nor can the proposal be answered by saying that many State-local governments are simply not trying hard enough: nearly all of them seem to be increasing their relative tax takes, although they start from different bases and select different tax policy instruments for heavier use.

PROJECT '70: PROJECTING THE STATE-LOCAL SECTOR*

BY SELMA J. MUSHKIN and GABRIELLE C. LUPO

Extrapolations into the future, whether empirically founded projections or hunches that are revealed only by their consequences in action, are being made and will continue to be made. We live in the present and cannot avoid the future; the decisions we make today will affect tomorrow. Indeed, many of them must look toward a longer range future. Such decisions, whether made against the background of articulated forecasts or out of a subconscious but often quite strong feeling about the climate of life to be expected, imply projection in the sense of some view of the future. The choice is not between making and not making an extrapolation into the future; it is between making the projections in overt and sometimes quantitative terms, and proceeding by feel and by faith. Even inaction implies some picture of the future.—Kuznets.

INTRODUCTION

Project '70, summarized here, is a study of the State and local sector calling for projection of expenditures and revenues for 1970 as part of a larger research effort on national economic growth models. The project consisted of the separate evaluation for the year 1970 of approximately 100 expenditure components for each of the 50 States and the District of Columbia, and approximately half as many revenue items, within a consistent set of economic and demographic assumptions. These were judgmental projections, *not* time trendings, carried out on a very disaggregate basis. Following is a summary description of the projection procedures and findings of Project '70. The details of the study and its methods are available in separate manuscripts.[1]

The State and local governments constitute a large and rapidly growing sector within the national economy, one whose absolute and relative importance is likely to increase further in years to come. Yet, advance budgeting and planning, which are accepted means of achieving efficiency in the private sector, are not standard methodology for the State and local governments. As a general rule States and localities still operate with severely restricted time horizons. The need is increasingly evident for State and local governments to develop methods for projecting program requirements 5 to 10 years in the future, and for appraising the extent to which existing revenue sources can be expected to meet projected expenditures. Great benefits would accrue from techniques which increase State and local government

*Based on an article in the *Review of Economics and Statistics*, May 1967.

[1] Selma Mushkin and Eugene McLoone. *Public Spending for Higher Education in 1970*, Council of State Governments. Research Memorandum 374; Selma Mushkin and Robert Harris. *Transportation Outlays of States and Cities: 1970 Projections*, RM 375; Selma Mushkin, *State Programing and Economic Development*, RM 379; Selma Mushkin and Robert Harris. *Financing Public Welfare: 1970 Projections*, RM 380; Selma Mushkin. *Property Taxes: The 1970 Outlook*, RM 381; Selma Mushkin and Eugene McLoone, *Local School Expenditures: 1970 Projections*, RM 382; Robert Harris. *Income and Sales Taxes: The 1970 Outlook for States and Localities*, RM 384; *Financing Public Hospitals and Health Services: 1970 Projections*. in manuscript; *Water, sewerage, and other Sanitation Expenditures of State and Local Governments: Projections to 1970*, in manuscript.

capacities to project revenues reliably, to anticipate program developments and financial requirements, and to appraise alternative revenue-expenditure packages. And, if Federal revenues are to be shared with the States, the need for rationalized public planning will become even more acute.

Much additional research is needed on projection techniques that would provide a generalized *and* consistent approach to the range of projection problems. Equally important, such research would yield projections that are comparable between jurisdictions and even across time. Any fiscal planning for a jurisdiction larger than the single State necessitates comparability and consistency.

Greater precision in projecting national aggregates for the State-local sector requires State-by-State analysis to avoid the distortion of omitting geographical distributional affects. States are not identical in expenditure level and pattern or in tax level and structure: expenditure beneficiary groups and tax bases do not grow at the same rate from State to State. Consequently, the regional composition of national aggregate expenditure or revenue items changes over time. Projecting revenue or expenditure components at the diverse growth rates (that is, State by State) accomplishes the reweighting precluded to projections of a national total at an average rate of growth.[2]

It is the intent of the authors in this summary presentation to encourage further study of State and local revenue and expenditure projection techniques. The research described can be the foundation of additional work. One logical sequel is the conversion of the components applied in evaluation of separate program developments to mathematical relationships. Such a transformation should yield a detailed formal model of the State-local government sector whose equations were *not* derived by time trending, and whose parameters are *not* exclusively derived from national totals. Another possibility is assessment of the techniques actually employed for 1970 as a basis for generalization of the dynamics of State and local expenditure developments and of the intergovernmental relations involved in our multilevel public sector.

CONCEPTS

As the U.S. economy grows, both absolutely and in terms of relative measures such as income per capita, dollar yields of the existing revenue structures of States and localities will certainly increase. At the same time, expenditures will increase (*a*) as population growth and migration, and price level increases raise the outlays necessary to continue existing levels of public services per beneficiary; (*b*) as nationally recognized needs for new public services or the expansion of existing programs are met with Federal assistance; (*c*) as generally recognized demands for new types or levels of public services or pressures to remedy deficiencies in public services are met by States and localities without a Federal grant program; and (*d*) as experiments with new directions and innovations in public programs occur.

[2] More specifically, the same projection technique applied State by State and to national aggregates yielded for 1970 a nationwide enrollment figure in public colleges and universities 500,000 different (7.2 million on a national average basis, 7.7 million as the total of the State-by-State projections). There was a computed difference of $1 billion in estimated nationwide tax yields for the fiscal year 1967 applying (*a*) the national average income elasticity of property and of nonproperty taxes, and (*b*) State-by-State income elasticities of the two broad classes of taxes despite an assumed unchanged State distribution of personal income between the base year (1963) and 1966.

If assumptions are made about economic and demographic changes during some future period, then the growth of revenues of present tax rates and structures, and the growth of expenditures just to maintain current levels of services, can be projected for that period. If Federal aids and consumer-voter pressures are assumed to succeed in stimulating higher levels of State and local services, and judgments are made about the probable speed of program developments, then the expenditures to provide additional or improved services in line with (assumed) national policy directions can also be projected for the period

This describes what Project '70 has done, in an attempt to accomplish the following:

1. Measure the relative sensitivity to economic growth of the taxing structures of States and localities, and of their expenditure patterns;
2. Assess the interstate differences in the capacities of present tax structures to finance these emerging program expenditures;
3. Measure the impact of nationwide program movements on the differing economic and demographic bases of the States; and
4. Determine the likely future impact of the State and local sector on the national economy.

Since neither the manner of response by a given State to the national program directions nor potential new programs are predicted, the results of Project '70 are not a set of predictions of expenditure (or revenue) levels. Rather, the output is a set of projections within our assumptions which provide some proximate answer to these problems.

GROWTH FRAMEWORK

The study design emphasized achievement of comparability between revenue and expenditure component projections for each State, and among States. To provide interjurisdictional, interprogram consistency, while the responses of revenue source yields and program developments and expenditures to economic growth were being projected, a unitary set of assumptions about economic and demographic variables was used in the projections.

The set of assumptions used in turn was generated by a macroeconomic growth model chosen from among several preliminary models of the national economy developed for the Federal Intra-agency Study of Economic Growth and Employment Opportunities. These structuring assumptions concern national economic and demographic developments, price movements, and productivity gains, and of course the general climate of the international scene. Some of the major components of the growth framework are: (1) a maximum rate of 4-percent unemployment throughout the period; (2) an average annual growth rate of GNP in constant prices of 4.1 percent; (3) a general price rise limited to 1.5 percent per year to derive estimates in 1970 current dollars with the growth in GNP at current prices of 5.7 percent per year; and (4) labor force increases at an annual rate of 1.6 percent due to population rise and output per worker increases of 2 percent per year. This combination of assumptions yields a GNP of $864 billion for 1970 and personal income of the residents of the States of $668 billion.

Additional assumptions were made about the progress in each of the States in response to national economic growth patterns and to demo-

graphic changes. The U.S. Bureau of the Census 1970 population projections by State were not available at the project's start. Therefore population by age group by State was derived for this study.[3]

Projections of personal income by component by State were also developed specifically for this study. Subsequent stages of the project required projected 1970 figures for personal income components for each State; these were not available elsewhere.[4] The following components were derived separately: (1) wages and salaries; (2) farm income; (3) enterpreneural earnings; (4) income from interest, dividends, and net rents; and (5) transfer payments in three categories.

TAX REVENUES

There are a series of methodological choices to be made in projecting tax revenues, even under the assumption of unchanged tax rates and structures.

Tax revenues can be projected by projecting the trend over a selected past period of tax collections for each major tax source (on a per capita or aggregate basis). These could be simple time trends, or derived by correlations with income of the residents of the State, or other variables. This technique, while frequently used, automatically builds into the projection changes in tax rates and structures over time without distinguishing yields of altered tax provisions from the yields flowing from economic growth.

Alternatively, the value or amount of the tax base can be projected; this, of course, requires explicit identification of the changes in tax bases as distinct from rates or structures. This procedure permits the separation and separate focus upon the responses of tax bases (and thus yield with given rates) to economic and demographic changes; and allows measurement of revenue results of explicit tax rate or structure changes under the assumed economic conditions.

The second method was followed for the most part in projecting revenues by State for 1970. The values of tax bases for major sources of State and local taxation were identified and projected ahead, assuming rates and structures of taxes enacted by May 1, 1965; effective property tax rates on market value are at 1962 levels.[5]

The tax base itself presents projection method problems and alternatives. Technique possibilities are: (*a*) projecting trends in State-by-State tax base values over a selected period (again, this can be a time trend, or an analysis of correlations with other variables, as income, earnings, urban concentration of the population, density of population, over time); and (*b*) determining State-by-State income elasticities of

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[3] The population estimates are a combination of U.S. Bureau of the Census projections of population 14 years of age and over by State, of earlier estimates of total population by age groups developed by the U.S. Bureau of the Census for the National Education Association, and of annual rates of population growth implicit in the annual population series, by State, published by the U.S. Bureau of the Census for the past census years.

[4] The general method was to compute the trend in each of the per capita components over the period 1952–62, adjust the trend values proportionately to the estimated 1970 national aggregates, and multiply by the appropriate population estimate. For example, the trended values of average nonfarm wages and salaries in each State were multiplied by an estimate of work force in each State. The work force estimate in turn was derived by applying 1960 labor force participation rates to the age, sex, and race composition of the projected 1970 population in each State, and further adjusting for the projected national changes in participation rates for each age, sex, and racial group. Then the projected employment level was applied. The employment figures essentially assume a proportionate scaling down of unemployment in each State, so that the 4-percent unemployment assumption applies to the Nation as a whole rather than to each State.

[5] Except in the case of "special" property taxes.

the tax bases over a past period, and using these income elasticities to project the future values of tax bases.

One can define as the determining factor in a decision the least favorable component in the problem; in this instance, data characteristics and availability determined the projection technique employed for a given tax base.

As a general rule, informational materials for which a time series are available differ in detailed definition from specific statutory bases of taxes; further, the definitions of statutory base for certain taxes differ State to State. This creates problems if bases are projected State by State unless an attempt is made to measure and project the tax base as defined by tax statute in each State. Neither data nor time constraints allowed this. Even if national aggregates of tax bases were to be projected and then geographically allocated, the appropriate definition of the "base" for the national aggregate would still be problematic.

If some proxy tax base is used in place of the statutory definition for lack of historic information on the base, adjustments must be made in the proxy base after it is projected forward. The adjustment of base values for statutory differences (between State bases or between the proxy and the tax base or both) can be achieved two ways. The rates applied to the uniform tax base or proxy can be varied from statutory levels to derive effective rates on proxy base which compensate for differences in statutory base definitions.[6] Or, statutory rates can be applied to the proxy base values in a selected year to determine variation between the estimated and actual collections in that period. The differences, if not large, can be converted to a series of State-by-State adjustment indexes. These adjustment indexes can then be applied to the estimated yields which result from applying statutory rates to the projected proxy base.

There remains the process of choosing an index to stand proxy for particular tax bases, in those instances where data do not permit the isolation and projection of the statutory tax base. This reduces to deciding which is the best analog of those available, such as "personal income" as the proxy base of general sales taxes, or "cigarette consumption" as the proxy base of tobacco product excises. Where no available data series will satisfactorily stand proxy, one must be constructed. Those taxes for which a proxy base for projection had to be so built also presented great variances in the definitions of taxable items composing the base. Rather than constructing various proxies, with application of statutory rates, uniform proxies were constructed and effective rates were applied to compensate for variations in State definitions of the bases. The content of the uniform proxy for a tax base was defined by the practices of the States and localities in which more than half the population of all the States imposing the particular tax live.

TREATMENT OF VARIOUS TAXES

For no tax were time series data on State-by-State values or even on a national aggregate of the statutory tax base available. Thus, the

[6] This approach is similar to that followed in measuring relative use by the States and localities of representative tax sources. See Selma Mushkin and Alice Rivlin, *Measures of State and Local Fiscal Capacity and Tax Effort,* Advisory Commission on Intergovernmental Relations.

revenue projections in Project '70 began with the choice or construction of a proxy tax base. Then where possible, State-by-State base values were projected to 1970. Where State-by-State data were unavailable or did not provide reliable projections,[7] a national aggregate of the proxy tax base was projected to 1970 and allocated among States. For the personal income tax, only, a different method was employed, as discussed below. Then the proxy base values were adjusted for statutory differences, by (*a*) using effective, not legal tax rates; or (*b*) applying an adjustment index to the yield of statutory tax rates for alcoholic beverages excise tax. The more significant the revenues provided by a particular source, the more care was taken in the details of its projection technique.

Excise taxes were the least complex calculations. The proxy bases chosen were: cigarette consumption for tobacco products, gasoline consumption for highway fuels, consumption of three categories of alcoholic beverages for taxable alcoholic beverages, and motor vehicles for motor vehicle and motor vehicle operators' licenses. For general sales taxes, where a wide variation in statutory bases exists, several possible base proxies were considered. The base chosen as best fit proxy was personal income by State.

In projecting corporate income tax yields a best fit allocation formula[8] was applied to an estimated 1970 taxable corporate income for the United States, based upon corporate income in GNP terms projected for 1970 in the national economic growth model. For the State personal income taxes, the proxy used was a reconstructed yield series using May 1, 1965, tax structures and rates for each State. The series for each State was constructed for 1952–61, and the (personal) income elasticity found; this income elasticity then was used to project the 1970 value of the yield by State at constant personal income tax rates.[9]

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[7] Corporation income, tobacco products, alcoholic beverages tax, and motor vehicles and motor vehicle operators' license proxy bases.

[8] For 1959 and 1962, "corporate income" as reported by the taxing States to Project '70 was regressed on the percentage distribution of (*a*) wages and salaries; (*b*) property (commercial and industrial) values; and (*c*) retail sales, these being the three factors typically used in State statutory allocations of corporate income for tax purposes. The average for each State of its percent share of the three factors gave the best fit. The percent distribution among States of the projected 1970 values of wages and salaries, commercial and industrial property values, and retail sales were averaged to derive the 1970 allocation formula.

[9] The following method was used to construct an "as if" series of tax accruals for 1952–61. The basic data used were the distribution of adjusted gross income as defined for Federal income tax purposes in each year for each State broken into size classes (for 1952–56, in thousands of dollars: 0–1, 1–2, 2–3, 3–4, 4–5, 5–10, 10–15, 15–20, 20–50, 50–100, 100+; for the years 1957–61, the 5–10 class was in addition, broken into $1,000 intervals). (1) Applying these data we computed the tax at the mean income in each class for (*a*) a single taxpayer; and (*b*) a married taxpayer with two children, using the State statutory rate, deduction, and exemption provisions. (2) The two tax liabilities were averaged together, the weights being the proportion of joint versus individual returns for that year for that size class in the statistics of income. This average tax liability was divided by the mean size class income to yield an effective tax rate for that size class of that State of that year. (3) The size class rates were applied to the amount of income in that class, and the yields totaled to give income tax accruals for that year for the State on a proxy basis.

Once the series were constructed, regressions of the form: $\text{Log } T_t = a + b \log X_t$, where T_t is the constant-rate tax series and X_t is personal income, were fitted. Correlation coefficients all exceeded 0.9 (adjusted for degrees of freedom). The curves were forced through actual collections for 1963, to correct any consistent errors in level. Estimates of 1970 personal income by State, when inserted in the fitted equations, gave the estimates of personal income tax yields used. Adjustments were subsequently made to reflect changes in tax rates between 1963 and May 1, 1965.

Projecting the property tax base poses nearly as many problems as does projecting the bases of all other taxes combined.[10] A standard tax base was defined in accordance with the property taxing policies of States and localities in which over half the population reside to include real property, durable producers' goods, inventories, and livestock. Major components of these classes of property were separately estimated and projected for each State: nonfarm residential real estate, farm properties, vacant lots, commercial and industrial real estate,[11] and producers' durable equipment,[12] inventories, and so forth.

Income elasticity based projections were tested on a nationwide basis by depreciating and repricing base year capital values to 1970, and adding projected new construction year by year, again depreciating and repricing the additions to 1970. For an historic period, results of the two methods were fairly close.

Projected 1970 revenues were obtained by applying 1962 effective tax rates on the standard property tax base by State to the projected 1970 values of the bases.

PROGRAM EXPENDITURES

There are alternative techniques that can be used to project program expenditures. Most simply, the historic rate of increase of expenditures in the aggregate or by category can be trended into the future in total or in per capita terms. Such a projection reflects neither program developments nor underlying changes in population characteristics or concentration, nor economic changes or growth.

For those functional areas where potential recipients of the service can be identified, the future beneficiary load can be projected separately and multiplied by the observed relationship between expenditures per beneficiary and per capita income. This method is unsuitable for some expenditure categories, such as transportation. More importantly, per capita income is assumed in this type of projection to be a proxy reflecting (*a*) changes in cost; (*b*) public choice of service level; and (*c*) the capacity of States and localities to finance public services, so that these variables are not available for explicit treatment.

A third approach is to increase the number of variables used in projection to analyze the factors affecting demand and supply of different categories of public services. These economic and social determinants have recently been studied for all State and local spending

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[10] "The" property tax is not a unitary tax. Rather, it is a series of levies on varying combinations of a dozen divers bases, imposed by some 80,000 jurisdictions. The component bases neither grow at uniform rates, nor respond to the same economic determinants; additionally, data for a number of the bases are not available.

[11] The 1961 market value of nonfarm residential real estate for each State was projected to 1970 assuming income elasticities as found for 1956–61 (the only 2 years for which such data were available). The value of 1961 farm acreage was projected to 1970 on the basis of multiple regression relation of year-to-year change in per acre values of farm real estate to corresponding first differences in personal income. (Other relevant variables, notably farm income and population density, were significantly correlated with farm real estate values in only a few States, and consistently explained a considerably smaller percentage of the observed variation than did personal income.) A unit income elasticity for public utility properties was asssumed on the basis of a national analysis of the movement of public utility property taxes between 1957 and 1962, adjusted for tax rate changes: then the estimated property taxes paid by public utilities in 1962 were projected to 1970.

[12] The 1961 stocks of producers' durable equipment were estimated by depreciating and summing the new equipment purchases for each past year (from Census data) and repricing the total to 1961 levels. This base year stock was projected to 1970 assuming the 1961 ratio of producers' durables to commercial and industrial real property.

and for some services, especially education. However, useful projection techniques have not yet been generated by these studies, especially projections that give encouragement to program planning and advance fiscal budgeting as an integral part of such programing.

Another procedure is to define a standard unit of service in each functional area (such as hospital beds, number of classrooms). The workload in each program is projected into the future, as a function of assumptions about economic and demographic variables, and program scope. Then the workload is combined with a projection of cost per unit which again reflects the underlying assumptions about economic and social changes, and increases in quality of public services.

Project '70 was particularly concerned with the impacts of economic growth and emerging program developments on the expenditures of the States and localities. Therefore, workload projection was the basic methodology in Project '70's program projections. In this technique the variables sensitive to economic, demographic, and program level changes are the ones explicitly determining expenditures. The accessibility of this particular set of variables facilitates the introduction of specific assumptions about future economic, demographic, and program developments. It also permits quantification of the effects of altering assumptions about future developments, and provides a basis for long-range program evaluation.

The only major expenditure category for which workload techniques were not employed was highway expenditures. A workload computation would necessitate a compilation of highway requirements, whereas revenue potential is likely to define the feasible, and thus determine actual highway expenditures. A modified economic and social determinant projection was carried out, similar to the method used by U.S. Bureau of Public Roads. Capital outlays for highways were projected, based on projected Federal aid as a major source of funds and on personal income as a proxy for the revenue-raising potential in the State (from all sources) and for the overall level of economic activity influencing the demand for highway transport.

The projections of other major program expenditures were based on workload computations, and started for each functional area with the selection (in some instances, formulation), of a standard unit of service. As an initial step the change in the workload that would just maintain the present scope of public service, given economic and demographic changes by 1970, was projected. Further changes in the magnitudes of workloads were projected as results of: (*a*) national program developments and the Federal grant legislation enacted to encourage the implementation of such developments;[13] and (*b*) additional State-initiated programs in response to nationwide standards and needs in various functional areas. Judgments were made about the impact of these program changes on workload magnitudes.

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[13] The following assumptions were made about Federal grants-in-aid in 1970, in measuring their effects on workload magnitudes and cost per unit, in each program in each State: (1) Existing grants will continue through 1970, including grants made under authorizations expiring before 1970. (2) New legislation enacted by the 89th Cong., first sess., will receive appropriations equal to authorizations, through 1970 (except vocational rehabilitation, whose offerings to States traditionally have much exceeded their "takings"). (3) Revision upward of grants authorized under the Elementary and Secondary School Act of 1965, and the National Defense Education Act. (4) Expansion of operations and appropriations under the Economic Opportunity Act of 1964. (5) Continued growth of Federal share of public assistance payments. (6) Increase in authorizations for grants for mass transportation facilities and for school health (an assumption made as a concomitant of the assumptions with respect to operation of the proposed medical assistance program). (7) No additional direct nationally administered programs that would either enlarge or reduce expenditure requirements in the States and localities.

The projection of cost per service unit to 1970 was based on several related assumptions. First, it was assumed that as a minimum, quality in each class of public service will equal the 1962 level for that State. Second, the probable impact of the 1970 national grants-in-aid assumed (as noted above) on program quality levels was evaluated. Third, judgments were made about likely State-initiated improvements in the quality of public services to fill deficiencies relative to the national standard and to meet generally recognized demands for higher quality. All public services were recosted or repriced to the 1970 level.[14]

At this point, a couple of specific examples of program expenditure projection may help to clarify the methods. Higher education and public welfare expenditures have been selected as illustrative. The program developments and the costing procedures for these developments have been spelled out elsewhere for those functions and other major functions.

HIGHER EDUCATION

Expenditures for public institutions of higher education were classified by three major program objectives carried out by colleges and universities, namely, teaching of students, conducting research, and providing services for the community. The three components were projected separately.

The major function of higher education is the teaching of students. The standard unit of service in this higher education program was defined as enrollments for degree credit by State in public colleges and universities and was projected to 1970.

(1) The 18- to 21-year-old population projected for 1970 by State was multiplied by the proportion of 1963's 18-year-olds graduating from high school by State (upped differentially by State to reflect increases in holding power of elementary and secondary schools). This yielded the four classes of high school graduates 1967–70 by State from whom the four college classes of 1970 are drawn.

(2) These projected 1967–70 high school graduates by State, multiplied by the proportion of 1963 high school graduates attending college for degree credit for the first time in 1963, by State (increased differentially by State to reflect enlargement of demands for college education and reduction of attrition rates), yielded the 1970 undergraduate degree-credit enrollments of 18- to 21-year-olds by State of residence.

(3) To these State of residence figures were applied the 1963 migration rates (for 18- to 21-year-old degree-credit undergraduates) to give projected degree-credit college enrollments of 18- to 21-year-olds in each State in 1970. Degree-credit enrollments of undergraduates over 21 (part-time students) were added to give total undergraduate degree-credit enrollment in each State.[15]

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[14] The level of prices paid by governments for goods purchased was assumed to increase at the same rate as the general price level, 1.5 percent per year. Wages and salaries paid by governments were assumed to rise in line with the projected trends in nonfarm average wages and salaries in each State. Possible economies in scale of operation were taken into account for functions where a decreasing cost per unit of service was appropriate: in other cases a constant cost per unit of service was indicated by the available information.

[15] The 1961–62 enrollments of part-time undergraduates over 21 were projected to 1970 levels, and further increases in these part-time students were assumed in those urban areas projected to grow faster than the total population of their State.

(4) The 1961–62 enrollments of graduate and first professional students by State were projected to grow at a faster rate than was the national undergraduate enrollment.[16] The assumed uniform growth rates of existing graduate and professional institutions were amended to reflect the impact of (*a*) the new National Defense Education Act programs, and (*b*) any projected growth of undergraduate enrollment much in excess of graduate school growth in the State (it was assumed graduate enrollments would also increase faster).

(5) The sum of total undergraduate, professional, and graduate student enrollments is total college and university enrollment.

(6) The 1955–63 increases in private college and university enrollments by State were trended to 1970 to obtain the 1970 private total enrollments by State: this was subtracted from total enrollments to leave public institution enrollment for each State, following the assumption that public service levels would not decline, and that demand for higher education would continue to be met despite the growth in population of college-going age. These 1970 residuals were changed (for 18 States) where base year data inadequately reflected new State policies.

In projecting current teaching expenditures per enrollee, these expenditures were divided into personal service expenditures, and expenditures for commodities or contractual services. The personal service component that represents payrolls and fringe benefits was computed at 75 percent of total current teaching expenditures per enrollee, a percentage derived from nationwide data on payroll costs for instructional and all educational and general purposes. The assumption about salary is a key element in determining the projected amount of cost per student. Average salaries paid by public institutions of higher learning have been assumed to rise 1.5 times as much as other salary and wage payments in each State, or to about 50 percent above the 1961–62 levels. Certainly a faster than competitive rate of increase in salaries would be required to attract and retain gifted teachers in a market characterized by shortages. It is also assumed, however, that student faculty ratios by 1970 will rise by 20 percent. This 20-percent rise is based on the conclusion of an earlier study by the Office of Education that such an increase in student-staff ratios would be the maximum consistent with maintenance of quality. Any large rise according to this earlier study would build "into the academic structure a planned reduction in quality of instructional service." The salary and student-staff ratios are patently linked: a smaller rise in student-staff ratios would mean higher salary payments, and higher salary payments than projected would mean less pressure on student-staff ratios. The commodity and contractual service expenditures per enrollee (25 percent of student higher education current costs) were repriced to 1970 by the projected general price level rise.

The capital outlays by State on facilities for public student higher education were projected to 1970 on the basis of (*a*) assumed construction of dormitory and instructional facilities required for the additional students by State; (*b*) assumed replacement or renovation of

[16] 10.7 percent compared to 7.6 percent, reflecting increased demands for graduate education.

obsolete, substandard, and rundown buildings by 1970; and (*c*) assumed continued rise in construction costs (at 3.1 percent per year) from 1962 levels in each State.

The 1970 capital plus current expenditures per enrollee by State with projected enrollments in 1970 by State determine the projected level of public expenditures in 1970 on student higher education in each State.[17]

Expenditures on the other activities of public higher education institutions, research, and public services and extensions, were also projected to 1970 by State, to provide projected total, total current, and total capital expenditures in 1970 by States for institutions of higher education.

Total 1962 current (noncapital) outlays on research were projected to 1970 on the following assumptions: (*a*) 75 percent of outlays are for personal services; the level of wages and salaries paid will be in accord with general faculty salaries will rise at 1½ times the rate of other nonfarm wages and salaries in each State); (*b*) 25 percent of outlays are for commodities and contractual services; costs per unit will rise at 3 percent per year reflecting the increased complexity of equipment; (*c*) the volume of research activities thus repriced to 1970 levels will grow at 8 percent per year to 1970; (*d*) the public institution share in these total current expenditures on research will be 60 percent in 1970; (*e*) the allocation between States in 1970 of these public current expenditures on research reflects the 1962 pattern of research expenditures less administrative overhead costs.

Public institution capital outlays for organized research were estimated by State for 1970 from National Science Foundation estimates of national research facility needs.

PUBLIC WELFARE

Expenditures for State and local public welfare programs are composed of: (*a*) various programs of cash-assistance payments; (*b*) several categories of vendor payments for medical services; and (*c*) administration, preventive services, and training expenditures. These were separately projected by State to 1970.

The standard unit of service projected to 1970 was the aid recipient for the four federally aided categorical cash-assistance payments programs (old-age assistance; aid to families with dependent children; aid to the blind; and aid to the permanently and totally disabled). In cash assistance to needy not qualifying under one of the federally aided programs (general assistance) the service unit was the caseload.

In projecting recipient loads and total expenditures, the present pattern of Federal aid for the special categories only, not for general assistance, was assumed to continue; it was further assumed that standards of assistance will not change significantly by 1970, and that preventive measures to reduce public dependency, such as the economic

[17] In estimating 1970 expenditures by enrollments, an implicit assumption is made that the mix of full- and part-time students in each State does not change from its 1962 level. If a full-time student is defined as one carrying at least 75 percent of the "number of credit hours required for graduation, divided by the number of terms normally taken for graduation," then the equivalent in full-time students of the gross enrollments adjusted to include summer sessions per State can be calculated. These "full-time student equivalents," and the costs per full-time student equivalent, are figures more nearly comparable State to State than gross enrollment data. Their values for 1962 by State, and projected values for 1970 by State were computed to allow meaningful interstate comparisons.

opportunity program, will not significantly reduce caseloads as early as 1970. Therefore, recipients in the four special categories and the caseload for general assistance programs were projected to 1970 on the basis of trends in the number of recipients (and caseload) for each category for each State from 1953 to 1964. Since introduction of and changes in State programs and in Federal grant provisions lead to interprogram transfers of cases which distort the trends in each program, computed trend values had to be adjusted by inspection to remove these distortions.

There was thus an implicit assumption in the projections that no further alterations in interprogram caseload relationships will occur. This assumption was relaxed only for old-age assistance recipients; it was assumed that the introduction of national hospitalization insurance will have the effect, in the 12 States that have *not* adopted medical assistance programs for the aged prior to 1964, of reducing the projected number of old-age assistance recipients by 25 percent of the projected concurrent recipients of old-age assistance and old-age, survivors, and disability insurance. The proportion by State of old-age assistance recipients concurrently receiving old-age, survivors, and disability insurance was projected to 1970 by linear extrapolation of the 1960–64 change in this proportion.

In line with the assumption of no significant changes in standards of assistance by 1970, there were assumed to be no significant changes in real levels of cash assistance by 1970. Average annual 1964 payments per recipient (or case) by category by State were repriced to 1970 by the projected rise in the cost of living (1.2 percent per year).[18]

The product of recipients per category, and payments per recipient in each category is 1970 cash assistance by State in each category.

In projecting for 1970 by State the nonaged recipients of medical services paid for by federally aided welfare programs, it was assumed that: (*a*) by 1970 all States will have extended vendor-payment programs for children and other medically indigent, in line with the legislation expanding the Federal medical assistance program to include children and other medically needy; (*b*) the standards for medical indigency in 1970 will very among the States in proportion to the standards set for cash payments that determine the number of nonaged receiving categorical assistance; (*c*) medical indigents will be in a 2-to-1 ratio to nonaged categorical cash assistance recipients—a judgmental assumption which tests out for 1963 data. Thus, the 1970 potential recipients (nonaged) in each State of vendor payment services were projected as twice the number of recipients of categorical aids exclusive of old-age assistance.

The costs by State of medical services provided per nonaged recipient were projected to 1970 assuming that services provided would on the average amount to half the per capita cost of personal health services for all persons under 65 years of age. The 1963 per capita cost of personal health services for all persons under 65 years was repriced to 1970 at the historical rate of increase of medical care prices (3.6 percent per year), then multiplied by an index of State-to-State differences in medical costs, based on 1963 per diem costs of short-term hospital care in non-Federal hospitals.

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[18] Average old-age assistance payments to recipients receiving only old-age assistance, and to recipients concurrently receiving old-age, survivors, and disability insurance were separately projected to 1970.

Projected 1970 State and local vendor payments for old-age assistance and medical assistance for the aged were based on (*a*) the projected 1970 number of old-age assistance recipients in each State, and (*b*) 1963 per recipient vendor payments in each State, reduced by that share in each State devoted to hospital services which national hospitalization insurance will cover, then repriced to 1970 with the increase in medical care costs.

Projected 1970 State and local expenditures for vendor payments in general assistance programs in each State were calculated assuming the fiscal year 1964 ratio of vendor payment cases to cash assistance cases under general assistance programs would continue, and that services provided per case would remain at present levels.

Administration, preventive services, and training expenditures by State were projected for 1970 by assuming a minimum level of expenditure in 1970 on these services of 13 percent of assistance costs (in 1963, the national average expenditure for these services was 10 percent of assistance), with those States which in 1963 spent more than 13 percent projected to spend the same percentage in 1970 as in 1963.

FINDINGS

The application of these summarized methods within the backdrop economic model yielded a set of findings on State and local finances in 1970. Following are some of these findings, as they bear on the complex of relationships which Project '70 was designed to clarify:

1. The likely future role of the State and local governments as a growth sector of the national economy;
2. The responsiveness of present State and local taxing structures and yields to economic growth;
3. The relationship of State and local program expenditures to growth of the national economy;
4. Additional fund requirements of States and localities for these emerging program expenditures.

STATE AND LOCAL SECTOR IN THE GNP ACCOUNTS

At the end of World War II, there existed a large backlog of unmet public needs due to wartime restrictions on construction, relative stability of State and local governmental employee salary levels, and neglect of certain public facilities in the years preceding the war. Population growth and the continuing concentration of the population in metropolitan areas created additional pressures for State and local spending; purchases of goods and service rose rapidly. Between 1946 and 1952 these purchases grew at an average annual rate of 15.2 percent in current dollars; State and local purchases of goods and services have continued to increase at rates of 8 percent or more per year, a rate substantially in excess of the rate of growth in national output.

State and local demands for goods and services can be expected to continue rising faster than gross product (barring increased world tensions): States and localities provide services essential to urban living, such as street and highway construction and maintenance, water supplies, police and fire protection; they carry out such basic governmental functions as education.

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We have projected State and local purchases of goods and services to rise to $97.3 billion, which is almost 55 percent above the 1964 amount and more than 80 percent above purchases in our base year 1962. As a quick assessment of this magnitude, it may be noted that if State and local purchases were to increase as they did between 1962 and 1964 by about $5 billion per year, a total of over $90 billion would be reached by 1970.

We have projected within the context of our national model a declining rate of increase of State and local purchases of goods and services, in consequence of certain demographic and program developments:

1. The rate of growth of school-age population is declining markedly, and is projected for the years ahead at less than half the rate of increase in the past (3.8 percent per year 1952–58, 3.1 percent 1958–64, and 1.2 percent per year 1964–70).
2. Despite continuing increases in public college and university enrollments, private institutions may be expected to carry a part of the growing educational load.
3. Highway construction expenditures have been increasing at a declining rate and some further dropoff in this rate may be expected as the Interstate Highway System nears completion.
4. Use and tax support of public hospitals have been lowered by voluntary health insurance; this trend will be accelerated by the recently enacted national hospital insurance program for the aged.
5. Technological and scientific advances have reduced the importance of public health controls on contagious and infectious diseases; the urgency of medical services for the chronically ill has increased, but there is not yet developed a clear demarcation of public versus private responsibility for these services.[19]

There are antithetical or countervailing forces as well: the likely concentration of more of the population in urban areas brings a concomitant requirement for enlarged public services; increased national aid to States is stimulating expanded outlays on (*a*) public facility supports for industrial development in the economically depressed regions and (*b*) programs designed to overcome the effects of poverty, and to prevent public dependency.

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[19] Transfer payments by States and localities as well as purchases of goods and services will be affected by the reduced rate of growth in the child population, and by the expansion of the national social insurance system that each year brings additional aged persons on to the annuitant rolls, and reduces the loads on State and local public assistance programs.

TABLE 1.—*State and local government receipts and expenditures, selected years 1946–64, and 1970 (projected)*

[In billions of dollars]

	1946	1957	1962	1964	1970	
					Illustration I	Illustration II
Receipts [1]	$12.9	$38.2	$58.6	$68.6	$105.5	$99.8
Personal tax and nontax receipts	1.5	5.2	8.7	10.6	15.9	15.8
Corporate profits tax accruals	.5	1.0	1.4	1.6	2.3	2.3
Indirect business tax and nontax accruals	9.3	25.5	36.9	41.9	59.9	57.9
Contributions for social insurance	.5	2.3	3.5	4.1	5.7	5.7
Federal grants-in-aid	1.1	4.2	8.0	10.4	21.8	18.1
Expenditures [1]	11.0	39.5	57.6	67.2	101.4	101.4
Purchases of goods and services	9.8	36.6	53.7	63.1	97.3	97.2
Transfer payments to persons	1.7	4.2	5.7	6.5	8.0	8.0
Net interest paid	.3	.5	.8	.8	1.1	1.1
Less current surplus of government enterprises	.7	1.8	2.6	3.1	5.1	5.1
Surplus or deficit on income and product account [2]	1.9	−1.4	.9	1.4	4.1	−1.6

[1] Totals may not add due to rounding.
[2] These amounts reflect the financial operations of the State and local retirement systems under which reserves have been accumulating.
Source: 1946, 1957, and 1964: Survey of Current Business, August 1965, table 9, pp. 38-39.

State and local purchases have reached and exceeded total purchases by the National Government; except as military requirements compel Federal procurement to rise, they would continue in excess of National Government purchases. State and local purchases of goods and services as a ratio to National Government purchases of goods and services for selected years as shown below:

1946	0.57
1957	.74
1962	.85
1964	.97
1965 (IV quarter annual rate)	1.0

INCOME ELASTICITY OF STATE AND LOCAL TAXES

After projection of the 1970 yields of present State and local taxes under conditions of economic growth,[20] the implicit income elasticities of the several taxes were computed, State by State. Also, the projected changes in the yields of the present tax structure, aggregated geographically for each tax, were related to the assumed changes in gross national product on which the projections are based. These implicit gross product elasticities, by type of tax as shown in table 2, generally agree with earlier findings.[21] However, considerable State-to-State variation exists: elasticities computed for one or several States are not representative of the norm, and national average elasticities are very undescriptive of particular States. The higher elasticity computed in illustration I for the property tax yield is notable; the State and local tax structure overall has a computed gross product elasticity, alternatively, of 1.0 or 1.1. The higher overall elasticity corresponds to illustration I for the property tax, with its gross product elasticity of 1.2.

[20] The most recent computations use rates as of Mar. 1, 1965, except for property taxes in which case effective rates are as of 1962, the latest year for which there are comparable figures for all the States.
[21] See Otto Eckstein, *Trends in Public Expenditures in the Next Decade,* Committee for Economic Development, 1959; Dick Netzer, "Financial Needs and Resources Over the Next Decade: State and Local Governments." *Public Finances: Needs, Sources, and Utilization,* National Bureau of Economic Research, 1961.

TABLE 2.—*Projected growth in yield of State and local taxes, fiscal year 1962 and calendar year 1970, and implicit gross national product and personal income elasticities*

Type of tax	Percent increase [1]	Elasticity [2]	
		Gross national product	Personal income
Total:			
Illustration I	64.4	1.1	1.1
Illustration II	59.3	1.0	1.1
Property:			
Illustration I	73.4	1.2	1.3
Illustration II	62.3	1.0	1.1
Nonproperty	56.8	.9	1.0
Sales and gross receipts	48.3	.8	.9
General	57.8	1.0	1.0
Selective	40.7	.7	.7
Motor fuel	36.1	.6	.6
Alcoholic beverage	34.9	.6	.6
Tobacco products	24.3	.4	.4
Insurance	72.0	1.2	1.3
Public utilities	55.9	.9	1.0
Parimutuels	72.0	1.2	1.3
Amusements	75.2	1.3	1.3
Other	46.1	.8	.8
Income	95.2	1.6	1.7
Personal	102.1	1.7	1.8
Corporation	79.6	1.3	1.4
Death and gift	66.5	1.1	1.2
Severance	30.1	.5	.5
Motor vehicle and operators' licenses	32.0	.5	.6
Corporate licenses	60.0	1.0	1.1
Other	55.5	.9	1.0
Exhibit items:			
Gross national product	60.0		
Personal income	56.2		

[1] Projected growth at rates effective in 1962.
[2] Percent increase in tax yield from 1962 to 1970 per 1 percent increase in GNP or personal income over the same period. Since personal income is projected to grow at a slightly slower rate than GNP, expressing the growth rates per 1-percent increase in personal income results in slightly higher elasticities.

Measurement of the income elasticity of the property tax base or yield (the subject of a considerable body of research) presents conceptual difficulties.[22] Unlike income or sales, the value of the property tax base is not uniquely defined by statute and does not automatically respond to economic change. Rather, the value of the property tax base depends on the actions of taxing agencies and assessors. In making illustrations I and II, and a third illustration (not shown), differing assumptions were made about reassessment practices.

The assumption of illustration I was that the property tax base grows with the market value of property, and that the ratios of assessments to market values of property remain unchanged. Under this assumption the taxable value of property is projected to rise from $1.1 trillion in 1961 to almost $2 trillion by 1970.

[22] See Dick Netzer, "Income Elasticity of the Property Tax: A Post-Mortem Note," *National Tax Journal*, June 1964.

TABLE 3.—*Summary of general property tax base at market values, 1961 and 1969–70 (projected)*

[In billions]

Class of property	1961	1969–70	Percent increase	Elasticity [1]
Total	$1,118.1	$1,987.3	77.7	1.26
Real	903.3	1,649.7	82.6	1.34
Personal	214.9	337.6	57.1	.93
Nonfarm residential	509.8	976.7	91.6	1.48
Commercial and industrial	391.3	656.8	67.9	1.10
Real	204.2	358.0	75.3	1.22
Personal	187.1	298.8	59.7	.97
Farm	158.1	221.4	40.0	.65
Real	130.3	182.5	40.0	.65
Personal	27.8	38.9	40.0	.65
Vacant lots	35.2	94.3	167.9	2.72
Minerals	23.8	38.2	60.5	.98

[1] Percentage growth in property value per 1-percent increase in gross national product between 1961 and 1969–70.

In illustration II, the rate of lag in reassessment observable between 1956 and 1961 was assumed to continue. In this interval, assessed valuations increased by 34 percent, while market values of property rose 41 percent; that is, assessed values rose 0.83 percent for each 1-percent increase in market values, and the taxable value of property is projected to rise to $1.8 trillion by 1970.[23] [24]

The derived gross product elasticities correspond to the projected total tax yield in 1970 of $70.3 billion (illustration I) or $68.2 billion (illustration II) and total receipts on a gross product account basis (less social insurance contributions and Federal grants-in-aid) of $78 and $76 billion in the two illustrations.[25]

Using past experience as our criterion, we can outline a structure within which reasonableness can be evaluated. In the 10 fiscal years 1954–64 tax collections rose by a total of $25.7 billion, or 8 percent per year. This historic increase is due in part to the response of tax bases to economic growth (the State and local tax structure unchanging), in part to rises in effective tax rates with rising income if existing tax structures are in fact progressive, and in part to the legislative alterations in the tax rates and structures that did occur. The relative importance of changes in tax rates and structures and of automatic tax base and "built-in" effective tax rate growth in this period can be estimated; applying the gross product elasticities derived in this study for the present tax structures to the revenue level and gross product increases of the past we can approximate the revenue increase attributable to tax base growth and to base-year tax structures having non-

[23] A third calculation was made in an attempt to measure the more nearly automatic responsiveness of the property tax to economic growth, treating reassessment of older properties as a purely administrative decision. In this illustration, it was assumed that the property tax base is increased only by the addition of newly constructed properties to the tax rolls and that older properties are not reassessed, but are kept on the rolls at 1961 levels (the latest year for which information is available); the 1970 property tax base was thus projected at $1.6 trillion for 1970, or 18 percent below the base at market value. The implicit gross product elasticity of this alternative is 0.7.

[24] An unpublished memorandum of Allen D. Manvel, Chief, Governments Division, U.S. Bureau of the Census, indicates for the interval 1961–63, a GNP elasticity for assessed valuations of less than unity.

[25] Again it must be stressed that the aggregates are based on the $864 billion gross national product projected for 1970 and are the sum of the totals computed by tax and by State.

zero effective tax rate income elasticities and allocate the residual revenue increase to legislative changes in tax rates and structures. This computation is shown in table 4;[26] in the decade fiscal 1954–64 "automatic" yield growth would account for 80 percent of increments in total tax collections, while statutory tax rate or structure changes would account for the remaining 20 percent of the increased yield. To provide this increase in yield, the index of statutory rates and structure of the entire State-local taxing system must have risen by a total of 23 percent of its base year level over the interval, or by 2.1 percent per year. The relative changes in the index of statutory rates and structure, and the implicit annual rates of change of this index for various taxes are also shown in table 4.

TABLE 4.—*State and local tax yields, fiscal years 1954 and 1964 and calendar year 1970 (projected)*

[Dollar amounts in millions]

Tax source	Actual collections		Projected yields of constant tax structure		Percent increase over period			Percent per year		Implicit statutory rate increase, 1954–64	
	1954	1964	1964	1970	1954–64 Actual	1954–64 Projected	1963[1]–70, projected	1954–64, actual	1963–70, projected	Over period	Per year
Total taxes	$22,067	$47,785	$38,814	$70,310	116.5	75.9	53.2	8.0	6.3	23.1	2.1
Property tax	9,967	21,241	38,618	32,981	113.1	86.8	[2] 60.6	7.9	7.0	14.1	1.4
Personal income tax	1,127	3,791	2,590	6,550	236.4	129.8	85.6	12.9	9.2	46.4	3.9
Corporate income tax	778	1,695	1,509	2,294	117.9	94.0	43.4	8.1	5.3	12.3	1.2
Sales and gross receipts taxes	7,276	15,762	11,489	21,881	116.6	57.9	44.9	8.0	5.4	37.2	3.2
Other, including licenses	2,918	5,296	[3] 4,608	6,604	81.5	57.9	28.7	6.1	3.7	14.9	1.4

[1] Based on average for two fiscal years 1963 and 1964 to approximate calendar year.
[2] Assuming gross product elasticity of 1.2.
[3] Assuming gross product elasticity of 0.8.

Data bearing directly on changes in effective tax rates are available only for the property tax; these data suggest a 1.5 percent per year increase in effective property tax rates (or 7.5 percent over the period 1957–62,[27] which corresponds reasonably well to the increase per year shown for the property tax in table 4.

[26] Let T_o be the tax yield during the base year, B_o the tax base, A_o the effective tax rate of the base year tax structure during the base year, and $L_o=1$ where L is an index of statutory rates and structure set equal to one for the base year.

Let the tax yield in some future year be $(T_o+\Delta)$, the tax base be $(B_o+\Delta B)$, the effective tax rate of the base year tax structure be $(A_o+\Delta A)$, and the index of statutory rates and structure be $(L_o+\Delta L)=(T_o+\Delta T)/(B_o+\Delta B)(A_o+\Delta A)$.

If the gross product elasticity (somehow available) of the base year tax structure is applied to T_o and to the change in gross produce between the base year and future year, then by definition an estimated tax yield is calculated, $E\equiv(B_o+\Delta B)(A_o+\Delta A)L_o$. In the context of the computations made, this is equivalent to assuming that the relative responsiveness of the effective tax rate of the 1954 tax structure to the 1954–64 income levels is the same as the projected responsiveness of the effective tax rate of the 1962 tax structure (used to calculate the income elasticities) to actual 1962 income and projected 1970 income.

Then, the relative change in the index of statutory rates and structure, $\Delta L/L_o=\Delta L$, is equal to $\left(\frac{\Delta T}{T_o}-\frac{E-T_o}{T_o}\right)/\left(1+\frac{E-T_o}{T_o}\right)$, or $\frac{\Delta T}{E}-\frac{E-T_o}{E}$.

[27] U.S. Bureau of the Census, Government Division, *Property Taxation in 1962*, November 1964, p. 19.

Total tax collections with constant revenue structure are projected to rise 6.3 percent per year; whereas the estimated State and local purchases of goods and services rise 7.7 percent per year as indicated above (1962–70) and total general State and local expenditures are projected to grow 7.2 percent per year.

INCOME ELASTICITIES OF STATE AND LOCAL EXPENDITURES

Less attention has centered on the income elasticity of State and local expenditures than on the income elasticity of State and local taxes. Yet, findings of social and economic determinant studies emphasize the significant relationship between State and local expenditure and aggregate income.[28]

States and localities are producers of an important segment of total national product, their level of production and of spending on inputs is multiplely linked to national economic growth. Some of the obvious relationships can be listed as follows:

(*a*) Consumer-voter demands for the package of public outputs change concurrently with growth in income, and income per capita;

(*b*) Growing national product enlarges the capacity of governments to finance expenditures without changing their revenue structures;[29]

(*c*) Private sector output per worker influences wage and salary levels in the public sector, just as the private sector mostly determines the market prices of goods and, therefore, procurement prices paid by governments;

(*d*) In turn, State and local indirect taxes (and demands for goods and services) affect the prices paid in the private sector.

The expenditure projection of Project '70, derived by a highly disaggregative procedure, are summarized in table 5 showing the amounts by function, the annual growth rates, and the ratios of these growth rates to the growth in the national product in the context of the overall economic model.

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[28] Determinant studies are typically cross sectional regressions of per capita expenditures of States and localities on a variety of variables, as income per capita, population density, degree of urbanization; per capita income is the most explanatory of interstate variations. Recent research examines relative changes in income and expenditures over time, see James Dusenberry, Otto Eckstein, and Gary Fromm, "A Simulation of the U.S. Economy in Recession," *Econometrica*, October 1960; Roger Bolton, "Predictive Models for State and Local Government Purchases," unpublished manuscript for Brookings Institution, 1966; E. Cary Brown and Albert Ando, "Government Revenues and Expenditures," unpublished manuscript for Social Science Research Council, December 1963.

[29] Empirical findings substantiate a significant consumer-voter reluctance to alter a tax system with *known* effects; attaining the preferred provision of governmental services is traded for avoiding the uncertainties attendant on a tax change. Put in other words, fiscal capacity is still a determinant of government spending even in a general analytic framework.

TABLE 5.—*State and local general expenditures, by function, calendar years 1963 and 1970 (projected)*

[In billions]

	Calendar 1963	Calendar 1970 (projected)	Growth rate per annum (percent)		GNP elasticities	
			1954–64	1963–70	1954–64 [1]	1963–70
General expenditure	$66.6	$108.3	8.5	7.2	1.6	1.3
Education [2]	25.2	44.6	9.7	8.5	1.8	1.5
Local schools	19.6	31.0	8.6	6.8	1.6	1.2
Higher education	5.1	12.1	14.6	13.1	2.7	2.3
Transportation	12.1	17.4	7.8	5.3	1.5	.9
Highways	11.4	16.2	7.8	5.1	1.5	.9
Air and water	.6	1.2	7.8	9.0	1.5	1.6
Public welfare	5.6	8.9	6.5	6.8	1.2	1.2
Health and hospitals	4.8	8.0	7.4	7.7	1.4	1.3
Police and fire	3.5	5.1	7.2	5.6	1.4	1.0
Natural resources and local parks	2.6	4.3	9.2	7.2	1.7	1.3
Sewerage and sanitation	2.1	3.5	7.9	7.3	1.5	1.3
Interest on general debt	2.3	3.6	12.6	7.0	2.4	1.2
Other general	8.5	13.0	7.9	6.3	1.5	1.1

[1] Computed on basis of average gross product for calendar years.
[2] Includes educational allowances and manpower training not shown separately, "other" education in census definitions.

NOTE.—Totals may not add due to rounding.

To provide a framework within which to interpret these varied elasticities and relative growth rates, we returned to our basic methodology. As indicated earlier, for each activity the magnitude of the workload at a standard definition was computed for 1970; then the goods and services required to provide the 1962 level of public service per unit were costed out at 1970 prices. Approximately uniform increases in scope of service through expansion of the workload, e.g., addition of preprimary schoolers, and in quality of service (more goods and service provided to each unit of the workload) were built in for each State, as a response to national program policies.

The projected magnitude of expenditure increases depended upon the increases projected in the workload at a standard definition of an activity, upon the projected increases in the prices paid by State and local governments for personal services, and for goods utilized in providing public services, and upon the projected increases in scope and quality of service in each functional area.

Workload.—The workload at standard definition in a number of program areas is some segment (age group or other) of the population; costs, and quality and scope remaining constant, State and local expenditures on these activities will grow as does this population segment. Growth of gross product is also related to the growth of a population component, namely the work force; prices, and output per worker remaining constant, gross product will grow as does the work force. So that, other things being equal, we should expect a greater than unitary gross product elasticity for State and local expenditures on those public services for which the workload grows faster than the comparable factor of GNP growth, the work force. Similarly, we should expect a unitary gross product elasticity of expenditures where the workload grows proportionately to the number of employed in the economy, and a low gross product elasticity if the workload grows more slowly than the employed labor force.

A comparison of workload rates of change and employment rates of change for selected functions is shown below:

Per annum increases in labor force and private employment, and in workloads of State and local governments, 1954–64 and 1963–70

	1954–64	1963–70
Total civilian labor force	[1] 1.4	[1] 1.8
Private employment (nonfarm)	[1] 1.4	[1] 2.1
Local schools (school age population)	3.2	1.3
Higher education (college age population)	3.1	3.6
Urban services: Police, fire, sanitation, sewerage, water supplies, transit, etc. (urban population)	[2] 2.6	[2] 2.0
Public welfare:		
Assistance recipients	[3] 3.1	[3] 2.7
Aged population	2.4	1.6
Other public services (total population)	1.7	1.4

[1] Based on U.S. Bureau of Labor Statistics data.
[2] Based on U.S. census data for period 1950–60; projection assumes that all additions to population are ocated in urban places.
[3] Change reflects impact of social insurance program extensions on public assistance caseloads.

Cost per unit.—The cost increases over time in providing standard levels of public services per workload unit are in the main increases in wages and salaries of State and local governmental employees. As described in the presentation of methodology, in repricing personal services to 1970 levels, it was assumed that State and local governmental wages and salaries would move competitively with wages and salaries in the private (nonfarm) sector. In the economic model underlying the projections, it was assumed that private wages and salaries would increase in proportion to increases in output per worker. Gross private product (prices and work force remaining constant) will increase as does output per worker. In the projections, costs of personal services were increased in proportion to the growth in output per worker, and therefore will move with the gross private product (nonfarm), other things being equal.[30] Generally speaking, if the workload for State and local governmental functions moved with the employed labor force, and if unit costs [31] changed proportionately to output per worker (in current dollars), the product elasticity of State and local expenditures would be unity except for extensions of scope and quality of services.[32]

Quality and scope of services.—In using this quality and scope of service concept to interpret our projections, and in testing the idea against historical data, we must determine whether "quality and scope" can be measured other than as a residual and whether the factors con-

[30] This assumes that there are no changes over time in the productivity of workers employed by State and local governments. Also, the economic rents which the owners of skills in inelastic shortrun supply receive in the guise of higher wages and salaries is not explicitly dealt with; this implicitly assumees that these (salary) economic rents increase in proportion to increases in productivity, whereas they will increase or decrease as demand for the various scarce skills changes. In fact, in making the projections of Project '70 these "other things" were not held constant. For instance, as already noted, in projecting States and local expenditures on higher education to 1970, it was assumed that student-faculty ratios would rise by 20 percent by 1970 without reducing the quality of instructional service, an assumed major increase in productivity in the public sector; it was also assumed that wages and salaries paid in teaching and research activities in public institutions of higher education would rise 1.5 times as much as other wage and salary payments in each State, due to "a market characterized by shortages."

[31] Personal services are not the only input for State and local government activities; as indicated earlier in the methodology, costs per unit were separately projected to increase with private wages and salaries (nonfarm), with construction costs, and with general price level for the nonpersonal service, nonconstruction component of procurement expenditures.

[32] We shift the analysis here from gross national product to gross private product (nonfarm) because of the methodology used in the disaggregated projections.

tributing to changes in quality and scope can be isolated in the data, and so separately measured.

Under one set of simplifying assumptions,[33] the difference between the rate of growth of workload and the rate of growth of State and local employment may be interpreted as a measure of the extent of increased scope or quality of services. Suppose the only public service provided was hospitalization for mental illness, with the incidence of mental illness uniform for all age groups in the population, and an unchanging standard for hospitalizing the mentally ill, so that the workload can be identified as population. Growth in population, if the patient-hospital personnel relationship was not altered, would lead to an increase in mental hospital employment exactly proportionate to the increase in the population. A faster increase in employment in these hospitals would suggest a lower patient-personnel ratio and higher quality of care.

If in this example, we relax the assumption of a constant ratio of public sector wages to private sector wages, then changes in the ratio of State and local employment to State and local workload are only a partial measure of changes in scope and quality of services. If the rate of wage increase in the public sector is less than the rate of wage increase in the private one, the caliber of the staff may have declined, and thereby decreased the quality of the service provided; a faster growth of public sector wages than private sector wages would indicate improvements in the quality of public services. By comparing the rates of change in output per worker in the private sector (nonfarm), with the rates of change in average wages and salaries for public employees we then can obtain a second type of measure of extension in quality or scope of public service.

During the period 1954–64 the growth in the workload of State and local governments measured rather crudely was 2.4 percent per year;[34] employment in State and local government rose 4.3 percent per year; thus on the first approximation basis the increase in scope and quality is 1.9 percent per year during the decade. In this same interval average wage payments to State and local employees rose by 4.4 percent per year, a rate of increase in excess of the rate of growth of output per private nonfarm worker in current prices of 0.2 percentage points. (In the decade 1954–64 there was still some catching up on wartime lags in public salary level changes, and therefore pay increases greater than in the private sector, as "quality" was being restored.) If this "extra" wage increase is combined with a rate of employment growth above the rate of increase in workloads in the State and local sector, we arrive at a combined estimate of quality or scope of public service change during this 1954–64 period of 2.1 percent per year.

The three factors—the growth in the workload of State and local governments, the rise in cost per unit of service, and the rise in quality or scope of service—account for the 8.9 percent past rise in personal services provided by the States and localities. (See table 6.)

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[33] Public services require only personal service inputs: productivity of workers in the public sector does not change over time; the ratio of wage rates in the public sector to wage rates in the private sector does not change over time.

[34] An average of the rates of growth in total population and in school-age population, weighted by the ratios of educational to total expenditures, and of noneducational expenditures to total expenditures.

TABLE 6.—*Per annum growth in private gross (nonfarm) product and on personal services provided by State and local governments*

PRIVATE GROSS (NONFARM) PRODUCT (PGP)

[In percent]

	Output per worker				
	PGP (nonfarm)	Work force	Current dollars	1958 dollars	Price deflator
1954–64	[1] 5.7	[2] 1.4	[1] 4.2	[1] 2.4	[1] 1.8
1963–70	[3] 5.7	[3] 2.1	[3] 3.6	[3] 2.3	[3] 1.3

PERSONAL SERVICES, STATE AND LOCAL GOVERNMENTS

	Expenditure on personal services	Workload	Cost per unit	Private sector output per worker	Quality and scope of service	
					On 1st basis	On combined basis
1954–64	[4] 8.9	[5] 2.4	[6] 4.4	4.2	[5] 1.9	[5] 2.1
1963–70	[4] 7.6	[5] 1.4	3.6	3.6	[5] 2.4	[5] 2.4

[1] Council of Economic Advisers, Economic Report of the President, January 1966.
[2] Employment data from U.S. Bureau of Labor Statistics.
[3] 1970 estimates from one of several national economic models, Federal Interagency Committee on Economic Growth and Employment Opportunities.
[4] Personal services, U.S. Bureau of Census, Governments Division, for fiscal years 1954 and 1964 with average for fiscal 1962–63 and 1963–64 used as calendar year 1963. The 1970 figure is an approximate one, implicit in current operation expenditure projections of Project 1970.
[5] See text for explanation of estimates.
[6] Computed from U.S. Bureau of Census, Governments Division, data on public employment and payrolls.

NOTES.—(1) General expenditures of State and local governments in the fiscal years 1954–64 grew 8.5 percent per year; the projected figures suggest a rate of growth of 7.2 percent per year in general expenditures. (2) Growth of output per worker will not completely reflect output per man-hour increases, due to changes in the average workweek. A decrease in the average workweek constituted part of the basic economic model used.

Applying the same analysis to the projections made for 1970 we can break into separate components the approximate 7.6 percent per year growth in State and local personal services implicit in our 1970 expenditure projection and relate the projection to the underlying economic model.

For the period ahead the workload is rising more slowly than it did in the decade past. We have assumed that public wage and salary payments will grow proportionately to private output per worker (nonfarm) in current dollars. Therefore, the residual increases in personal service expenditures represent our implicit allowance for increased quality and scope of service.[35] Within this scheme of evaluation the differences in overall rate of growth in personal service expenditures are attributable primarily to the difference in workload past and prospective, with the scope and quality of public services projected to rise over the period ahead at a rate approximately equal to that experienced earlier.

[35] For the States and localities relative growth in quality and scope of services is defined as

$$\frac{\text{(relative growth in expenditures on personal services)}}{\text{(relative growth in workload) x (relative growth in private output per worker)}}$$

Relative growth in expenditures on personal services is by definition the product of the relative growths in (State and local) employment and in cost per employee. Therefore the measure of growth in quality and scope of services on this residual basis is definitionally equivalent to the measure on combined basis of the text.

These projected extensions in scope and quality of services are closely tied to current national policies as embodied in the recent authorizations by Congress of substantially increased Federal payments to the States and localities. Some $22.1 billion of Federal grants-in-aid were estimated for 1970 based on legislation adopted by June 1965, with relatively minor extensions beyond these enactments.[36] During the basic research of Project '70 national programs were anticipated often prior to formal submission to the Congress; on the whole, the anticipations were surprisingly close to the later congressional action.

The procedure basically assumed that Federal grants-in-aid to the States and localities would achieve what they set out to achieve, a stimulation of State and local spending.[37] In the past decade higher Federal aids stimulated about 65 percent of the enlarged scope and quality of State and local services; the equivalent proportion of the projected extensions accounted for by Federal aids is 75 percent, as shown below:

Average annual growth in Federal payments to States and localities, actual, 1954–64, and projected, 1963–70 [1]

[In percent]

	Fiscal 1954–64	Calendar 1963–70
Federal payments to States and localities	14.7	12.8
Federal contribution to expenditure growth [2]	1.4	1.8
Federal payments as a percent of changes in scope and quality of services	66.7	75.0

[1] The figures relate to total Federal aids, including aids for transfer payments and for construction such as the Interstate Highway System.
[2] Federal payments to States and localities weighted by the proportion of Federal grants to State and local expenditure in the base year.

The higher proportion of Federal aids to extension in quality and scope of services reflects at least two aspects of the altered intergovernmental fiscal structure: (*a*) the larger share of grants in the period ahead designed to stimulate current expenditures rather than capital outlays and (*b*) Federal matching ratios higher than in the past—90 percent for example for the antipoverty program.

1970 OUTLOOK FOR STATE AND LOCAL FINANCES

The income and fund requirements of the States and localities are summarized in table 7, as projected for 1970. In any year funds are needed to meet general expenditures and the governments' contribution to retirement funds, to redeem State and local debt as it becomes due, and to provide additional working capital, that is increments in amounts of cash in sinking funds and on hand as the aggregate outlay mounts. For the combined purposes, we project the 1970 fund requirements of States and local governments at $122 billion.

[36] Some 50 officials were consulted in the preparation of these estimates to reflect agency plans. The estimates remain, however, the responsibility of the project staff and cannot be attributed to the Federal agencies. See note on p. 15 for the assumptions on which projections of Federal aids were based.

[37] In Roy Bahl and Robert Saunders, "Determinants of Changes in State and Local Government Expenditures," *National Tax Journal*, March 1965, this conclusion is reached in another way. In a study of interstate variations in changes in expenditures among the States over the period 1957–60, they relate expenditure changes to changes in per capita income, population density, urban population, Federal grants, and public school enrollments with the finding that the changes in per capita Federal grants to the States is the only factor which significantly affects changes in State and local spending per capita.

TABLE 7.—*Fund requirements of State and local governments, fiscal year 1964 and calendar year 1970 (projected)*

[In billions]

	Calendar year 1970	Fiscal year 1964
	Fund requirements	
Total	$121.8	$79.0
General expenditures	108.3	69.3
Additional government contributions to retirement funds	2.5	1.7
Debt redemption	7.5	5.0
Additional working capital	3.5	3.0
	Revenues available	
Total		$68.2
High revenue illustration	$107.9	
Low revenue illustration	102.2	
General revenues, own sources, including net liquor store profits		58.7
Illustration I	86.4	
Illustration II	84.3	
Net utility revenues	—.6	—.5
Revenues from Federal Government		10.0
Illustration A	22.1	
Illustration B	18.5	
	Gross additional fund requirements	
Presumptive		$10.8
High revenue illustration	$13.9	
Low revenue illustration	19.6	
Actual		11.2

The revenues available include general revenues from own sources counting net liquor store profits in liquor monopoly States as equivalent to alcoholic beverage taxes in other States, net revenues from public utility operations, and Federal payments to State and local governments.

The figures suggest 1970 gross additional fund requirements at the low end well within the borrowing capacity of the States and localities. The additional funds (gross) required depend upon the property tax alternative included, and on the projected 1970 amount of Federal payments to States and localities. Two illustrations for the Federal grants-in-aid are shown; in illustration A the figure is based as indicated earlier on appropriation authorizations plus assumed follow-through on program extension. In illustration B the Federal payment amount is arbitrarily scaled down to $18.5 billion, essentially assuming no followthrough expansions of the programs enacted.[38] In assessing these figures, it is important to bear in mind that a separate estimate of gross borrowing derived by assuming that States and localities in 1970 would finance the same share of their capital outlay (less highway construction) through debt issues as they financed in the base year 1962 places these gross new issues at $14.9 billion, given the projected 1970 capital outlay. The higher figure on gross fund

[38] Since June 1965, when the study computations were completed, new grant legislation has been proposed by the administration.

requirements of $19.6 billion indicates a need for additional revenue sources—Federal, State, or local.

Link of fiscal and economic outlook.—The economic framework of the growth model used is intimately tied on both the revenue and expenditure sides to the projection results. The findings on State and local finances of this study are more dependent upon the particular model—set of economic and demographic assumptions—than those of previous studies; it is not just the revenue findings, but the expenditure projections as well, which are so sensitive.

The use of current prices permitted the inclusion of effects on the projected 1970 revenues and expenditures of relative price movements of the different components of the purchases of the States and localities; a constant price model cannot thus reweight its implicit price indexes. Further, some account was taken of the impact on expenditures of increasing competition for scarce skills in the economy.[39]

The methodology of Project '70 does not appear to yield conservative results. Our findings as outlined below indicate that if the economic model were descriptive of output changes in the economy, and the same scope and quality change had been built into a 1954-based projection for 1964 as we have implicitly built into our 1962-based projection of 1970, we would have overshot the expenditure growth that did occur.[40] Thus the methodology of Project '70 appears to lack the conservative bias apparently inherent in earlier projections of State and local activities.

Comparison of annual rates of growth, 1954–64[1]

	GNP	State-local personal services			Total
		Workload	Cost per unit	Quality and scope changes	
Actual	5.6	2.4	4.2	2.1	8.3
Project 1970	5.7	2.4	4.2	2.4	9.9

[1] In current prices.

Alternative economic models.—Within this same evaluative structure it is possible to alter the 1970 economic model,[41] keeping workload and scope and quality growth rates unchanged, and derive a different estimate of growth in personal service expenditures of States and localities.

The alternative economic model selected for test purposes is again one developed for the Interagency Committe on Economic Growth, but one that reflects more recent economic events. It postulates for 1970 a 3-percent unemployment rate (rather than a 4-percent rate), a greater increase in output per worker (nonfarm) by 1970, a higher price increase, and a GNP in 1970 dollars of $918 billion, in place of the $864 billion used in the disaggregative study.

[39] Recently, some projections have been made applying productivity increases to project wages and salaries in the State and local sector, following Project '70 methodology. See Dick Netzer, *State-Local Finance in the Next Decade,* unpublished manuscript for Committee for Economic Development, August 1965.

[40] At least as applied to personal services.

[41] For this example the demographic assumptions of the model are unchanged, but these could be altered also.

The extension of quality and scope of service of 2.4 percent per year is implicit in the finding of the study, for which programs were costed out individually, reflecting national policy directions. When this result is carried over to the alternative model, the resulting annual rate of growth of State and local expenditures on personal services is 8.8 percent. (See table 8.)

TABLE 8.—*Per annum growth in private gross (nonfarm) product and in personal services provided by State and local governments, 1963–70, in 2 economic models*

ECONOMIC MODELS [1]

[In percent]

	PGP (nonfarm)	Work force	Output per worker		Price deflator
			Current (dollars)	Constant (dollars)	
GNP of $864,000,000,000	5.7	2.1	3.6	2.3	1.3
GNP of $918,000,000,000	7.0	2.2	4.8	3.0	1.7

PERSONAL SERVICES, STATE AND LOCAL GOVERNMENTS [1]

	Expenditure on personal services	Workload	Cost per unit	Private sector output per worker	Quality and scope of service
GNP of $864,000,000,000	7.6	1.4	3.6	3.6	2.4
GNP of $918,000,000,000	8.8	1.4	4.8	4.8	2.4

[1] 1970 estimates from 2 of several national economic models, Federal Interagency Committee on Economic Growth and Employment Opportunities. See text for explanation of estimates.

As the economic model is changed, the projected 1970 revenues will also be changed; the movement of tax revenues with gross product has been discussed earlier. Charges may be expected to move with current operating expenditures for the programs they relate to, and thus indirectly with economic activity. The responsiveness of Federal aids to States and localities to economic activity poses a problem that requires considerable study. The two largest grants, highways and public assistance aids, are responsive to a degree. Highway grants are dependent upon gasoline and motor vehicle taxes earmarked for such purposes in the national highway trust fund; public assistance grants are open ended with the Federal Government matching the amounts spent per recipient in the States. Elementary and secondary school funds may turn out to be responsive to changes in cost per child, but there is insufficient experience to suggest whether appropriations will be sufficient to cover rising costs, or whether actual State allocations will be scaled down to appropriation amounts. The new economic development programs should also vary as unemployment rates change.

Relative to the higher GNP of the alternative economic model, the showings of table 7 on projected fund requirements of the States and localities in 1970 are not significantly altered.

WHITHER STATE AND LOCAL FINANCE?*

BY JAMES A. MAXWELL

"Read not to contradict and confute, nor to believe and take for granted, nor to find talk and discourse, but to weigh and consider."
Francis Bacon, *Essays*, 50, "Of Studies."

Answers to the question posed in the title of this chapter may be sought by extrapolating past financial trends and modifying them according to expectations of changing conditions.[1] This is neither an objective nor a certain technique, and readers should, therefore, be sturdily skeptical. Prior chapters have, moreover, occasionally recalled past predictions. Their fraility, even when made by experienced observers, should heighten skepticism. The course of history has often confounded the prophets.

REALLOCATION OF FUNCTIONS

As the preceding chapters have indicated, the performance of most civil functions is now a State-local responsibility. The Federal Government plays a minor role. Thirty years ago, a semirevolution in the allocation of governmental functions erupted—the first in the history of the federation. But its force petered out with World War II and, in postwar years, a new intergovernmental equilibrium seems to have been established. Despite a marked expansion in the overall expenditure on major civil functions, the State-local *share* has been dominant and constant. This generalization hides some ambiguity. Through grants, the Federal Government does participate in the financing of many civil functions, but in no case has this been a prelude to centralization. Performance of the functions has been left in State-local hands, subject to a modicum of Federal conditions.

This practice of cooperative federalism does not correspond to the theory of separation of functions which was in the minds of the Fathers of the Constitution. But the theory was infringed by practice from the beginning, so that nowadays, in the words of Morton Grodzins, "as colors are mixed in the marble cake, so functions are mixed in the American Federal system. * * *. From abattoirs and accounting through zoning and zoo administration, any governmental activity is almost certain to involve the influence, if not the formal administration, of all three planes of the Federal system." [2] Even when the function receives no aid, intergovernmental collaboration is common. But grants have proliferated, and they enable Congress to recognize growth

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*Reprinted from Maxwell, James A., *Financing State and Local Governments*, The Brookings Institution, Washington, D.C.

[1] I have borrowed the title, as well as certain ideas, from an article by Laszlo Ecker-Racz in *The Journal of Finance* (May 1964), pp. 370–381. See also the discussion of the article by Jesse Burkhead, *ibid.*, pp. 385–389.

[2] "The Federal System," in *Goals for Americans* (1960), pp. 265–267.

of a national interest in new functions, while leaving administration in State-local hands. State and local governments, responsive to the diversity of civilian needs and demands, secure financial assitsance which enables them to achieve a level of performance acceptable to the Congress. No reallocation of functions from the State to the Federal level is required.

EXPENDITURE TRENDS: 1948–63

In the 15 years 1948–63, State and local expenditure for general government (less Federal grants) rose by $40.4 billion (from $15.9 to $56.3 billion). Some part of the rise was illusory, being attributable to a rise in the prices of what State and local governments bought. The relevant price rise during this period was approximately 72 percent, and deflation of State and local expenditures would reduce the figure for 1963 from $56.3 to $32.7 billion. In addition, population had grown by 29.1 percent and allowance for this increase would reduce the figure to $23.2 billion. If, therefore, the effects of both price and population changes are removed, the increase is not from $15.9 to $56.3 billion, that is, by 254 percent, but from $15.9 to $23.2 billion, that is, by 46 percent. This figure indicates roughly the quantitative and qualitative growth from 1948 to 1963 in State-local government provision of goods and services.

What kinds of State-local expenditures grew most raipdly? What functions account for the aggregate increase of $40.4 billion? What would be expected, education is the leader, and more than four-tenths ($17.7 of the $40.4 billion) went to it. Table 10–1 and chart 10–1 show that highways, public welfare, and health and hospitals account for another one-quarter of the increase. These four major functions together were responsible for nearly seven-tenths of the increase.

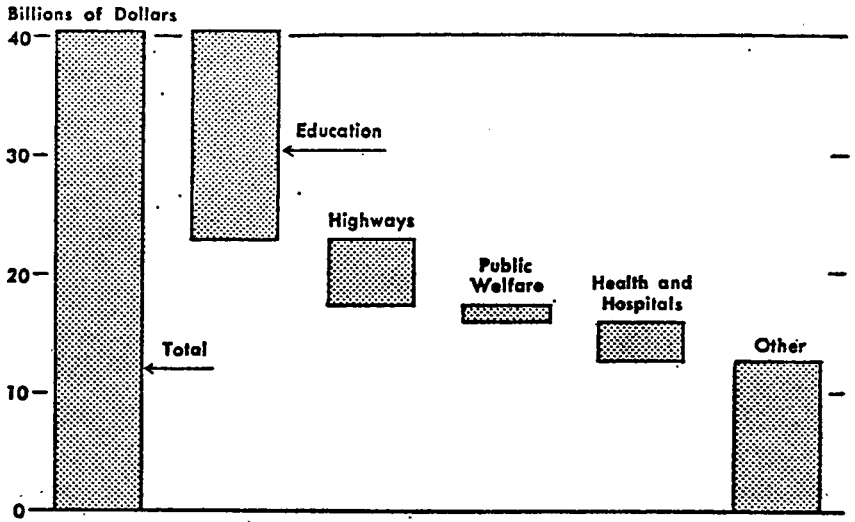
TABLE 10–1.—*State-local general expenditures (less Federal grants) for civil functions 1948 and 1963*

[Money amounts in billions of dollars]

Function	1948	1963	Amount of increase	Percentage of total
Education	$5.0	$22.6	$17.7	43.7
Highways	2.7	8.2	5.4	13.5
Public welfare	1.4	2.7	1.3	3.4
Health and hospitals	1.2	4.5	3.3	8.0
Other	5.6	18.3	12.7	31.4
All functions	15.9	56.3	40.4	100.0

Source: Appendix table A–5.

CHART 10-1. Increase in State-Local General Expenditure (Less Federal Grants) for Civil Functions, 1948–63



Source: Same as Table 10-1.

Refinement of the increases will not be attempted here. Very probably the aggregate price rise of 72 percent in State-local goods was reflected in the prices of goods for each of the major functions, and certainly unusual changes in school population, in the number of the aged, and in the number of motor vehicles help explain the particular functional increases in expenditure. School population rose much faster than did total population from 1948 to 1963 (65 percent compared to 29 percent), and so did enrollment in State and local institutions of higher education; the number of persons aged 65 years and over increased by 47 percent; motor vehicle registration rose by 103 percent. The old and the young are heavy consumers of State-local expenditure on education, public welfare, and health and hospitals. Nonetheless, some real increase took place—qualitative and quantitative—per relevant units for all of the functions.

Expenditure Projections

Several investigators have estimated that in the next decade the rate of expansion of State-local expenditures will continue unabated. Population growth—especially in the percentage of young and old—will not decelerate. Standards for governmental services will keep pace with the rising general standards of living in an affluent society. Indeed, their pace may surpass the average because more governmental services will be rendered in city areas which, in comparison with rural, have higher levels of cost. In many States the relatively low level of State-local expenditure is partly attributable to low urbanization; more urbanization will mean higher expenditure. And new social needs are visible which may be expected to burgeon into substantial governmental expenditure. Examples are urban renewal, metropolitan transport, and remedies for air and water pollution.

REVENUE TRENDS: 1948–63

The record of State-local performance in raising revenue during the years 1948–63 was remarkably good (see table 10–2 and chart 10–2). Nobody in the immediate postwar years ventured to predict that tax yields would rise by $31 billion—by 233 percent (from $13.3 to $44.3 billion). By far the largest absolute contributor to the increase was the property tax. Its receipts responded with unexpected elasticity to new construction, higher property values, and higher tax rates. The next largest amount was provided by taxes on sales and gross receipts—the retail sales tax and selective excises. Nine States enacted a retail sales tax during the years 1948–63; many States raised their rates and a few broadened their bases. All of these moves reinforced the revenue productivity of the rapid rise in consumption. Taxes on individual income contributed $2.8 billion of the increase. Only four States enacted such a tax 1948–63. The important forces behind the remarkable growth in receipts were the rising base, improved administration (especially by withholding), and small increases in the level of rates. The revenue elasticity of this tax is high, but it has failed to gain enactment in 17 States which, together, account for 40 percent of the Nation's population. "Charges and miscellaneous" added $7.9 billion, a very marked relative increase.

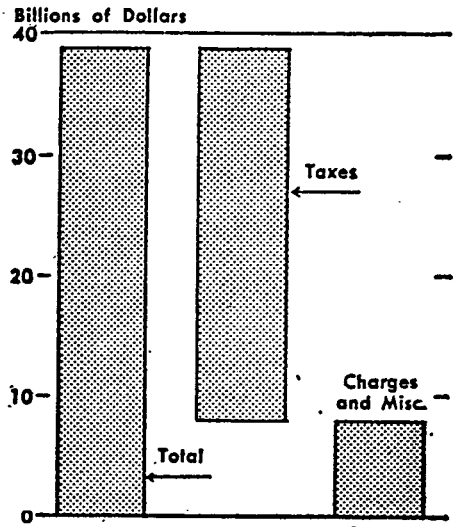
TABLE 10–2.—*State-local general revenue collected from own sources, 1948 and 1963*

[Money amounts in billions of dollars]

Source	1948	1963	Amount of increase	Percentage of total
Taxes	$13.3	$44.3	$31.0	79.7
Property	6.1	20.1	14.0	36.0
Sales and gross receipts	4.4	14.5	10.1	26.0
Individual income	0.5	3.3	2.8	7.2
Corporation income	0.6	1.5	0.9	2.3
Other	1.7	4.9	3.2	8.2
Charges and miscellaneous	2.0	9.9	7.9	20.3
Total revenue	15.3	54.2	38.9	100.0

Sources: U.S. Census Bureau, "Historical Statistics of the United States: Colonial Times to 1957" (1960); "Governmental Finances in 1963" (1964). Intergovernmental revenues grew by $6,800,000,000 (from $1,900,000,000 to $8,700,000,000) from 1948 to 1963.

CHART 10-2. Increase in State-Local General Revenues Collected from Own Sources, 1948–63



Source: Table 10-2.

Revenue Projections

Growth in the tax base in the years ahead will automatically increase State-local revenues. Most estimators reckon, however, that this increase will not match the increase in expenditures. State and local governments may therefore have to add to the weight of their taxes by higher rates and broadened bases. Will such action create taxpayer resentment and perhaps retard the growth of spending? Surely the answer will depend strongly on what happens to Federal taxes. If their level should not be eased, citizen reistance to higher rates of State-local taxes might, perhaps, be significant. The resistance would, of course, be uneven because, in many areas, the present weight of State-local taxes is not heavy. Calculations by the Advisory Commission on Intergovernmental Relations indicate that, in 1960, actual tax collections in 30 States were less than what would be collected through a representative (or average) tax system. In the other 20 States actual collections exceeded the potential collections of a representative system (see table 10–3); here, the leeway for tax rate increases is less.

TABLE 10–3.—*Actual tax collections and estimated yield of representative tax system, per capita, 1960*

State	Actual	Representative	Difference	State	Actual	Representative	Difference
Hawaii	$237	$153	$84	Michigan	$220	$201	$19
New York	288	212	76	Maryland	199	187	12
Vermont	223	171	52	Mississippi	130	115	15
Maine	199	158	41	Minnesota	219	209	10
Massachusetts	234	194	40	Louisiana	188	178	10
Oregon	234	208	26	Arizona	209	201	8
California	278	254	24	South Carolina	129	122	7
Alaska	162	140	22	Georgia	142	139	3
Rhode Island	197	176	21	West Virginia	151	150	1
Wisconsin	216	196	20	Colorado	231	231	0
Utah	201	205	−4	North Dakota	199	219	−20
New Jersey	207	212	−5	Nevada	274	295	−21
Washington	202	207	−5	Iowa	209	231	−22
North Carolina	139	145	−6	Idaho	194	218	−24
Pennsylvania	176	184	−8	Indiana	180	205	−25
Tennessee	135	144	−9	Virginia	138	163	−25
Kansas	218	228	−10	Delaware	198	227	−29
New Hampshire	187	197	−10	Illinois	206	235	−29
Oklahoma	177	189	−12	Kentucky	119	149	−30
Alabama	121	134	−13	New Mexico	174	207	−33
Arkansas	126	139	−13	Montana	224	261	−37
Connecticut	213	226	−13	Missouri	152	200	−48
South Dakota	199	217	−18	Nebraska	174	241	−67
Ohio	189	208	−19	Texas	162	243	−81
Florida	184	204	−20	Wyoming	238	325	−87

Source: Advisory Commission on Intergovernmental Relations, Measures of State and Local Fiscal Capacity and Tax Effort (1962), pp. 126–27.

The assumption that the level of Federal taxes will be retained may be replaced by other assumptions. A very few years ago, some informed people expected (and advocated) a large increase in Federal expenditure for defense; at present more optimistic expectations are common. If Federal taxes were reduced, the ameliorative effects on State-local finances would be important.

What forms might the reduction take? Most obvious would be a simple and unconditional reduction. In such cases the States could move in as their particular situation indicated. What particular Federal taxes should be cut? If the test were what taxes the States could handle with efficiency, the choice would fall on such Federal excises as taxes on liquor, tobacco, and gasoline.

Reduction might take the form of a tax credit against the Federal income tax by which taxpayers could deduct from their Federal liability some limited part of the amounts they paid for State income or retail sales tax. For example, Jones, a resident of Wisconsin with a Federal liability of $100, who paid $10 as a Wisconsin income (or sales) tax, might be allowed to deduct this latter sum from his Federal liability. Obviously Wisconsin could act to increase its tax collection from Jones by $10 without increasing his *total* taxes. Several schemes for credits have been proposed, and no doubt can exist that the device could be used to ease State-local finances.[3] Use of tax credits might be coupled with efforts, in the form of Federal conditions, to ameliorate interstate tax conflicts.

A difficulty or fault of either form of Federal tax reduction is that the gains would accrue more to richer than to poorer States. The reason is simply that rich States have the productive bases for taxes. For this reason, a plan of tax reduction might reasonably be combined with

[3] See James A. Maxwell, *Tax Credits and Intergovernmental Fiscal Relations* (Brookings Institution, 1962).

a plan for equalizing Federal grants, or even for a new unconditional grant allocated on the basis of overall State fiscal need. The likelihood that expansion of grants will take place in the years ahead is strong, and the grounds for endorsement of such a step have been examined in chapter III.

State-Local Debt

In the years since World War II borrowing by State and local governments has grown even more rapidly than ordinary spending and taxing. This increase has been almost entirely for capital purposes because State and local governments are narrowly limited in their legal powers to borrow to finance deficits on current operations. The market for State and local bonds has remained receptive and interest rates have been low. And yet several aspects of the State-local debt structure are worrisome. One weighty but unattractive reason for the low yield is the exemption of interest from Federal income taxes. This privilege or subsidy is firmly rooted against change, even though change is needed. By offering a legal method of tax avoidance, the exemption impairs the logic of a progressive tax on income and reduces Federal revenues. A subsidy geared to the volume of borrowing by a governmental unit is objectionably stimulative of borrowing.

Combined with self-imposed constitutional and statutory limitations on debt, the subsidy has tempted State and local governments into dangerous forms of debt, especially by the issuance of nonguaranteed bonds. Almost nonexistent at the State level before the war, these now make up over half the total outstanding. Through industrial aid bonds, some State and local governments are exploiting the interest exemption for projects which are private rather than public. And the enormous use of nonguaranteed bonds for purposes which are not self-financing is utterly imprudent.

State-Local Intergovernmental Finances

The pattern here is very diverse, and some of the diversity is a natural and desirable product. State governments display different tax preferences, and, so long as they avoid perverse use, this is not objectionable. But perversion has not, in practice, been avoided. It is a perversion when State governments reach outside their boundaries to enlarge their tax base, as, for example, when the value of sales in the State of destination is given heavy weight in allocating the net income base of corporation, when the income earned in a State by individuals who reside in a different State is included in the tax base of both States, when buyers who purchase out of State are charged a use tax by the home State and a sales tax by the other State. When different tax definitions are used by the States, the fact that each definition would be acceptable, if generalized, is not enough. The actual *operation* of the rules of taxation, like rules of the road, should be uniform. If the States cannot, by themselves, achieve this goal, multiplication of inequities will, in time, justify and bring about Federal intervention.

State governments have also critical and unfulfilled responsibilities to their local units. Property tax is the one natural and normal source of major tax receipts for these units. But effective utilization of the

tax requires State help, and the nexus of the help will consist of framing and enforcing rules of behavior. Here also perverse use—competitive undervaluation and inaccuracies of assessment of individual properties—must be controlled, if not eliminated. Recently local units in some States have levied nonproperty taxes, and in several large cities these have been fiscally productive. Nonetheless, the spread prompts forebodings that the distribution of employment and purchasing power may be distorted, that compliance and administrative costs will prove excessive, and that the structure of federalism will be damaged. Alternatives, both fiscal and nonfiscal, are available. The fiscal program should include reform of the property tax, extension of local user charges, and expansion of State grants. The nonfiscal program should free the cities from the details of legal bondage, and consolidate and rationalize the structure of local governments.

Conclusion

A Federalist in the 1960's is plagued with anxiety concerning the problems of American federalism. History will inform him that the course of federalism has seldom run smooth, and that, periodically, for almost 180 years similar worries have been endemic. This information will, perhaps, be a consolation, but it is unlikely to be a sedative. Are not the flaws now displayed by American federalism different in nature from those that worried Madison? Are they not less susceptible to remedy? Is not the economy more interdependent and therefore more sensitive? Are not social and welfare problems more national? If the answers are affirmative, does this mean that the States as governmental units are obsolete? The preceding pages support no such conclusion; rather do they present evidence of an opposite tenor.

Yet it would be rash to allow beliefs—not to say dogmas—rooted in past experience to retard search for the ways by which American federalism can be strengthened. Confident complacency would be misplaced because evidence of new flaws is in full view. What, for instance, should the States do concerning the serious economic and social problems of metropolitan areas? Even if Federal help is necessary for adequate remedy, State governments should not default on their manifest responsibilities. Must not the States invent ways to cooperate effectively among themselves? Must they not yield sovereignty to the other States as an alternative to loss to the Federal level? Should not the States somehow devise rules of tax behavior which will be uniform across the Nation?

James Madison, surely a classic federalist, once observed:

> If * * * the people should in future become more partial to the Federal than to the State governments, the change can only result from such manifest and irresistible proofs of a better administration, as will overcome all their antecedent propensities. And in that case the people ought not surely to be precluded from giving most of their confidence where they may discover it to be most due.[4]

[4] E. G. Bourne (ed.), *The Federalist* (1901), vol. I, No. XLVI, p. 322.

INTERGOVERNMENTAL FISCAL RELATIONS IN THE UNITED STATES*

BY GEORGE F. BREAK

STATE-LOCAL FISCAL PROSPECTS FOR 1970

How serious the fiscal problems of the U.S. Federal system are likely to be in the future depends to a large extent on the difficulties which State and local governments will face. If these are moderate and if they are handled with dispatch in most areas, the Federal system of government is not likely to be subjected to undue strains. If, however, the problems are so great, or the will to solve even minor problems so weak, that only halting progress is made in the public sector, U.S. federalism is liable to lose vitality over the next decade. Which prospect is the more realistic is not easy to determine. Some insights can, however, be obtained by systematically examining future needs and demands for the services of State and local governments and by relating these to their future revenue-raising powers. Several projections of this sort have already been made for the early 1970's,[1] but the most detailed and comprehensive are the State-by-State estimates currently being made for 1970 by the Project '70 staff of the Council of State Governments (CSG). These, accordingly, will be used as the basis for the discussion below.

Forecasting in this area is a hazardous undertaking. Given our far-from-adequate knowledge of the determinants of State-local expenditures and tax programs and of the interrelationships between them, the best one can do is to work out the implications of a number of more or less reasonable assumptions about future fiscal behavior. What emerges from these quantitative exercises is a set of "if then," or conditional, forecasts. For example, *if* the economy develops in such-and-such a way and *if* present service levels and quality are maintained, *then* State-local expenditures for some particular program can be expected to be $\$x$ million in 1970. Such projections, as they have come to be called, do not necessarily represent the forecaster's best guess as to what will in fact happen. Instead they are intended as a basis for improved fiscal programing which, if it does

*Reprinted from: Break, George F., *Intergovernmental Fiscal Relations in the United States*, The Brookings Institution, Washington, D.C., 1967, Excerpts from Introduction, Chapter VI, pp. 248–252.

[1] See, for example, L. Laszlo Ecker-Racz, "Whither State and Local Finance?" *Journal of Finance*, vol. 19 (May 1964), pp. 370–381; Otto Eckstein, *Trends in Public Expenditures in the Next Decade* (Committee for Economic Development, April 1959); Robert J. Lampman, "How Much Government Spending in the 1960's?" *Quarterly Review of Economics and Business*, vol. I (February 1961), pp. 7–17; National Planning Association, *Long-Range Projections for Economic Growth: the American Economy in 1970*, Planning Pamphlet No. 107 (1959); Dick Netzer, "Financial Needs and Resources Over the Next Decade: State and Local Governments," in National Bureau of Economic Research, *Public Finances: Needs, Sources and Utilization* (Princeton University Press, 1961); and Outdoor Recreation Resources Review Commission, *Projections to the Years 1976 and 2000: Economic Growth, Population, Labor Force and Leisure, and Transportation*, Study Report 23 (1962).

develop to any extent, is itself likely to invalidate any forecast derived mainly from past experience.

STATE-LOCAL SPENDING IN 1970

Any set of projections must be based on some assumption about the general state of the economy in the year selected for study.[2] For this purpose the CSG projections make use of one of the official macromodels developed for the Interagency Study of Growth in the United States. This assumes a low rate of unemployment in 1970 (not more than 4 percent of the labor force), a GNP of $864 billion, and a population of 208 million. Real output is assumed to increase by 4.1 percent a year on the average between 1962 and 1970; prices are to go up by 1.5 percent a year; and personal income per capita is to rise by 35.5 percent, from $2,366 in 1962 to $3,207 in 1970.[3] There is no need to emphasize the upward push that all of these changes are likely to exert on State and local spending.

The push will have to be a strong one, however, if it is to produce results that match those of the recent past. Between 1953 and 1963 State and local general expenditures rose by 132 percent, from $28 to $65 billion. (For further details see table IV–12.) Were this same rate of increase to be maintained between 1960 and 1970, general expenditures in 1970 would be about $120 billion, implying an increase in the relative importance of State-local spending from 11.5 percent of GNP in 1964 to 14 percent in 1970 (based on the $864 billion estimate cited above). While at first glance such rapid growth may seem unlikely, it is the forecast of one expert,[4] and in the past forecasters have tended to understimate increases in State-local expenditures.[5]

Whether past growth rates will in fact be continued is, needless to say, an exceedingly complex question. For one thing, future needs are not likely to be the same as past needs. As table IV–12 shows, local school expenditures accounted for no less than 30 percent of the total 1953–63 increase in State-local spending, but in the decade ahead enrollments can be expected to rise more slowly, thereby lessening the pressure on local school boards. This situation is shown in the following population projection:[6]

Age group	Population (millions)		Percentage increase, 1963–70
	1963	1970	
Under 10	41	45	10
10 to 14	18	20	11
15 to 19	16	19	19
20 to 24	13	17	31
25 to 44	47	48	2
45 to 64	38	42	10
Over 65	18	20	11

[2] In addition, of course, this assumption must be consistent with the specific sectoral projections that are then developed.

[3] Selma J. Mushkin and Eugene P. McLoone, *Public Spending for Higher Education in 1970* (Council of State Governments, February 1965), pp. 61–66.

[4] L. Laszlo Ecker-Racz, *op. cit.*

[5] Between 1957 and 1963, for example, State-local expenditures rose at an average annual rate of 7.9 percent, whereas the Eckstein and Netzer projections cited in footnote 2 above were only 4.3 and 4.8 percent, respectively.

[6] U.S. Bureau of the Census, *Current Population Reports*, series P–25, No. 279 (Feb. 4, 1964), p. 5. These projections are the Census Bureau's Series A, which is based on the continuation of the average annual level of age-specific fertility rates in 1960–63.

Large quality gaps will remain among schools, but these are more difficult to recognize than quantitative deficiencies, and many of them will be in large cities where the problems of financing needed improvements, as noted in chapter V, are especially acute. Therefore, local school expenditures may rise much less rapidly in the future than they have in the past.

This is not likely to be the case, however, with public higher education. Not only is the large group of postwar babies just beginning to reach college age, but there have also been steady increases in the percentage of high school graduates, in the proportion of them going to college, and in the proportion of college graduates continuing their academic studies. The Mushkin-McLoone estimate of the result of all of these factors is an increase in degree-credit enrollment in colleges and universities from less than 4.5 million in 1963 to nearly 7.7 million in 1970.[7]

Unfortunately, estimating enrollments is only the first and also the least difficult step in projecting governmental expenditures on higher education. Among the many problems encountered, the most troublesome appear to be: (1) forecasting future increases in rates of pay for faculty and nonacademic personnel (payrolls constitute about 75 percent of total expenditures for student higher education); (2) estimating what will happen to student-faculty ratios; (3) guessing the extent to which improved teaching methods, more effective use of space, and so forth, will raise university productivity; and (4) forecasting the extent to which university facilities and State funds will become involved in upgrading the skills of adult workers.

With regard to the first two, the CSG projections, which are summarized in table I–9, assume that academic salary rates will rise by 50 percent between 1962 and 1970 (compared to a 33-percent increase for wage and salary rates in general) and that student-faculty ratios will have risen by 20 percent by 1970.[8] The projection shown on the first line of table I–9 is highly sensitive to both of these assumptions. If student-faculty ratios were to remain stable, for example, higher education expenditures per full-time student equivalent in 1970 would be $1,259 instead of $1,058—a 41-percent increase over 1962 per student costs of $895 rather than an 18-percent rise.[9] Similarly, since three-quarters of student higher education expenditures goes into faculty and other academic payrolls, the realism of the $4.6 billion figure projected for 1970 will depend very much on whether a 50-percent increase in salary rates is sufficient to attract the large and highly qualified staff needed to handle the forthcoming enrollments. Opinions on this question will differ, but it seems clear that some of the most important fiscal problems State governments are likely to face during the next decade will be in the field of higher education.

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[7] *Op. cit.*, p. 45. This assumes that more than half of the 18-to-21-year-old group will go to college in 1970, compared to 40 percent in 1960 and only 30 percent in 1950 (*ibid.*, p. 2).

[8] *Ibid.*, p. 17. A rise in student-faculty ratios may represent, of course, either a decline in educational quality or an improvement in teaching methods so that a given quality can be maintained at lower cost. This appears to be the only explicit allowance made in the CSG projections for item 3 in the list above. Lack of reliable data at the time the preliminary estimates were made also precluded any quantitative treatment of item 4. *Ibid.*, pp. 26–27.

[9] *Ibid.*, p. 47.

TABLE I-9.—*Expenditures of public colleges and universities, by major type, actual 1962 and projected 1970* [1]

Type of Expenditure	Amount (millions)		Percentage increase 1962-70
	1962	1970	
Student higher education	$1,792	$4,589	156
Research, public services, and other current costs	1,302	3,981	206
Capital outlays	949	3,527	272
Total	4,043	12,098	199

[1] Data are for fiscal 1962 and calendar 1970.

Source: Selma J. Mushkin and Eugene P. McLoone, "Public spending for Higher Education in 1970" (Council of State Governments, February 1965), pp. 48-52.

NOTE.—Figures are rounded and may not add to totals.

Cities, on the other hand, are likely to encounter some of their greatest difficulties in dealing with poverty and with transportation systems. It is still too early to tell how rapidly the economic opportunity program, inaugurated in August 1964, by Public Law 88-452, will develop; but if it proves to be an effective way of dealing with underdeveloped human resources and if Federal shares of total costs, currently extending up to 90 percent, are reduced as scheduled in the law,[10] State-local expenditures in this area may be substantial by 1970. Michael Harrington, for example, has estimated that a minimum of $100 billion is needed over the next 10 years to deal adequately with the economic problems of disadvantaged groups.[11] How realistic this particular estimate is, and how rapidly it, or some other level of operations, will be achieved remain to be seen. As shown in table I-10, for example, the CSG projections show public welfare expenditures growing more slowly between 1962 and 1970 than they did between 1957 and 1962, primarily because older people will qualify for increasing amounts of social security and medicare benefits. Even so, total public welfare expenditures are expected to approach $9 billion in 1970, with State and local governments contributing nearly $4 billion of their own funds.

TABLE I-10.—*Expenditures for public welfare, by major type, actual 1957 and 1962 and projected 1970* [1]

Type of expenditure	Amount (billions)			Average annual growth rates (percent)	
	1957	1962	1970	1957-62	1962-70
Cash assistance	$2.7	$3.5	$4.5	5.3	3.0
Other assistance [2]	.8	1.6	4.4	15.5	12.8
Total	3.5	5.1	8.9	7.8	6.8
Financed by:					
Federal aid	1.6	2.5	5.1	9.6	8.8
State-Local funds	1.9	2.6	3.8	6.4	4.6

[1] Data are for fiscal 1957 and 1962 and for calendar 1970.
[2] Includes vendor payments, administration services and training, and the poverty program.

Source: Selma J. Mushkin and Robert Harris, "Financing Public Welfare: 1970 Projections" (Council of State Governments, July 1965), p. 49.

[10] To 75 percent for work-study programs and to 50 percent for work-training, community action and adult basic education programs.
[11] *New York Times*, Nov. 16, 1964. See also his *The Other America: Poverty in the United States* (Macmillan, 1962).

It is difficult enough, as will be seen in chapter V, to determine the best solution to urban transportation problems, to say nothing of forecasting what expenditures cities will make for this purpose in 1970. That substantial increases can be expected, however, is indicated by the number of detailed studies of transit systems that have already been made or commissioned. The CSG projections for public transportation outlays, which are summarized in table I–11, allow for this by raising the 3.4-percent average annual growth rate in 1957–62 to 13.2 percent for 1962–70. This is based on the assumption, which appears reasonable in the case of capital expenditures for highways,[12] that mass transit expenditures will be closely related to Federal aid, which in turn is projected to rise from $150 million in fiscal 1966 and 1967 to $300 million in 1970.[13] Given the financial difficulties which many of the largest cities face, urban transportation spending is also likely to depend on the extent to which the Federal and State Governments shoulder an increasing share of the responsibility for promoting education, public welfare, and the development of human resources generally. As will be seen in chapter III, the high mobility of the U.S. population provides a strong argument for operating all of these programs on a shared cost basis. To increase the extent to which this is done would release local funds for other purposes; and if, in addition, some of the revenue reforms discussed in chapter V were enacted, still more public needs could be met in metropolitan areas.

TABLE I–11.—*Expenditures for public transportation, by major type, actual 1957 and 1962 and projected 1970* [1]

Type of expenditure	Amounts (in billions)			Average annual growth rates (in percent)	
	1957	1962	1970	1957–62	1962–70
Highways	$7.8	$10.4	$15.1–[2]$16.2	5.7	4.5–5.4
Transit systems	.6	.7	2.0	3.4	13.2
Water transit	.2	.3	.5	9.1	5.5
Airports	.2	.4	.7	9.7	8.2
Total	8.9	11.7	18.3–19.4	5.7	5.4–6.1

[1] Data are for fiscal 1957 and 1962 and for calendar 1979.
[2] The higher projection assumes that Federal highway aid is increased from the scheduled $3,900,000,000 to the $4,902,000,000 which the Bureau of Public Roads estimates will be needed to complete the Interstate Highway System on time.

Source: Selma J. Mushkin and Robert Harris, "Transportation Outlays of States and Localities: Projections to 1970" (Council of State Governments, May 1965), p. 39.

In sum, then, all projections of future State-local spending levels represent an uneasy compromise between the economic needs for public services and the political and financial constraints within which governments must operate. Therefore, it seems best to give here no

[12] A cross-sectional regression analysis for 1961–63 produced the following equation, which was used in deriving the 1970 CSG projections:

$$X_1 = 11.09 + 0.40X_2 + 1.16X_3.$$

where X_1 = per capita capital expenditures for highways,
X_2 = per capita personal income, and
X_3 = per capita Federal aid for highways.

For this equation, $R^2 = 0.90$. Selma J. Mushkin and Robert Harris, *Transportation Outlays of States and Localities: Projections to 1970* (Council of State Governments, May 1965), p. 12.

[13] *Ibid.*, p. 27. As the authors stress, their projections for mass transit expenditures are based much more on political feasibilities than on economic needs.

more than a rather wide interval estimate of 1970 state-local general expenditures. For the lower limit a figure of $100 billion seems appropriate, that being a good round sum and one that would be a slightly lower percentage of the projected 1970 GNP of $864 billion than State and local expenditures actually were in 1962–63. Since State-local tax systems, as will be seen in the next section, have a GNP elasticity of approximately unity, it seems unlikely that their 1970 spending will fall below $100 billion. How far it will rise above that mark will depend upon how impatient people are about fulfilling public needs and on how well, and in what ways, the various fiscal problems to be discussed in later chapters are handled. The CSG preliminary estimate for 1970, for example, is $108 billion, and as already noted, a level of $120 billion would be produced by a simple continuation of past trends. Since other expert projections fall in this same range, it seems reasonable to suppose that the level of general expenditures with which State and local governments will have to contend in 1970 will lie somewhere between $100 and $120 billion.

STATE-LOCAL TAX RECEIPTS IN 1970

The next question, of course, concerns the amount of assistance State and local governments can expect to get in 1970 from their existing tax systems. While all major taxes must be analyzed for this purpose, the property tax stands out because of its relative importance.[14]

Percent of State and local tax receipts, fiscal year 1965

Tax:	
Property	44.7
General sales and gross receipts	15.4
Motor fuel sales	8.4
Individual income	8.0
Corporate income	3.7
Motor vehicle and operators licenses	4.1
All other	15.7

Unfortunately for forecasters, neither the tax nor its base has behaved in a very regular fashion in the past. As table I–12 shows, GNP elasticities have varied considerably both for different types of property during any given period of time and for any given type of property over different periods of time. Especially notable are the significantly higher elasticities that have prevailed during the last 10 or so years.

TABLE I–12.—*GNP elasticities of the market value of the property tax base and its major components, selected periods, 1899–1961*

Type of property	Period					
	1899–1957	1899–1929	1929–48	1948–57	1953–57	1956–61
Nonfarm residential	0.9	1.0	0.6	1.0	1.2	1.6
Nonfarm nonresidential	.8	.9	.3	1.1	1.8	1.9
Farm	.5	.6	.6	.8	1.0	1.0
All real	.8	.9	.7	1.0	1.4	1.6
Personal	.9	.9	.9	1.1	1.3	----------
All	.9	.9	.7	1.0	1.4	1.5

Source: Benjamin Bridges, Jr., "Income Elasticity of the Property Tax Base," National Tax Journal, vol. 17 (September 1964), pp. 255 and 260–62.

[14] U.S. Bureau of the Census, *Quarterly Summary of State and Local Tax Revenue, April–June 1965* (September 1965), p. 1. The data are for the 12 months ended with June 1965.

Projection of 1970 property tax receipts, therefore, requires a disaggregation of the tax base into those types of property that can be expected to increase in value at different rates in the future. (This means, of course, forecasting both price changes on existing property and the value of new construction.) Ideally, one should also take into account the wide interstate variations in the treatment of different kinds of tangible and intangible personal property. To do so, however, might yield only small increases in reliability at considerable extra cost, and in making their projections the Project '70 staff of the Council of State Governments has simply used a representative general property tax base that is kept uniform from one State to another.[15] By dealing separately with nine categories of property [16] and relying heavily on 1956–61 relations between property values and personal income, they estimated that total 1970 property tax receipts would be $33 billion if effective tax rates remain constant. Constant effective rates imply, of course, rising nominal tax rates as long as assessed values of existing properties lag behind rising market values. To some extent assessed values did lag between 1956 and 1961[17] and if during the late 1960's a similar lag should be combined with constant nominal tax rates, 1970 property tax revenues would, according to CSG calculations, be only $30.9 billion.

Both of these estimates, which imply GNP yield elasticities for State-local property taxes between 1.0 and 1.2, lie at the high end of the range of elasticity estimates recently given by the Advisory Commission on Intergovernmental Relations (ACIR) as shown in table I–13. Should their GNP elasticity be only 0.7, for example, property taxes would yield State and local governments only $27.6 billion in 1970.[18] Which end of this rather wide range the actual yields approach will depend not only upon the volume of future new construction and the rate at which prices rise on existing properties but also upon the effects which

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[15] Selma J. Mushkin, *Property Taxes: 1970 Outlook* (Council of State Governments, October 1965), p. 19. The representative tax base excludes both household goods and intangible personal property.

[16] Residential realty, commercial and industrial realty, farm realty, vacant lots, public utility properties, inventories, farm personal property, nonfarm producers' durables, and motor vehicles. In addition, the yields of special property taxes were projected separately, but at $1.2 billion they made up less than 4 percent of the total 1970 property tax revenue.

[17] See U.S. Bureau of the Census, *1957 Census of Governments*, vol. V, *Taxable Property Values*, and *1962 Census of Governments*, vol. II, *Taxable Property Values*.

[18] From the definition of yield elasticity we have:

$$\Delta T = \frac{T_0}{GNP_0} \cdot \Delta GNP \cdot \epsilon$$

where

T_0 = tax revenue in the base year,
GNP_0 = gross national product in the base year,
ΔT = change in tax revenue between the base year and the year of forecast,
ΔGNP = change in gross national product between the base year and the year of forecast, and
ϵ = yield elasticity.

Substituting values for fiscal 1964 and 1970 in the above equation we have:

$$\Delta T = \frac{21.2 \times 261}{609} \epsilon$$
$$= 9.1\epsilon$$

According to this computation, therefore, a change of one-tenth of a point in the *GNP* yield elasticity for State-local property taxes would change projected 1970 tax revenues by $0.91 billion.

existing property tax inequities have on the willingness of local electorates to support steadily rising nominal tax rates. It may be, as some have hinted, that the general property tax has recently been basking in an Indian summer of prosperity which, unless some of the reforms discussed in chapter V are adopted, will soon be followed by a long winter of relative stagnation.

TABLE I–13.—*Gross national product elasticities of the major categories of State general revenue sources*

Revenue source	Elasticity estimates		
	Low	Medium	High
Property taxes	0.7	0.9	1.1
Income taxes:			
Individual	1.5	1.65	1.8
Corporate	1.1	1.2	1.3
Sales taxes:			
General	.9	.97	1.05
Motor fuel	.4	.5	.6
Alcoholic beverage	.4	.5	.6
Tobacco	.3	.35	.4
Public utilities	.9	.95	1.0
Other	.9	1.0	1.1
Auto license and registration	.2	.3	.4
Death and gift taxes	1.0	1.1	1.2
All other taxes	.6	.65	.7
Higher education fees	1.6	1.7	1.8
Hospital fees	1.3	1.4	1.5
Natural resources fees	.9	1.0	1.1
Interest earnings	.6	.7	.8
Miscellaneous fees and charges	.6	.7	.8

Source: ACIR, Federal-State Coordination of Personal Income Taxes (October 1965), p. 42.

Property tax receipts have not yet been alone in their rapid growth in recent years (table I–14). Between 1953 and 1963 State-local individual income tax yields rose by an average of nearly 21 percent a year, and from 1957 to 1963 general sales tax receipts grew by nearly 12 percent a year. These figures, of course, reflect rising tax rates, new adoptions, and base expansions in addition to the automatic response of established taxes to an expanding GNP. Some indication of the difference between the two sets of influences may be obtained by comparing the 1957–63 and 1963–70 GNP elasticities given in table I–15. With both automatic and discretionary tax changes at work in 1957–63, State-local tax collections expanded by 17 percent for every 10-percent increase in GNP; as projected by the CSG staff at constant tax rates, however, between 1963 and 1970 total yields are to rise by only 11 percent for every 10-percent increase in GNP. On this latter basis, 1970 tax revenues of State and local governments would be $70 billion. Variations of one-tenth of a point in the GNP yield elasticity used for State-local tax systems as a whole would raise or lower that figure by approximately $2 billion.[19] As shown in table I–16, ACIR estimates of the GNP elasticity of total State general revenue (taxes plus user charges and fees) in the 1964–70 period extend from a low of 0.8 to a high of 1.1. If a similar range is applied to taxes alone, 1970 tax receipt projections would fall between $64 and $70 billion.

[19] Using the equation given above in footnote 18 and taking fiscal 1964 as the base year, we have:

$$T=\frac{48\times 261}{609}\epsilon=20.6\epsilon$$

TABLE I-14.—*Percentage increases in State and local tax collections by major type of tax, 1953–63, 1957–63, and 1964–65*

Tax	Average annual percentage increase in yield		
	1953–63	1957–63	1964–65
Property	11.5	10.5	7.9
General sales and gross receipts	10.8	11.6	8.5
Motor fuel sales	----------	6.6	5.9
Individual income	20.7	15.2	10.9
Corporate income	8.6	6.0	13.9
Motor vehicle and operators licenses	----------	4.9	4.4
All other [1]	7.6	8.6	6.9
Total	11.1	9.8	7.9

[1] 1953–63 includes motor fuel sales and motor vehicle and operators' license taxes.

Source: U.S. Bureau of the Census, Census of Governments, 1962, vol. VI, No. 4, "Historical Statistics on Governmental Finances and Employment; Summary of Governmental Finances in 1963 and Quarterly Summary of State and Local Tax Revenue, April–June 1965" (September 1965), p. 1.

TABLE I-15.—*GNP yield elasticities of major State-local taxes, actual 1957–63 and projected 1963–70 at constant tax rates*

Tax	Yield elasticity	
	1957–63	1963–70
Property	1.8	1.2
General sales and gross receipts	2.0	1.0
Motor fuel sales	1.1	.6
Individual income	2.6	1.9
Corporate income	1.0	1.2
Motor vehicle and operators licenses	.8	.5
All other	1.5	.8
Total	1.7	[1] 1.1

[1] If the 1963–70 GNP elasticity of the property tax were taken as 1 or 0.8, the elasticity of the total State-local system would be 1 and 0.9, respectively.

Source: Council of State Governments, "Projections of Tax Revenues: Preliminary Tables (October 1964), table 3.

TABLE I-16.—*Estimates of the GNP elasticity of total State general revenue in 1947, 1954, 1964, and 1970*

Fiscal year	Elasticity estimate		
	Low	Medium	High
1947	0.74	0.83	0.93
1954	.75	.85	.94
1964	.82	.92	1.01
1970	.89	.99	1.09

Source: ACIR, Federal-State Coordination of Personal Income Taxes, p. 43.

STATE-LOCAL FISCAL PRESSURES IN 1970

The preliminary projections in the preceding two sections show a gross gap between expenditures and taxes in 1970 for State and local governments ranging from $30 to $56 billion. This gap could be filled in any one of four major ways: (1) by State-local user charges and miscellaneous fees: (2) by Federal grants-in-aid; (3) by an increase in State-local indebtedness; and (4) by structural changes in State-

local tax systems brought about by the adoption of new taxes, by expansions of the bases of existing taxes, or by the enactment of higher tax rates.

A rough indication of what might be expected in 1970 from the first two sources, on the basis of past experience, is given in the tabulation below. The "A" projections were derived by taking the 1962–63 ratios of each source of receipts to GNP and applying them to a projected 1970 GNP of $870 billion; the higher set of "B" projections was obtained by simple extrapolation of 1952–62 trends in the receipts-to-GNP ratios. In each case the GNP ratios used are given in the tabulation of alternative projections of nontax State-local revenues in 1970:

Type of revenue	Projection A		Projection B	
	Revenue/ GNP ratio used	Projected revenue (billions)	Revenue/ GNP ratio used	Projected revenue (billions)
User charges and miscellaneous fees	0.016	$14	0.02	$17
Federal grants-in-aid	.014	12	.02	17

Projecting the contribution that State-local borrowing is likely to make to the financing of general expenditures in 1970 is made particularly difficult by several factors: the widespread existence of constitutional and statutory debt limitations; the close relation between long-term debt issues and State-local capital expenditures; and the dependence of State-local borrowing powers on the market for tax-exempt securities, a market which may well not expand in the future at the same rate as other financial markets. Suffice it to note here that in recent years State and local governments have increased their outstanding long-term indebtedness by about $6 billion a year. If this amount is added to the figures given in the preceding paragraph, nontax receipts in 1970 would range between $32 and $40 billion, or within the lower half of the projected gross expenditure-tax gap. There is, in short, a definite possibility that fiscal pressures in the next 5 years will not rise beyond the ability of State and local governments, operating mainly within the present Federal fiscal framework, to deal with them. There is, however, at least an equal possibility that the pressures will soon be too great to be met in conventional ways; it is this prospect that brought about this study.

The Fiscal Problems of Federalism

State and local governments now stand at one of the most important crossroads in their development. While citizens have been demanding more and better public services, governments often have been dominated by rural electorates with little interest in emerging urban problems and run by unimaginative officials with the help of inferior staffs. Signs at the crossroad point in one direction to a neglect of urgent public needs and in the other to a steady decline in State and local responsibilities as civic needs are increasingly satisfied from Washington. On the other hand, the legislative reapportionments now underway promise to create State governments that will be more

responsive to the problems of the times. With sufficient funds they can then begin to attract the talent that they need to get on with the job. Whether the required revenue sources will be developed in time is still an open question. The major problems and possibilities are summarized briefly in the remaining sections of this chapter and discussed in detail in chapters II–V.

TAX COORDINATION

Use of the same tax by two or more levels of government poses obvious threats to the efficient operation of a Federal system of government. With the proper use of some of the coordinating devices discussed in chapter II, however, this threat can be turned aside and an efficient and equitable tax system designed that, at least potentially, places ample sources of tax revenue within the reach of all but the poorest State and local governments.

TAX COMPETITION

Whether they can obtain these revenues, however, is another question. The trouble is that State and local governments have been engaged for some time in an increasingly active competition among themselves for new business. If there is, as Edwin C. Gooding suggests, a "New War Between the States,"[20] the main weapons are State guarantees of private loans to new business, direct State loans for the same purpose, local bonds issued to finance the construction of industrial facilities for lease to private firms, tax exemptions and concessions, and statewide, privately financed development credit corporations. Between 1960 and 1962 one or more of these inducements were put into operation by 19 States, and nine additional ones were authorized in 1963.[21] On September 30, 1963, only five States were not using any of the devices, and 12 States had authorized three or more.[22]

In such an environment government officials do not lightly propose increases in their own tax rates that go much beyond those prevailing in nearby States or in any area with similar natural attractions for industry. They may do so if the additional revenues are required to finance programs with localized benefits known to be highly desired by business firms or their employees, but there are many situations in which the benefits are too intangible or too diffused geographically to have much drawing power, or at least so they appear to the average State or local legislator. If such programs are to be provided at all, they must be financed either by taxes that are not highly objectionable to business managers or by generous Federal grants-in-aid. Active tax competition, in short, tends to produce either a generally low level of State-local tax effort or a State-local tax structure with strong regressive features. Paradoxically, the more widespread it is, the more likely it is to produce these

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[20] See his four-part article with that title in the Federal Reserve Bank of Boston's *New England Business Review* (October and December 1963, and July and October 1964).

[21] *Ibid.* (October 1963), p. 2.

[22] Benjamin Bridges, Jr., "State and Local Inducements for Industry. Pt. I," *National Tax Journal*, vol. 18 (March 1965), pp. 3-4. The five States using none were Arizona, California, Nevada, Texas, and Utah, and the 12 that had authorized three or more were Arkansas, Hawaii, Kentucky, Maine, Maryland, Minnesota, Mississippi, Oklahoma, Rhode Island, Tennessee, Vermont, and West Virginia.

debilitating fiscal effects without creating the stimulating economic effects sought by the tax competitors.

It is difficult to judge exactly how much State and local taxing powers are weakened by tax competition. Several regions have already been highly successful in attracting certain kinds of business by spending money on higher education and research. As worker skills continue to be upgraded, more and more people may shift their attention from the height of tax rates to the quality of local public services. The difficulty is that such changes in human attitudes develop slowly. In the meantime the familiar alternating movement of hesitant tax rate advances, followed by a gradual matching of them on the part of other State and local governments, followed by further rate advances, and so forth, is likely to continue. If speed is of the essence, as it may well be, other means of financing high-priority State-local programs will have to be found. Some help can be obtained through the right kind of tax coordination; for the rest it may be necessary to turn to intergovernmental grants.

INTERGOVERNMENTAL GRANTS-IN-AID

The case for functional grants from one level of government to another rests on the existence of public benefits that spill over the boundaries of the governmental unit operating the program in question. That these externalities are important in various fields, such as education, health, and public welfare, is the theme of chapter III, where it is argued that an economically optimal solution to the problem can be provided only by open-end, matching grants that are carefully restricted to specific programs and that are managed jointly by the grantor and grantee governments. The problems involved in enacting and operating such grant programs are analyzed, and existing Federal and State functional grants are then appraised from this point of view. In spite of its rather haphazard and irregular growth, the present system has many desirable features, and new, improved ones are steadily being added. The conclusion is that intergovernmental functional grants have been an important part of the U.S. Federal system, and that with further development they can contribute much more.

There are, however, definite limits beyond which they should not be pushed. Well before these limits are approached, serious consideration should be given to a more controversial type of intergovernmental grant—one under which the money is extended with no strings, or with very few strings, attached. As Walter W. Heller and Joseph A. Pechman, among others, have stressed, unconditional Federal grants could do much to enable the poorest States and the poorest local governments to bring their public service levels more in line with those prevailing in the rest of the country.[23] In addition, unconditional grants are one way of obtaining the government programs for local benefit which are widely desired by the people but which cannot, because of interstate and interlocal tax competition, be locally financed even in the wealthiest jurisdictions.

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[23] Walter W. Heller, *New Dimensions of Political Economy* (Harvard University Press, 1966); Joseph A. Pechman, "Financing State and Local Government," in *Proceedings of a Symposium on Federal Taxation* (American Bankers Association, 1965; Brookings Institution Reprint 103, 1965.)

Whether a workable program of unconditional Federal grants could be designed and whether it would represent a superior or an inferior use of Federal funds forms the subject matter of chapter IV. These questions have already received considerable public attention, and the recent vote of the 1965 Governor's conference to ask the Federal Government to study the matter further is likely to keep the proposal under serious discussion as one important means of solving the fiscal problems of a Federal system.

EXPENDITURE COORDINATION AND ANALYSIS

It is in metropolitan areas that some of the most difficult problems of intergovernmental relations arise. Because of the political fragmentation that characterizes most of them, benefit spillovers are a common phenomenon, and action on areawide programs is frequently stymied either by organizational inadequacies or by the lack of an objective basis for cooperative agreements among independent municipal jurisdictions. Both of these problems are discussed in chapter V. Alternative forms of metropolitan government are suggested to deal with organizational problems. The contributions which modern systems analysis can make to a workable solution of jurisdictional problems are discussed. In both cases the prospects seem encouraging, particularly if Federal and State Governments lend their financial and technical assistance to local efforts to deal with such mounting metropolitan problems as traffic congestion, air and water pollution, slums and neighborhood blight, and the underprivileged, undereducated people that represent such a waste of national resources.

METROPOLITAN REVENUE REFORM

Part of the metropolitan fiscal problem could be solved by means of metropolitan revenue reform. Property tax inequities and inefficiencies need to be eradicated; local sales and income taxes could be used more extensively and effectively than they now are; and the whole system of user charges and miscellaneous fees could be revised and expanded. Some observers contemplate more radical changes now that the conversion of the general property tax into a local tax on net wealth seems administratively feasible for the first time, thanks to the development of computers and data processing. This shift would materially increase local taxing powers. All of these reforms, which are analyzed in the last section of chapter V, would require considerable assistance from higher levels of government, but once enacted they would place metropolitan governments in a much better position to handle their own fiscal affairs in their own individual ways.

Economic and Fiscal Variables of States

In the following chapters whenever complete tabulations have been unnecessary, a sample of States has been used to illustrate the point at at issue. This sample of 19 States was selected to provide a broad geographical coverage and to include States exhibiting widely different economic and political conditions. The following table summarizes some of these characteristics for the selected States.

Sample of States ranked by selected economic and fiscal variables

State and region	Rank [1] on the basis of—		
	1963 per capita personal income (1)	1959 per capita income produced (2)	1959–60 tax effort index (3)
New England: Massachusetts	9	11	27
Mideast:			
New York	5	3	18
New Jersey	8	8	43
Delaware	11	18	50
Maryland	3	28	38
Great Lakes:			
Indiana	18	13	37
Illinois	7	4	42
Wisconsin	23	25	22
Plains:			
Minnesota	24	20	10
Missouri	14	12	49
South Dakota	40	38	1
Southeast:			
Virginia	34	34	47
Tennessee	46	47	35
Florida	32	37	26
Alabama	48	48	40
Mississippi	51	51	8
West:			
Colorado	22	15	16
California	6	5	15
Oregon	13	29	19

[1] From highest to lowest.

Sources: (1) Appendix table A-1, col. (2). (2) ACIR, Measures of State and Local Fiscal Capacity and Tax Effort (October 1962), pp. 27–28. (3) Appendix table A-6, col. (1).

SUMMARY OF CONFERENCE OF EXPERTS (NOV. 18–19, 1965)

Discussion

A 2-day conference on intergovernmental fiscal relations in the United States not only provides a forum for the discussion of that many-faceted problem but also serves as a laboratory experiment in the sociology of interdisciplinary coordination. Happily, this conference produced some worthwhile analysis of different aspects of a number of promising fiscal reforms and also showed that economists, political scientists, and other fiscal experts can focus jointly on a problem and even air fundamental disagreements in a purposeful and cordial atmosphere. It gives hope that cooperation on a widespread scale may be in the years to come produce fruitful results in an area of increasing importance to our national well-being.

In their search for solutions fiscal policymakers face a wealth of difficulties, but they also possess a rich source of ways and means. Conference discussion made clear the fact that there is no one grand reform that would solve all problems. It also made apparent, however, the existence of a large number of useful policy tools, each capable of adding its own contribution and hence of filling some of the gaps left by other policy measures. What is needed, then, is a skillful integration of selected policies, each blend being adapted to the specific circumstances of the locality where it will be applied. The general tone of

the conference seemed to be one of cautious but definite optimism, evincing an expectation that the outstanding problems of intergovernmental fiscal relations will be resolved in such a way as to insure a salient role for all three levels of government.

State-Local Fiscal Prospects for 1970

The conference began with a review of the 1970 projections of State-local expenditures and receipts that have been worked out over a 2½-year period on behalf of the Inter-Agency Committee on Economic Growth and are being published by the Council of State Governments (CSG) in a series of research memorandum.[1] When aggregated for all of the States, these projections yield the following broad totals:

Category:	*Billions*
General expenditures	$108.3
General revenues	106.0—108.1
From own resources [1]	84.3— 86.4
From Federal sources	21.7
Total fund requirements [2]	121.8
Total funds available [3]	107.9

[1] The higher figure assumes constant effective tax rates; the lower figure assumes that nominal property tax rates remain constant and that there is some slippage of assessed values behind the market values of existing property. See the discussion of this point in ch. I.
[2] Includes amounts needed for debt redemption, for contributions to government retirement funds and for working cash funds.
[3] These fall short of general revenues because of projected negative net utility revenues.

Discussion of these figures centered around two closely related features, both of which elicited some sharp reactions from several of the conference participants. The first was the projection of growth of general expenditures at a rate below their rate of growth in the past 5 or in the past 10 years.[2] In large part this conclusion was drawn from the expectations that primary and secondary school enrollments will grow at significantly slower rates, that the Federal social insurance and Medicare programs will take some of the load off State and local welfare and public hospital expenditures, that highway construction will fall short of its recent rapid rate of growth, and that a slowing down of internal population migration will mean fewer people moving into relatively high-cost local governmental jurisdictions. While the projections also take full account of some rapidly growing State-local programs, such as higher education, regional economic development, and poverty eradication, it is not expected that these will take up all of the slack left by the first set of programs. The second controversial feature of these projections is the relatively optimistic fiscal picture they paint of the country as a whole in 1970. Even with no further increases in tax rates, general revenues, it is estimated, will come within $2 billion of general expenditures, and total fund requirements will be only $13.9 billion greater than total funds available, a gap that is likely to be well within the borrowing capacity of State and local governments in 1970. In fiscal 1964, for example, those governments issued new long-term debt of $11.2 billion.

[1] In addition to those cited in ch. I, see Selma J. Mushkin and Eugene P. McLoone, *Local School Expenditures: 1970 Projections* (Council of State Governments, November 1965).
[2] As noted in ch. I, a continuation of trends of the recent past would produce 1970 State-local general expenditures of $120 billion.

Considerable doubt was expressed by some conference members about the realism and usefulness of these projections. As one participant put it, "I don't know of a single individual in any responsible position who is willing to say 'I shall not need any further tax increases from now on to 1970.'" In the view of another "* * * to suggest any substantial decline in the rate of growth of expenditures is to be more sanguine than for the good of society we ought to be." Others, however, minimized the danger that optimistic fiscal projections would induce State and local legislators or administrators to moderate their efforts to expand spending levels. These officials, they reasoned, are much more likely to react by throwing up their hands in disbelief than by sitting on them complacently.

Extended discussion of the many difficulties involved in making long-term fiscal projections emphasized the importance of three sets of factors: (1) unpredictable effects of new economic and political developments and of technological and scientific advance in particular; (2) the impact of Federal grants-in-aid on State-local spending levels; (3) the complex interactions and feedbacks that undoubtedly exist between one side of the government budget and the other—that is, between State-local expenditure and revenue programs.

On the first point it was noted that "* * * scientific advances continually bring into being new functions of government that we can't forecast 5 or 10 years ahead." In the political sphere legislative reapportionment was seen as a factor making long-term predictions especially difficult at this time. If Federal expenditures on research and development are continued at their current high levels, they may well, it was argued, produce important technological breakthroughs in such areas as the control of air and water pollution that will stimulate new bursts of spending by State and local governments. In general, there seemed to be a widespread feeling that it is all too easy to underestimate the stimulus that scientific research is likely to give to public expenditures.

Federal grants-in-aid, it was noted, are particularly troublesome to the fiscal forecaster because they enter his calculations both as a source of funds for State and local governments and as one of the important factors making for higher levels of State-local spending. In neither case is their future importance easy to predict. As noted in chapter I, a linear projection of the 1952–62 trend in the ratio of grants to GNP yields Federal grants of $17 billion in 1970, and this figure does not even fall within the range of the CSG projections, which extend from a low of $18.5 billion (no further expansion of existing programs) to a high of $24 billion (some enactment of new programs). Uncertainty is compounded when one turns from these figures to their potential significance for State-local spending levels in 1970. The few empirical studies that have been made of the relationships between Federal grants and State spending have failed for various reasons to produce satisfactory results. Though the issue was not directly debated at the conference, one expert did state that in his opinion:

> * * * Federal aid has exercised a multiplier effect on State and local government activity. The entry of the Federal Government into a new functional field quite often has triggered State and local expenditures in that field for matching purposes, and

> then the State and local governments have gone on and on and on—way beyond the original Federal stimulation.

Other conferees, however, felt that these expansionary effects, which have occurred in vocational education and public health, tended to be the exception rather than the rule.

For present purposes the most important fiscal feedback mechanism is that between rising revenues and new expenditure programs. Will the former typically pull the latter up with them so that projected budgetary surpluses are eliminated by expenditure levels higher than originally expected, or will rapidly rising revenues simply lead to a reduction in tax rates? Opinion on this question was divided. While some did anticipate falling tax rates, especially on property, in the surplus States, others argued that expenditures "will simply in the ordinary normal course of events expand to eat up the anticipated surplus." Two very disparate pictures of State and local finance in the 1970's can be drawn, depending upon which of these alternatives is accepted.

Suppose, to take a highly simplified example, that a 1970 surplus of $100 million is projected for one group of States and that a deficit of $100 million is projected for another. If there is no feedback from expected surpluses to expenditure levels, fiscal pressures and rising tax rates in one area will be offset by fiscal ease and falling tax rates in the other, so that for the Nation as a whole average tax rates may remain virtually unchanged. In that sense there would be no aggregate fiscal gap in 1970, though no one would minimize the difficulties faced by public officials in the States with projected deficits. On the other hand, if spending levels do react to rising revenues in the surplus States, projected expenditures for them will in fact be too low by $100 million, and the fiscal gap of $100 million in the deficit States will be the total gap for the Nation as a whole. To fill it, program service levels will either have to be cut back or tax rates increased.

Neither of these two extreme cases is likely to materialize. Presumably in some areas public attention is focused on high tax rates rather than on low public service levels, and this autonomously generated surpluses will be used to reduce tax burdens. Wherever additional public benefits are thought to outweigh additional private ones, however, such surpluses are likely to provide the occasion for expenditure increases. To some unknown extent, then, the CSG 1970 projections, which take no account of the surplus-expenditure feedback mechanism, underestimate total State-local spending levels and hence the size of the nationwide fiscal gap in that year.

In discussing the rapidly rising State-local spending levels, which everyone thought were inevitable, participants raised questions about the size of the tax rate increases necessary to deal with them, but to some the more important problem concerned the kinds of tax increases that are in prospect. In the words of one participant:

> * * * the real issue, therefore, is not the exact number, but how to have a mix of grants-in-aid, property taxes, sales taxes, to meet this [the pressure for higher expenditures] that would be better than simply letting things grow through pressure and through no planning at all.

One of the paradoxes of State and local governmental finance is that where the need for revenue reform is greatest—namely, where expend-

itures regularly outstrip the built-in growth of revenues—the means for achieving it are likely to be in shortest supply. Ad hoc policymaking is not good enough, and one of the important contributions that the 1970 CSG projections have made is to give governments that face a potential financial problem in that year an opportunity to engage in effective fiscal planning. Indeed, stimulus of such planning has been the main objective of Project '70, and much of the work of its staff has been directed to that end.

Tax Coordination

Since it ordinarily involves shifting revenues from one governmental unit to another, tax coordination has always provoked considerable controversy among State and local officials, and its explosive qualities were duly demonstrated by conference reaction to some of its complex issues. These issues included the adoption of credits against an individual's Federal income tax liability for part or all of any State or local income tax he pays, the search for an optimal set of State income taxes on multistate corporations, and the devising of workable solutions to the problems created by the application of State sales and use taxes to interstate transactions.

* * * * * * *

Metropolitan Fiscal Problems

That large urbanized areas exist and that they have complex fiscal problems are fully recognized facts of modern life. Whether the governmental unit known as the city has become an anachronism, or whether it continues to serve some distinctive, definable purposes amid these conditions, are matters of opinion. Conference discussion of these points proved only that a wide diversity of opinion does exist.

Does the concentrated central city characteristic of the Northeast contribute something unique and important to the national welfare that cannot be supplied by the pattern of sprawling metropolises growing up in the West and Southwest? Should the power vested in municipalities be strengthened, or should it be increasingly turned over to larger jurisdictions responsible for entire metropolitan areas or even for groups of metropolitan areas? Answers to these questions cannot be settled upon unless preliminary agreement has been reached on the specific values that local governmental units should be responsible for preserving and developing. That such agreement is far from possible at the present time was amply demonstrated by the discussion. As one participant put it:

> So this neat theory that the activities of government, be they in education or health or international relations, can be split up into neat packages on the basis of logic has no logical foundation.

Despite the lack of clarity as to what is being accomplished or why, however, a further fact of modern life is that metropolitan councils are being formed and that large sums of money are being channeled into them. One discussant described these councils as "always starting out with a wonderful Young People's Christian Association beginning and then ending up in futility," while another spoke of them as having "a vested interest in not trying to do anything for fear they will

collapse." Other conferees were less pessimistic about their promise, or perhaps simply more resigned to making the best of their inevitability:

> I would point out to everybody that you may look down your noses at these councils, but there is one thing for sure—you are going to have a lot more of them and they are going to have more power, because the Housing Act of 1965 contains a little amendment, subsection (g) to 701, which will start underwriting on a permanent basis two-thirds of the administrative costs of these councils from this time on—two-thirds of their budget will be funded by the Department of Housing and Urban Development, provided they meet the specifications of plans and move in the way that HUD wants them to go. Well, they are going to be given more and more power in terms of reviewing applications for Federal grants.

There was considerable support for using the county as the basic unit of metropolitan government, whenever it is big enough. within the foreseeable future, to encompass the urban area. Unlike metropolitan councils, counties have well-established powers and responsibilities,[3] and to shift functions to them from smaller municipalities would, it was argued, moderate some of the destructive interlocal tax competition that now exists, spread the costs of metropolitan services more equitably by combining rich suburbs and industrial enclaves with the poorer parts of the urban area, and permit full utilization of available economies of scale, especially those derived from the ability to attract top quality personnel. In the words of one participant:

> * * * as you move from 10,000 to 20,000 population and the resulting budget to one that covers a population of 50, a hundred thousand, or a little bit more. you go up the scale in the quality of men that you can attract, and this has a tremendous impact on the behavior of the government.

It was also stressed that too often in the past divided responsibilities in urban areas have precluded a positive and dynamic response to emerging social and economic problems, even after they have matured into fullblown crises, as in Watts, Calif., in the summer of 1965:

> * * * Sargent Shriver sent a team out to study Watts, to determine what the Poverty Program could do there. The Department of Health, Education, and Welfare sent a group, the State of California sent a group, the county of Los Angeles sent a group, the city of Los Angeles sent a group, and then they invited some private agency people and they worked around the clock for several days.
>
> They got what the Federal people thought were commitments on who was going to do what, and the Federal people made some commitments on their own of what they would do. And as of 2 weeks ago, I am told, not one thing has been done by anybody, except one little minor program dealing with vocational training.

Others, however, were skeptical of the importance of the contributions that better governmental organization was capable of making

[3] It should be noted, however, that three States—Alaska, Connecticut, and Rhode Island—do not have counties as part of their local governmental structure.

to problems of the Watts variety. In the view of one, "If anybody really wanted to do anything about Watts it could be done now," and another remarked:

> One of the great arguments against the creation of metropolitan areas * * * is that to the Negroes they look precisely like a measure to keep the metropolitan areas in white hands. Just at the time that the Negroes are really getting hold in the cities you enlarge the boundaries of the cities by including lily-white suburbs into which they can't get, and say now we are going to govern over this larger area. Watts would not have been prevented by a metropolitan government—it might have been intensified by it.

These observations brought forth a discussion of two opposite, but not necessarily conflicting, trends that seem to be developing in metropolitan areas. On the one hand, there is a move to reduce the number, and increase the size, of decisionmaking units in the hope of achieving more rapid and more efficient solutions to urban problems. On the other hand, there is a move, particularly by minority groups who lack political power at higher levels of government, to make the local neighborhood the sovereign unit of control over a number of important public programs.

What this suggests, of course, is a highly decentralized kind of metropolitan federalism, and the conference discussed at some length the problems involved in establishing such a system. Few seemed optimistic about the ability of cities and municipalities to achieve the reforms on their own. What limited success there has been in this respect in the past, it was noted, is mainly attributable either to the dedicated work of lone individuals—New York City was cited as an example—or to purposeful action on the part of higher levels of government, as in Winnipeg, or to both, as in Toronto. On the latter score it was recommended that Federal functional grants, particularly those administered by the Department of Housing and Urban Development, be used more and more to encourage the development of metropolitan political institutions. An even more important role, however, could be played by the States, either individually or in association with their neighbors where interstate metropolitan areas are involved. The Tennessee Valley Authority was cited as a valuable guideline for these purposes:

> I would like to call your attention to the remarkable experience we have had in TVA. TVA was a national institution which was geographically located in a given area and spanned a number of States and succeeded in managing itself with a very high sensitivity to the political structures and underlying functional requirements of that area.
>
> This argues that the States might be able to do the same thing in their metropolitan areas, to establish metropolitan authorities which are State authorities, which in the initial stage would be purely dependent politically on the State, but which in time might add other representatives and eventually might have a legislative body that was completely elected from the metropolitan region. But in the initial stage they might be branches of the State, so that you don't raise the issues of local home rule, and so forth: and then you give this body, this State body, control over the allocation of those Federal funds that go to the structures of the

metropolitan nexus—transportation, federally supported highways, State-supported highways, water pollution control, air pollution control, etc.

With help from above and continued pressure from below, city governments, it was generally felt, have a reasonable chance of improving their structure and hence of getting on with the important tasks that face them. The major guidelines provided to them by the conference discussion were well summarized by one participant:

> Well, then, we take the county as the basic governmental unit for the bulk of urban areas, and we experiment with various things, including councils, in the other metropolitan areas that are not covered by the county, and then we counsel patience and fanatic work on the part of all.

SOME THOUGHTS ON THE DETERMINANTS OF STATE AND LOCAL EXPENDITURES*

BY ELLIOTT R. MORSS**

INTRODUCTION

In several recent articles, economists and others[1] have found ways to explain considerably more of the interstate variation in State and local government expenditures than Fabricant was able to do earlier.[2] Fabricant, by using three independent variables in multiple regression analysis,[3] succeeded in explaining 72 percent of the interstate variation in per capita 1942 State and local government expenditures. Fisher was able to explain 65 percent of the 1960 interstate expenditure variation by using two of Fabricant's variables and five others.[4] Lest this be taken as a step backward in explanatory power, it should be mentioned that Fabricant's three variables above explained only 53 percent of the 1960 interstate variation.

Sacks and Harris were able to get a higher coefficient of multiple determination (R^2) than Fisher for 1960 by including, along with Fabricant's variables:

1. a State aid variable (together, the four variables gave $R^2=.67$);
2. a Federal aid variable (together, the four variables gave $R^2=.81$);
3. both of the above two (together, the five variables gave $R^2=.87$).

One purpose of this study is to point out a new variable, which, when used by itself or in conjunction with other variables, will contribute substantially to the explanation of interstate differences. By itself, this variable will explain 72 percent of the 1960 interstate variation in total per capita State and local expenditures, which is

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**The author is with the Fiscal Affairs Department of the International Monetary Fund, but the paper does not necessarily reflect the Fund's viewpoint. Thanks are due William Baumol, Harvey Brazer, and Harold Shapiro for their criticisms of an earlier draft of this paper.

[1] Glenn W. Fisher, "Determinants of State and Local Government Expenditures: A Preliminary Analysis," *National Tax Journal*, XIV (December 1961), pp. 349–355; Fisher, "Interstate Variation in State and Local Government Expenditure," *National Tax Journal*, XVII (March 1964), pp. 55–74; Ernest Kurnow, "Determinants of State and Local Expenditures Reexamined," *National Tax Journal*, XVI (September 1963), pp. 252–255; Seymour Sacks and Robert Harris, "The Determinants of State and Local Government Expenditures and Intergovernmental Flows of Funds," *National Tax Journal*, XVII (March 1964), pp. 75–85.

[2] Solomon Fabricant, *The Trend of Government Activity in the United States Since 1900*, National Bureau of Economic Research, New York, 1952, pp. 122–131.

[3] Fabricant's variables were percent urban, population density, and per capita income.

[4] Fisher substituted percent of families with less than $2,000 income, 1959, for Fabricant's per capita income variable. His other new variables were: the yield of a representative tax system for each State, 1960, as a percent of the U.S. average; the percent increase in each State's population, 1950–60; an index of two-party competition; the percent of population over 25 with less than 5 years schooling, 1960. In explaining interstate variation, the regression coefficients of only two variables (the poor families and representative tax system variables) were greater than 1.5 times their standard errors.

quite likely considerably more than either of the variables that Sacks and Harris introduced could explain singly. While there has not yet been time to include this variable in a multivariate analysis, there is little doubt that for most years, upward of 90 percent of the variation in State and local expenditures will be explainable by this new variable when used in conjunction with the Federal and State aid variables.

As evidence on the remarkable explanatory power of this new variable, the detailed results of the simple linear regression are given:

$$Y = 52.60 + \underset{(.11)}{1.24X} \qquad R^2 = .713$$

In this regression, Y=1960 total per capita general State and local government expenditures, by State, and X=1960 total per capita State and local tax collections, by State.

Using tax receipts to explain expenditures will probably raise some eyebrows. But in so doing, it focuses attention on the main purpose of this piece—a discussion of the legitimacy and usefulness of some of the empirical analyses currently being done on determinants of government expenditures.

While there has been a large outpouring of statistical analyses purporting to explain State and local expenditures or some aspect thereof, there has been little written consideration given to the purposes these analyses are to serve.[5] This is unfortunate, for these purposes should be of primary importance in deciding on the research approach to be taken.

To highlight this point, consider the purposes of the findings announced in the introduction. Since there was no mention of the overall significance of the findings, one might conclude that the only aim was to increase the coefficient of multiple determination (R^2) over what was recorded in earlier studies. Such an aim is hard to justify unless it serves some higher purpose. Of course, the research reported on was also weak in that the obvious question concerning the direction of causality was not even mentioned. However, rather than spending more time on rubbish of this sort, consideration will now be given to the possible uses of work on expenditure determinants and to the research designs that will make these studies most useful.

Of the possible purposes for such research, three of the most important are:

1. Understanding.
2. Prediction.
3. Guidelines for normative decisions.

[5] In addition to the State and local studies cited earlier, work on local expenditures has been done by many authors, including Brazer, Davenport, Scott and Feder, Hawley, and Walker. (For a partial bibliography, see H. E. Brazer, *City Expenditures in the United States*, Occasional Paper 66, National Bureau of Economic Research, 1959, pp. 13–16.) Another group of writers has focused on the variations in particular types of expenditures (for example, see Werner Z. Hirsch, "Cost Functions of an Urban Government Service: Refuse Collection," Reprint No. 10, Institute of Government and Public Affairs, University of California, Los Angeles, 1965, and Jerry Miner, *Social and Economic Factors in Spending for Public Education*, The Syracuse University Press, 1963). While primary emphasis in this paper will be on the State and local studies, comments will also be made on the approaches taken by the writers cited above.

Understanding

It is important to understand what causes expenditure levels to be what they are and what causes them to change. Now, one can argue interminably about what should qualify as a legitimate cause.[6] But it does seem reasonable to say that as social scientists, we might contribute to understanding by measuring the relationships between the variables being analyzed and other economic, political, and sociological variables.

On the other hand, studies that document the fact that changes in a particular variable are associated with changes in its components add little to our knowledge of the expenditure process. Putting it slightly differently, little is to be gained from simply regressing the dependent varaible on itself or on parts of itself. Where there is no interdependence between the parts, one will find a 1-to-1 relationship, which is hardly informative. In cases where there are interactions between the parts, the relationships, although not 1-to-1, may well prove to be equally uninformative. To see what is really going on in such cases, one needs more than a single-equation model.

As an example of the above points, consider using Federal aid to explain State and local expenditures. Inasmuch as States and localities must spend virtually all the Federal aid they receive, it is not surprising to find that aid and expenditures move together in a "statistically significant manner." Indeed, using aid to explain expenditures is analogous to using taxes to explain expenditures in the sense that both aid and taxes are sources of funds. The fact that these variables turn out to have substantial explanatory power serves as little more than verification of the quite obvious fact that government receipts and expenditures are closely related.

The above does not mean that in appropriately constructed econometric models, the regression coefficients of Federal aid variables would not be interesting. For it is of considerable importance to know what a lower level governmental unit's response will be to an aid payment. Indeed, it would be very interesting to differentiate empirically between the responses of such governments to the different types of provisions of the various aid programs. But if the aim is to get reliable answers to questions such as these, single equation models of the type used in the works cited earlier will not suffice. Because of the interactions between independent variables in these models, a multiple equation model should be developed and tested empirically.

In elaboration of the above point, let us define State and local expenditures (Y) as being equal to Federal aid payments (Z_1) plus State and local expenditures other than those financed by Federal aid payments (Z_2), i.e.,

$$Y = Z_1 + Z_2 \tag{1}$$

Suppose further that the value of Z_1 is given exogenously, i.e., that its value does not depend on either Z_2 or Y. As suggested earlier, it is reasonable to assume that Z_2 will depend at least in part on Z_1. Holding all other factors affecting Z_2 constant, it is assumed that the relationship between Z_1 *and* Z_2 may be expressed in the form:

$$Z_2 = a + bZ_1 \tag{2}$$

[6] For example, one might say a cue stick causes a billiard ball to move; or one might say it was the player's energy in moving the cue stick that caused the ball to move.

If this is the case and the relationship is a fairly strong one, the regression coefficients resulting from regressing Y on Z_1 and Z_2 will not give reliable estimates of future responses of Y to changes in Z_1 and Z_2 respectively. Putting it slightly differently, the correlation between Z_1 and Z_2 may cause very substantial changes in their regression coefficients whenever any new observations are included in the regressions. It is important to stress that these conclusions hold whether or not the regression coefficients appear to be significant in terms of the usual standard error and F-tests of significance. In short, a high correlation between independent variables will lead to unstable and hence unreliable estimates of the regression coefficients.

The proper way to get true estimates of the parameters involved in the above case is to calculate the reduced form of equations (1) and (2), which is:

$$Y=a+Z_1(1+b) \tag{3}$$

The regression coefficient of Z_1, $1+b$, gives an estimate of the effect an increase in Z_1 will have on Y. It is superior to the estimate derived from regressing Y on Z_1 and Z_2 in that it makes allowances for the interaction between Z_1 and Z_2. But equation (3) is not entirely satisfactory. For its R^2 will overstate the explanatory power of the behavioral relation between Z_1 and Y. That is, the R^2 will be high because it will include the percent variation explained by the 1-to-1 identity relationship as well as the percent variation explained by the behavioral relationship between Z_1 and Y.

To get an accurate measure of the extent of the behavioral relationship between Z_1 and Y, the identity element should be removed. This may be done by subtracting Z_1 from both sides of equation (3), leaving:

$$Z_2=a+bZ_1 \tag{4}$$

To get some idea of the quantitative importance of this point, consider a test of the latest popular finding—that Federal aid is an important determinant of State expenditures. With the 1960 per capita State and local expenditures as data, the following results are obtained when Y is regressed on Z_1:

$$Y=226.96+\underset{(.27)}{1.25}Z_1 \qquad R^2=.30$$

Ignore for the moment the crudity of the model. The results suggest that Federal aid payments explain 30 percent of the variation of Y from its mean and that there is a significant, positive relationship between Y and Z. Now, consider what happens to the results of the identity portion between Y and Z_1 is removed. This may be done by using the equation (4) formulation. The results are then:

$$Z_2=227.30+\underset{(.27)}{.25}Z_1 \qquad R_2=.02$$

There is little in these results to suggest that any sort of meaningful relationship exists between the dependent and independent variables. In short, it appears that the Federal aid variable is significant in ex-

plaining variations in State and local expenditures only because these lower level governments are required to spend all of the Federal aid payments they receive. This is hardly an interesting finding. Indeed, it should make one wonder about the importance of the "discoveries" of Sacks and Harris, Kurnow, Brazer,[7] and others that Federal aid is significantly related to government expenditures.

If understanding the effects of Federal aid on State and local expenditures is the objective, it would be useful to do some studies of a type quite different from those considered above. Federal-aid programs are often made available several years before States or localities start using them, and they often involve a substantial monetary commitment on the part of the government unit receiving the aid payment. When there is some delay between the establishment of a Federal-aid program and its use by individual States, it is particularly questionable to say Federal aid caused State expenditures to change, even if one is talking about expenditures excluding Federal aid. Given that there are some lags between the establishment of aid programs and their adoption by States and localities, it would be interesting to explore the reasons for the lags between program establishment and utilization. Here, a cross-section analysis might yield some interesting results. That is, one might attempt to determine why some States make use of a particular program immediately, while others take considerably more time. To study this question, regression analysis might be used. The time lag between program enactment and adoption by individual States might be the dependent variable, with such things as per capita income, a lagged value of the State's budget deficit or surplus, and some proxy of the State's need for the particular aid project used as explanatory variables.

Prediction

Research methods may be less restrictive when prediction, rather than understanding, is the objective. Indeed, so long as the researcher is careful in the interpretation of his statistical results, there are virtually no restrictions on what might be used as predictor variables.[8] The researcher is free to use whatever combination of variables he feels will give him the best prediction. For predictive purposes, therefore, tax receipts, aid payments, budget deficits, lagged values of the dependent variable or parts thereof might legitimately be used as predictor variables.

This does not mean the predictor's job is necessarily an easy one. For while he need not concern himself with formulating a model that has intuitive *a priori* appeal, his success or failure can be measured quite precisely by the size of his residuals. In any case, the important point is that research methodology for prediction may differ substantially from the methods that should be used when understanding is the primary research objective.

[7] Brazer used intergovernmental revenues per capita to explain variations in per capita city expenditures. He said that the high positive correlation can be explained "* * * principally in the fact that it [the intergovernmental revenues variable] serves as a partial measure of the distribution of functional responsibilities among other cities on the one hand and its other local subdivisions on the other." Only then does he go on to suggest that "* * * it represents a partial indication of the availability of funds with which expenditures *may* be financed." [Italics are mine.] (Brazer, *op. cit.*, p. 67.)

[8] Of course, the researcher is under one restriction: his model must be formulated so that the data needed to generate predictions will be available prior to the time at which the predictions are needed.

Normative Guidelines

Cross sectional multivariate regression results may serve as useful guidelines when one is attempting to answer certain normative questions. For good or bad, many welfare decisions are made on the basis of what is considered to be an "equitable norm." One value of a regression equation is that it facilitates the calculation of norms that can be far more sensitive than unweighted numerical averages.

For example, it might be felt that aid payments to a particular government unit should depend on the unit's expenditures as compared with the expenditures of other units having the same per capita income and area. A regression of expenditure on income and area across all government units will permit one to make an estimate of expenditures of all areas having the appropriate income and area. The deviation of the particular unit's expenditure from this average might then be used as a criterion for deciding whether the unit should be spending more or less, or whether it should be receiving Federal aid, etc.

If an expenditure study is to be used for normative purposes, independent variables of welfare interest should be included, *regardless* of their explanatory power. Indeed, the variation in expenditures after taking account of such variables might be a criterion in deciding whether an aid program is needed.

The approach that should be taken in the normative study will therefore differ substantially from studies where either prediction or understanding are the chief objectives. In the latter cases, a "good fit" is desirable as a sign that the hypothesis being tested is consistent with what has happened in the real world. For a normative study, a different approach should be taken. The model to be tested should include the important welfare variables. In such circumstances, "goodness of fit" will be important, but not as measure of the success or failure of the researchers. Rather, "goodness of fit" will indicate the deviation of the real world situation from the welfare norms specified by the model.

Another type of normative analysis has been done by Hirsch.[9] He attempts to explain differences in per capita expenditures by means of cost variables. For example, he attempts to explain per capita refuse collection by means of such variables as number of refuse collection, disposal costs, and number of pickup locations. The presumed objectives of these studies is to develop a cross section cost function as a norm against which one might view the cost performance of particular government units.

The notable result of Hirsch's studies is the low explanatory power of his cost equations. For example, in his refuse study, the highest R^2 was .76. This is remarkable in that many of Hirsch's independent variables appear to be part of his dependent variable.

The relatively low explanatory power of Hirsch's results raises an issue as to their usefulness. Part of the unexplained variation is probably due to differing degrees of efficiency among governmental units, but part is also probably due to real cost differences not allowed for in Hirsch's cost functions. My conclusion is that the relatively low explanatory power of Hirsch's results means they should not be used

[9] See Hirsch, *op. cit.*, and also "Analysis of the Rising Cost of Public Education," *Study Paper No. 4*, U.S. Congress, Joint Economic Committee, Government Printing Office, 1959.

as a cost standard against which to measure the efficiency of particular government units. Indeed, if information on the performance efficiency of a government is desired, the best approach is still to call in an outside party to do a time study analysis.

Three possible objectives of expenditure studies have been considered, and the different research approaches to each have been spelled out. Several general remarks should be added, however, which apply irrespective of objective.

The Need for Disaggregation

Given there is some opportunity costs, the wisdom of making additional studies of the expenditure behavior of several government units taken together is questionable. Putting it more positively, there is considerable need for and much to be learned from studies of individual government units. One of the primary reasons for constructing predictive models is to help government officials estimate their future revenue needs. In most cases, these officials will be interested in the future revenue neds of their respective governments, and not in the future needs of a combination of government units.

From the standpoint of understanding, it is likely that much is being missed when, for example, State and local governments are studied as a single unit. Political institutions and pressure are usually quite different at the State and local levels, and the importance of these differences may not appear until the units are considered separately.

Of course, this does not mean the interactions between aggregates of government units (e.g., localities and the State government) are not important. They are. But in order to get at them, it would be useful to have some idea of how these government units perform individually.

The need for greater disaggregation applies as well to studies of variations in different types of government expenditure. Many of the recent studies make it quite apparent that variations in specific expenditures cannot be satisfactorily explained by the same variables.[10] This is not surprising. There is little reason to expect that welfare expenditures and natural resource expenditures, for example, can be explained by the same variables. It is easy to regress more than one variable on a single set of independent variables once the data have been collected. However, if satisfactory explanations of variations in specific expenditures are to be developed, different types of expenditures will have to be given more individual attention than has been done to date.

Hopefully, when more detailed consideration is given to the different types of expenditures, the custom of throwing Fabricant's "troika" of independent variables into virtually every regression can be stopped. At the time it was done, Fabricant's work was perhaps a step forward. In 1965, using two variables as highly correlated as population density and the degree of urbanization as independent variables in the same regression equation borders on the absurd.

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[10] *E.g.*, Sacks and Harris, *op. cit.*, table IV; p. 83.

The Type of Analysis

Whether the objective has been understanding or prediction, it is extremely difficult to understand the recent emphasis on cross section analyses.[11] For predictive purposes, time series analyses of individual government units would unquestionably be superior to the cross section approach in the following sense: expenditure changes for a particular government unit can virtually always be predicted more accurately from its own history than from a collection of current relationships holding in government units with very different political and economic characteristics.

For the case in which the objective is understanding, use of cross sectional analysis involves the danger that because of substantial social, economic, and political differences among areas, variables that are important in particular areas might not appear significant. For example, it might be that the degree of cooperation needed to permit a certain percent increase in expenditures varied among States, a cross section analysis for a particular time period would not necessarily indicate the significance of this variable.

The cross section approach is dangerous in that it will not usually uncover the dynamic relationships between political and economic variables that cause State expenditure levels to change. It is assuming altogether too much to say differences in the levels of State and local expenditures among States can be explained by factors common to all States.

One argument that could be made in favor of the cross sectional approach is that it will permit one to see what variables are significant in many areas. However, the same information can be uncovered by doing time series analyses of individual areas. Variables that are important in many areas will turn out significant in many of the separate time series studies.

In short, if one must choose between cross sectional and time series analysis for either prediction or understanding of expenditure determinants, the scales are definitely tipped in favor of the latter.[12] However, one need not make an absolute decision to use one or the other. In many instances, the researcher may find covariance analysis to be a satisfactory compromise. The covariance technique is a very powerful analytical tool in that with very little in the way of restrictive assumptions, it permits one to take advantage of time series and cross secional data simultaneously.[13]

Probably the most important reason for the paucity of time series analyses is the alleged lack of relevant time series data.[14] Admittedly, it takes hard work to turn up the sort of data needed to understand the dynamic interactions that determine expenditure levels. And if one succeeds in dredging up data to explain the expenditure process for a particular government unit, his findings might be looked down on

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[11] Following Fabricant's lead, all of the studies cited earlier use cross section analyses of the 48 States to explain variations in per capita State and local expenditures.

[12] As noted earlier, the cross sectional approach will likely be appropriate in cases where the objective is to establish "norms" for policy guidelines.

[13] A covariance analysis could be formulated to test for differences in slopes and intercept in the regression equations when the data are classified by State or by year. For an example of a covariance analysis testing for differences in intercept among sets of data, see John B. Lansing, Jung-Chao Liu, and Daniel B. Suits, "An Analysis of Interurban Air Travel," *Quarterly Journal of Economics*, LXXV (February 1961), pp. 87–95.

[14] *Cf.*, Miner, *op. cit.*, p. 41.

by some because they will not necessarily explain the expenditure process of all government units. Nevertheless, because the factors influencing government expenditure decisions probably differ considerably among governments, some detailed, specific time series studies are needed if in order to learn more about expenditure determinants.

The Form of the Hypothesis

In all of the studies cited above but one, it was assumed that the effects of the independent variables were additive. That is, regressions of the form $Y=a+b_1X_1+b_2X_2+\ldots+b_NX_N$ were fitted, where Y took the values of the dependent variable and the X's took the values of the independent variables. Kurnow argued that such a model is not realistic because there are obviously interactions between the independent variables. For this reason, he tested a slightly different hypothesis. Instead of assuming the effects to be simply additive, he assumed $Y=aX_1^{c_1}X_2^{c_2}\ldots X_N^{c_N}$. According to this hypothesis, the effects of a change in an independent variable will depend on the values of the other independent variables as well as on the size of the change.[15]

The question of which formulation is most appropriate should not be answered on an *a priori* basis.[16] Presumably, the best formulation is the one that best approximates the real world, and this cannot be determined without empirical testing. In this respect, it is interesting to note that Kurnow, when using the same independent variables as had been done in earlier research, was able to explain more of the interstate variations in expenditures with his formulation than was explained by the additive formulation. It should be stressed that these results do not cinch the case in favor of the Kurnow approach. With other, and perhaps more realistic, independent variables, it is conceivable that the additive hypothesis will appear superior to Kurnow's. Ultimately, the issue need not be decided in favor of either approach. There are many other possible formulations: the important thing at this point is to keep an open mind on alternative formulations.

Conclusions

One purpose of this piece has been to stress that the objectives of an expenditure study should have an important influence on the research methods employed. A second purpose has been to suggest several possible directions for needed research.

In earlier days, I would have cautioned researchers not to think too long about the methodology and the objectives of their studies. For indeed, it used to be that nothing could kill research progress as effectively as musings over the types of methodological questions raised here.

But times change. And today, with computers that can rapidly investigate the relationships between whatever numbers they are fed, we should have the time to consider carefully what we are doing and how we intend to do it.

[15] To get this hypothesis into a form that can be tested by linear regression techniques, logarithms are taken: $\log Y=a+c_1 \log X_1+c_2+\ldots+c_N \log X_N$. Note that in this case the regression coefficients are elasticities, i.e., they are estimates of the percent increase in the dependent variable that will result from a given percent increase in an independent variable.

[16] Intuitively, one might favor a formulation that takes account of interactions among the independent variables. It should be mentioned that Kurnow's formulation is only one of many, possible ways to allow for interaction effects. And it is possible that Kurnow's method for allowing such effects so distorts the real world situation that it would be preferable to stick with the additive approach until a more realistic interaction model is introduced.

GOING BROKE ON A $600 BILLION NATIONAL INCOME*

BY L. LASZLO ECKER-RACZ**

You, the executives of America's cities, have experienced firsthand I have no doubt, the skeptical reactions of your foreign colleagues to your tales of budgetary plight. How can it be so in this land of affluence, where so many billions can be spared to help other lands?

The anomalies of this governmental system are not easily made meaningful to others; possibly not even to ourselves.

How can one explain that a society which is speeding headlong into urban concentrations can be erecting ever higher social, economic, and legal barriers between artificially fragmented segments of essentially single metropolitan communities?

How can one explain that in the oldest and strongest Federal system the Central Government can enjoy fiscal ease while State and local governments plunge from one fiscal crisis into another?

How can one explain a people emotionally committed to fair and ability-to-pay taxation, reducing Federal income tax rates while State and local governments are obliged to push regressive consumer taxes and discriminatory property taxes to increasingly higher levels?

How can one explain the States of a Union constitutionally committed to economic solidarity and the free flow of interstate commerce looting one another's businesses and making a political virtue of economic chauvinism?

How can one explain a nation morally committed to an equal educational opportunity for all young people, spending the least on children needing it the most, and spending the most on those needing it the least?

How can one explain that the metropolitan areas containing most of this country's vast wealth contain also the bulk of its poverty and deprivation?

Indeed, how can one explain the fiscal desperation of America's "great cities" that symbolize our wealth and strength to all the world at a time when the national income has increased by more than $180 billion in 6 short years?

Despite these contradictions, public pressure, political ingenuity, and economic prosperity have combined to produce an impressive governmental performance.

The 42 largest cities, for example, have managed in one decade to finance an increase in spending for general government purposes from $4 to $7½ billion (1954–64). State and local government as a whole has managed an 8- to 9-percent yearly increase in its spending level for nearly 20 years.

It is noteworthy, too, that this was accomplished without too much violence to the country's political dogma. You know it well:

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*Speech before the U.S. Conference of Mayors, Dallas, Tex., June 14, 1966.

**Assistant Director, Advisory Commission on Intergovernmental Relations.

Leave maximum responsibility for governmental services in the hands of those close to the people; at the local level if possible, at the State level if necessary, but not at the Federal level unless it pertains to national defense and international affairs.

Much of the unprecedented increase in spending since World War II has occurred at the local level. These governments still account for about half, and the States for another quarter, of this country's direct expenditures for civilian government. State-local expenditures for general government services now exceeds 80 billion per year and more than double every 10 years.

The second tenet: Match the responsibility for spending with a responsibility for taxing so that those who have the pleasure of spending bear the onus of taxing.

As you have reason to know, this rule, too, continues to be heeded. State and local governments have financed about 85 cents of each new dollar of spending from their own resources.

The dogma has a third part: Bridge the gap between State-local spending needs and revenue resources with Federal financial aid but use such aid sparingly and only for clearly specified purposes.

The record: Federal aid still provides only about one-seventh of new State-local revenue needs and is always earmarked for explicitly prescribed functions.

If local and State performance has been creditable and if the old articles of faith continue to be heeded, why then is there so much concern? Why are so many troubled? Why is this Federal-State-local system preoccupying the professional journals, the weekly publications, and the daily press? Indeed, why are you taking time in this busy conference to discuss it?

Those concerned with the financial arrangements of our Federal system are prompted by different reasons, are stimulated by different motivations.

For example, local leadership in varying stages of recovery from the last fiscal crisis girds itself for more crises it knows to be on the way. Its revenue gaps keep recurring because national prosperity increases local revenue needs nearly twice as fast as tax collections.

Leadership at all levels is troubled because so many community needs remain unsatisfied, particularly in the poorer sections of the country, and the spotlight of the National Administration's "Great Society" goals illuminates these deficiencies for all to see.

At the same time, another group, not particularly given to reticence, frets over increasing National Government involvement in problems it deems to be the business of the cities, counties, and States. It is discomfited, too, by the changes taking place and by the enlarged dimension of the business of government. A $70 billion increase in State and local spending in 20 years alarms it, despite the fact that during the same 20 years national income has grown by more than $400 billion.

The management of these expenditures has not been painless. You who witnessed these developments in your city halls and State legislatures have been privy to some traumatic hours experienced by political leadership overtaken by periodic State and local fiscal crises. The record of significant tax enactments at local, and especially at State levels, is liberally strewn with once promising political careers, abruptly terminated by disgruntled voters.

People appear to have an irrational aversion to tax increases and are particularly resentful of those mandated by their local leaders. Few things stir their ire more than a rise in the tax on their homes. It matters not that those homes have increased in value and, after providing the family with shelter for years, can be sold for more than they cost.

Yes, the Federal system with its emphasis on local responsibility for governmental services, and with its insistence on local financing, is experiencing some growing pains. From all indications, moreover, these pains may become more acute. The forces that produced the growth in expenditures during the immediate past, reinforced by some new ones such as the administration's emphasis on improving the quality of life, will continue to be operative into the foreseeable future, and the restraints against tax increases show no signs of abating.

Whatever their reasons, people in increasing number believe that the job of government is being done imperfectly; some even say poorly. They associate their disappointments with this Federal system, and on occasion even question the capability of the system to serve future needs.

These are but different manifestations of the same condition: postwar developments have outstripped the financial arrangements of the Federal system; they have left them out of joint.

As urbanization continues, more of the fiscal resources drift into the suburbs while more of its governmental caseload congregates in the core cities.

As national prosperity continues, progressively more of its revenue bounty gravitates toward the Federal Treasury, while the governmental responsibilities it generates gravitate toward city halls and State capitols.

In short, the distribution of needs is the reverse of the deployment of resources. The resources are here, but in the wrong places.

There need be no doubt about our capability to finance the people's governmental needs; nor about the practicality of accomplishing it within the philosophical principles of this Federal system. The performance of the Nation's economy—a $225 billion increase in production since 1960—is warrant for the first assertion; the responsiveness of intergovernmental arrangements to the country's needs since the early 1930's, supports the second.

I submit, ladies and gentlemen, that if political responsibility were not fractionated among governmental levels, the cities would not be going broke on a $600 billion national income; our 200 million people would have the benefit of a comparable level of basic governmental services supported by a comparable level of taxes wherever they chanced to live. Moreover, with a $7,200 (and rising) median family income their tax burden would be quite reasonable. The ratio of all Federal, State, and local taxes to the output of our economy (22 percent of GNP) is as low as at any time during the past decade, except in the depressed year of 1959.

My purpose in putting it this way is not to deprecate revered political arrangements, nor to cast envious eyes on centralized governmental systems. It is rather to identify our institutional differences as a basis for emphasizing the need to deploy political power more effectively.

If the economist is right and the obstacles to the adequate financing of peoples' needs *are* political, not economic, how do we get at them?

First, we need to recognize that the increased mobility, urbanization, and social consciousness of the population has deprived some people-oriented (as distinguished from property- or business-oriented) governmental services of their exclusively local coloration.

The boundaries of governmental service areas need to be enlarged all up the line: from central cities and suburbs to urban and metropolitan areas, from rural and urban areas to the States; and from the States to the Nation.

Artificially fractionated political boundaries need not be allowed to jeopardize critically important public objectives. The undertaking to improve the quailty of life for all people and to provide their children with adequate educational opportunities has long ceased to be only a private family aspiration; it is now a community obligation essential to natonal progress at home and national influence abroad.

The *second* prerequisite follows from the first—a corresponding expansion in the areas of financial support, from artificially created local enclaves to metropolitan areas, to States, and to the Nation. Nowhere is this need more evident than in the large urban aggregations where misplaced loyalty to the concept of "home rule" is taken for license to spawn mutually exclusive islands of wealth and poverty and to aggravate social and economic disparities.

Third, increased State and Federal financial participation will need to be accompanied by a more earnest local and State fiscal effort.

There is no need to delay you with the specifics of what needs doing. They are detailed and documented in the State Legislative Program and supporting reports of the Advisory Commission on Intergovernmental Relations. Many of them are articulated in your own conference resolutions.

Fourth. States will need to raise their protective umbrella to shelter the fiscal freedom of local jurisdictions, and the Federal Government, in turn, will need to shield both State and local governments.

As large regions and the 50 States develop into a single interdependent industrial and commercial market, local and State governments grow increasingly more vulnerable to destructive and self-defeating tax competition. Admittedly, the influence of tax considerations on the location decisions of business is grossly overstated. However, its impact on State and local taxation is not. Fear of losing business to another jurisdiction haunts the mind and stills the pen of the State and local lawmaker, and special pleaders have developed the skill of exploiting this fear to a high art.

If, for example, at the local level there is need to improve property tax administration—and all agree that there is—local jurisdictions that cannot be expected to go it alone. States will need to prescribe it, enforce it, and assist in it.

If there is need for consolidation and amalgamation into larger local government areas—as there clearly is—the State (and the Federal Government) can encourage it in various ways, especially with the leverage afforded by its programs of financial aid.

If, at the State level the need is for more effective income taxation—and I submit that it is—the Congress can stimulate it by giving Fed-

eral taxpayers a more generous writeoff for income taxes paid to States, or conceivably make it a condition of general-purpose financial aid.

Lastly, there is need for a better public understanding of the role of Government in the American way of life. The people's, particularly prosperous young people's antipathy to taxes, all too frequently encouraged by those eager for electoral support, is detrimental to the contribution Government can and does make to productivity and public well-being.

Can there really be any doubt that the $20 billion devoted to local public schools in 1964 were at least as productive as the $20 billion spent on liquor and tobacco? That the $6 billion expended that year on all public welfare programs were at least as useful as the $7 billion dispensed for toilet articles, preparations, and beauty aids? Or that the $2.4 billion expended on police protection were just as essential as the similar amount spent on jewelry and watches? Clearly people's perspective on the comparative value of its private and public dollars leaves something to be desired.

You may have noted a common denominator in my five-item agenda—an increasing degree of intergovernmental involvement.

Its realization will require central cities and suburbs to make common cause to provide a more uniform level of services financed from their collective resources.

It will require urban and rural areas to make common cause to strengthen the States so that they may make better use of their resources to improve their effectiveness.

The States, in turn, will need to make common cause with one another to speed a better realinement of the Federal-State division of fiscal responsibilities and the deployment of a larger share of national resources to State and local programs.

This will not come easily. The concept of decentralization is deeply rooted in American mores. On the other hand, however, the record abounds in demonstrations of the kind of inventive genius the Constitution was designed to foster.

Who would have foreseen in 1930 when "taxation for revenue only" was the gospel, that by the middle of that decade the party in power would be battling for progressive taxation to redistribute wealth?

Few would have predicted in 1940 that by 1946 it would become congressional policy to utilize the National Government's total resources to avoid unemployment.

Indeed, who would have wagered in 1960 that 4 years later, with a deficit budget, the Congress would be making sharp tax rate cuts in the confident expectation that the resulting economic stimulation would more than compensate for the revenue loss: that indeed, it was the only realistic path to a balanced budget.

Yes, America's political institutions and its supporting theories can renew themselves. As we approach the 1970's, the question on many minds is whether that institution's flexibility will stretch to enable the Federal Government to devote more of its revenue largesse to the people-oriented services still so heavily dependent on limited local and State resources.

The problems of the Federal-State-local system rarely command sustained top policy attention because the Government bureaucracies as well as private interest groups are function oriented. Such problems

are thought to be proper grist for the mills of study groups and task forces.

The Federal Government is organized and operates along functional lines. The executive branch departments are so organized, the congressional committees are so organized, and the public contacts of both are with groups and individuals concerned with specific functional programs. Witnesses at congressional hearings are spokesmen for the farmer, the aged, the schools, the defense industries; not for Government, not for the Federal system.

At the State level the same functional specialization prevails, and those who speak for government and might be making common cause, dissipate their political leverage on core city versus suburb issues, on rural versus urban, on city versus county issues.

Ladies and gentlemen, the burden of my message is simply put. The fiscal problems of local governments, just as those of the States, are political and institutional, not economic. This country's creativeness and productivity is more than equal to the President's and your aspirations for our fellow Americans. There need be no doubt on that score. If some still lingers, only political leadership can dispel it.

If the economist is obliged to abdicate to the practitioner of politics, what better forum than the U.S. Conference of Mayors? Your cities contain half of the country's population. You personify American political strength. We have it on the authority of that master of the art of politics, the President of the United States, that "the cities of all the States have become more and more an active force in Washington."

Deploy some of that political power not only in Washington, but in State capitals as well, to help focus to level policy attention on bringing this Federal-State-local system into better harmony with the last third of the 20th century. As you succeed, those who will follow in your footsteps will find their opportunities for serving their people measurably enlarged.

Your time is now. When Vietnam is behind us—hopefully quite soon—and the Federal Treasury is once again embarrassed by overly large revenue dividends generated by an expanding economy, the surpluses are likely to be preempted by those with the best prepared and politically most compelling claims. They should be your claims, not for more bits and pieces of special purpose grants, but for whatever it takes to make State and local government a creative force in this Federal system.

Part 2

FEDERAL: SURPLUSES? WHEN? HOW MUCH?

PRIMING THE PROJECTION MACHINERY: CRITICAL ASSUMPTIONS*

PREPARED FOR THE SUBCOMMITTEE ON ECONOMIC PROGRESS, JOINT ECONOMIC COMMITTEE

As has been pointed out, the estimates presented in this study are projections, not forecasts. The mechanism of the projection consists of a series of past relationships between various economic variables, together with observable long-term trends. To start up this machinery, one must first prime it with a set of assumptions that appear reasonable and realistic in view of the uses to which the resulting estimates are to be put in the later analysis. In the present case, the machinery was primed by starting off with the following basic assumptions:

(1) The war in Vietnam was assumed to terminate by the end of 1967, or at least cool down enough to allow some reductions in the size of the Armed Forces and the rate of expenditures thereafter.

(2) Two alternative sets of estimates or models are presented in the projections—the A set assumes that the rate of unemployment will average 3 percent of the civilian labor force; the B set is based on a 4-percent rate of unemployment.

(3) Different patterns were assumed for increases in gross national product per man-hour for the two models that were set up. For the A model, output per man-hour in the private sector was assumed to average 3.1 percent per year between 1966 and 1970, and 3.5 percent from 1970 to 1975; for the B model, the average annual gain was assumed to be about 3 percent per year throughout the period from now until 1975.

(4) Projections of the total labor force conform to the latest estimates of the Bureau of Labor Statistics, Department of Labor, summary of which is provided in the next section of this report.

(5) For both sets of projections, the Armed Forces were assumed to average 2.7 million in 1970—about equal to the 1965 average—and 2.6 million in 1975.

(6) In both sets of projections, it was assumed that the average weekly hours would decline by one-half hour between 1967 and 1970, and an additional reduction of one-half hour between 1970 and 1975—these reductions being roughly comparable to these experienced in the decade of the 1920's when the economy was operating at high employment rates and enjoying rapid growth without inflation.

(7) Overall prices (as measured by the GNP deflator) for the A set were assumed to grow at an annual rate of 2 percent per year; for the B set, the price rise was assumed to be 1.5 percent per year, conforming to the experience of the period from 1959 to early 1965.

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* Reprinted from *U.S. Economic Growth to 1975: Potentials and Problems*, study prepared for the Subcommittee on Economic Progress of the Joint Economic Committee, Washington, 1966, excerpts pp. 8–16, 39–42, 48–49, 52–55, 60.

(8) Wage rates in both public and private employment were assumed to rise by the average annual gain in output per man-hour in the private economy, plus an allowance for the annual gain in consumer prices. This assumption insured that through the period of the projection the relative income shares of the GNP would be maintained at the fractions experienced at the beginning of the period.

(9) To produce a balanced model, it was necessary at a later stage in the construction of the projections to make assumptions about the rate of personal saving to disposable personal income. For the A set of projections, the assumption was 5 percent, for the B set, 5.5 percent.

It is worthy of note, in connection with these assumptions, that modest variations could be made without serious impact on the models that are projected in this study; but major changes in the assumptions would undoubtedly have important effects both on the magnitudes developed in the projection and on the analysis of their implications for policy. Specifically, should defense requirements—particularly for the Vietnamese war—mount substantially beyond what has been assumed and continue along—more than perhaps a year—beyond the termination assumed for the model, we would eventually need to reconsider the implications of this factor for the model.

The assumed changes in overall prices (GNP deflator) were chosen somewhat arbitrarily as being reasonable standards of achievement under the assumptions of 3 and 4 percent unemployment in the two sets of estimates. It is quite possible to arrive at other estimates according to what one assumes to be good or poor performance in maximum employment.

It should be stressed that the assumed rates of changes in the GNP deflator and in wage rates are meant to represent effectively stable prices after allowance is made for the particular way in which prices and wages are handled in the national income accounts. The assumptions made above are roughly consistent with a stable wholesale price index, but with rises in other nongoods prices to reflect two factors: First, the indexes treat changes in Government wage rates as a change in the price of Government services. Hence, if as in this model, it is assumed that Government wage rates move up in step with private wage rates, then the index will show a rise in the price of Government services, there being no allowance for changes in productivity in this particular case. Second, the model assumes that overall shares in national income between wages and salaries, on the one hand, and other income shares, on the other, are constant. To insure this, it is necessary to make allowances in wage rates for the impact of rising service prices. If, alternatively, the model had assumed that all prices would be completely stable, that is, the GNP deflators were constant over the next 10 years, then the parallel assumption for wages would be to keep them precisely in line with changes in productivity.

The reader is warned, too, concerning the basis for the assumptions about rates of personal saving. The average personal saving rate for the years 1961–65 was 5.5 percent, the rate used for the B projections. This seemed reasonable in view of the fact that this B set assumes a 4-percent unemployment rate. The lower saving rate used for the A set of projections was chosen because more of the employed labor force would be in the low-income group at a 3-percent rate of unemployment than would be the case were the unemployment rate to average 4 percent. It is a familiar phenomenon that low-income families

generally save less as a proportion to their income than those in higher income classes. The increase in the proportion of the lower income group in the total labor force would naturally tend to reduce the actual saving rate.

One final warning to the reader: These projections do not present a detailed analysis of the financial side of the model. In particular, there is no explicit analysis of the relationship between the growth of the money supply and the performance of the economy under the assumptions of these two sets of projections. It was not necessary for the purposes here to specify an exact annual rate of increase in the money supply, however defined, nor to make a detailed analysis of the financial side of markets. In any case, this would have been beyond the resources available for the study. However, it must be clear that the model does assume that the Federal Reserve on the average will take steps to make possibe whatever increase in the money supply proves by experience to be consistent with the growth in the economy and the assumed price levels.

HOW MUCH CAN WE PRODUCE: POTENTIAL SUPPLY

Although there are a number of ways of answering the question as to how much our economy can produce, one of the simplest ways of analyzing the problems of estimating the potential supply of GNP is: Estimate the total number of people working, the total number of hours worked, and the average output per man-hour—the total output being the product of these three numbers.

Projections of the total labor force used in this study conform with the latest estimates of the Department of Labor; Growing, from about 80 million in 1966 to 86.4 million in 1970 and to 93.6 million in 1975 for the A set of estimates; and growing to 86 million in 1970 and 93.6 million in 1975 for the B set of estimates. These estimates imply an average annual rate of increase of about 1.8 percent over the coming decade, compared to the actual rate of 1.3 percent experienced from 1948 to 1964. This increased rate of growth in the total labor force reflects standard Bureau of the Census projections of the population (all of the population in the labor force in 1975 has already been born), and historical rates of participation of the total population in the labor force—the latter adjustment making allowances for the aged, the infirm, full-time students, housewives, and others not available for employment. Changes in the Armed Forces over the period are given in the assumptions in the previous section, as well as the rates of unemployment for the two sets, A and B. Labor force participation rates as a percentage of the population 14 years of age and over work out to 57.6 percent in 1970 and 57.5 percent in 1975 under assumption A, and 57.3 percent in 1970 and 57.5 percent under assumption B. Putting these figures together, we develop the estimates of labor force and employment given in table 1. Chart I pictures the movements in the total population and labor force, 1929–75. It will be noted that total employment rises somewhat more under the A assumption than under the B, rising from 74.9 million (including the Armed Forces) in 1965 to 90.9 million under the A assumption and to 90 million under the B assumption.

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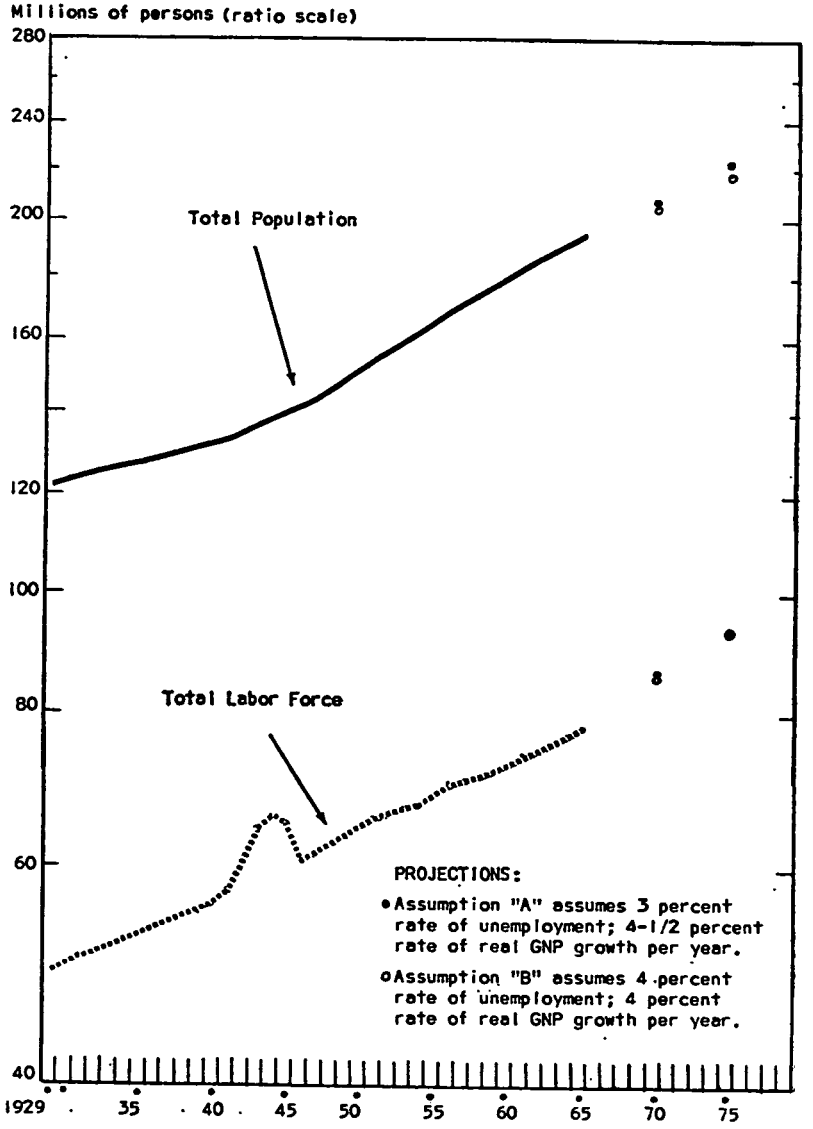
TABLE 1.—*Derivation of estimates of employment, 1965–75*

Year	Total labor force		Armed Forces	Civilian labor force		Rate of unemployment		Civilian employment	
	A	B		A	B	A	B	A	B
	Millions	*Millions*	*Millions*	*Millions*	*Millions*	*Percent*	*Percent*	*Millions*	*Millions*
1965	78.4	78.4	2.7	75.6	75.6	4.6	4.6	72.2	72.2
1966	80.0	80.0	3.1	76.9	76.9	3.8	3.8	74.0	74.0
1967	81.6	81.5	3.1	78.5	78.4	3.8	4.0	75.5	75.3
1968	83.2	83.0	2.7	80.5	80.3	3.5	4.0	77.7	77.1
1969	84.8	84.5	2.7	82.1	81.8	3.2	4.0	79.5	78.5
1970	86.4	86.0	2.7	83.7	83.3	3.0	4.0	81.2	80.0
1971	87.9	87.5	2.7	85.2	84.8	3.0	4.0	82.6	81.4
1972	89.4	89.1	2.7	86.7	86.4	3.0	4.0	84.1	82.9
1973	90.8	90.6	2.6	88.2	88.0	3.0	4.0	85.6	84.5
1974	92.2	92.1	2.6	89.6	89.5	3.0	4.0	86.9	85.9
1975	93.6	93.6	2.6	91.0	91.0	3.0	4.0	88.3	87.4

Source: U.S. Departments of Labor and Commerce; and staff, Joint Economic Committee.

CHART I.—GROWTH IN POPULATION AND LABOR FORCE, 1929–65, AND PROJECTIONS FOR 1970 AND 1975



U.S. Department of Commerce, Office of Business Economics

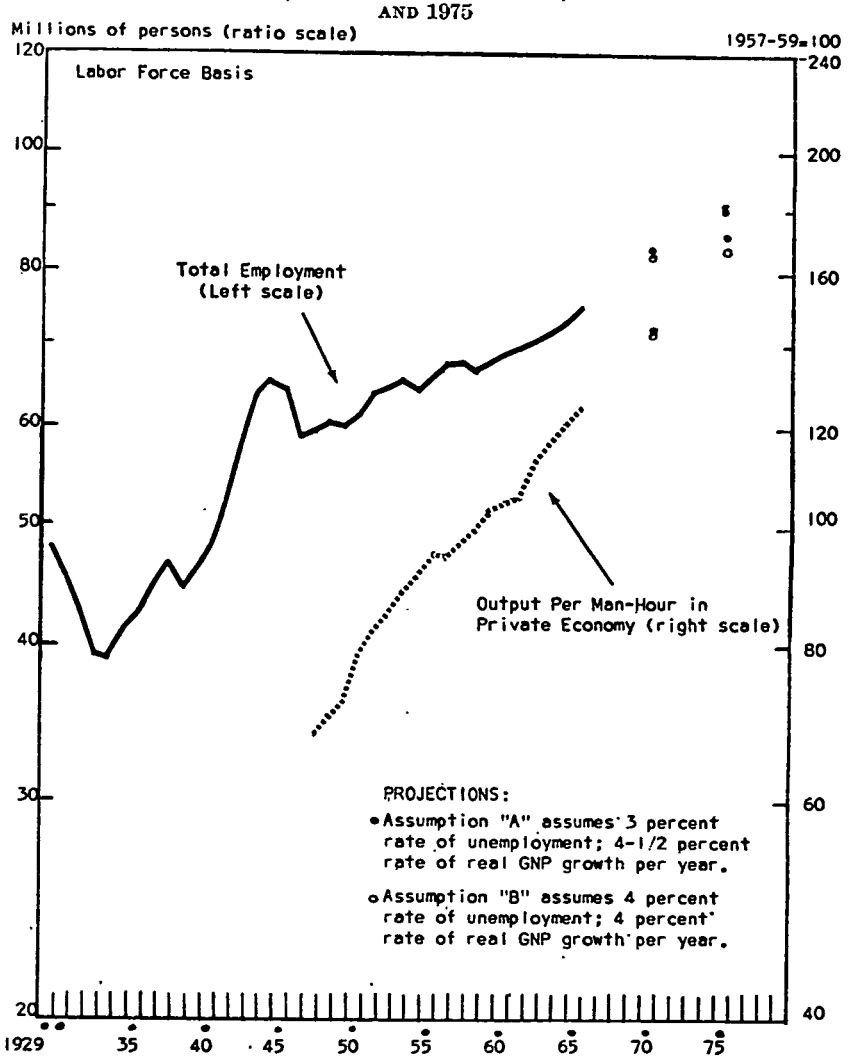
In the previous section, we have already indicated that we assume decline in average weekly hours by one-half hour between 1967 and 1970, and an additional one-half hour between 1970 and 1975. We also indicated assumptions about the increased output per man-hour. Chart II illustrates comparative movements in employment and output per man-hour. Putting these figures together in table 2 in index numfer form (1965=100), we obtain an increase in real GNP of 56.4 percent by 1975 under the A set of estimates, and at 50.7 percent under the B set. Translated into billions of 1958 dollars, this is a rise from $614 billion in 1965 to $960 billion in 1975 under the A assumption, and to $925 billion under the B set of estimates.

If we translated these constant dollar figures into current dollars using the assumption about the implicit price deflator given in the previous section, the GNP rises from $681 billion in 1965 to $1,310 billion in 1975 under the A set and to $1,205 billion under the B set. (See table 3.) It is interesting that the economy will move into the trillion dollar category around 1971 in the A model, and around 1972, a year later, in the B model.

It may be useful to look at the two models in historical perspective as illustrated in chart III. Both sets of estimates rise broadly in line with the trend of recent high employment years but somewhat above the long-term rate. The estimates indicate a potential for economic growth at a rate of 4 percent per year under the B model and 4½ percent per year under the A model over the decade, compared to about 3 percent over the last 60 years or more, and 3.5 percent over the 17 years from 1948 to 1965.[1] As will be seen in later analysis, these rates of expansion will not come automatically but will require some adjustment of public and private policies from time to time.

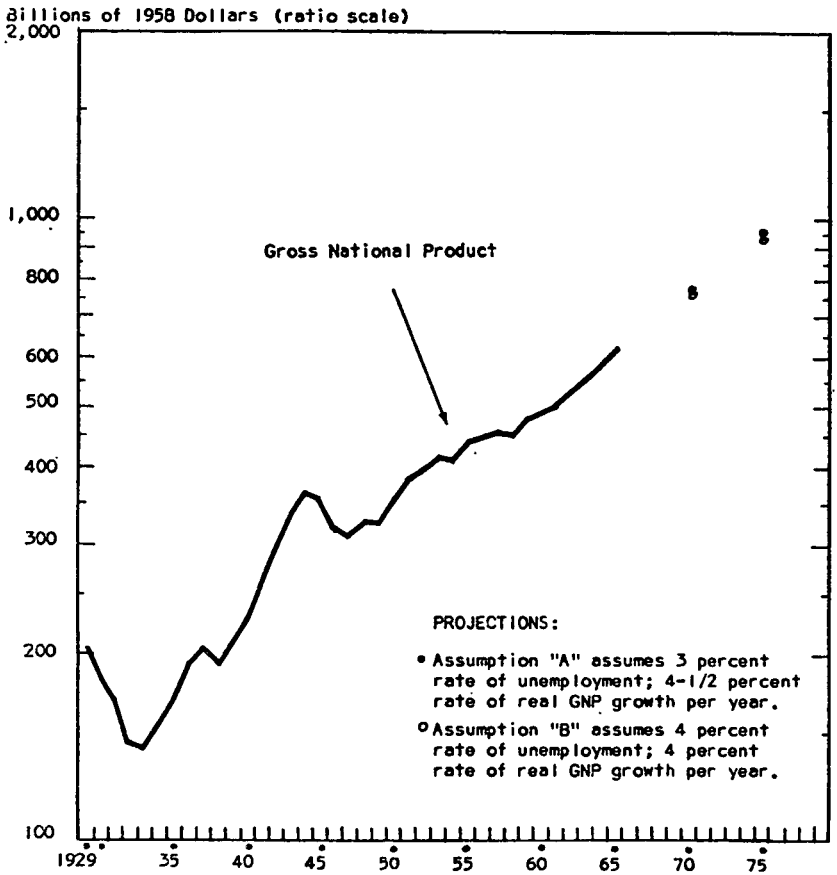
[1] Average annual rate of growth based on a logarithmic regression.

CHART II.—EMPLOYMENT AND PRODUCTIVITY, 1929–65, AND PROJECTIONS FOR 1970 AND 1975



U.S. Department of Commerce, Office of Business Economics

CHART III.—GROWTH IN REAL GROSS NATIONAL PRODUCT, 1929–65, AND PROJECTIONS FOR 1970 AND 1975



U.S. Department of Commerce, Office of Business Economics

TABLE 2.—*Estimates of potential supply of gross national product, 1966–75*

ASSUMPTION A

[Index 1965=100]

	Total employment	Hours worked per week	Total man-hours	Real GNP [1] per man-hour	Real GNP [1]	Real GNP [1] (billions of 1958 dollars)
1965 (actual)	100.0	100.0	100.0	100.0	100.0	614
1966 (estimate)	102.9	100.0	102.9	102.5	105.5	648
1967	104.9	100.0	104.9	105.1	110.3	677
1968	107.3	99.6	106.9	107.7	115.1	707
1969	109.7	99.2	108.8	110.7	120.4	739
1970	112.0	98.7	110.5	113.5	125.4	770
1971	113.9	98.4	112.1	117.2	131.4	807
1972	115.9	98.1	113.7	120.8	137.3	843
1973	117.8	97.8	115.2	124.6	143.5	881
1974	119.5	97.6	116.6	128.6	150.0	921
1975	121.4	97.4	118.2	132.3	156.4	960
ASSUMPTION B						
1965 (actual)	100.0	100.0	100.0	100.0	100.0	614
1966 (estimate)	102.9	100.0	102.9	102.5	105.5	648
1967	104.7	100.0	104.7	104.9	109.8	674
1968	106.5	99.6	106.1	107.6	114.2	701
1969	108.4	99.2	107.5	110.6	118.9	730
1970	110.4	98.7	109.0	113.6	123.8	760
1971	112.3	98.4	110.5	116.3	128.5	789
1972	114.3	98.1	112.1	119.3	133.7	821
1973	116.3	97.8	113.7	122.2	138.9	853
1974	118.2	97.6	115.4	125.3	144.6	888
1975	120.2	97.4	117.1	128.7	150.7	925

[1] Assumes a 4.5-percent annual rate of growth for real GNP 1966–75 for assumption A, and 4 percent for assumption B.

Source: Staff of the Joint Economic Committee; and Office of Business Economics, Department of Commerce.

TABLE 3.—*Gross national product projections, 1967–75*

	Assumption A			Assumption B		
	GNP (billions of 1958 dollars) [1]	Implicit GNP price (1958=100) [2]	GNP (billions of current dollars)	GNP (billions of 1958 dollars) [3]	Implicit GNP price (1958=100) [4]	GNP (billions of current dollars)
1965 (actual)	614	110.9	681	614	110.9	681
1966 (estimate)	648	114.0	739	648	114.0	739
1967	677	116.3	787	674	115.7	780
1968	707	118.6	839	701	117.4	823
1969	739	121.0	894	730	119.2	870
1970	770	123.4	950	760	121.0	920
1971	807	125.9	1,016	789	122.8	969
1972	843	128.4	1,082	821	124.6	1,022
1973	881	131.0	1,154	853	126.5	1,080
1974	921	133.6	1,230	888	128.4	1,140
1975	960	136.3	1,310	925	130.3	1,205

[1] Assumes a 4.5-percent annual rate of growth for real GNP, 1966–75.
[2] Assumes 2.0-percent annual increase for GNP implicit price, 1966–75.
[3] Assumes a 4.0-percent annual rate of growth for real GNP, 1966–75.
[4] Assumes a 1.5-percent annual increase for GNP implicit price, 1966–75.

Source: Staff of the Joint Economic Committee; and Office of Business Economics, Department of Commerce.

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ALTERNATE TAX AND FISCAL POLICIES

On account of the overall progressive tax structure, Federal revenues in the coming decade are likely to be rising faster than the GNP. A staff memorandum to the committee in 1961 analyzed in detail the

relationship between Federal receipts and expenditures on the one hand, and the business cycle and economic growth on the other.[2] That study indicated that Federal tax receipts fluctuated much more violently than national income or GNP, reflecting the fact that the marginal rate of tax on changes in incomes or profits is substantially larger than the average rate. After all, tax rate structures are progressive and some incomes are not taxable. It appears that, in general, as the economy grows along the full employment or potential trend, Federal revenues rise by about one-fourth of the year-to-year rise in potential GNP in current prices. On the other hand, the average share of Federal revenues in the cyclical departures of the actual GNP from the full employment or potential trend has been over one-third, or about 36 percent in the period 1954–61.

According to several recent studies, such revenues are also likely to be rising more rapidly than the "normal" or trend increase in Federal expenditures.[3] However, the recent acceleration of military costs occasioned by events in Vietnam has resulted in an acceleration in Federal spending which, at least temporarily, eliminates the potential Federal surpluses envisioned in these earlier studies. In the period after Vietnam, when improvements in the international environment permit the reduction of U.S. military outlays, the Nation faces large and growing high employment budget surpluses, actions would need to be considered to reduce the overall effective Federal tax rate as necessary (or to increase expenditures further).

The major problem involved here would be to identify initial policies which would be sufficiently prompt and effective to prevent serious unemployment and excess industrial capacity from developing. Such negative influences, if unchecked, could accelerate into a major recession.

In such "contingency" planning, the balance struck between tax reduction and increased Government spending would be influenced by the inferences as to the relative importance to be accorded to the private sector versus the public sector—to private demand for such goods and services as food, clothing, housing, and recreation, as against public demand for roads, space explorations, public health, and social services.[4]

At the present time, the type of fiscal policy decisions that face economic policymakers appear to be quite conventional, involving restraint on civilian expenditures and otherwise dampening any latent inflationary pressures resulting from the military buildup. Assuming successful resolution of the Vietnam situation in the near future, the type of longer run fiscal policy decisions that would be facing the Nation appear to be more pleasant ones. These may involve primarily choices among alternative methods of tax reform and reduction. Tax reductions, under those conditions of stable or declining defense spending, could both assist in achieving a maximum employment economy and also be possible because of a rapidly rising level of GNP.

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[2] 1961 Joint Economic Report, H. Rept. 328, 87th Cong., first sess., pp. 119–125.

[3] Cf. Joseph A. Pechman, "Financing State and Local Government," in American Bankers Association, Proceedings of a Symposium on Federal Taxation, 1965, pp. 71–84; Selma J. Mushkin and Robert F. Adams, "Emerging Patterns of Federalism," National Tax Journal, September 1966, pp. 225–247.

[4] Cf., U.S. Congress, Joint Economic Committee, "Twentieth Anniversary of the Employment Act of 1946: An Economic Symposium, Invited Comments on Directions for the Future," 1966, pp. 188–189.

At the margin, of course, the choice may be somewhat more difficult, involving balancing the desirability of providing additional Government services against the benefits of a larger private sector of the economy. Table 15 indicates some of the possible alternative methods of tax reduction. Possible expenditure increases are dealt with subsequently.

Table 15 also lists a few of the many factors that would need to be taken into account in selecting among possible tax changes. In good measure, the evaluation may be a question as to which are the dominant purposes of the tax action. Clearly, an increase in personal exemptions—which benefit the lower brackets more than proportionately—would tend to act as an income equalizer by reducing after-tax income inequality; a reduction in estate and gift taxes—which are borne primarily by the highest income groups—would have the reverse effect.

In contrast, a choice between excise reductions and cuts in the corporate income tax would involve judgments as to the extent that either of these taxes are shifted and of the ultimate incidence, technical questions which are still being debated in the public finance literature. An example of a more widely controversial question would be the relative emphasis on low-bracket individual income tax reductions versus high bracket and corporate tax reductions in an effort to increase the level of national output. Some contend that increasing the investment funds available to the high-saving individuals and corporations would be more effective in fostering economic growth; others, of course, contend that bolstering the purchasing power of consumers, particularly those in the low-income groups who spend virtually all of their available income, would provide the needed demand to generate rising employment and economic growth. This may also represent the type of issue that is never completely settled, but is continually present in determining the proper degree of emphasis between one or another at any given point in time.

TABLE 15.—*Choices among alternative tax policies*

POSSIBLE TAX CHANGES	SOME FACTORS TO BE CONSIDERED
Across-the-board changes in rates	Effects on equity among taxpayers
Corporate taxes:	Effects on income distribution
Depreciation practices	Effects on GNP growth rate
Investment credits	Effects on allocation between consumption and investment
Basic rates	Effect on built-in stabilizers
Individual taxes:	Effect on relative emphasis between saving and investment
Emphasizing upper brackets	
Emphasizing lower brackets	
Exemptions	
Deductions	
Capital gains treatment	
Pension trusts	
Excises:	
General	
Selective	
Estate and gift taxes	
User charges	

The Changing Composition of Federal Expenditures

This report, as do most others dealing with future trends in the American economy, shows very substantial increases in civilian Government expenditures, if past trends continue into the future. On the other hand, projections of defense spending are notoriously unreliable. Should the current rise in military outlays continue longer than anticipated, or accelerate, decisions would be necessary as to whether these additional requirements should be at the expense of foregoing some tax reduction or some projected civilian government expenditure increases.

Under the assumptions underlying this report, very substantial increases are projected in civilian government spending programs. Numerous program choices are involved in these projected levels of government spending. The recent introduction of a planning-programing-budgeting system in the Federal Government is highlighting the types of choices that can be made, but hardly simplifies the process of allocating public resources among numerous competing ends.

Table 16 is an attempt to illustrate, in perhaps the simplest form, how proposed new or expanded Federal expenditure programs can be related to the broad and basic functions of purposes of government.[5]

Table 16.—*Some possible Federal expenditure increases*

Possible increases	Defense	Welfare	Economic development
Second Panama Canal	Primary		Secondary.
Supersonic transport	Secondary		Primary.
Social security liberalization		Primary	
Planetary exploration	Primary		
Operational desalinization			Do.
Universal veterans' pensions		Primary	
Large-scale rural development program		Secondary	Do.
Many others			

The most general level of choice might be of the nature of selecting among (1) developing a supersonic commercial transport aircraft, (2) proceeding with an operational brackish and salt water desalinization effort, or (3) embarking upon a large-scale rural development program, all aimed at promoting the economic development of the United States. So viewed, these—and other similar programs—are alternatives for each other in attaining a major national objective. Likewise, liberalizing the benefit paid under the social security program and establishing universal pensions for all veterans over 65 are alternate means of providing supplementary incomes to the Nation's elderly population. The present emphasis in the executive branch's planning-programing-budgeting system appears to be on the specific program or department level. However, the eventual application of the choice-among-alternatives approach may alter considerably the overall program emphasis in the Federal budget, by indicating the relative advantages (in such terms of high ratios of benefits to costs) of one category of Government program over another.

* * * * * * *

[5] For an attempt at implementing this approach, see M. L. Weidenbaum, "Which Resources for What Goals: Another Look at the Budget," Challenge, July 1964.

AN ILLUSTRATION OF THE PROCESS OF ADJUSTING POLICIES TO PRODUCE BALANCED ECONOMIC GROWTH

So far we have projected the past into the future, noted the imbalances that seemed to occur as a result, and reviewed the policy choices that may face public and private policymakers in the years ahead.

However decisions are made to produce a better equilibrium than would occur from merely letting the economy continue into the future as in the past, one thing is made clear, we hope, by this point. The adjustment process will involve many complicated reactions of the economy to any changes in policy that are made. Furthermore, a wide variety of choices are available as to the shifts in policy that can be made. Merely to illustrate the complexities involved and to show how maximum employment, rapid growth, and stable prices could be achieved, the staff, in cooperation with the Office of Business Economics, sets forth in the accompanying tables and charts a full employment growth model achieved by adjusting essentially public policies. This stage 2 or illustrative model is purely arbitrary. The large Federal surplus generated in the stage 1 projection of the past into the future was apportioned so that in 1970 there would still remain a Federal surplus equal to about one-half of 1 percent of the GNP in that year, and rising to about 1 percent of the GNP in 1975.

The remaining surplus was then distributed so that one-third would go for personal tax cuts and the remaining two-thirds would be increases in Federal expenditures, mostly in the form of transfers and grants-in-aid to State and local governments.

This remaining two-thirds was then allocated by functions on the basis of order of priorities. For example, 30 percent was allocated for aid to elementary and secondary education in addition to the amount implied in the grants-in-aid used in model I; 25 percent went for additional aid for urban renewal and community facilities. Table 24 shows the allocations used by major functions. The amounts by functions were then distributed by type of Federal expenditures—purchases of goods and services, transfer payments, and grants-in-aid to State and local governments—roughly on the basis of trends shown for the period 1962–65. (See Survey of Current Business, July 1966.)

The resulting aggregate of grants-in-aid to State and local governments was then assumed to be reflected in additional purchases of goods and services by State and local governments.

The additional transfer payments yielded an adjusted personal income from that of model I; and together with the cut in personal taxes, a new estimate of disposable personal income was derived. Federal purchases were increased by the amount derived from the procedure explained above.

With these modified projections, a new set of estimates for the components of GNP and income were derived using the relationships applied in model I, but maintaining the levels of GNP and national income. Many of the components of GNP and national income were, of course, modified as a result of the injection of the additional Federal expenditures and the personal tax cuts.

In particular, projections of real nonresidential fixed investment derived in model I, which were exceptionally high in relation to real

GNP, were reduced so that their ratio to real GNP would conform with the long-term downward tendency of this ratio since 1929.

The reworking of the new estimates through the accounts yielded projections of personal consumption expenditures which were of an order of magnitude consistent with extrapolations of past relationships; personal saving rates turned out to be close to those assumed in model I and corporate profits were consistent with the new rates of investment. This illustrative projection is presented in tables 19 through 28 in the same detail as the original stage 1 projections which carried the past into the future unaltered. To make the outcomes a little easier to see, we have prepared charts IV through VIII which illustrate the developments from 1929 through 1965, together with projections for 1970 and 1975.

* * * * * * *

TABLE 21.—*Government receipts and expenditures, adjusted to illustrate an equilibrium full-employment position*

[In billions of dollars]

	Actual, 1965	Projection A		Projection B	
		1970	1975	1970	1975
FEDERAL GOVERNMENT					
Receipts	124.9	181.7	260.7	175.1	237.4
Personal tax and nontax receipts	54.2	80.2	121.2	77.3	111.0
Corporate profits tax accruals	29.1	41.1	55.8	38.7	47.3
Indirect business tax and nontax accruals	16.8	17.7	24.1	17.2	22.2
Contributions for social insurance	24.8	42.7	59.6	41.9	56.9
Expenditures	123.4	177.9	250.3	170.9	224.4
Purchases of goods and services	66.8	80.9	99.3	78.5	93.1
Transfer payments	32.4	55.8	81.4	54.6	75.4
To persons	30.3	53.4	78.8	52.2	72.8
To foreigners (net)	2.2	2.4	2.6	2.4	2.6
Grants-in-aid to State and local governments	11.2	25.1	51.4	21.7	37.7
Net interest paid	8.7	11.1	12.6	11.1	12.6
Subsidies less current surplus of Government enterprises	4.2	5.0	5.6	5.0	5.6
Surplus or deficit (—), national income and product accounts	1.6	3.8	10.4	4.2	13.0
STATE AND LOCAL GOVERNMENT					
Receipts	75.3	122.0	193.8	115.2	168.6
Personal tax and nontax receipts	11.8	21.1	36.9	20.0	32.3
Corporate profits tax accruals	2.0	3.0	4.1	2.8	3.5
Indirect business tax and nontax accruals	45.8	66.0	91.7	64.2	86.0
Contributions for social insurance	4.5	6.8	9.7	6.5	9.1
Federal grants-in-aid	11.2	25.1	51.4	21.7	37.7
Expenditures	73.7	122.0	188.6	116.4	168.2
Purchases of goods and services	69.4	116.9	182.7	111.3	162.4
Transfer payments to persons	6.9	8.7	10.5	8.7	10.5
Net interest paid	.6	.6	.6	.6	.6
Less: Current surplus of government enterprises	3.2	4.2	5.2	4.2	5.2
Surplus or deficit (—), national income and product accounts	1.6	0	5.2	—1.2	.3

Source: Department of Commerce, Office of Business Economics, and staff, Joint Economic Committee.

TABLE 22.—*Contributions for social insurance and government transfers to persons*

CONTRIBUTIONS FOR SOCIAL INSURANCE

[In billions of dollars]

	Actual, 1965	Projection A		Projection B	
		1970	1975	1970	1975
Old-age and survivors insurance	17.4	33.2	47.3	32.6	45.0
Employer contributions	8.2	15.7	22.5	15.5	21.5
Private	7.2	14.3	20.6	14.1	19.6
Government	1.1	1.4	1.9	1.4	1.9
Employee contributions	8.2	15.7	22.5	15.5	21.5
Self-employed persons contributions	1.0	1.8	2.3	1.6	2.0
Unemployment insurance	3.8	5.1	6.8	5.0	6.5
Other	8.0	11.2	15.2	10.8	14.5
Total	29.2	49.5	69.3	48.4	66.0
GOVERNMENT TRANSFER PAYMENTS TO PERSONS, ADJUSTED TO ILLUSTRATE AN EQUILIBRIUM FULL EMPLOYMENT POSITION					
Old-age and survivors insurance	18.1	31.4	42.7	31.4	42.7
Unemployment insurance	2.3	2.7	3.3	3.7	4.4
Other	16.8	28.0	43.3	25.8	36.2
Total	37.1	62.1	89.3	60.9	83.3

Source: Department of Commerce, Office of Business Economics, and staff, Joint Economic Committee.

TABLE 23.—*Projected Federal budget surplus (national income accounts basis) for 1970 and 1975 and an illustration of a possible allocation*

[In billions of dollars]

	Projection A		Projection B [1]	
	1970	1975	1970	1975
Projected surplus under existing tax legislation and Federal programs and other economic assumptions	17.6	54.2	15.3	43.8
Illustrative allocation of surplus:				
1. Amount remaining as surplus in Federal budget	4.8	13.1	4.6	12.0
2. Reductions in personal income taxes [2]	4.3	13.7	3.6	10.6
3. Increases in Federal purchases, transfers, and grants-in-aid to State and local governments [3]	8.5	27.4	7.1	21.2

[1] Assuming ½ of 1 percent of GNP in 1970; 1 percent of GNP in 1975.
[2] Assuming ⅓ of projected Federal surplus allocated in reduced personal taxes.
[3] See table 24 for Federal surplus allocated by functions and expenditure type.

Source: Staff, Joint Economic Committee.

TABLE 24.—*Federal surplus allocated by function and expenditure type* [1]—*An illustration*

	Percent allocated (illustrative) (2)	Assumption A (in billions of dollars)								Assumption B (in billions of dollars)							
		1970				1975				1970				1975			
		Total	Purchases of goods and services	Transfer payments and net interest paid	Grants-in-aid	Total	Purchases of goods and services	Transfer payments and net interest paid	Grants-in-aid	Total	Purchases of goods and services	Transfer payments and net interest paid	Grants-in-aid	Total	Purchases of goods and services	Transfer payments and net interest paid	Grants-in-aid
Amount of Federal surplus to be allocated		8.50				27.40				7.10				21.20			
Elementary, secondary, and higher education	30	2.55	0.13	0.13	2.29	8.22	0.41	0.41	7.40	2.13	0.11	0.11	1.91	6.36	0.32	0.32	5.72
Urban renewal and community facilities	25	2.13	.21	.11	1.81	6.85	.69	.34	5.82	1.78	.18	.09	1.51	5.30	.53	.26	4.51
Health and hospitals	15	1.27	.45	.25	.57	4.11	1.44	.82	1.85	1.06	.37	.21	.48	3.18	1.11	.64	1.43
Labor (training, etc.)	15	1.27	.25	.70	.32	4.11	.82	2.26	1.03	1.06	.21	.58	.27	3.18	.63	1.75	.80
Natural resources, including recreation	10	.85	.76		.09	2.74	2.47		.27	.71	.64		.07	2.12	1.91		.21
Veterans—education, hospitals, etc.	5	.43	.11	.32		1.37	.34	1.03		.36	.09	.27		1.06	.27	.79	
Total	100	8.50	1.91	1.51	5.08	27.40	6.17	4.86	16.37	7.10	1.60	1.26	4.24	21.20	4.77	3.76	12.67
Addendum:																	
Government compensation		3.77				12.24				3.15				9.47			
Federal		.82				2.65				.69				2.05			
State and local		2.95				9.59				2.46				7.42			

[1] Allocation of parts made on basis of 1961–65 trend of ratios by type of expenditure and function.
[2] Arbitrary.

Source: Staff, Joint Economic Committee.

TABLE 25.—*Percent distribution of real GNP* [1]

	Actual, 1965	Assumption A		Assumption B	
		1970	1975	1970	1975
GNP	100.0	100.0	100.0	100.0	100.0
Personal consumption expenditures	64.5	65.6	65.7	65.6	65.5
Durable goods	10.8	12.0	13.0	11.6	12.4
Nondurable goods	29.0	27.7	26.4	27.8	26.3
Services	24.7	25.8	26.4	26.2	26.9
Gross private domestic investment	15.9	15.3	15.7	15.2	15.5
Nonresidential fixed investment	10.6	9.8	9.5	9.8	9.5
Residential structures	3.9	4.5	5.0	4.5	5.0
Change in business inventories	1.4	1.0	1.2	.9	1.0
Net exports of goods and services	1.0	1.0	.9	1.1	1.1
Government purchases of goods and services	18.6	18.1	17.7	18.2	17.9
Federal	9.4	7.8	6.7	7.9	7.0
State and local	9.2	10.3	11.0	10.3	10.9

[1] Based on table 19.

Source: Department of Commerce, Office of Business Economics, and staff, Joint Economic Committee.

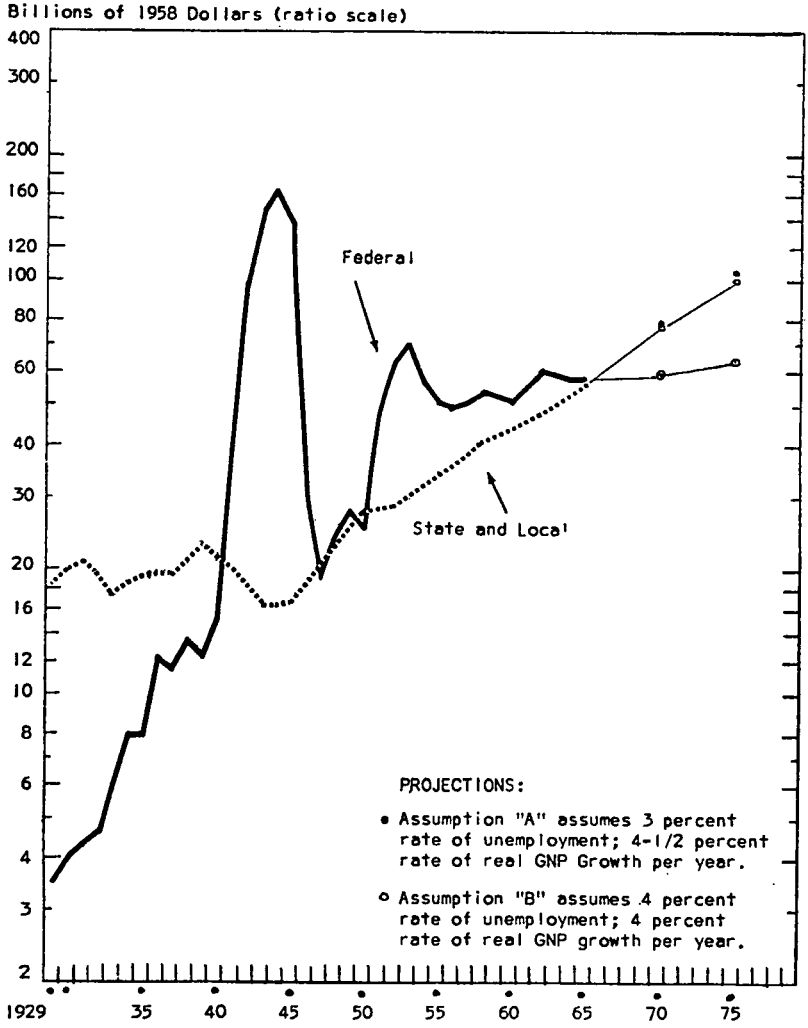
TABLE 26.—*Percent distribution of GNP* [1]

	Actual, 1965	Assumption A		Assumption B	
		1970	1975	1970	1975
GNP	100.0	100.0	100.0	100.0	100.0
Personal consumption expenditures	63.3	63.3	62.3	63.4	62.6
Durable goods	9.7	9.8	9.6	9.5	9.4
Nondurable goods	28.0	26.1	24.1	26.2	24.3
Services	25.7	27.5	28.6	27.7	28.8
Gross private domestic investment	15.6	15.0	15.4	14.9	15.2
Nonresidential fixed investment	10.2	9.2	8.6	9.2	8.8
Residential structures	4.1	4.8	5.5	4.8	5.5
Change in business inventories	1.3	1.0	1.2	.9	1.0
Net exports of goods and services	1.0	1.0	.8	1.0	1.0
Government purchases of goods and services	20.0	20.8	21.5	20.6	21.2
Federal	9.8	8.5	7.6	8.5	7.7
State and local	10.2	12.3	13.9	12.1	13.5

[1] Based on table 19.

Source: Department of Commerce, Office of Business Economics, and staff, Joint Economic Committee.

GOVERNMENT PURCHASES OF GOODS AND SERVICES, 1929–65, AND PROJECTIONS FOR 1970 AND 1975



U.S. Department of Commerce, Office of Business Economics

FEDERAL BUDGET PROJECTIONS: SUMMARY AND CONCLUSIONS*

BY GERHARD COLM and PETER WAGNER

Economic projections have become one of the major instruments for guidance in public and private decision-making. Business management uses short-term, medium-term, and long-term projections for evaluating future market prospects; it makes projections of the economy as a whole and of its own and its customers' particular branches of business. Labor unions use projections, especially those dealing with the employment outlook and prospective productivity gains, in planning collective bargaining strategy. Government uses economic projections as benchmarks for leaving out specific programs (for example, water supply or transportation programs) and for guidance in formulating overall economic, fiscal, and monetary policy.

THE NEED FOR A STUDY OF BUDGET PROJECTIONS

Today, Government expenditures and revenues are very important factors in all economic projections. Attempts to forecast them involve many difficulties because they are determined not only by long-term economic factors, but also by political factors and economic fluctuations. This is true particularly of the expenditures and receipts of the Federal Government. Therefore, a detailed exploratory study of projections of the Federal budget seems to be useful and timely.

Budget projections are desirable for other purposes in addition to their usefulness in making general economic projections. Economists and policymakers have felt for some time that the next year's Federal budget could be appraised much more meaningfully if it could be seen in a perspective of several years. This need was emphasized in a statement by the National Planning Association a decade ago [1] and also in a statement of the Committee for Economic Development published in 1962.[2] Recently a subcommittee of the Joint Economic Committee of the U.S. Congress recommended that the budget for each year should be presented in the context of a broader, longer-run set of budgetary projections, for which a 5-year period was thought desirable.[3]

Actually there is no short-term economic forecast that does not incorporate a budget prediction as one of the most important vari-

*Reprinted from: Colm, Gerhard and Peter Wagner, *Federal Budget Projections*, The Brookings Institution, Washington, D.C., 1966, I, IV, V, VI, IX.

[1] *The Need for Further Budget Reform, a Joint NPA Statement* (National Planning Association, 1955).

[2] *Fiscal and Monetary Policy for High Employment* (Committee for Economic Development, 1962).

[3] *The Federal Budget as an Economic Document*, Report of the Subcommittee on Economic Statistics of the Joint Economic Committee, S. Rept. 396, 88th Cong., first sess. (1963).

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ables. And the intermediate- and long-term economic projections prepared regularly by the National Planning Association[4] and other organizations include projections of expenditures at all levels of government. In 1959 special studies of trends in public expenditures were prepared by Otto Eckstein under the auspices of the CED[5] and by staff members of the NPA.[6] The Budget Bureau itself published 5- and 10-year projections in the last days of the Eisenhower administration.[7] The Budget Bureau regularly puts together 5-year budget projections as guides for Executive budget policy, but these projections are for internal use only and are not made public.[8]

The present study has a dual purpose. First, it presents a set of up-to-date[9] intermediate- and long-term projections of the Federal budget. They were prepared in two steps, presented as model I and model II. These estimates were made before defense expenditures were increased for the Vietnam conflict.

Second, this study attempts to identify the difficulties that are encountered in making such projections and offers recommendations on the feasibility of including medium- and long-term budget projections as a regular feature of the official budget presentation.

Nature of Projections and Assumptions

It should be emphasized that the projections made here are illustrative in character and are in no sense to be regarded as definitive predictions. They indicate the *trend* of expenditures, with the future year indicated (1968 or 1973) serving merely as a benchmark. Fluctuations around the trend line cannot be reflected in the predictions, and periodic revisions are called for to take account of new developments, unforeseen at the time the projections are made.

While projections may be made on either a normative basis—what needs to be done to accomplish certain goals?—or a probability basis—what is most likely to happen?—this study seeks only to estimate *probable* developments, including those resulting from the efforts of Government to promote a desirable rate of economic growth.

A difficulty arose in deciding whether to present estimates in constant or in current dollars. Early in the study we came to the conclusion that projections in terms of constant prices were of limited value for medium- and long-term forecasting of budget trends. This is so particularly in the case of revenue projections. While a number of calculations have been made in constant prices for purposes of comparison, most of the detailed figures are shown in current prices, since these give a more realistic picture.

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[4] National Planning Association, Center for Economic Projections, *National Economic Projection Series* (issued annually).

[5] Otto Eckstein, *Trends in Public Expenditures in the Next Decade* (Committee for Economic Development, 1959).

[6] Gerhard Colm and Manuel Helzner, "Financial Needs and Resources of the Next Decade: At All Levels of Government," in *Public Finances, Needs, Sources, and Utilization* (Princeton University Press, 1961).

[7] U.S. Bureau of the Budget, *Ten-Year Projections of Federal Budget Expenditures* (Jan. 18, 1961).

[8] Budget Bureau Circular No. A 11 (July 1964), requests from the various agencies program statements and estimates of new obligational authority and of expenditures under existing and proposed legislation for 3 years beyond the next budget year. Thus 5 years are covered, including the current and the ensuing fiscal years. The 5-year projections of the Department of Defense are not comparable with the expenditure estimates for the other agencies.

[9] As of February 1965.

The assumed growth of the American economy, on which our projections are based, is shown in table 1. (The estimated increase of projected GNP that is believed compatible with the model I budget projection would fall short of the full employment level of GNP.)

The estimates in table 1 are based on the Department of Commerce accounts before the August 1965 revisions of the income and product accounts by economists in the Department. All figures and projections in our study are calculated on the basis of the old estimates. The main conclusions of the study would not be affected by the revisions. If anything, the new figures give further emphasis to our findings. A more detailed explanation of the differences between the two sets of estimates and their implications for the study is given in the introduction to the appendix tables.

TABLE 1.—*Models I and II: Gross national product in current and constant prices 1963–73*

[In billions of current dollars and constant fiscal year 1963 dollars]

Fiscal years	Model I		Model II	
	Current prices	Constant prices	Current prices	Constant prices
Actual:				
1963	568.0	568.0	568.0	568.0
1964	604.0	593.9	604.0	593.9
Projected:				
1965	640.0	620.8	640.0	620.8
1966	681.5	651.5	681.5	651.5
1967	709.5	669.3	725.3	683.0
1968	739.5	688.5	771.0	715.2
1969	773.0	711.1	813.3	743.4
1970	807.5	733.4	858.0	773.0
1971	844.0	756.3	905.2	803.2
1972	882.0	780.5	955.0	834.8
1973	921.5	804.8	1,007.5	867.8

Projections are forecasts made under specific, often alternative, assumptions. It is important to state the assumptions explicitly so that a user can modify the projections if he wishes to make different assumptions.

OVER-ALL ASSUMPTIONS

Certain general assumptions have been made and basic choices taken that are common to all the sets of projections in this study:

1. In the short-term projections (for the fiscal year 1966), the President's proposed budget is used without change.
2. It is assumed that a policy of program expansion will be associated with continuing budget restraint and that, wherever possible, encouragement of private enterprise and support of State-local programs will be preferred to programs operated entirely by the Federal Government.
3. It is assumed that the Employment Act of 1946 will continue to be a guiding influence for the Government and that Federal expenditure, tax, credit, and monetary policies will be shaped to support reasonably full employment, adequate economic growth, and reasonable price stability.[10]
4. It is assumed that productivity in Government services increases at the same rate as in private activities.

[10] For exact definitions of these terms, see model II, below.

ALTERNATIVE MODELS

Presenting very broad ranges of estimates with many alternatives always protects the producer of the estimates but is annoying to the user. Alternatives are often misleading if the reader infers that the most probable value is the mean of the several alternatives, and the projections in this study should not be so interpreted.

Model I. The model I estimates are made under the assumption that no new programs will be adopted, except those already proposed in the 1966 budget,[11] and that there will be no further reductions in tax rates, except for those proposed in the budget for excise taxes. The projections assume that the substantial increase in social security taxes (nearly $5 billion annually) will become effective on January 1, 1966, as proposed.

Revenues are calculated in model I on the assumption of a rate of economic growth of 4.4 percent a year, or 3.1 percent in constant dollars. Consistent with this modest rate of growth, a higher and increasing rate of unemployment (5.7 percent for fiscal 1968 and 7 percent for fiscal 1973) has been assumed for this model. Similarly, because of the reduced pressure on resources of all kinds (including labor resources) implied in model I, we have assumed a price increase of only 1.3 percent annually.

It is also assumed that defense expenditures will remain at a virtually even level, some actual reduction in defense programs being offset by the continuing price rise.

Model II. This model includes program changes (additions or cutbacks) and changes in revenue legislation upon which, in the opinion of the authors, decisions are likely to be made during the period under consideration (to 1973). Certainly medium- and long-term projections based only on percent legislation and policy proposals would be unrealistic. In the course of the years changes will be proposed and adopted. However, it is unlikely that there will be many changes, at least in the next 5 years, that are not now being considered informally by the agencies concerned or recommended by various groups. Although predicting *when* these changes are likely to occur is very hazardous, this task has been undertaken in model II.

The policy changes assumed in model II should not be understood to be either recommendations or definite forecasts. The estimates have been made to illustrate the problem and to serve as a basis for procedural recommendations. But, tentative as they are, the model II estimates must be regarded as more realistic than those of model I, especially for the long-range projections. In a sense, model I estimates should be regarded as only a phase in the process of making projections rather than as alternative final projections.

Specific assumptions made for model II are as follows:

1. All model II estimates assume that the Federal Government will adopt policies that will reduce unemployment to 4 percent of the civilian labor force during fiscal 1967 and that it will remain at that level for the period covered by the study. It is assumed that

[11] Major proposals of the President that are included in the projections but were not yet legislated at the time the manscript was completed are specified in ch. VI. The figures include all Presidential proposals contained in the fiscal year 1966 budget; later recommendations or congressional amendments could not be taken into account.

a rate of growth of 4 percent annually in real terms will accomplish this objective once unemployment has been reduced to a 4-percent rate.

2. For the intermediate and longer range domestic programs, it is assumed that the war on poverty will be continued and that the Federal Government will continue to respond to the challenge of great technological possibilities. This implies further emphasis on educational, training, and technological development programs in areas in which private enterprise cannot be expected to perform adequately without Government support.

3. All model II estimates assume that prices will increase at an average annual rate of 1.5 percent and this will apply to the prices of goods and services bought by the Federal Government.[12]

Because of the uncertainty about the timing of program expansion, model II is presented in two variations. Model II–A assumes a smaller increase in expenditures and larger tax cuts; model II–B assumes a larger increase in expenditures and small tax cuts. Model II–A in turn is presented in two combinations, one (II–A1) assuming a virtually constant level of defense expenditures, and the other (II–A2) assuming a substantial reduction in defense expenditures. This introduces a further complication into the projections, as any future reduction in defense programs will probably be associated with a larger increase in nondefense spending, and vice versa.

Summary of Projections

Projections based on President Johnson's proposed budget for 1966 indicate that Federal expenditures for nondefense purposes will increase substantially over the level estimated for the fiscal year 1966. Although the President has proposed a number of new programs which would add only relatively small amounts to expenditures in fiscal 1966, they could, if fully implemented, become substantial in later years. Also, the 1966 expenditure estimates were reduced by provision for about $3 billion of receipts from the sale of financial assets.[13] Our estimates make only a minor allowance for further liquidation of such assets. This makes the increases in program costs appear somewhat larger than they really are.

This summary will present our projections of total Federal receipts and expenditures in terms of the consolidated cash budget. Detailed estimates in terms of the cash budget, as well as of the administrative budget and the Federal sector of the national income accounts budget, can be found in chapter VI and in the appendix tables.

MODEL I

The assumed rate of growth for model I (3.1 percent annually) is lower than the 4-percent rate considered to be adequate and assumed for the rest of the models. But even at the 3.1-percent rate,

[12] The increase in prices reflects the average price rise as it is applicable to the GNP as a whole. It is a weighted average of the GNP components. Assuming a continuing increase in the quality of products and services, a 1.5-percent annual price rise may not be inconsistent with the assumption of actual price stability.

[13] These include loans held by the Veterans' Administration, the Export-Import Bank, the Federal National Mortgage Association, the Small Business Administration, and others.

revenues would increase faster than expenditures with some consequent slowdown in the rate of expansion (assuming a relatively restrictive credit policy designed to combat the balance-of-payments deficit). Table 2 shows Federal expenditures and receipts under model I.

TABLE 2.—*Model I: Cash budget, 1963, 1966, 1968, and 1973* [1]

[In billions of current dollars for fiscal years]

Item	Actual, 1963	Proposed, 1966	Projected	
			1968	1973
Gross national product	568.0	681.5	739.5	921.5
Expenditures:				
Defense	53.4	52.5	52.8	53.3
Other	60.4	74.9	89.0	114.4
Total	113.8	127.4	141.8	167.7
Receipts	109.7	123.5	[2] (137.9)	[2] (175.2)
Excess of receipts (+)	−4.0	−3.9	(−3.9)	[3] (+7.5)

[1] In this and the following tables, all figures for fiscal year 1963 are actual; those listed as "proposed 1966' are the official estimates of the 1966 budget; and those listed as "projections" for 1968 and 1973 are based on our own assumptions for the particular model as given in the text and in table 1.

[2] The revenue estimates do not take account of possible further tax reductions. Figures in parentheses are estimates that appear unrealistic without assuming tax reductions beyond those proposed in the 1966 budget. See text for a discussion of assumptions on which the various models are based.

[3] See the text for comments about the effects of this surplus on the rate of growth.

NOTE.—Details may not add to totals due to rounding.

The largest expenditure increases under the President's program would occur in social security benefit payments, in education, in health programs, and in the economic opportunity program. In the labor field increased expenditures would be brought about largely by substantially higher unemployment insurance payments under the double impact of improved benefits and a higher unemployment rate due to the slower growth of the economy.

The 1968 budget would still show a small deficit at an unemployment rate of 5.7 percent (as compared with the full employment rate of 4 percent). If this projection were computed under the assumption of full employment (with higher tax yields from full employment income and reduced expenditures because unemployment insurance payments would be lower), it would show some surplus in 1968 and a very large surplus in 1973.

Model I, therefore, is not presented as a real alternative because the very size of the surplus would hinder economic growth, thereby leading to rising unemployment and forcing the government to adopt either an increase in programs or a reduction in tax rates or a combination of both in order to achieve a higher rate of economic growth and to reduce unemployment. The existence of this surplus (combined with a fairly restrictive monetary policy) would probably be incompatible with sustaining even the inadequate rate of growth assumed for this model.

MODEL II

The new and expanded nondefense programs assumed in model II are specified in part II. The principal new programs assumed to come up for debate and adoption during the coming decade are in the domestic field and concern housing, health, research, education and

training, and the economic opportunity programs, as well as improvements in the social insurance programs. All of them are programs that have been recommended by some groups but are not included in present official proposals. Model II–A makes relatively small allowances for these new and expanded programs, and model II–B allows for increases of considerable size. Projected expenditures and receipts under the two versions of model II–A and under model II–B are shown in table 3.

TABLE 3.—*Model II under various assumptions—II–A1, II–A2, and II–B—Cash budget, 1963, 1966, 1968, and 1973* [1]

[In billions of current dollars for fiscal years]

Item	Actual 1963	Proposed 1966	Model II–A1 projections		Model II–A2 projections		Model II–B projections	
			1968	1973	1968	1973	1968	1973
Gross national product	568.0	681.5	771.0	1,007.5	771.0	1,007.5	771.0	1,007.
Expenditures:								
Defense	53.4	52.5	52.8	53.3	49.7	43.5	49.7	43.5
Other	60.4	74.9	93.7	[2] 129.0	93.6	[2] 129.0	103.3	155.0
Total	113.8	127.4	146.5	182.3	143.3	172.5	153.0	198.5
Receipts	109.7	123.5	[3] (146.4)	[3] (198.4)	[3] (146.4)	[3] (198.4)	146.4	199.7
Excess of receipts (+)	−4.0	−3.9	(−0.1)	[4] (+16.1)	(+3.1)	[4] (+25.9)	(−6.6)	+1.2

[1] Model II–A1 assumes present defense programs; II–A2 and II–B, substantially reduced defense programs.
[2] For an explanation of interest calculations on the Federal debt, see ch. X.
[3] The revenue estimates do not take account of possible further tax reductions. Figures in parentheses are estimates that appear unrealistic without assuming tax reductions beyond those proposed in the 1966 budget. See text for a discussion of assumptions on which the various models are based.
[4] See the text for comments about the effects of this surplus on the rate of growth.

NOTE.—Details may not add to totals due to rounding.

In both models II–A and II–B the adoption of new programs and some expansion of most existing programs beyond present or proposed legislation have been assumed; expenditures for space and agriculture, however, would be reduced. Under the stimulus of additional programs the economy would grow at a higher rate, and revenue would increase correspondingly faster. Some further cut in taxes by 1968 and a substantial reduction by 1973 would be feasible and necessary to support the rate of growth posited for Model II–A1. In the case of Model II–A2 (the arms-reduction model) an earlier and more substantial tax cut would be necessary. By 1973 a modest tax cut might be advisable for model II–B as well. These reductions could take the form either of a lowering of Federal tax rates or of a sharing of Federal revenues with State and local governments so that they could reduce their taxes or increase their expenditures without State local tax increases.

Model II–B assumes adoption of the same new or expanded nondefense programs as in Model II–A but with considerably larger amounts. However, this model seems realistic only if a substantial reduction in defense expenditures is assumed. Therefore, this substantial increase in nondefense expenditures is not combined (as it is in Model II–A) with another variation showing a continued high level of defense expenditures. Whether in this case, in addition to the large increase in nondefense expenditures, a relatively small cut in taxes

or transfer to State-local governments would also be possible depends on the development of the other sectors in the economy. However, such transfers would be less urgent, as this model assumes very substantial increases in Federal grants-in-aid to State and local governments.

CONCLUSIONS

From a comparison of these various models some obvious conclusions can be drawn:

1. If the programs initiated or proposed in recent years are implemented by adequate appropriations and administrative policies, Federal expenditures are likely to increase year by year by considerable amounts. This will be true even if some programs are implemented only slowly.

2. The increase in economic activities (combined with a very small increase in prices) will result in an increase in revenues in excess of that projected in expenditures. The automatic increase in receipts (including social security taxes) resulting from a 5.5-percent economic growth (in current dollars), under present tax legislation, will amount to somewhat more than $7 billion a year. for the period 1968–73 it is estimated at about $10 billion. There will also be a "built-in" increase in expenditures resulting from the development in existing programs, the price rise, service of the national debt, and other factors. Under present legislation this automatic increase might be estimated at over $3 billion a year. If adoption and implementation of the Great Society program in full is assumed, the built-in increase may amount to over $6 billion a year. This means that under existing and proposed legislation the automatic increase in revenue would exceed the built-in increase in expenditures by an average of $3 to $4 billion each year for the period 1968–73. If it is assumed that in a base period the full employment budget is in balance with other economic factors, this would mean that each year there would be room for some increase in programs or initiation of new programs, some reduction in tax rates, some possible sharing of funds with State and local governments, or some combinaton of these. In fact, it would be necessary to give effect to some or all of these measures in order to achieve and maintain full employment in in future years.

3. The size of the tax reduction that will be possible (and needed if a depressing effect on the economy is to be avoided) will depend on the size and pace of the expansion of Federal expenditure programs.

4. None of our models shows a ratio of Federal expenditures to the gross national product (GNP) assumed for the same period that is higher than that of fiscal year 1963, and most alternatives remain substantiallv below that level. (See table 4.)

TABLE 4.—*Model I and model II: Federal expenditures as a percentage of gross national product, cash budget, fiscal years 1963, 1966, 1968, and 1973*

Item	1963	1966	1968	1973
Actual expenditures	20.0			
Proposed expenditures		18.7		
Projected expenditures in—				
Model I			19.2	18.2
Model II-A1			19.0	18.1
Model II-A2			18.6	17.1
Model II-B			19.8	19.7

Chart 1 shows the projected rate of growth of Federal cash expenditures (in constant dollars) in the perspective of the past 35 years and also in relation to the actual and projected GNP. It shows that the estimates made here, even though they were not obtained by extrapolation, are in line with the historical experience of periods in which no major emergency occurred.

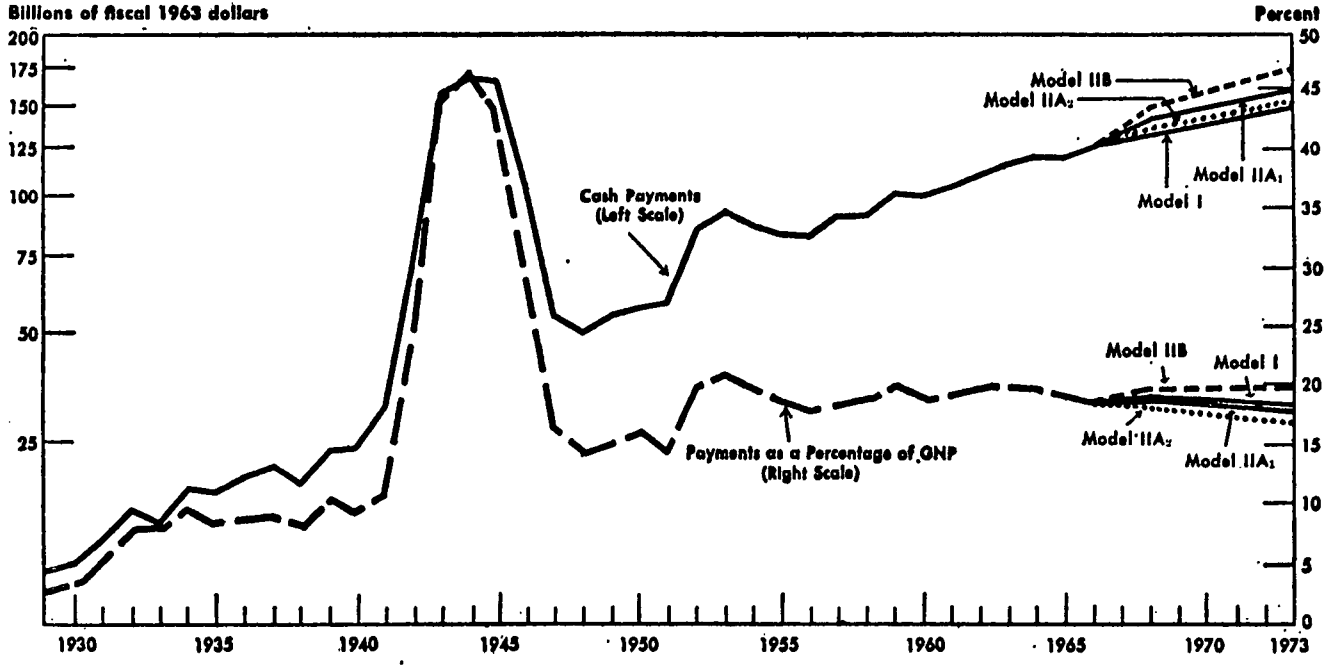
For an economic evaluation of present and proposed programs, and those under consideration, it should be remembered that some grants, particularly those concerned with transportation, housing, health, welfare, economic opportunity, and education call for matching by the States so that in many cases they would involve additional State or local, as well as Federal, expenditures. Also some of the programs, particularly the various housing loan programs, Export-Import Bank, and Commodity Credit Corporation loans, as well as many others, provide for Federal guarantee or insurance of loans issued by private enterprise or State and local governments. These would add only very small amounts to Federal budgetary expenditures. In addition many agencies use their receipts from the public as revolving funds, and only their net expenditures are reflected in the budget. These examples are given to show that the operations of the Federal Government have a considerably greater impact on the Nation's economy than a brief glance at the budget figures alone would suggest.

PROCEDURAL RECOMMENDATIONS

This study was undertaken because of the conviction that intermediate- and long-term budget projections are needed as elements in intermediate- and long-term economic projections and to provide perspective for evaluating the budget for the ensuing year. Given the present character of Government programs, it is nonsensical to think in terms of a 365-day budget. The problem posed for the present study was not whether or not intermediate- and long-term budget projections are desirable; nor did we need a study to prove that making longer term budged projections is a hazardous undertaking. By preparing projections we hoped to gain insight into the specific difficulties one encounters and to explore ways to overcome or reduce the difficulties and hazards. Although the validity of our projections can be tested only by comparison with actuals at a future time, we submit the following tentative conclusions from our experience:

1. From this effort to project budget expenditures and revenues for intermediate- and long-term periods (5 and 10 years) ahead it appears that it is feasible to make meaningful projections.

CHART 1. Federal Cash Payments to the Public, Fiscal Years 1929–66, and Projected 1968 and 1973, in Dollars and as a Percentage of GNP[a]



[a] As a percentage of calendar year GNP, 1929–41; as a percentage of fiscal year GNP, 1942–73.

2. The Budget Bureau could probably make more reliable estimates if other Government agencies were given more specific guidelines and would devote a greater effort to the preparation of their own budget projections. They also should submit a list of program proposals that are under serious discussion in their areas of responsibility even though these are not yet officially recommended by the President. The Budget Bureau should not, however, merely collect and compile the agency estimates but should evaluate them and especially should appraise new program proposals for which no specific agency is currently responsible. The Budget Bureau should also identify programs that may be terminated or curtailed.

3. Giving the various agencies and their subdivisions responsibility for medium- and long-term budget projections is important because thinking in these longer run terms will have a desirable effect on the attitude of the officials concerned.

4. It is important to formulate broad assumptions with respect to the political and economic situations, both international and domestic. Projections will always remain hypothetical in character. The assumptions should be formulated in interagency consultations and communicated to all officials concerned with the preparation of projections.

5. It is assumed that Federal budget policy will be used as one of the tools for attaining the general economic objectives of developing the Nation's potential resources, approximating full employment, and maintaining reasonable price stability. Therefore, budget projections should be related to, and integrated with, general economic projections. This will require cooperation between the Budget Bureau and the Council of Economic Advisers.

6. Budget projections should first be prepared on the basis of existing policies and official policy proposals for a 5-year period. In addition, it would be desirable to prepare another set of estimates to include those changes in expenditure programs and tax legislation which are only under consideration but which are likely to be adopted within the projection period. It becomes increasingly important to include program and tax changes beyond those officially proposed when longer time periods are covered by the projections. For estimates going beyond the 5-year period, this procedure becomes absolutely necessary. Alternative projections may be useful in this situation. Projections that allow for program and tax changes that are not yet officially proposed should be clearly identified in order to avoid any confusion between officially proposed program and tax changes and those that have merely received unofficial consideration.

7. It is useful to build up the projections from considerable agency detail. However, details should be presented only broad functional classifications. The longer the period for which projections are made, the fewer details should be given.

8. It is recognized that any projections released by the Federal Government will arouse controversy. This is so especially in the case of projections similar to our model II, which envisage the possibility of new legislation initiating some expenditure programs or terminating others, or imply that changes in tax legislation might be adopted in the future. Publication of such hypothetical projections might present difficulties for Federal agencies, because including these changes might make it appear that the administration was proposing that they

be made. Before a projection of this kind is included in official documents, Congress and the public should become more familiar with such projections. The inclusion of program changes that are not yet approved has the advantage that it may stimulate a public debate before an official recommendation is made. For a strictly transitional period it might be advisable to limit the publication of projections by the Bureau of the Budget to 5-year projections based on existing and officially proposed legislation only.

9. For these reasons, a research organization not connected with the Federal Government might fulfill a very real and necessary educational function in preparing and publishing independent projections of Federal revenues and expenditures, particularly longer term ones. Because of the controversial nature of these projections, and in order to facilitate intelligent discussion, it might be desirable to continue the preparation and publication of such private estimates even after the Federal Government has begun to publish projections on a regular basis.

10. Any such projections, whether originating within or outside the Federal Government, would have to be revised and updated on a continuing basis in the light of changing circumstances if they are to furnish reliable guidance to economic policymakers in business and Government.

11. Projections have to be worked out on a year-by-year basis. Publication of intermediate and longer term estimates may be confined to a smaller number of benchmark years. It is recognized that individual years would deviate from such a trend line.

12. For the purpose of integrating budget projections with general economic projections, and to facilitate a comparison with the national income accounts, the definition and terminology of the object classification contained in the budget document, and the national income usages of these terms must be more closely alined. At present the definitions are not closely related. In addition, it would help if the object classification in the budget document were computed and published on an expenditure basis, and not only on an anticipated new obligational authority basis, which is the practice at present. A classification of Government functions that distinguishes current operations from programs designed to support the future productivity and growth of the economy would be desirable.

13. We feel that at the agency level it is generally not desirable for the same persons to be engaged both on current work and on budget projections covering future years. When one is immersed in budget detail, it is exceedingly hard to divorce oneself sufficiently from current pressures to retain an imaginative outlook regarding future needs and possible developments.

For these reasons, it is suggested that the task of making such projections might be assigned to special program officers at the agency level, and to an expanded section of the Bureau of the Budget which would be concerned with broad Government programs. Of course, in all cases, close cooperation with the budget officers in each agency and with the Budget Bureau examiners would have to be established.

14. These recommendations would mean a heavier workload for the Bureau of the Budget, and its staff would have to be increased somewhat. Similarly, a limited number of additional persons would be necessary in other agencies.

All projections of budget receipts and expenditures must allow for a great number of variables, the effects of which can only be estimated. Ultimately, a new computer techniques would be of considerable help in this. For example, it may not be too fanciful to hope that eventually a computer bank could be established capable of storing and processing budget and economic data to indicate broadly what effects any given combination of expenditure and tax policies might have on any major sector of the American economy. Federal budget projections would be indispensable in this case, and a considerable number of policy alternatives could be explored in this fashion.

PROBLEMS IN PROJECTING FEDERAL BUDGETS*

This chapter considers some of the special problems that arise in projecting Federal budgets, such as those involved in predicting the future course of Federal-State-local fiscal relations, of the government-business relationship, and of the ratio of the Federal budget to an increasing gross national product. It also considers the staffing needs of the Budget Bureau if the projections are to be undertaken on a regular basis and some of the political problems involved.

Federal-State-Local Fiscal Relations

In the past 50 years Federal-State-local fiscal relationships have undergone drastic changes. Before World War I, the Federal Government accounted for 30 percent of total Government cash expenditures. In 1952 the percentage had increased to 72 percent (including Federal grants) and declined to 64 percent by the fiscal year 1963. The main contributing factors were the large increases in Federal defense expenditures, expenditures resulting from previous wars, and the Federal old-age and survivors' social insurance system. However, excluding defense and international expenditures and expenditures resulting from previous wars, the Federal Government share doubled temporarily during the depression but declined after World War II. During the last decade these domestic nondefense Federal expenditures have shown a rising trend, as table 8 shows.[1]

* Ch. IV.

[1] U.S. Bureau of the Census data were used both in the paragraph above and in table 8 because only these historical data for both the Federal and State-local governments were available on a comparable basis. The concepts used include trust fund expenditures, which are significant in this relationship. For the table, domestic nondefense expenditures were defined to include for the Federal Government total expenditures less the functional categories of national defense and international affairs, interest on the general debt, and veterans' services not elsewhere classified; and for State-local government, the total expenditures.

TABLE 8.—*Domestic nondefense expenditures of Federal, State, and local governments, selected years, 1902–63* [1]

Fiscal years	Total (in billions of current dollars)	Federal expenditures as a percentage of Federal, State, and local government expenditures	
		Including intergovernmental transfers	Excluding intergovernmental transfers
1902	1,325	17.9	17.4
1913	2,765	18.8	18.4
1927	9,261	17.0	15.7
1936	13,410	43.4	36.6
1953	48,898	38.5	32.6
1963	119,828	43.9	36.8

[1] See note 1 to the text for an explanation of the data used.

Sources: U.S. Bureau of the Census, The U.S. Census of Governments, "Historical Statistics on Governmental Finances and Employment," vol. VI, No. 4 (1964); U.S. Bureau of the Census, Governmental Finances in 1963 (November 1964).

Over the next decade Federal expenditures for defense and defense-related programs may level off or decline while the greatest increase may occur in programs that traditionally belong to local jurisdictions, such as education, urban development and mass transportation, police protection, and so on. In contrast, Federal revenues, particularly from income and profits taxes, will in general rise faster in response to economic growth than will local tax receipts. This may lead to a situation where Federal income taxes could be reduced periodically to prevent a "fiscal drag" while local tax rates are continuously raised. Alternatives are a continued rise in Federal grant-in-aid to State and local programs or some tax-sharing arrangement between the Federal Government and State and local governments.

The projections in all models assume a very substantial increase in Federal grant-in-aid programs. Table 9 shows grants-in-aid as a share of Federal expenditures in 1953 and 1963 and the projections under various models for 1973. In addition, as was pointed out in chapter I, before 1973 a situation is likely to arise calling for either another cut in Federal tax rates or some tax-sharing arrangement. The latter alternative would make it possible for State and local governments to improve their services without increasing tax rates. Specific consideration of these and other alternatives of the future Federal-State-local financial relationships was believed to be outside the scope of the present study. Nevertheless, it should be emphasized that it will become increasingly necessary to consider the national tax system (including State and local taxes and also social security taxes) as an interrelated whole.

TABLE 9.—*Model I and model II: Grants-in-aid as a percentage of Federal expenditures, national income budget, fiscal years, 1953, 1963, 1966, and 1973*

Item	1953	1963	1966	1973
Actual grants-in-aid	3.7	7.4		
Proposed grants-in-aid			10.2	
Projected grants-in-aid in:				
Model I				14.1
Model II-A1				14.4
Model II-A2				15.1
Model II-B				17.0

Government-Business Relationship

The projections in this study are based on the assumption that the Government will take over only functions that cannot or cannot adequately be performed by private enterprise. It is not always easy, however, to decide where the line of demarcation should be drawn between Government activity and private enterprise. In this respect, the last few decades have brought important innovations. Gone are the times when Government provided only clearly defined administrative, protective, and judicial services and private enterprise provided all production and distribution of goods and other services (if such times really ever existed).

There were the "emergency" activities of the Federal Government during the depression of the thirties, which brought about, for example, the electrification of certain private railroads. Another example is provided by the Federal guarantees, insurance programs, and in some cases purchases of mortgages, which have helped in the construction and purchase of about 28 percent of all privately owned and privately built homes in this country since the inception of these programs. Federal support of home financing has broadened into the fields of slum clearance, urban renewal, and mass transportation, which have required cooperation among the Federal Government, local governments, and private enterprise, and sometimes also nonprofit private organizations.

The World War II and Korean war periods again saw new developments of Government-business cooperation in Government-owned, but privately operated, factories for defense production. Postwar weapons and space technology made the Federal Government the main financial source for research and development in the United States. The Government has been financing most of the research and development costs for the peacetime use of atomic energy and of a byproduct (isotopes) of greatest usefulness for medical, agricultural, and industrial purposes. New forms of Government-business relationships have been tried in this field too.

During the fiscal year 1964, the Federal Government provided more than $15 billion for all kinds of research and development—about two-thirds of all funds devoted to this purpose in the United States during this period. This not only contributed to the development of new industries, like electronics and space equipment, but affected indirectly the whole level of technological sophistication of American industry. Much of the Government-financed research for Government purposes is carried out under contract by private enterprise and private research organizations. Going even further, the Communications Satellite Corp. (Comsat) represents a new departure, a semiprivate, semipublic organization created for the commercial utilization of space communication facilities on an international scale.

It is indeed difficult to foresee what the future of this Government-business relationship is likely to be and what impact it may have on future budgets. There are now pending new developments in such fields as the desalinization of brackish or sea water, water and air pollution, weather control, further developments in space exploration, the farming and mining of the oceans, new technologies in rapid ground transportation, supersonic air transportation, new research efforts in such

areas as high-energy physics, astronomy, and so on. These are examples of fields in which expenses and risks for research and development exceed what private enterprise and academic and other nonprofit research organizations are able or willing to undertake without some kind of Government support. If the Federal Government participates in further development in these fields, this could add large expenditures to Federal budgets. Alternatively, the Federal Government might furnish indirect support, possibly in the form of subsidies or loan guarantees, which would mobilize private funds as well and use private management and talent as far as possible, with much smaller additions to the budget.

Actually the projections here assume that, where it apears feasible and efficient, the Government will support private efforts rather than perform these quasi-commercial functions itself. Therefore, only limited amounts have been included in model II budgets for these purposes. The impact of Government action, however, is not fully measured by the impact of the expenditures directly included in the budgets.

The Federal Budget and GNP

As was stated in chapter I, the model II projections anticipate in only one of the alternative combinations a small increase in the relationship of Federal spending to the growing GNP (model II–B). Even in that particular case, the ratio would be below that for fiscal 1963. In all other combinations the share of the Federal sector declines somewhat, particularly in the case where a reduction in defense expenditures is assumed (model II–A2). Projected revenues were cut by the reduction in excise taxes to the extent proposed by the President in his budget message (and therefore included in models I and II). In model II–A further substantial tax cuts or the sharing of Federal revenue with State-local governments are implicitly assumed to become effective before the end of the period under consideration. Thus, the Federal Government would support economic growth in the coming decade both by an increase in programs and by some further tax reduction. The models imply that for the next decade the expansion in programs will probably make a greater contribution to economic growth than will tax reduction. Nevertheless, future policy could emphasize either program expansion or tax reduction. In order to demonstrate these possibilities, alternative projections are presented here, assuming more or less rapid program expansion, associated with little or substantial further tax cuts, respectively.

An increase in programs designed to combat poverty would open up new mass markets and thereby have an impact on business opportunities. A related increase in educational and training programs would help to meet the skill requirements of modern technology. The increase in programs of a developmental character (urban renewal, transportation, new technologies) would raise the horizon for new private investment and thereby affect the development of the Nation's economic potential (the "leverage effect" of Government programs).

Increases in such programs do not merely affect economic growth directly. They could be designed to maintain a balance, in combination with tax reductions, between the increase in the economic potential and the increase in aggregate purchasing power.

Several critical questions may be asked about the economic aspects of these projections.

1. What about economic fluctuations? It is believed that the model II projections are in accord with the requirements of a reasonable rate of sustained economic growth. A steadfast policy in support of economic growth reduces the likelihood of severe recessions. Nevertheless, it would be utopian to expect that policies in support of steady growth will always be perfect and fully successful. Therefore, it is reasonable to expect that fluctuations will occur at least in the rate of growth and possibly at times even in the level of activities. For this contingency, anticyclical monetary and fiscal policies should be held in readiness. This topic was, however, outside the scope of the present study. As was mentioned above, it is for this reason that the projections are not to be regarded as predictions for any specific year (which may turn out to be a recession year) but rather as benchmarks on a trend line.

2. Some believe that in this age of technological development and urbanization, Government responsibilities are bound to increase in both absolute and relative terms, and that this will be reflected in a rising ratio of the budget to GNP. This is not assumed in our study.

We are dealing only with the Federal budget. As was mentioned above, the increase in expenditures for nondefense activities has been larger at the State-local level than at the Federal level. Some of the growing responsibilities of the Federal Government, however, are not fully reflected in the Federal budget. There are indirect ways in which the Government contributes to economic growth and welfare. Furthermore, there is a question about the continuing validity of the thesis (first pronounced 75 years ago) that the share of Government is bound to rise along with increased industrialization and urbanization.[2] While certain Government responsibilities rise with increasing abundance, others may decline.

3. Our budget projections do not provide for any systematic repayment of the national debt, but rather envisage the possibility of some further increase in the debt. Would this not result in continuing inflationary tendencies?

Debt-financed deficits are undesirable if they contribute to excessive demand and price inflation. Of a different nature, however, are deficits which, in combination with appropriate monetary policies, can prevent an otherwise likely deflation and economic contraction. A growing economy requires a broadening financial structure. This will be brought about primarily by an expanding private capital base. With the relative importance of the public sector, steady economic growth without some increase in the public debt (Federal or State-local) is hardly conceivable. An alternative to a broadening of the financial superstructure of the economy would be a steady price decline. This is not a realistic alternative, however, except under conditions of a prolonged economic depression. When the Government debt increases because of Federal spending to support economic growth, the relationship of the debt to GNP does not rise. It is not the absolute amount of the national debt that is important for an evaluation of the "debt burden," but

[2] Adolph Wagner, *Finanzwissenschaft*, 4 volumes (Leipzig, 1877–1901); vol. I, 3d ed., 1883: vols. II–III, 2d ed., 1880–1912.

rather the relationship of the debt and the debt service to GNP and taxable incomes. This ratio has been steadily declining and, according to our projections, will continue to decline. Actually the ratio of the Federal debt to GNP declined during the decade from the end of 1954 to 1964 from 75 to 51.7 percent. Under our projections it would decline further to about 40 percent by 1973.

In contrast to a growth-supporting increase in the national debt, recession deficits are caused by declining taxable incomes and profits and increasing payments for unemployment and social assistance benefits. They lead to an increase in the debt in relation to a stagnant or declining GNP and result in an increase in the real burden of the debt.

The model II projections are based on the assumption that the relationship between Government payments and receipts will be adjusted to fit into the pattern of balanced economic growth without causing either inflationary excess demand or a purchasing power deficiency in relation to the economic potential.

In the model II projections a steady small increase in prices (1.5 percent a year) is assumed as measured by the available price indexes. This is not meant as a forecast but really as a stable price assumption, taking into account that price indexes do not make adequate allowances for quality improvements. It may well be that prices will at times rise by more than 1.5 percent during the coming years. A larger price rise in the United States, however, is more likely to be initiated by the operation of the wage-price or price-wage spiral than by a limited increase in the national debt.

Administrative Requirements

An adequate staff is needed if budget projections are to become a regular responsibility of the Federal Government. The projections presented in this study were prepared by a small staff of a private research organization with no authority to ask the several Government agencies to prepare estimates for their fields of responsibility. Numerous interviews were held with agency officials and with Budget Bureau personnel. They were very helpful. However, in no case were estimates obtained from Government agencies which could be used directly for our own estimates.

On the basis of our study it seems certain that with an adequate staff the Budget Bureau could prepare intermediate- and long-term budget projections as a regular routine function. They should be revised periodically. It was necessary, even within the relatively short lifetime of this project, to revise earlier estimates to a considerable extent. For example, some estimates had to be moved from model II to model I after President Johnson's messages of January 1965.

Some observations were made in the course of this study which should be of value for future work:

At the working level of making projections, it is difficult to achieve harmony between projections built from the ground up on a detailed agency basis, and less detailed projections based on a functional program approach.

In the agency interviews, a recurring pattern appeared. Increases in expenditures were estimated for the 1 or 2 years following the next budget year, then a leveling off, and a slight but persistent decline after the 5-year level. Psychologically the tendency can be explained

by the fact that the agency budget for the ensuing budget period had probably been cut back by the Bureau of the Budget and the Congress below the level the agency thought desirable, and this had resulted in an accumulation of programs regarded as worthwhile for possibly as long as 2 or 3 years ahead. After that period, however, it becomes difficult to treat future needs imaginatively within an agency framework, and it is in this context that functional estimates based on calculations worked out from the top down furnish a useful check.

When it comes to the estimates of new programs or program contraction, the agencies are often not able (or inclined) to provide the needed information.[3] Here the Budget Bureau would have to play a major role.[4] This applies particularly to the question of discontinuing or cutting back existing programs because at the agency level it is never easy to visualize that any of them may be dispensable.

Nevertheless it is very important that agency heads be asked to consider intermediate- and long-term budget requirements in their fields. Quite apart from the value of obtaining this information, it is of considerable educational value if the heads of the agencies and bureaus are forced to look at their programs in a longer time perspective.

Adequate staffing arrangements are required for this work, both at the agency level and in the Budget Bureau. The need is obviously most pressing at the agency level, particularly since it seems undesirable that personnel engaged on current agency problems should be too deeply involved in future projections in any major role. There are few persons trained to estimate agency programs for a number of years ahead in a responsible fashion and yet imaginatively. It may be advisable to coordinate their training with the Bureau of the Budget.

There will also be additional staff requirements in the Bureau of the Budget. The Bureau already has a number of qualified persons with experience in this field who could form the nucleus of any group dealing with budget projections. However, these persons are usually swamped with current work, and an increase in personnel capable of performing projections work and of working well with agency personnel would be highly desirable.

Political Considerations

Some skeptics, while conceding that meaningful budget projections can be made, say that it would not be desirable to have longer term projections prepared and published by the Government itself. Actually the Federal Government has been preparing budget projections for internal purposes but has rarely approved their publication.[5] For one thing, it is feared that estimates concerning future years would be interpreted as definite decisions. If the estimates are done in a spirit of boldness, they may raise premature controversy. If they are done with caution and restraint, they may bind the hands of the administration

[3] For a discussion of special problems pertaining to new programs, see pp. 45–46.

[4] The senior author cannot refrain from recording the following anecdote. In 1944, when he was assigned the task of projecting a postwar Federal budget, he had an interview with a well-known admiral who was assigned to work on plans for a postwar Navy. When asked about the Navy's thinking about the required size of annual expenditures for a postwar Navy under general assumptions which were given to him, the only answer that could be obtained from the admiral was "First you have to tell me what total defense expenditures will be. Then I can answer your question for the Navy. The Navy always requires at least one-third of the expenditures for the total Defense Establishment."

[5] See pp. 2–3, especially note 8.

for future action. And there is a general and understandable tendency in Government not to show its hand earlier than is absolutely necessary. There is also sometimes the fear that showing the full future budget impact of programs under consideration may reduce congressional willingness to authorize them.

These arguments cannot easily be dismissed. But they are not necessarily conclusive. By presenting alternative projections, based on existing legislation and policy recommendations, on the one hand, and on possible future changes, on the other, the difference between programs that are officially recommended and those that are under consideration for future determination can be clearly demonstrated. Estimates for programs that are under debate will contribute toward a better informed consideration of such programs. Nevertheless, as was mentioned above (pp. 16–17), some time may be needed until this difference between recommended and considered programs and policies is fully understood. This difficulty, real as it is, should not represent an immovable obstacle to the preparation and eventual publication of longer term projections by the Government.

One reason why the executive branch should not only prepare but also publish intermediate- and long-term projections is that such projections should be available to Congress. They are needed for a more meaningful examination of budgets for the ensuing year by the Appropriations Committees, for a better-informed consideration of pending tax legislation by the House Ways and Means and the Senate Finance Committees, and especially for the appraisal of the economic outlook by the Joint Economic Committee of Congress. The latter has been suggested as the most logical body to examine interrelated budget and economic projections (without going into details of appropriations or tax legislation) and to transmit the result of its study to the legislature committees. This would probably be preferable to the revival of the Joint Budget Committee, whose experiences were not very encouraging.[6] It is recognized that a great deal of educational work may be necessary before the American public will understand the proper role and the advantages of projections of Federal receipts and expenditures for a longer period ahead.

It would be the task of private research organizations to pave the way for a better understanding of the issues involved by focusing attention on them and by familiarizing the public with the whole concept of these projections.

It is also important that the fullest amount of intelligent public discussion be stimulated by the publication of alternative projections from Government and private sources.

PROJECTIONS OF FEDERAL RECEIPTS*

Projections of Federal revenues depend on many variables, most of which are beyond the scope of this study. They include such variables as private investment, personal consumption expenditures, and State and local government spending. While assumptions have been

* Ch. V.

[6] For a more detailed discussion, see Gerhard Colm, *The Federal Budget and the National Economy,* Planning Pamphlet No. 90 (National Planning Association, 1955), pp. 64 ff.

made concerning all of them (see appendix table A–1), the study has not been concerned with their derivation in detail.

For this reason, our revenue figures are only illustrative. This is true particularly of model II–A, and to a lesser extent also of model I, because the attainment of the revenue figures shown will depend on the adoption of a number of other measures, as is outlined in the discussion of each model below.

Tax Revenues and the Rate of Economic Growth

The most important single determinant in any projection of Federal revenues is the rate of economic growth that is assumed for the period under consideration. Details of the assumptions made here for our various models regarding growth rates are given in chapter I. Except for a few minor adjustments, which are described under the appropriate tax involved, no changes in legislation affecting revenues have been assumed beyond the excise tax cuts proposed by the administration in the January 1965 budget message.

The crucial importance of the rate of growth for all revenue estimates can be illustrated by the following example. At the present time (the first quarter of 1965) the GNP is probably about $20 and $25 billion below the level of reasonably full employment (not more than 4-percent unemployment). Merely reaching this level of employment would require an increase in economic activities that would raise Federal revenues by a least $5 billion, since profits would be especially strong in such a recovery.

Once that level of employment is attained, every $10 billion of increase in GNP will result in an increase in Federal tax revenues of about $2 billion, without any change in tax legislation. After reaching the "reasonably full employment level" the assumed continuing rate of growth of 4 percent annually in real terms implies an increase in revenues in excess of $8 billion annually. In turn, the fact that the level of taxation in relation to the level of expenditures is itself a very important determinant of the rate of economic growth is one of the main reasons why budget projections in the framework of economic projections are a necessity for fiscal and economic planning. In this chapter account is taken of the influence of economic growth on tax revenue. The effect of expenditures and revenues on economic growth has been discussed in chapters I and II.

Overall Revenue Projections

Even a brief look at the revenue projections summarized in table 10 confirms the fact that economic growth is the main determinant of future revenue. Under the by no means extravagant assumptions for economic growth, Federal receipts in models II–A and II–B (according to the consolidated cash budget) would increase by 18 percent over a 2-year period to 1968, and by about 60 percent by 1973—assuming no changes in present tax legislation. This increase would give an opportunity for an increase in needed Federal programs, a transfer of revenue to State and local governments, a reduction in tax rates, or some combination of the three.

TABLE 10.—*Model I and model II: Federal receipts in administrative budget, cash budget, and national income accounts, 1963, 1966, 1968, and 1973* [1]

[In billions of current dollars for fiscal years]

Item	Actual 1963	Proposed 1966	Projected 1968			Projected 1973		
			Model I [2]	Model II-A [2]	Model II-B	Model I [2]	Model II-A [2]	Model II-B
Gross national product	568.0	681.5	739.5	771.0	771.0	921.5	1,007.5	1,007.5
Personal income	452.1	538.5	586.5	604.5	604.5	740.0	786.0	786.0
Corporate profits	48.6	66.0	67.5	76.1	76.1	73.5	99.5	99.5
FEDERAL RECEIPTS—ADMINISTRATIVE BUDGET AND CASH BUDGET								
Individual income tax	47.6	48.2	(52.7)	(56.0)	56.0	(69.0)	(76.2)	76.2
Corporate profits tax	21.6	27.6	(28.9)	(31.9)	31.9	(32.0)	(40.9)	40.9
Excise taxes	9.9	9.8	(10.5)	(11.3)	11.3	(14.0)	(16.0)	16.0
Estate and gift taxes	2.2	3.2	(3.4)	(4.0)	4.0	(3.9)	(6.0)	6.0
Customs	1.2	1.5	(1.7)	(1.8)	1.8	(2.2)	(2.6)	2.6
Other	3.9	4.1	(3.7)	(3.7)	3.7	(4.2)	(4.5)	4.5
Total receipts, administrative budget	86.4	94.4	(100.9)	(108.7)	108.7	(125.3)	(146.2)	146.2
Employment taxes	14.9	18.7	(25.3)	(26.0)	26.0	(33.8)	(36.7)	36.9
Deposits by states (unemployment insurance)	3.0	2.9	(3.2)	(3.0)	3.0	(5.0)	(4.0)	4.0
Gasoline and other highway excises	3.3	4.0	(4.4)	(4.4)	4.4	(5.4)	(5.4)	6.5
Other, less interfund transactions	6.5	8.1	(8.8)	(9.0)	9.0	(10.7)	(11.1)	11.1
Less: Intergovernment transactions	−4.3	−4.5	(−4.7)	(−4.7)	−4.7	(−5.0)	(−5.0)	−5.0
Total, net trust fund receipts	23.4	29.1	(37.0)	(37.7)	37.7	(49.9)	(52.2)	53.5
Total receipts, cash budget	109.7	123.5	(137.9)	(146.4)	146.4	(175.2)	(198.4)	199.7
Total receipts as a percentage of GNP	19.3	18.1	(18.6)	(19.0)	19.0	(19.0)	(19.7)	19.8
FEDERAL RECEIPTS—NATIONAL INCOME ACCOUNTS								
Personal tax and nontax receipts	50.1	52.2	(57.0)	(61.0)	61.0	(74.0)	(83.3)	83.3
Corporate profits tax accruals	22.1	24.7	(28.2)	(31.0)	31.0	(31.5)	(40.9)	40.9
Indirect business tax and nontax accruals	15.2	16.1	(17.3)	(18.5)	18.5	(23.0)	(25.5)	26.7
Contributions for social insurance	22.1	28.0	(33.5)	(34.0)	34.0	(45.5)	(47.3)	47.6
Total, national income accounts	109.6	121.0	(136.0)	(144.5)	144.5	(174.0)	(197.0)	198.5

[1] Figures listed under "proposed 1966" are from the President's budget message; those listed as projections for 1968 and 1973 are based on our own assumptions for the models as given in the text.

[2] Figures in parentheses are estimates that appear unrealistic in the absence of additional measures. See also table 2, p. 9.

NOTE.—Details may not add to totals due to rounding.

It is assumed in model II-B that pressure for making up deficiencies in Government programs is so strong that the increase in revenue would be used largely for financing an increase in expenditures on the Federal or State-local level primarily through considerably increased grants-in-aid to the States and increases in transfer payments. In addition, the substantial increases in grants-in-aid projected in model II-B would enable State and local governments to keep local taxation well below levels that would otherwise be necessary. This would mean an effective further measure of tax relief to individuals and corporations.

By contrast, in model II-A the choice is deliberately left open whether the excess of revenues over expenditures is to be used for periodic Federal tax reductions or for benefiting State and local governments by tax-sharing arrangements or a system of unconditional grants. Conceivably a combination of all three methods could be used, par-

ticularly if some arms reduction should prove feasible. It should be repeated here that the revenue estimates made under the assumption of present or presently proposed (as of January 1965) tax rates should be regarded only as a basis from which the feasibility of, and need for, future tax reduction could be considered. This applies especially to model II–A. Without some further measures on the tax side the assumed rate of growth could not be expected to develop.

Similar considerations apply to model I, for which a lower rate of growth has been assumed. Tax revenues have been worked out accordingly. In the consolidated cash budget they will increase (from 1966) by less than 12 percent by 1968 and by 42 percent by 1973. However, in this case, too, a reduction in taxes or adoption of one of the other measures described may be necessary, particularly for 1970 and subsequent years, in order to achieve even the more limited objectives assumed for this model.

Projections by Major Tax Sources

The revenue estimates have been worked out in accordance with the projected assumptions described in chapter I (pp. 3–7). Within this framework, estimates for the various major sources of receipts have been worked out for the period 1967–73 for the consolidated cash budget. Overall revenue projections have also been prepared for this period for the administrative budget and for the receipts side of the Federal Government sector in the national income accounts. With some minor exceptions described under the individual tax sources, no changes in tax legislation beyond those foreshadowed in the President's 1966 budget have been incorporated in the estimates. Even though it is not reflected in the estimates, however, it is assumed that a further tax reduction, or alternatively a tax sharing, will take place during the period of the projections.

The Individual Income Tax

Models II–A and II–B assume a small decline in the proportion of GNP represented by personal income, from about 79.6 percent of GNP in 1963 to about 78 percent in 1973. Conversely, small increases have been assumed in the shares represented by corporate profits, depreciation, and indirect business taxes. These shifts do not apply to model I, where such relationships are projected to remain practically unchanged.

All models show a rise in actual tax collections for every year. However, because of the recent (1964) tax cut, the percentage of total GNP claimed by the individual income tax remains below the 1963 level throughout the entire period covered by the study. In 1973 this tax will claim about 7.5 percent of GNP in all models, whereas the 1963 figure was 8.4 percent. In dollar terms, collections would rise from $47.6 billion in 1963 to a 1973 level of $69 billion in model I and $76.2 billion in models II–A and II–B. The individual income tax would account for well over 50 percent of total Federal administrative budget receipts in all models.

CORPORATE PROFITS TAX

Ever since its enactment in 1909, the corporate profits tax has been the most volatile of tax sources, fluctuating greatly with the ups and

downs of the business cycle, generally with a lag of about 6 to 9 months (reflecting the lag of tax collections behind accruals).

Our models take account of the reductions in corporate profits tax rates of the years 1963–64 and the gradual advance of payment dates to put the tax for larger corporations on an almost current basis. Consequently it seemed desirable to align corporate tax receipts with current fiscal year GNP and corporate profits figures in each case, whereas hitherto it has been the practice to compare such receipts with GNP and profit figures of the preceding calendar year.

In models II–A and II–B our calculations assume an immediately rising profits trend in relation to GNP, to slightly under 10 percent of GNP, where it is assumed to remain broadly unchanged through 1973. (All figures are for fiscal years.) For model I the profits trend is assumed to be considerably less favorable because the economy would be generally less prosperous, and projected profits would amount to only 8 percent of GNP in 1973.

In absolute terms, by 1973 the yield of the corporate profits tax is projected to reach a level of $40.9 billion (over 4 percent of GNP) for models II–A and II–B, and $32 billion for model I. This would constitute approximately 28 percent of total Federal administrative budget revenues for the "full employment" models, but only about 25.5 percent in the case of model I.

EXCISE TAXES

We have assumed that the proposals in the President's budget message for a reduction in excise taxes as of July 1, 1965, will be enacted, but that no further changes in existing legislation will take place. The only exception concerns gasoline and other highway excises, which models I and II–A assume will continue at present rates throughout the period under study. (At present the gasoline tax is scheduled to drop to 1.5 cents a gallon on October 1, 1972.) Model II–B assumes a tax rise of 1 cent a gallon starting in fiscal 1970 to pay for an extended highway program. In absolute terms, the rise in excise taxes (in table 10, "excise taxes" plus "gasoline and other highway excises") from fiscal 1966 to fiscal 1973 is from $13.8 billion to $19.4 billion in model I, $21.4 billion in model II–A, and $22.5 billion in model II–B.

The old traditional taxes on alcohol, tobacco, and documents (the last one is unimportant) are projected to show less-than-average increases, although in all cases they show substantial growth in absolute terms.

Excise taxes will continue to be an important component of total Federal revenues, accounting for over 10 percent of total receipts from the public in 1973 in all the models.

ESTATE AND GIFT TAXES

Estate and gift taxes have been assumed to rise more than in proportion to the rise in GNP because of the fact that a rising percentage of deceased persons will leave taxable estates and also because of the element of progressiveness in the application of these taxes. The yield depends in large part on asset values—stocks, real estate, etc. For these reasons, receipts in model I are projected at considerably lower levels than in models II–A and II–B because such asset values are

likely to be lower in an economy with a slower rate of growth. Their yield is projected to increase from $3.2 to $3.9 billion between fiscal 1966 and fiscal 1973 in model I and to $6 billion in models II–A and II–B. In terms of percentages of GNP, the increase is significant only in the last two models. And even in these models, the share of estate and gift tax receipts in total Federal administrative budget revenues would amount to only about 4 percent. It must be remembered that increases in this category are held down because credits on Federal taxes are granted for State gift and inheritance taxes, and it has been assumed that by 1973 virtually all the States will have increased these taxes to the point where the maximum possible Federal credit is applicable.

CUSTOMS DUTIES

The revenue yield of customs duties depends on two factors: general economic conditions and U.S. tariff policy. It has been assumed here that reasonably full employment conditions will mean a more-than-proportionate increase in the dollar value of imports and that this will be only slightly offset by a further lowering of tariffs. A recent Brookings study [1] indicates that prices of imports will probably rise more than prices of exports.

Customs receipts are expected to rise from $1.5 billion in fiscal 1966 to $2.6 billion in 1973 (only $2.2 billion for model I), but even by that date, they will represent less than 0.3 percent of total GNP and less than 2 percent of administrative budget revenues.

MISCELLANEOUS RECEIPTS

Miscellaneous sources, including such items as interest on loans, dividends and deposit earnings, and sales of products and property, are so mixed and there are so many uncertain items—particularly those arising from the disposition of federally owned assets (including the strategic stockpile which was accumulated largely on the basis of World War II requirements)—that detailed forecasts become meaningless. It has therefore been assumed that such receipts will show only small increases during the period.

TRUST FUND RECEIPTS

Model I projections of employment taxes and voluntary payments by the States for their employees have been worked out on the basis of the existing law, incorporating all scheduled increases. Also included are the increases in social security tax rates and in its tax base proposed by the President, as well as the proposed taxes to finance medicare for the aged and to improve the unemployment insurance system. No further increases in rates or base have been assumed. For all the calculations a 3-percent annual increase in wage rates has been assumed, while for current dollar models an additional annual price increase of 1.5 percent is included (1.3 percent for model I). With unchanged ceilings for contributions, this means that a slowly declining percentage of all wage and salary payments will be covered.

[1] Walter S. Salant and Emile Despres, Lawrence B. Krause, Alice M. Rivlin, William A. Salant, Lorie Tarshis, *The United States Balance of Payments in 1968* (Brookings Institution, 1963).

Model I estimates are based on a study by Robert J. Myers.[2] It was assumed that the increase in receipts due to the 1.3-percent annual price increase projected in the model would just about offset the decrease in revenues due to the assumed higher rate of unemployment, since Myers' figures are based on reasonably full employment with no change in prices. For models II–A and II–B slight increases were projected because of the assumption of an increased labor force and lower unemployment, as well as slightly greater price increases. The arms reduction model shows a further small increase because of its slightly higher civilian labor force.

Employment taxes are projected to constitute a rising portion of federal cash receipts, increasing from $18.7 billion, or 2.8 percent of GNP, in fiscal 1966 to $33.8 billion (model I) and $36.9 billion (model II–B) by 1973, at which time they would account for about 3.6 percent of GNP. By far the greatest portion of such receipts will consist of contributions to the OASI and disability insurance trust funds. Contributions to the railroad retirement fund will decline slightly though by no means in line with the recent and anticipated future decline in railroad employment, as it was felt that this development would not have its full impact on these funds until well after 1973.

Employment taxes will constitute a steadily rising percentage of all Federal receipts, rising from 13.6 percent in fiscal 1963 to between 18.5 and 19.3 percent 10 years later. However, it should be pointed out that under less favorable employment conditions, employment tax revenues would fall considerably short of the levels projected here. But, of course, the same observation applies to all other tax sources.

For models II–A and II–B, which are based on the assumption of reasonably full employment, the figures show only a slight rise in unemployment tax deposits by States during the later years of the decade, because of increases in the labor force. It was felt that even increasing the earnings base for calculating contributions would not make any significant difference, as under existing legislation most States would be likely to reduce their tax rates on covered earnings correspondingly. With nearly full employment, the estimates here are compatible with continuous small increases in the benefits provided by the individual States. Model I figures are somewhat higher throughout, because the slower rate of growth inherent in that model would cause a higher rate of unemployment and this would require larger tax deposits by the States in spite of an increasing share of Federal support for this purpose.

Employee and agency contributions to the civil service retirement fund (in table 10, these are included in the "other" category) are bound to rise slowly year by year, and they have been projected accordingly.

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[2] Robert J. Myers, "Actuarial Cost Estimates for the Hospital Insurance Act of 1965 and Social Security Amendments of 1965." Actuarial Study No. 59 (U.S. Department of Health, Education, and Welfare, 1965). See also the *25th Annual Report of Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Social Security Trust Fund, Board of Trustees, 1965).

PROJECTIONS OF FEDERAL EXPENDITURES*

In this and the remaining chapters we undertake to project the expenditures side of the Federal budget. In this chapter the general assumptions underlying the projections are detailed. In chapters VII through X the estimates under the various models are given by functional classifications grouped under the broad categories of national security, economic development, welfare, and general government operations.

Our expenditure estimates follow the general assumptions outlined in chapter I. Expect in model I they postulate the approximation of reasonably full employment (no more than 4 percent of the labor force unemployed) toward the end of fiscal 1967 and the economy's ability to sustian this level of employment thereafter.

On the domestic scene, it is assumed that there will be no change in the division of functions performed by the Federal Government and by State and local governments. In regard to world affairs, one set of estimates is based on a continuation of the present defense posture, while a second set assumes that there will be some reduction in defense expenditures.

Definitions of the three models presented were given in chapter I, and the various combinations of defense and nondefense expenditure levels were also described. Expenditure details have been worked out under several different classifications.

The first classification shows expenditures by function and is further subdivided by Government agency under each functional category. These estimates have been developed in detail, but are presented here in summary form.

Because of space limitations, the classification of expenditures by agency is presented in the appendix tables, and this too is in summary form. For the same reason, the object classification, although prepared in detail, is not presented.

Expenditure Estimates by Budget Concept and Functional Category

Tables 11 and 12 present our expenditure models on the consolidated cash and the national income accounts basis for selected years. Year-by-year tables for these, as well as for administrative budget expenditures, are in the appendix (tables A–15, A–16, and A–17 for expenditures). The consolidated cash budget table (table 11) is subdivided into broad functional classifications which have been grouped into the four "supercategories" of national security (including space and international), economic development (including education), welfare (including agriculture), and general government operations (including interest). The chapters that follow are also based on these four classifications.

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* Ch. VI.

TABLE 11.—*Model I and model II: Federal expenditures in cash budget by 4 major categories, 1963, 1966, 1968, and 1973*

[In billions of current dollars for fiscal years]

Item	Actual, 1963	Proposed, 1966	Projected, 1968				Projected, 1973			
			Model I	Model II-A1	Model II-A2	Model II-B	Model I	Model II-A1	Model II-A2	Model II-B
National security, international, and space:										
National security activities [1]	53.4	52.5	52.8	52.8	49.7	49.7	53.3	53.3	43.5	43.5
International affairs and finance	3.8	4.2	4.8	5.5	5.5	7.0	5.5	8.5	8.5	11.8
Space research and technology	2.6	5.1	6.0	4.0	4.0	7.0	6.0	4.0	4.0	6.5
Total	59.8	61.8	63.6	62.3	59.2	63.7	64.8	65.8	56.0	61.8
As a percentage of total expenditures	51.7	47.9	44.0	41.9	40.7	41.0	38.0	35.6	31.8	30.8
Economic development:										
Natural resources	2.5	2.9	3.3	3.6	3.6	3.9	3.9	4.4	4.4	5.0
Commerce and transportation	5.8	6.5	8.1	8.7	8.7	9.2	10.4	11.5	11.5	12.9
Education and research	1.2	2.6	4.3	4.8	4.8	5.3	8.0	9.5	9.5	12.5
Total	9.5	12.0	15.7	17.1	17.1	18.4	22.3	25.4	25.4	30.4
As a percentage of total expenditures	8.2	9.3	11.1	11.7	12.0	12.0	13.2	13.8	14.6	15.1
Welfare:										
Agriculture	5.7	4.1	5.0	4.6	4.6	4.3	5.0	4.6	4.6	4.1
Housing and community development	−0.3	0.7	1.6	2.3	2.3	3.0	2.8	4.0	4.0	6.9
Health research and services	1.3	2.2	2.8	3.2	3.2	3.7	4.7	5.5	5.5	7.2
Labor and manpower [2]	3.5	3.6	4.2	4.4	4.4	5.1	7.4	6.2	6.2	7.8
Economic opportunity programs	----------	1.3	1.9	2.4	2.4	2.8	3.7	4.3	4.3	5.5
Public welfare services	3.1	4.2	4.6	5.3	5.3	6.4	5.7	6.9	6.9	9.0
Social insurance [3]	17.8	22.8	26.0	27.5	27.5	28.0	33.3	39.5	39.5	45.5
Veterans' benefits and services	6.0	5.1	6.1	6.7	6.7	6.7	7.0	7.8	7.8	7.8
Total	37.1	44.0	52.2	56.4	56.4	60.0	69.6	78.8	78.8	93.8
As a percentage of total expenditures	32.0	34.1	36.3	38.2	38.7	38.7	41.0	42.5	45.0	46.6
General Government operations:										
General government	2.0	2.4	2.7	3.1	3.1	3.1	3.5	4.3	4.3	4.3
Interest on the Federal debt	7.4	8.8	9.6	9.6	9.5	9.8	10.0	10.5	10.5	10.7
Total	9.4	11.2	12.3	12.7	12.6	12.9	13.5	14.8	14.8	15.0
As a percentage of total expenditures	8.1	8.7	8.6	8.2	8.6	8.3	7.8	8.1	8.6	7.5
Total, cash budget expenditures	115.8	129.0	143.8	148.5	145.3	155.0	170.2	184.8	175.0	201.0
Less adjustments [4]	−2.0	−1.6	−2.0	−2.0	−2.0	−2.0	−2.5	−2.5	−2.5	−2.5
Total, adjusted cash budget expenditures	113.8	127.4	141.8	146.5	143.3	153.0	167.7	182.3	172.5	198.5

[1] Includes military functions of the Department of Defense, military assistance, the Atomic Energy Commission, and other defense-related activities.
[2] Includes unemployment compensation.
[3] Excludes unemployment compensation.
[4] These include a number of items which cannot be assigned to any specific catetory. The largest items are negative amounts—connected with the accounting treatment of agency expenditures and salary deductions for retirement of Federal employees.

TABLE 12.—*Model I and Model II: Federal expenditures in the national income accounts, 1963, 1966, 1968, and 1973*

[In billions of current dollars for fiscal years]

Item	Actual, 1963	Proposed, 1966	Projected, 1968				Projected, 1973			
			Model I	Model II-A1	Model II-A2	Model II-B	Model I	Model II-A1	Model II-A2	Model II-B
Purchases of goods and services	63.6	66.7	70.5	72.5	69.5	73.2	77.5	79.0	70.5	76.0
Transfer payments	29.2	35.2	41.5	43.0	43.0	45.2	52.5	62.0	62.0	73.8
Grants-in-aid to State and local governments	8.3	13.0	17.5	18.5	18.5	20.5	23.5	26.0	26.0	33.5
Net interest paid	7.4	8.6	9.5	9.5	9.5	9.6	10.0	10.5	10.5	10.7
Subsidies less current surplus of government enterprises	3.8	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.0
Total	112.3	127.0	142.5	147.0	144.0	152.0	167.0	181.0	172.5	197.0
Total expenditures as a percentage of GNP	19.8	18.6	19.3	19.1	18.7	19.7	18.1	18.0	17.1	19.6

As is apparent from table 11, our projections show very substantial shifts among the various classes of expenditures during the period under study. To a certain extent, such a shift is already taking place. National security expenditures are expected to decline from 46.9 percent of cash budget expenditures in fiscal 1963 to 41.2 percent in fiscal 1966 if proposed programs are carried out. By contrast, the tables show substantial increases in economic development and welfare expenditures. In our projections these trends become more pronounced. Security expenditures make up 32.5 to 37.2 percent of all projected budgetary expenditures in fiscal 1968 and between 22 and 31.9 percent of all such expenditures in fiscal 1973. Significant increases in relative importance are shown by expenditures for economic development (particularly for education), which gain from 8.2 percent in fiscal 1966 to between 13.2 and 15.1 percent of all cash budget expenditures in fiscal 1973, and by welfare expenditures, which are projected to rise from 32 percent to between 41 and 46.6 percent of all outlays during the same period.

Expressed in terms of the national income accounts (see table 12) our projections show the greatest increases in transfer payments (mainly all kinds of social insurance and interest) and in grants-in-aid to State and local governments. These payments increase substantially because of much greater outlays in the categories of commerce and transportation (the interstate highways program is financed by means of grants-in-aid), housing and community development, health research and services, economic opportunity programs, public welfare services, and education and research. In all these categories no change is envisaged in present Federal-State-local relationships; and in models II–A and II–B, for most new programs, it is assumed that the direct Federal role will be kept to a minimum in favor of State and local responsibility.

MODEL I

Why do the projections show an increase in expenditures even in the model which excludes adoption of new programs? For one thing, we assume gradually rising prices; and, more important, many existing programs imply increasing expenditures. This is the case, for example,

with certain grant-in-aid programs that match rising State expenditures. It is true even more of many new programs proposed by President Johnson that are now included in the budget with relatively small initial amounts and for which expenditures will rise in future years. Table 13, showing planned expenditures for fiscal 1966 for some of these new programs and the new obligational authority requested for them, offers a good illustration of what may be expected in future years.

TABLE 13.—*Major additions to Federal programs proposed in the President's budget for fiscal year 1966* [1]

[In millions of current dollars]

Item	Administration's proposed expenditures	New obligational authority requested
International: Investment in Inter-American Development Bank	25	250
Commerce and transportation:		
Surface transport research	10	20
Area Redevelopment Administration	40	400
Post Offices, direct Federal construction	18	92
Education:		
Assistance to elementary and secondary education	500	1,255
Academic facilities loans and grants [2]	165	642
Assistance to colleges and college students	100	260
Agriculture: Rural housing insurance fund	40	100
Housing and community development:		
Public assistance grants	15	150
Urban mass transportation [3]	48	161
Health: Health centers, etc	95	191
Labor: Broadened and extended Manpower Development and Training Act	92	140
Economic opportunity programs [4]	1,346	1,500
Public welfare services:		
Public assistance: increased Federal share, expanded medical assistance to needy children, etc	214	214
Other: expanded vocational rehabilitation	7	10
Total	2,715	5,385

[1] Proposals relating to social insurance are not included.
[2] Enacted in 1964, but it is estimated that only $3 million will be spent in fiscal 1965.
[3] This item is not new, but there have been no major expenditures previously.
[4] Some initial funds for the attack on poverty were included in the 1965 budget.

Finally, the impact of some factors that have tended to reduce recorded expenditures in recent years will necessarily diminish. This applies particularly to the sale of assets by such agencies as the Veterans' Administration, the Federal Housing Administration, the Department of Agriculture, and the Export-Import Bank.

On the other hand, some reductions in expenditures may result from the phasing out of existing programs (for example, the program for hardening missile sites) or from increased efficiency. While we cannot be certain that our estimates strike the right balance between the built-in increases and probable economies, it is clear that the former will average between $5 and $6 billion annually in the cash budget, based on existing and officially proposed legislation only.

MODEL II

Model II–A incorporates a number of new programs, in addition to those included in model I. This results in higher expenditures, although it is assumed that a few programs, notably in agriculture, will decline somewhat. There are two variations to this model. The first (model II–A1) shows the same amount of defense expenditures as model I, while in the second (model II–2) defense expenditures are cut back by nearly $10 billion from 1966 to 1973.

Model II–B may be called the civilian high-expenditures model. It contains all the new programs also included in model II–A, but projects that they will be initiated faster and on a larger scale. In addition, in a few instances it contains expenditures for programs that are not included in the model II–A estimates because it has been assumed for the latter model that they will not begin until after fiscal 1973. As may be seen from table 14, the principal program increases for all models are concentrated heavily in the welfare and economic development fields. Under these programs considerable assistance would be given to State and local governments, thus enabling them to carry out their steadily growing functions with a much lower taxload than would be possible without Federal support.

TABLE 14.—*Model II: Federal expenditures, showing increases over model I for new or changed programs,*[1] *cash budget, 1968 and 1973*

[In billions of current dollars for fiscal years]

Item	Projected, 1968		Projected, 1973	
	Model II-A	Model II-B	Model II-A	Model II-B
National security: Gradual arms reduction [2]	−3.1	−3.1	−9.8	−9.8
International affairs and finance:				
International police force	.2	.8	1.0	2.4
Increased economic assistance	.1	.7	1.4	2.9
Space research and technology:				
Reduced lunar program (stretchout)	−2.0		−2.0	
Accelerated lunar and increased interplanetary programs		1.0		.5
Natural resources: Larger reaction programs	.1	.1	.1	.3
Commerce and transportation:				
Increased highway construction				1.0
Increased regional development programs (more areas)	.2	.4	.3	.6
Post Office deficit decrease				−.5
Education and research: Increased assistance to—				
Elementary and secondary education	.2	.4	.5	1.2
Higher education	.2	.5	.5	2.0
Vocational education		.1	.1	.2
National Science Foundation	.1	.1	.1	.3
New research programs not elsewhere classified	.1	.2	.2	.6
Agriculture: Smaller support programs	−.4	−.7	−.4	−.9
Housing and community development:				
Increased urban mass transportation programs	.1	.1	.1	.5
Increased urban renewal	.1	.3	.3	.8
Increased public housing, "spot" renewal, rent subsidy plan	.1	.2	.3	.7
Contingency fund		.1		.3
Health:				
New research programs for National Institutes of Health	.1	.2	.1	.5
Expanded Public Health Service and other new health programs	.3	.5	.7	1.6
Labor:				
Expanded manpower programs	.1	.3	.3	.8
Expanded and liberalized unemployment benefits	.1	.6	.5	1.2
Economic opportunity:				
Larger community action programs	.1	.2	.2	.6
Expanded job corps	.1	.2	.2	.5
Expanded work-training programs and others	.2	.4	.3	.8
Public welfare services:				
New "general" welfare grants	.4	1.1	.6	1.9
Expanded "nationwide" food stamp program	.1	.1	.5	.5
Increased vocational rehabilitation and others	.1	.4	.1	.6
Contingency fund		.1		.3
Social insurance:				
Increased social security benefits	.4	.8	2.2	4.3
Increased medicare for the aged	.1	.2	.2	.4
Increased civil service and railroad retirement pensions	.1	.2	.2	.4
General medicare; private health insurance premium subsidy				2.5
Veterans benefits and services: Liberalized benefits	.6	.6	.8	.8
General Government: Various programs such as public defenders and compensation for crimes of violence	.1	.1	.2	.2

[1] For comparison, see model I projected expenditures in table 11.
[2] Not applicable to model II-A1.

Federal Government Civilian Personnel

Our projections assume a negligible rise in Federal employment during the period 1964–73. Reductions in civilian employment for the Department of Defense just about offset smaller increases in most other agencies dealing with civilian tasks. Fluctuations are introduced by the temporary requirements of the Census Bureau, but the overall figure for Federal civilian employment is expected to stay close to the 2.5 million mark.[1] Additional factors responsible for this relative stability of employment in the face of rising dollar expenditures are the anticipated increases in the productivity of Federal employees, and the greater emphasis on transfer payments and on grants-in-aid to the States. This applies particularly to model II–B. For these categories of expenditures, little additional manpower would be needed at the Federal level, since the actual administration of most programs would be at the State or local level. Thus there might be some further increase in nondefense employment in all variations of model II, but in models II–A2 and II–B it would be offset by lower civilian employment in the Department of Defense.

WELFARE EXPENDITURES*

This category includes many of the most important nondefense activities of the Federal Government. Urgent needs exist in almost every field of expenditures described in this chapter. In large part, they are today being met from State and local funds, some with the help of Federal grants-in-aid. The projections do not assume any significant shift of responsibility. However, we do assume a substantial shifting of Federal funds toward increased grants-in-aid for many of these programs in all our models, particularly in model II–B. This would be in addition to increases of direct Federal expenditures for these purposes. In view of the increasing importance of expenditures in each of these fields, we are treating Health Services and Research, Labor, Economic Opportunity Programs, Social Insurance, and Welfare Services as separate functional categories. Expenditures for Housing and Community Development, for Agriculture, and for Veterans Services are also included under this general heading.

Health Services and Research

This category consists of the Public Health Service (including National Institutes of Health), the Food and Drug Administration, and various health-connected programs of the Welfare Administration.[1] All of these agencies are in the Department of Health, Education, and Welfare. (See table 25.)

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[1] For details, see appendix table A–4.

[1] Grants for maternal and child welfare, the new program of grants for maternal and child health services, and the Children's Bureau. In addition, there are some foreign research outlays as well as expenditures for St. Elizabeths and Freedmen's Hospitals in Washington, D.C.

TABLE 25.—*Model I and model II: Federal expenditures for health services and research, administrative and cash budgets, 1963, 1966, 1968, and 1973*

[In billions of current dollars for fiscal years]

Item	Actual, 1963	Proposed, 1966	Projected, 1968			Projected, 1973		
			Model I	Model II-A	Model II-B	Model I	Model II-A	Model II-B
National Institutes of Health	0.7	1.0	1.2	1.3	1.4	2.0	2.0	2.5
Hospital construction [1]	0.2	0.2	0.4	0.5	0.6	0.7	1.0	1.2
Other public health services and other health activities [2]	0.4	1.0	1.2	1.4	1.7	2.0	2.5	3.5
Total, administrative and cash budgets	1.3	2.2	2.8	3.2	3.7	4.7	5.5	7.2
Total, administrative and cash budgets, as a percentage of GNP	0.2	0.3	0.4	0.4	0.5	0.5	0.5	0.

[1] Includes nursing homes, health centers, etc.
[2] Includes Food and Drug Administration and child and maternal health activities.

FOOD AND DRUG ADMINISTRATION

Expenditures for the Food and Drug Administration have been increasing rapidly during the last few years, largely because the public has finally realized the importance of the agency's responsibilities. These expenditures are bound to rise further as increasingly complex drugs and chemicals, as well as new methods of food processing, come to be used. However, the projected expenditures in the field, rising to $100 million by 1973, will always remain modest relative to those of other programs in this functional category.

PUBLIC HEALTH SERVICE

The National Institutes of Health. The chief research arm of the Public Health Service is NIH.[2] Its spectacular growth since 1953 has been assisted by the sympathetic interest taken by influential Members of Congress, supported by public opinion. One factor contributing to such widespread support is the fact that the largest part of NIH budget increases has gone not to finance its centralized operations but into research grants, chiefly to universities and research centers all over the country. All projections point to substantial further increases in health research expenditures as the number and remuneration of researchers and the amount spent on supporting staff and equipment all continue to rise. Models I and II–A assume that expenditures will triple between 1963 and 1973, and model II–B assumes a further rise in expenditures to $2.5 billion. However, the rate of expenditure increases assumed in all models is well below that experienced during the previous decade.

All other activities of the Public Health Service will continue to receive increasing emphasis. It is expected that in the future great importance will be attached to programs that will make research discoveries available as quickly as is compatible with safety to all Ameri-

[2] The National Cancer and National Heart Institutes, as well as the Institutes for Mental Health, Allergy and Infectious Diseases, Dental Research, Arthritis and Metabolic Diseases, Neurological Diseases and Blindness, Child Health and Human Development, and General Medical Sciences—and several independent divisions—constitute the National Institutes of Health.

cans, and this will mean new responsibilities for the PHS. Its two major areas of activity are now Community Health and Environmental Health.

Community Health. This program is concerned with such vital services as worker accident prevention, chronic diseases and the health of the aged, and activities to combat communicable diseases, including such scourges as tuberculosis and venereal diseases. Considerable attention will continue to be devoted to the training of nurses and other hospital aids in order to relieve shortages in these fields.

The education assistance grants for training doctors and dentists and funds to support medical and dental schools will have to be increased considerably in order to meet the declared goal of increasing the number of doctors by 50 percent and of doubling the number of dentists during the next 10 years. The 1966 budget marks a milestone in this direction. In this connection, it must be remembered that the United States is well down on the list of developed countries in the number of doctors per capita. Hospital construction activities under the Hill-Burton Act are also in this category. They have accounted for a steady stream of expenditures designed to spread hospital facilities more evenly throughout the Nation, and in model II–B we have assumed that these will increase in the future. With the continuing rise in the numbers of persons in the older age groups, which is bound to occur with advances in medical science, emphasis may be shifted toward the construction of more nursing home facilities under the Hill-Burton program.

Great benefits may be expected from the proposed new program for multipurpose regional medical complexes to provide specialized care for major diseases, including cancer, heart disease, and mental health, and to train specialists in these fields. This program is certain to attract widespread support because its benefits will be quite apparent throughout the Nation, particularly in areas where such specialized treatment has not been readily available in the past. Advances in the field of mental health and new progress in treating the problems of aging are expected to be specially noteworthy.

Environmental health. Progress in environmental health activities is likely to be equally marked during the coming decade. This expectation applies particularly to the crucial fields of water supply and water and air pollution control and to the expanded grant program for the construction of waste treatment works and of adequate sewers. It is assumed that public needs in these fields will receive increasing recognition and that this will be reflected in appropriations. Increased resources will also be devoted to studying the health consequences of the use of pesticides and chemical fertilizers. In all these endeavors, cooperation with State and local agencies is expected to continue, with the Federal Government possibly giving additional financial inducements to State and local authorities. Other areas of increasing expenditures will deal with the problems of waste disposal and the construction of an Environmental Health Center for supervising and centralizing research in the whole field.

HEALTH-CONNECTED WELFARE PROGRAMS

Material and child health care. This field, which has been the responsibility of the Children's Bureau of HEW, will also receive increasing attention. The Nation's record of infant mortality is far from enviable, and the rate is higher than in many other advanced countries. Since there is a pronounced correlation between family income levels and infant mortality, increasing stress will be laid on treating this problem on a broader social basis. This will call for higher expenditures, both to keep up with an increasing population and to upgrade the services provided. School health services are another "underdeveloped" segment, and they will receive increasing attention as all medical science makes progress toward stressing preventive medicine and treatment.[3]

Miscellaneous health services. These will share in the broad upward trend of expenditures. They comprise a great many activities, ranging from Indian health facilities, and general purpose Public Health Service hospitals, to the compilation of health statistics, to appropriations for retirement pay for commissioned officers of the Public Health Service and the Surgeon General's Office. St. Elizabeths and Freedmen's Hospitals must also be mentioned in this connection.

Labor and Manpower, Including the Unemployment Insurance Trust Fund

While the activities of the Department of Labor include a considerable number of disparate operations, from an expenditure point of view two of these stand out far above all others: expenditures devoted to manpower development and training and the Unemployment Insurance Trust Fund.[4] (See table 26.)

TABLE 26.—*Model I and model II: Federal expenditures on labor and manpower, administrative budget and cash budget, 1963, 1966, 1968, and 1973*

[In billions of current dollars for fiscal years]

Item	Actual, 1963	Proposed, 1966	Projected, 1968			Projected, 1973		
			Model I	Model II-A	Model II-B	Model I	Model II-A	Model II-B
Manpower administration	0.1	0.5	0.8	0.9	1.1	1.0	1.3	1.8
Others	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2
Total, administrative budget	0.3	0.6	0.9	1.0	1.2	1.2	1.5	2.0
Unemployment Insurance Trust Fund [1]	3.8	3.3	3.6	3.5	4.0	6.2	4.7	5.8
Total, cash budget [2]	3.5	3.6	4.2	4.4	5.1	7.4	6.2	7.8
Total, cash budget, as a percentage of GNP	0.6	0.5	0.6	0.6	0.7	0.8	0.6	0.8

[1] This fund combines the expenditures of the Federal-State and railroad unemployment systems.
[2] After adjustments for interfund transactions and intergovernmental transfers.

NOTE.—Details may not add to totals due to rounding.

[3] Model II-B includes expenditures of $900 million annually for a comprehensive school health service for up to 15 million children from disadvantaged families too poor to pay for regular medical attention.
[4] Contributions to the unemployment funds paid on behalf of Federal employees are also of some importance here.

It must be expected that the Department's major functions will become increasingly important. They comprise all matters concerned with labor-management relations, a field that is certain to become more crucial if the hoped-for productivity gains and effective labor-management wage-price guidelines are to be realized. They also include all matters affecting wage and labor standards [5] and the functions of the Bureau of Labor Statistics, the Bureau of International Labor Affairs, and the Secretary's and Solicitor's Offices.

While all these activities are projected to show increased expenditures, they are relatively small compared to the outlays for the Manpower Administration, which are scheduled to account for nearly 90 percent of total expenditures in this classification in the 1966 administrative budget. Nor is this proportion likely to change significantly in the future. Present and future technological developments make for a much more rapid obsolescence of job skills, and it cannot be taken for granted that persons who already have skills may not have to acquire different ones several times during their working lives. Retraining programs are expected to include about 260,000 adults and youths in 1966. This figure is expected to go up for all our models, as is the expenditure per individual participating in these programs. Model II–B envisages that during the early 1970's about 1 percent of the labor force may be in retraining programs every year if unemployment is not to exceed 4 percent. This would mean providing facilities for about 850,000 persons, and expenditures for this one program may well reach $1.3 billion by 1973.

It is also anticipated that the Manpower Administration will intensify efforts to provide youth employment opportunities, and this will require additional amounts to be provided in the administrative budget as well as in the trust funds. By contrast, appropriations for unemployment benefits to Federal employees and ex-servicemen are not expected to rise significantly, higher benefits probably being offset by fewer claimants.

By far the largest disbursements under the jurisdiction of the Department of Labor are from the Unemployment Insurance Trust Fund. These finance the administrative expenses of the former Bureau of Employment Security as well as all Federal and State expenditures in connection with the U.S. Employment Service, in addition to actual benefit payments. (See table 27.) For 1966, administrative expenses at all levels are scheduled to exceed $500 million. It is expected that in future years substantial improvements can be made in the USES, greatly extending the scope as well as the quality of its services. This will result in increased expenditures, particularly under model II–B. Projected unemployment compensation payments depend on several contingencies. Most important of these is the rate of economic growth that is assumed and the unemployment rates that are regarded as compatible with such assumptions. In this study we have assumed an unemployment rate of 4 percent for models II–A and II–B. Model I, based on only present and officially proposed programs, cannot be regarded as consistent with full employment aspirations, particularly over the medium and longer term. Under this assumption a rate of unemployment of over 7 percent would

[5] Expenditures for Federal employees' accident compensation claims are in the functional category of General Government Operations.

have to be expected by 1973, which would mean sharply increased payments for unemployment benefits. This is reflected in the model I expenditure figures, which are higher than those under model II–A in this category.

TABLE 27.—*Model I and model II: Rate of unemployment, rate of insured unemployment, and benefit payments, 1963–73*

Fiscal year	Net unemployment rate (percent)		Rate of insured unemployment (percent) [1]			Benefit payments from unemployment insurance trust fund (billions of current dollars) [2]		
	Model I	Models II–A and II–B	Model I	Model II–A	Model II–B	Model I	Model II–A	Model II–B
Actual:								
1963 [3]	--------	5.7	--------	4.4	--------	--------	3.0	--------
1964	--------	5.0	--------	3.8	--------	--------	2.8	--------
1965 (preliminary)	--------	4.8	--------	3.7	--------	--------	2.7	--------
Assumed: 1966	--------	[4] 4.5	--------	[4] 3.4	--------	--------	[4] 2.7	--------
Projected:								
1967	5.4	4.0	4.3	3.2	3.5	3.0	2.7	3.0
1968	5.7	4.0	4.6	3.3	3.6	3.3	2.9	3.4
1969	6.0	4.0	5.0	3.3	3.7	3.8	3.0	3.8
1970	6.3	4.0	5.3	3.4	3.8	4.2	3.2	4.2
1971	6.6	4.0	5.6	3.4	3.9	4.7	3.4	4.6
1972	6.8	4.0	4.9	3.5	3.9	5.1	3.7	4.8
1973	7.1	4.0	6.2	3.5	3.9	5.5	4.0	5.0

[1] Models I and II–A assume the introduction of Federal minimum standards of unemployment compensation and a gradual liberalization of the earnings base to $5,600 by 1973. Model II–B assumes further liberalization of standards and benefits.
[2] This fund combines benefit payments under Federal-State and railroad unemployment systems.
[3] For 1963 through 1966 identical figures are assumed for all models.
[4] For fiscal 1966, this is the official budget figure.

Another very important assumption concerns the extent of coverage (at present only about 60 percent of the total labor force is covered) and the size of benefits, which currently replace only about 25 percent of all labor income lost because of unemployment. Extensive improvements are projected for all our models; for model II–B we assume nearly full coverage at a benefit level approximating 60 percent of lost labor income for the overwhelming majority of cases. This would raise the benefit payments to nearly $5 billion by 1973. A possible projection of unemployment benefit payments under these assumptions is shown in table 27.

ECONOMIC OPPORTUNITY PROGRAMS

The Economic Opportunity Act was passed in 1964 to combat poverty in both urban and rural America. The program authorized under that legislation is included here. (See table 28.) Some of the component programs are under the direct jurisdiction of the Office of Economic Opportunity (which was created by the act) in the Executive Office of the President, and some are administered by other agencies, with OEO exercising coordinating jurisdiction. It operates from funds appropriated to the President. The whole program is still in the experimental stage and liable to changes in emphasis and direction. However, the projections reflect our conviction that it will continue to expand during the period under discussion, because the needs are manifest and many of the causes of poverty can be cured only on a long-term basis. The economic opportunity program puts heavy

emphasis on youth activities for two reasons. First, unskilled young people are having great difficulty in finding employment. Second, poverty is self-perpetuating from generation to generation, and it is considered best to break this cycle with the generation just entering adult life.

TABLE 28.—*Model I and model II: Federal expenditures on economic opportunity programs, administrative and cash budgets, 1966, 1968, and 1973*

[Amounts in billions of current dollars for fiscal years]

Item	Proposed, 1966	Projected, 1968			Projected, 1973		
		Model I	Model II-A	Model II-B	Model I	Model II-A	Model II-B
Community action	0.5	0.7	0.8	0.9	1.2	1.4	1.8
Job Corps	.3	.4	.6	.7	.9	1.1	1.4
Work and training programs	.5	.7	.8	.9	1.3	1.4	1.8
Other	.1	.1	.2	.3	.3	.4	.5
Total, administrative and cash budgets	1.3	1.9	2.4	2.8	3.7	4.3	5.5
Total, administrative and cash budgets, as a percent of GNP	.2	.3	.3	.4	.4	.4	.5

NOTE.—Details may not add to totals due to rounding.

Economic opportunity programs can be classified under four main headings: Community Action programs, the Job Corps, Work and Training programs, and miscellaneous measures. Community Action programs are the largest of these in terms of expenditures. The rationale behind this emphasis is that a successful attack on poverty can best be conducted at the local level by persons and local organizations acquainted with the problems of the poor in their own communities. These programs are designed to provide a framework for coordinating existing policies and programs and to fill any gaps that may be found. Considerable emphasis is laid on small-scale research programs to identify the causes of poverty and on preschool programs for culturally deprived children. Remedial reading, literacy courses, local leadership courses, and a host of other services are included in these programs, for which the Federal Government provides 90 percent of all needed funds. We project an increase in the 1966 level of expenditures of slightly under half a billion dollars to about $1.2 billion in 1973 under existing policies (model I) and over $1.8 billion for model II–B.

The Job Corps program is among the most important of the youth activities. One part is designed to operate in small rural centers, where young men will be engaged in conservation work, combined with an educational program designed to raise the level of their basic education. Sixteen thousand youths are expected to be enrolled in these rural centers by the end of fiscal 1966. This program is projected to grow very considerably to an annual intake of about 40,000 youths in model I, rising to over 60,000 in model II–B. The urban part of the program will provide young men and women with more specialized vocational training as well as an improved general education. At the end of fiscal 1966, 24,000 young people are expected to be enrolled in these urban centers, and our projections foresee a rise similar to that in rural centers, to about 60,000 in model I and over 100,000 in model II–B by 1973.

Work and Training programs consist of the Neighborhood Youth Corps, the College Work-Study program, and the Work Experience program. The first two of these are designed for young people. The Neighborhood Youth Corps offers full-time and part-time work to young people 16 to 21 years of age to give them some work experience and added income and thereby prevent them from becoming school dropouts. Those already out of school, in addition to obtaining work experience and incomes, also benefit from remedial education and counseling. It is anticipated that 290,000 youths will be served by the Neighborhood Youth Corps in fiscal 1966, and our projections foresee considerable further growth as the program becomes better established. By 1973 there will be more than 20 million people in the eligible age group.

The College Work-Study program, from which over 100,000 young people are scheduled to benefit in fiscal 1966, is designed to enable academically qualified students from low-income families to remain in college by providing summer and part-time jobs. All of our models provide for considerable increases in the scope of the work-study programs.

In contrast to these measures, whose purpose is to help young people, the Work Experience program is designed for needy, low-income adults to enable them to acquire needed skills and to become self-supporting. It is intended primarily for relief recipients and is used in conjunction with existing State and local programs. In 1966, 112,000 persons are scheduled to be enrolled in this program. The projections assume significant increases in the number aided under the program through 1973, to around 200,000 persons in model I and to 300,000 in model II–B. Altogether, work and training programs, estimated to cost slightly under $0.5 billion in 1966, are projected to show growth similar to that of the Community Action programs to about $1.2 billion in model I and to more than $1.8 billion annually in model II–B.

Of the important miscellaneous programs in this category, the adult literacy program may well reach a peak of 150,000 persons in a relatively short time. However, it is hoped that before the end of the period under discussion, the need for long-term continuation of this program will have declined because of the provision of a better educational base in schooling for underprivileged children. On the other hand, the VISTA (Volunteers in Service to America) program may well expand considerably from its small base of 5,000 persons in fiscal 1966; this program is designed to develop into a domestic Peace Corps and may well attract many who want to offer their services on a full- or part-time basis with little or no remuneration. Retired persons and housewives are obvious examples, and the tasks that await these volunteers are many and varied.

The granting of "very small" loans to farms families and very small businesses may well expand somewhat in the future. However, this activity will remain one of the less important ones under the Economic Opportunity Act, largely because the individual amounts involved will continue to be small.

It may be asked why we have assumed such significant increases for Economic Opportunity programs if we postulate that the United States is going to be reasonably prosperous. There is no real contradic-

tion here once it is realized that standards of what constitutes poverty are likely to shift upward in line with the general level of incomes. Our projections for models II–A and II–B also assume an extension of most of these programs to include older people, and II–B assumes that some new programs would be started.

Public Welfare Services

Public welfare services include most of the functions discharged by the Welfare Administration and by the Vocational Rehabilitation Administration of the Department of Health, Education, and Welfare, as well as the school lunch, milk, and food stamp programs of the Department of Agriculture. (See table 29.)

TABLE 29.—*Model I and model II: Federal expenditures for public welfare service, administrative and cash budgets, 1963, 1966, 1968, and 1973*

[Amounts in billions of current dollars for fiscal years]

Item	Actual, 1963	Proposed, 1966	Projected, 1968			Projected, 1973		
			Model I	Model II-A	Model II-B	Model I	Model II-A	Model II-B
Grants to States [1]	2.7	3.5	3.8	4.2	5.0	4.6	5.2	6.8
Vocational Rehabilitation Administration	.1	.2	.2	.4	.5	.4	.5	.7
Department of Agriculture programs [2]	.3	.5	.6	.7	.7	.7	1.2	1.2
Contingencies and new programs					.2			.3
Total, administration and cash budgets	3.1	4.2	4.6	5.3	6.4	5.7	6.9	9.0
Total, administrative and cash budgets, as a percent of GNP	.6	.6	.6	.7	.8	.6	.7	.9

[1] Includes programs for old-age assistance; medical assistance for the aged; and aid to dependent children, the blind, and the totally and permanently disabled.
[2] Includes school lunch, milk, and food stamp programs.

NOTE.—Details may not add to totals due to rounding.

By far the largest item of expenditures consists of grants to the States for public assistance. This includes programs for old-age assistance, medical assistance for the aged, and aid to dependent children, the blind, and the permanently and totally disabled. At present, no Federal funds are granted for contributions to the general assistance programs of States and localities.

Under our assumption of reasonably full employment, the public assistance caseload would be expected to show first a decrease and later, after the reasonably full employment level has been reached, only small increases in line with population trends. However, welfare expenditures cannot be viewed in isolation. They depend on general economic conditions and also on the content of other social programs (Federal, State, and local). Furthermore, rising standards may be reflected in the field of welfare expenditures as in all other segments of the U.S. economy. This is taken into account, particularly in our assumptions as to the costs of the various service programs, which are projected to rise by a large amount. Conspicuous among these is the new program of medical services for needy children. Expenditures for the Bureau of Family Services, the Office of Aging, and programs to

combat juvenile delinquency are also assumed to show substantial increases.

The efforts of the Department of Health, Education, and Welfare in the field of vocational rehabilitation are concerned with persons who are suffering from physical and mental disabilities. (General retraining programs are under the jurisdiction of the Department of Labor.) We have projected appreciable increases in the expenditures for the Vocational Rehabilitation Administration because it has been assumed that much more stress will be laid on rehabilitating mentally handicapped persons in future years.

All models show significant increases for the school lunch and special milk programs, due chiefly to increasing school enrollments and the inclusion of more school districts. The food stamp program would be increased to embrace many additional areas, and in models II–A and II–B it would be nationwide in coverage. Beyond the present programs both models II–A and II–B envisage that in future years Federal contributions for general public assistance payments will be forthcoming and that new programs for providing much better facilities for preschool and school-age children of working mothers, as well as for preschool assistance for children from low-income families, will be enacted.

While a number of other plans for general welfare programs have been actively discussed, the authors have not included them in their projections because it was felt that no public consensus on the programs could be expected by 1973, particularly if conditions are generally prosperous. These programs include a comprehensive system of family allowances for children (possibly limited to children after the first or second) or a system of income maintenance payments for the poorest segment of the population. In both cases, costs might be about $15 billion by 1973, or about 1.5 percent of GNP. Family allowances are paid in Canada and have been introduced in most Western European countries. The cost calculation has been based on a rough adaptation of the Canadian scale of benefits, with some increases. Family allowances (which could be subject to income tax) have had their advocates in this country for many years. Their adoption, however, is rendered doubtful by current generally prosperous economic conditions and by the increasing concern felt by many over undue population increases, particularly among low-income families.

On the other hand, a system of income maintenance payments for the poorest segment of the population has found an increasing number of advocates. A variation of this idea is the concept of a "negative income tax" advocated by Prof. Milton Friedman of the University of Chicago as a substitute for all other welfare programs. The cost estimate of about $15 billion or slightly more is based on a minimum family income of $3,000 for fiscal 1973, with somewhat more than half this figure for single-person consumer units.[6]

It must be emphasized that not all welfare programs discussed would be additive. For example, the income maintenance proposal would certainly reduce public assistance caseloads substantially, and while this would benefit mainly State and local government finances, there would also be significant savings in Federal expenditures. Another example

[6] See also James N. Morgan, *et al., Income and Wealth in the United States* (McGraw-Hill, 1962).

is the food stamp program, which could probably be entirely discontinued if an income maintenance plan were adopted, unless it is continued primarily as a farm support measure. These various welfare plans are discussed in some detail because, while we do not believe it likely that they will be in force by 1973, there is a good chance that some of them will be adopted in the later 1970's. Model II–B includes a contingency fund for future programs in this field.

Social Insurance [7]

By far the most important social insurance program is the social security program, which is administered by the Social Security Administration and financed through the Old-Age and Survivors Insurance and Disability Insurance trust funds.[8] The civil service retirement and the railroad retirement trust funds are also treated here. (See table 30.) Since its inception 30 years ago, the social insurance system of the United States has been improved periodically. While our model I estimates are worked out on the basis of present law and incorporate President Johnson's budget message proposals (including medicare for the aged), it would be unrealistic to believe that during the next 8 years no further improvements would be built into the system.

TABLE 30.—*Model I and model II: Federal expenditures for social insurance,*[1] *administrative and cash budgets, 1963, 1966, 1968, and 1973*

[In billions of current dollars for fiscal years]

Item	Actual, 1963	Proposed, 1966	Projected, 1968			Projected, 1973		
			Model I	Model II–A	Model II–B	Model I	Model II–A	Model II–B
Old-age and survivors, and disability insurance trust funds	15.8	20.4	21.4	22.4	23.1	26.5	32.5	[2] 35.7
Medicare for the aged	-------	-------	1.9	2.0	2.1	3.0	3.2	3.4
Civil service and railroad retirement trust funds	2.3	2.8	3.1	3.2	3.5	4.0	4.2	4.4
Transfers from administrative budget:								
Health insurance premium subsidies	-------	-------	-------	-------	-------	-------	0.1	2.5
Transfer to OASDI	-------	-------	-------	-------	-------	-------	-------	[3] (2.0)
Total, cash budget [4]	17.8	22.8	26.3	27.5	28.0	33.3	39.5	45.5
Total, cash budget, as a percentage of GNP	3.2	3.5	3.5	3.6	3.7	3.6	3.9	4.5

[1] Excluding unemployment insurance.
[2] Includes transfers of $2 billion from administrative budget.
[3] Included in figure for OASDI.
[4] After adjustments for interfund transactions and intergovernmental transfers.

NOTE.—Details may not add to totals due to rounding.

Thus model II–A assumes that social security benefits will rise in line with increases in the cost of living, with an additional annual improvement factor of 1.5 percent, resulting in a total increase in benefits of 3 percent a year. Model II–B makes the further assumption

[7] Unemployment insurance is included in the section on Labor and Manpower.
[8] The only significant items financed from general revenues are two proposed expenditures; the first would appropriate funds to pay for the liability incurred by the Government for military service credits, and the second would finance hospital benefits for aged persons who are not covered by social security.

that an annual improvement factor of about 3 percent will be built into the benefit system, resulting in a total increase in benefits of 4.5 percent a year. Similarly, both models II–A and II–B assume increases in the civil service and railroad retirement pensions and in the payments for medicare for the aged.

Model I estimates of OASDI expenditures and of the costs of medicare for the aged are based on estimates of Robert J. Myers, Chief Actuary of the Social Security Administration, with some adaptations.[9] Estimates in models II–A and II–B are based on the same figures and include the improvement factors mentioned above. In the case of model II–B, the higher improvement factor will cause expenditures to exceed trust fund revenues after 1970. The difference could be met either through increased contributions from employers and employees or in part through a transfer from general revenues (the administrative budget). The latter method is used in most countries of Western Europe. We have assumed that a contribution from general revenues to the extent of $2 billion will be made for this purpose in fiscal 1973, and this is reflected in administrative budget expenditures for that year.[10] The costs of medicare for the aged include only those incurred for social security recipients, at present about 85 to 90 percent of all persons over 65 years of age, with costs for the remainder being met from the general welfare budget; however, with the passage of time nearly the entire population in this age group will be covered through the social security system, and this is reflected in the cost estimates.

Estimates of OASDI expenditures in models II–A and especially II–B assume that by 1973 "'public social security" will form the base for a widespread system of supplementary private pension schemes covering virtually all occupational groups, and that such private benefits will be transferable from job to job as are public benefits. This combination would for the first time constitute a really comprehensive system of caring for the needs of all Americans of retirement age.

Additionally, model II–B assumes the establishment of a trust fund to help all Americans meet the rapidly growing costs of adequate health care, not indeed by providing universal medical care, but possibly by establishing a system of insurance premium subsidies to enable American families to meet the growing costs of constantly improving standards of adequate health care through private insurance protection. A sum of $2.5 billion is estimated for this purpose in fiscal 1973, to be financed by contributions from the administrative budget. January 1, 1973 is assumed as the starting date for the program. In model II–A a later effective date is assumed, and only a nominal amount is shown for preparatory expenditures. Should the need for such a development be regarded as not proven, particularly because of the special new programs for the aged and for needy children, it should be borne in mind that private consumer expenditures for medical care increased at an average rate of 8 percent annually during the period 1950–62 and that a continuation of this rate would mean total annual expenditures approaching $55 billion by 1973.

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[9] U.S. Social Security Administration, *Actuarial Cost Estimates for the Hospital Insurance Act of 1965 and Social Security Amendments of 1965*, Actuarial Study No. 59 (January 1965).

[10] We have not assumed that this "improvement factor" will go so far as to embrace the concept of "dynamic" pensions, which is in force in Germany and under which benefit payments are calculated and revised with reference to recent earnings in the retired individual's former occupation. However, such a plan may well gain acceptance in the future, particularly since somewhat similar provisions are already in force for U.S. military pensions.

In general, social insurance cost projections assume that such expenditures will be fitted into the pattern of the Nation's war on poverty and that they represent an important weapon in this struggle. Even with the "improvements" assumed in mode II–B, and when combined with welfare and other social programs, as a share of GNP these would still be below the level of current social welfare expenditures in Germany and France. It is anticipated, however, that in the next decade, most Americans will be able to regard these public benefits not as their only source of retirement income but rather as a secure base for additional privately financed benefits.

Veterans Benefits and Services

The principal expenditures in this category (see table 31) are for service-connected disability compensation, non-service-connected disability pensions, hospitals and medical care, readjustment benefits, and other benefits and services. There are also various trust funds, the most important one of which is for the veterans life insurance program.

Table 31.—*Model I and model II: Federal expenditures for veterans benefits and services, administrative and cash budgets, 1963, 1966, 1968, and 1973*

[In billions of current dollars for fiscal years]

Fiscal year	Model I	As a percentage of GNP	Models II-A and II-B [1]	As a percentage of GNP
ADMINISTRATIVE BUDGET				
Actual, 1963	5.2	0.9		
Proposed, 1966	4.6	.7		
Projected:				
1968	5.7	.8	6.2	0.8
1963	6.6	.7	7.4	.7
CASH BUDGET				
Actual, 1963	6.0	1.1		
Proposed, 1966	5.1	.7		
Projected:				
1968	6.1	.8	6.7	.9
1973	7.0	.8	7.8	.8

[1] Model II–A projections are the same as for Model II–B.

The largest expenditures by far for compensation for service-connected disability and death, scheduled to run at $4.1 billion in fiscal 1966. In future years the number of compensation cases is likely to fall slightly year by year (see table 32), but in our projections average benefit payments rise, and for the period under discussion this will more than make up for the declining caseload.

TABLE 32.—*Projected veteran population in civilian life and number receiving compensation and pension payments, 1963, 1968, and 1973*

[Fiscal years]

Item	Actual, 1963	Projected	
		1968	1973
Veterans in civilian life (in millions) [1]	22.0	21.1	20.0
Under 55 years of age	18.4	16.7	13.6
55 to 64	1.3	2.3	4.3
Over 64	2.3	2.1	2.1
Compensation claims (in thousands): [2]			
Disability cases	1,987	1,996	1,996
Death cases	375	360	349
Pension claims (in thousands): [2]			
Disability cases	1,182	1,240	1,200
Death cases	779	1,045	1,250

[1] On June 30 of each year.
[2] Average number of cases during fiscal year.

Source: Estimates based on figures supplied by the Veterans' Administration, October 1964, as revised.

By contrast, costs of pensions paid to veterans and their survivors for non-service-connected death and disability have been rising and will soon exceed those of service-connected compensation. Moreover, this trend is likely to continue. As of 1965, World War I veterans and their dependents constituted about 70 percent of the caseload, but payments to veterans of World War II and the Korean conflict and their survivors must be expected to rise as increasing numbers of veterans reach ages at which the rates of disability and mortality mount.

We have assumed in model I a continuation of the veterans compensation and pension programs provided for in existing legislation, but models II–A and II–B include the cost of a number of proposed increases.[11] The total cost would amount to nearly $800 million annually in fiscal 1967, gradually declining to a rate of over $600 million by fiscal 1973, as the number of World War I veterans declines. With the general improvement of old-age benefits we assumed that the pressure for special veterans' benefits will diminish.

HOSPITAL AND MEDICAL CARE

At over $1.2 billion, expenses for hospital and medical care are large and must be expected to increase further under the double impact of increasing medical and hospital costs and the higher age distribution of the veteran population. It should also not be forgotten that the quality of services provided to veterans has been continually improved. Hospital construction costs will be a continuing item, particularly because of modernization requirements and population shifts.

READJUSTMENT BENEFITS

Expenditures for veterans' education are expected to decline in model I. Under existing law, they will concern only orphans of war veterans because the program for Korean war veterans has expired.

[11] We have not included the American Legion proposal for a general pension of $100 monthly for all World War I veterans.

The sale of certificates of participation in the direct housing loans and housing loan guarantees for veterans have given these programs net receipts in recent years. This is expected to continue, though on a declining scale, because the portfolio of desirable loans is shrinking. In addition, veterans' benefits under this program are running out gradually. Extension of all GI bill benfits (education, insurance, housing) to all post-Korean servicemen has been suggested. We assumed that some new veterans' legislation might be adopted before 1973 and therefore have included a contingency allowance in models II-A and II-B.

PERSONNEL AND ADMINISTRATIVE EXPENSES

The Veterans' Administration has an outstanding record of achieving a greater productivity in its operation, undoubtedly helped by automation. This trend is expected to continue, and we have assumed a gradual decline in the number of personnel, except in the medical care category.

Trust fund expenditures are confined almost exclusively to payments under the veterans' life insurance program. We have projected that these will remain in the range of $450 to $650 million, depending partly on the choice of dates for insurance dividend disbursements.

AGRICULTURE

Practically all programs in this functional category are the responsibility of the Department of Agriculture. The only significant exception is the Farm Credit Administration, which is a public enterprise. Its activities are important only in connection with trust fund expenditures and affect the consolidated cash budget.

The Department of Agriculture's farflung activities reach into almost every county across the Nation. Most of its responsibilities are included in this functional category, with the exception of the Food-for-Peace program already discussed under International Affairs and Finance (in ch. VII); the milk, school lunch, and food stamp programs, which fall under the Public Welfare Services category above; and the Forest Service, which is treated under Natural Resources (in ch. VIII). Because the Department carries on many varied activities, in any projection of its future role, each of its major components must be examined if the aggregate figures are to be meaningful.[12]

For the program component that includes the Agricultural Stabilization and Conservation Service and the Soil Conservation Service, we have assumed a slowly rising trend of expenditures throughout the period under review for all models. We feel that whatever changes take place in agricultural price-support policy, farm income will continue to be supported by a variety of devices, and that these programs will figure prominently among them. This does not imply that exactly the same measures will be used in the future. However, such programs as watershed and flood protection, conservation operations, and some aspects of the soil bank will not disappear without similar ones replacing them. Further, it is likely in the case of program changes that the shift in expenditures will be toward these items. While for the Depart-

[12] These are the Agricultural Stabilization and Soil Conservation Service, the Commodity Credit Corporation, and the Farmers Home Administration.

ment as a whole some net reduction in expenditures has been assumed, this does not rule out substantial shifts among the various types of expenditures. In the budget's functional classification, expenditures for farm income stabilization, including those for price-support programs, make up 70 percent of all expenditures for agriculture and agricultural resources. This implies that there may be considerable flexibility in the choice of methods to achieve this objective.

Commodity Credit Corporation operations, which account for about 50 percent of all departmental expenditures today, are projected to run at lower levels than in the early 1960's, with a gradual decline to 1973. For models II–A and II–B we have assumed a radical change to a greater emphasis on income payments on a per farm basis, accompanied by a drastic reduction in price supports. These would be retained only to put a low floor under prices (possibly at 50 percent of a revised parity formula), and this implies reliance on the free market for nearly all sales of agricultural commodities. However, since Congress will probably not agree to a drastic cut in farm incomes for smaller farmers, income payments will continue to be sizable. Of course a new office might be set up to administer such payments, but it seems best to discuss them in this context, since they would be designed to replace most Commodity Credit Corporation expenditures.

Another major component consists of the Rural Electrification Administration and Farmers Home Administration. Concerning the latter, it is anticipated that the direct loan program will be replaced by a proposed loan insurance program for rural housing, resulting in considerable budgetary "savings." As to the Rural Electrification Administration, in models II–A and II–B it is assumed that the practice of making loans at 2-percent interest will be replaced entirely either by financing through the private market or at the very least on terms not more favorable than the interest costs on such loans to the Government. All models assume acceptance of the President's proposals that the REA be given authority to operate a revolving fund. This would result in an equal decrease in budget expenditures and receipts.

In contrast to these major programs, the host of functions performed by the Department of Agriculture in a variety of smaller programs will continue to expand. They include the Extension, Foreign Agricultural, Agricultural Marketing, Agricultural Research, Economic Research, Statistical Reporting, and the Rural Commodity Development Services and a number of general administrative and statistical activities. The scope of these activities is likely to increase in the future, and account has been taken of this in the projections, as shown in table 33.

TABLE 33.—*Model I and model II: Federal expenditures for agriculture, administrative and cash budgets, 1963, 1966, 1968, and 1973*

[In billions of current dollars for fiscal years]

Fiscal year	Administrative budget			Consolidated cash budget [1]					
	Model I	Model II-A	Model II-B	Model I	As a percentage of GNP	Model II-A	As a percentage of GNP	Model II-B	As a percentage of GNP
Actual, 1963	5.2	--------	--------	5.7	1.0	--------	--------	--------	--------
Proposed, 1966	3.9	--------	--------	4.1	.6	--------	--------	--------	--------
Projected:									
1968	4.8	4.4	4.2	5.0	.7	4.6	0.6	4.3	0.6
1973	4.8	4.4	4.1	5.0	.5	4.6	.5	4.1	.4

[1] Includes the Farm Credit Administration.

HOUSING AND COMMUNITY DEVELOPMENT

HOUSING AND HOME FINANCE AGENCY

Projections for the Housing and Home Finance Agency are full of pitfalls, mainly because this agency is made up in part of a number of quasi-independent units [13] and also because for many programs receipts from premiums and other charges and the sale of assets provide all or most of the financing. (See table 34.) A direct charge on the Federal budget is not involved. The greatest difficulties in making estimates and projections are caused by fluctuations in the amounts realized from the sale of assets, mortgages and direct loans, and real estate holdings since these depend on the state of the money market and on a number of other factors. Therefore, the overall budget figures of the agency do not measure the total activity generated by the financial outlays of its many branches. As for the future, the need for greatly expanded urban renewal and development programs is plain, though there is some difference of opinion as to whether the present institutional setting should be changed. While it is expected that promoting the agency to the status of a full-fledged department would meet some of the organizational problems, it must be emphasized that the needs for better housing and community development require more comprehensive programs, irrespective of any institutional changes. However, in this field most programs take a long time to be fully effective, and for this reason actual expenditures can be increased only gradually.

[13] The Public Housing Administration, the Federal Housing Administration, and the Federal National Mortgage Association.

TABLE 34.—*Model I and model II: Federal expenditures for housing and community development, administrative and cash budgets,*[1] *1963, 1966, 1968, and 1973*

[In billions of current dollars for fiscal years]

Item	Actual, 1963	Proposed, 1966	Projected, 1968			Projected, 1973		
			Model I	Model II-A	Model II-B	Model I	Model II-A	Model II-B
Urban mass transportation	(2)	(3)	0.2	0.3	0.5	0.4	0.6	1.1
Urban Renewal Administration [4]	0.2	0.4	.6	.8	.9	1.2	1.5	2.1
Federal Housing Administration	.1	−.1	−.2	−.2	−.2	−.3	−.3	−.3
Federal National Mortgage Association	−.4	−.5	−.2	−.2	−.2	(5)	(5)	(5)
Public Housing Administration	.2	.2	.3	.4	.5	.5	.7	1.1
Other Housing and Home Finance Agency and contingency fund	(3)	.1	.3	.7	.8	.4	.9	2.0
Federal Home Loan Bank Board [6]	−.3	−.3	−.3	−.4	−.4	−.4	−.5	−.5
District of Columbia	.1	.1	.1	.1	.2	.1	.1	.2
Total, administrative budget	−.1	(5)	.8	1.5	2.1	1.9	3.0	5.7
Trust funds and adjustments	−.2	.7	.8	.8	.9	.9	1.0	1.2
Total, cash budget	−.3	.7	1.6	2.3	3.0	2.8	4.0	6.9
Total, cash budget, as a percentage of GNP	--------	.1	.2	.3	.4	.3	.4	.7

[1] Minus figures indicate an excess of sales of assets from portfolios and other receipts over expenditures
[2] Very small.
[3] Small.
[4] Includes urban mass transportation proposed expenditure of $48,000,000 for 1966.
[5] In balance.
[6] Includes Federal Savings and Loan Insurance Corporation.

NOTE.—Details may not add to totals due to rounding.

Despite these limitations, practically all of the various programs of the Housing and Home Finance Agency are projected as showing substantial increases. One of the most striking increases is scheduled to occur in urban mass transportation, an expenditure currently made by the Office of the Administrator. The Federal Government provides assistance through loans, grants, or demonstration projects for existing planned local mass transit systems. In model I expenditures are estimated to reach $400 million by 1973, with $1 billion projected for model II–B. Indeed, the main limiting factor for such expenditures is the long leadtime necessary for planning and developing mass rapid transit systems.

Among the activities under the direct control of the Administrator of HHFA, those carried out by the Urban Renewal Administration require by far the largest outlays. Its largest expenditures are incurred in providing Federal assistance, amounting to 66⅔ percent (in some cases 75 percent) of net costs, to local governments for the acquisition, redevelopment, and rehabilitation of slums and blighted areas.

The major portion of expenditures for urban renewal are being incurred in connection with the write-down of land acquisition costs to bring these costs to a level low enough to stimulate private development. However, other grant programs, such as those for relocating families and businesses, for urban planning, and for openspace land, are also important. Furthermore new, imaginative programs may well supplement those currently in operation during the course of the coming decade. At present there is a serious lag, often lasting more than 5 years, between the approval of an urban renewal project and the time when significant expenditures are actually made. Our projections reduce this timelag appreciably, but it is a limiting factor in forecasts

of Urban Renewal Administration expenditures. The resources devoted to this field will depend on the priority that the Nation assigns to the rebuilding and rehabilitation of its urban areas. Our models assume increasing expenditures, reaching $1.2 billion in model I and $2 billion in model II–B by 1973.

Of the HHFA expenditures grouped under the Community Facilities Administration, public facility loans and advances for public works planning may have less scope for expansion. The same may apply to the Housing for the Elderly program if, as is intended, more of its financing comes from federally guaranteed loans from private sources. There is considerable potential for expansion of planning, research, and demonstration activities in this field, which, although they have a limited budgetary impact in themselves, are likely to spawn new programs that could become significant in the future.[14]

PUBLIC HOUSING ADMINISTRATION

The Public Housing Administration's main responsibility since its inception has been the administration of the low-rent public housing program. Its most important expenditures by far have been its annual contributions to local authorities to reduce the cost of public housing. Currently well over 500,000 units are assisted by these annual payments. While the need for low-income housing is likely to persist, the general public housing program has come under increasing criticism, and this has been reflected in our estimate of only 50,000 new units to be constructed annually under model I. A significant number of these would be special units for the elderly, for which there is considerable community support. Such a program would necessitate total annual subsidies exceeding $500 million. Model II–B assumes a doubling of the rate of construction to 100,000 units by 1973, which would raise total expenditures to $600 to $700 million annually. In addition, a new program of "spot" rehabilitation of existing private housing, suitable particularly for larger families, has just been undertaken. In the future this may well involve rent subsidies for private accommodations for large families, because their needs are often not met by public housing. The program's potential is very great and, if successful, it could well require expenditures of $200 to $400 million annually by fiscal 1973. This is reflected in our models II–A and II–B. In time the image of public housing would change considerably under the impact of the new programs.

FEDERAL HOUSING ADMINISTRATION

The Federal Housing Administration is responsible principally for the programs of Government-insured mortgages for homes and apartment buildings. It is also responsible for issuing loans for home modernization and repair and for various specially assisted mortgage programs. Its activities fluctuate in line with economic conditions, the availability of private credit on favorable terms, and a number of other factors. In most years, and despite an irregularly rising trend of mortgage defaults during the last decade, premium and other income has been more than enough to meet the agency's responsibilities in loan defaults and other expenses. Its excess of receipts over expen-

[14] College housing loans are treated under Assistance to Higher Education in ch. VIII.

ditures has served to reduce the total net budgetary resources devoted to the housing field. Our projections assume a continuation of this trend, though we realize that if such surpluses become too large, there will undoubtedly be considered pressure to reduce insurance permiums for mortgage programs insured by the Federal Housing Administration. The suggested program of federally insured private loans to finance the acquisition and development of land for new towns and communities might fall within the responsibility of the FHA.

FEDERAL NATIONAL MORTGAGE ASSOCIATION

The Federal National Mortgage Association's main function is to provide a market for federally insured mortgages for special programs. It has been outstandingly successful in discharging its functions. It is particularly valuable to private builders at times of general cerdit stringency. In addition, imaginative use can be made of its facilities to promote socially desirable housing programs for which private financing would not be readily forthcoming. Examples are the provision of mortgages bearing below-market interest rates for housing for families with low or moderate incomes, and a new proposed program for mortgage insurance for land development which would be too speculative for most conventional private lenders. FNMA holds a large stock of mortgages, acquired mostly in times of overall credit stringency. In recent years proceeds from the sales of such assets have considerably exceeded all of the Association's expenditures, resulting in a surplus which was available to reduce other budgetary outlays in the housing field. It is difficult to project the future of this program, and we have assumed that the Association's operations after 1968 will have a generally neutral effect on the federal budget.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

By contrast, it is estimated that the Federal Savings and Loan Insurance Corporation, which insures savings institutions, will have moderately increasing annual surpluses if generally prosperous conditions continue, since premiums should continue to exceed claims by a comfortable margin each year. These surpluses will continue to be available to reduce net budgetary expenditures in this field.

CONTINGENCY FUND

Model II–B contains an estimate for a contingency fund. Since housing and community development is an area where urgent unsatisfied needs will continue to exist and where new ideas and programs could gain acceptance in the next few years, additional expenditure estimates are included for such programs.

DISTRICT OF COLUMBIA

Estimates of future Federal payments to the District of Columbia to help defray expenses of the District government and for its services to the Federal Government show a slow but steady upward trend. In models II–A and II–B an additional annual contribution toward the expenses of constructing and operating a subway system has been assumed.

TRUST FUNDS

Finally, projections have been made for trust funds in this classification. The secondary market operations of the revolving fund of the FNMA fluctuate considerably from year to year. We have projected purchases to exceed sales somewhat in most years, thus imposing a net charge of $100 to $200 million annually on the cash budget. The main reason for this is that we expect moderately increasing building activity over the period. For the same reason, the Federal Home Loan Bank Board would require additional capital funds from time to time. District of Columbia municipal government trust fund projections reflect judgments as to the likely level of tax rates and public services in the District during the decade, as well as estimates of population and requirements.

Part 3

ANNOTATED BIBLIOGRAPHY

ANNOTATED BIBLIOGRAPHY*

I. Federal Aid to State and Local Governments: History, Trends, Developments, and Analysis

Advisory Commission on Intergovernmental Relations, *Federal-State Coordination of Personal Income Taxes*, Government Printing Office, Washington, D.C., 1965.

The book discusses the fiscal problems of the States and the role of the income tax. It discusses the factors promoting the use of the income tax and the opposition to it. The book points to a need for intergovernmental cooperation and discusses the Federal Government's role.

Bureau of the Budget, "Federal Aid to State and Local Government," *Special Analysis of the Budget of the United States, Fiscal Year 1967*, Government Printing Office, Washington, D.C., 1966.

Break, George F., *Intergovernmental Fiscal Relations in the United States*, The Brookings Institution, Washington, D.C.

This study of intergovernmental fiscal relations examines State-local tax sharing and grants-in-aid and makes some proposals for improvements and coordination. It also looks at metropolitan fiscal problems.

Breton, A., "A Theory of Government Grants," *Canadian Journal of Economics and Political Science*, May 1965, p. 175–87.

Colm, Gerhard, & Peter Wagner, *Federal Budget Projections*, The Brookings Institution, 1966.

Committee for Economic Development, *A Fiscal Program for a Balanced Federalism*, June 1967.

Elazar, Daniel J., "Federal-State Collaboration in the Nineteenth Century United States," *Political Science Quarterly*, June 1964, pp. 248–81.

The thesis of the article is that American federalism has traditionally been cooperative. The author divides the history of Federal cooperation into three periods. The first is the formative years from 1798–1848. This was the period of joint stock companies, banking, internal improvements, and education. The second era was 1848–1913, dominated by land grants. The third period is from 1913 to the present and has been one of increasing cooperation.

Fier, L., "A Note on Federal-State Fiscal Coordination," *National Tax Journal*, December 1961, pp. 405–08.

The article is concerned with breakdowns in Federal-State fiscal coordination. One example of the breakdown ocurred following the Korean War. The States were asked to withhold sale of bonds until they were needed to offset a recession. The States went ahead and sold bonds anyway to pay veterans' bonuses.

Freeman, Roger A., "Federal Grants and the Decline of the Federal System," a paper delivered to the 58th Annual Conference on Taxation, National Tax Association, New Orleans, Louisiana, November 9, 1965.

The article indicts grants-in-aid on the basis that they are controlling and restrictive.

Haskell, M. A., "Federal Grants and Budgetary Distortions," *Quarterly Review of Economics and Business*, May 1962, p. 79–87.

The article looks at allocations of State and local funds by function: education, police and fire, health and hospitals, highways, and public assistance. It concludes that it cannot support the view that grants are a cause of distortion, but if distortion does occur at all, it takes place in low income states.

*Prepared by Gail M. Larson, Antioch College.

Haskell, M. A., "Federal Grants-in-Aid: Their influence on state and local expenditures," *Canadian Journal of Economic and Political Science*, November 1964, p. 585–91.

The purpose of the article is to show that conventional analysis could be used in the study of intergovernmental fiscal relations. To illustrate, the author examines the question of whether or not grants-in-aid have a stimulation effect. He does not resolve the question, but the analysis is facilitated by using the tools of conventional analysis.

——— "Federal Grants and the Income Density Effect," *National Tax Journal*, March 1962.

Hopkins, T. D., "Income Distribution in Grants-in-Aid Equity Analysis," *National Tax Journal*, June 1965, p. 209–13.

In determining need for grants-in-aid, median income is often used as the criterion, neglecting the distribution of income. The evidence indicates that the greater the equality of income, the higher the median income. This has implications for tax policy. If the inequality is great, progressive taxes produce less revenue and regressive taxes produce more revenue.

Maxwell, James A., *Financing State and Local Governments*, The Brookings Institution, Washington, D.C., 1965.

This book on state and local finance discusses types of taxes and the revenue derived from them, and intergovernmental fiscal transfers. It contains a discussion of tax credits.

——— "Recent Developments in Federal-State Financial Relations," *National Tax Journal*, December 1960, p. 310–19.

The article is a discussion of the activity stimulated by the Kestnbaum Commission. The Joint Federal-State Action Committee studies what responsibilities the States could assume and recommends revenue adjustments in response. They made many recommendations, including that States assume responsibility for vocational education, waste treatment, increase disaster relief, and urban renewal efforts. The Federal Government would relinquish the telephone tax to the States to help finance the projects. The article concludes that there is too much variation among the States and a piecemeal approach would not work. The Intergovernmental Relations Subcommittee recommended a permanent Advisory Commission on Intergovernmental Relations, which was established.

Monypenny, P., "Federal Grants-in-Aid to State Governments: A Political Analysis," *National Tax Journal*, March 1960, p. 1–16.

Patterns of grants-in-aid show that the bulk of the money goes for public welfare, highway construction, education, and health and hospitals. Low income States do not receive more than wealthy States and grants have not produced any uniformity of expenditures. No major grant is based primarily on an equalization factor. Included is a discussion of the frequently cited justification for grants: promotion of National interests, stimulation of programs, the difficulties of State and local governments in raising revenue, greater administrative competence at the Federal level. Grants can be viewed as a result of political influence: those who cannot get what they want through local governments can go to Congress. (Includes Political Influence Charts.)

Musgrave, Richard A., (ed.), *Essays in Fiscal Federalism*, The Brookings Institution, Washington, D.C., 1965.

Mushkin, Selma J., "Barriers to a System of Federal Grants-in-Aid," *National Tax Journal*, September 1960, pp. 193–218.

The article discusses the two major proposals to improve Federal grants: 1) block grants, 2) to make procedure, requirements, and formulas more uniform. The proposals originated with the Hoover and Kestnbaum Commissions. The issues involved in block grants are that they would reduce Federal control, and they would aid the States financially. Although some uniformity may be desirable, too much could require too many readjustments and the differences in the programs in the States is, in part at least, due to preferences and needs.

———, and Robert F. Adams, "Emerging Patterns of Federalism," *National Tax Journal*, September 1966.

The article describes the patterns of intergovernmental relations. It discusses local government spending, State aid to local governments, cooperation of States to form regions, and the necessity of Federal grants.

Pechman, Joseph, *Federal Tax Policy*, The Brookings Institution, Washington, D.C., 1966.

Ruggles, Richard, "The Federal Government and Federalism: A View," Conference on Urban Economics, Washington, D.C., Jan. 1967.

Scott, A., "The Economic Goals of Federal Finance," *Public Finance* 1964, pp. 241–88.

Shultz, W. J., & C. Lowell Harris, *American Public Finance*, Englewood Cliffs, New Jersey: Prentice Hall Inc., 1965.

Chapter XXII. This chapter gives a history of State-local interrelationships. It discusses State assumption of local functions, State grants to local governments, State-local revenue relationships, supplementary local rates, extension of local tax authority, shared taxes, urban-suburban fiscal relationships, and revenue problems.

Chapter XXIII. The chapter deals with interstate fiscal relations. It tells of cooperation among the States with such examples as the reduction of overlapping multiple taxation. It discusses the development and objectives and the present state of grants-in-aid. It discusses the issue of Federal control, separation of revenue sources, shared taxes, and supplementary State rates.

Tax Foundation, Inc., *Fiscal Outlook for State and Local Government in 1975: Summary and Conclusions*, Washington, D.C. 1966.

Trescott, P.B., "Federal-State Financial Relations, 1790–1860," *Journal of Economic History*, September 1955, pp. 227–45.

The article is a history of Federal-State fiscal relations with tables showing financial transactions, discussion of the relations due to State debts, and tax sharing from the sales of public lands.

II. State Revenue Sharing and Aid to Local Governments

Gere, E. A., "Some Aspects of Massachusetts Public Finance: A Survey of Intergovernmental Fiscal Relations in the Commonwealth," Bureau of Government Research, 1961.

Green, J. L., & Clement, C. D., *Some Impacts of Intergovernmental Fiscal Relations in Georgia*, Bureau of Business Research, 1963.

The pamphlet is a study of the effects of intergovernmental transfers in one State. It looks at Federal grants to State and local governments, State grants to local governments, and local transfers to the State government. It examines trends in intergovernmental revenues and expenditures. It looks at the size and importance of grants and the impact of grants on the tax structure and functions of goverment in Georgia. Tables included.

Smith, A. H., "State Payments to Local Government in Wisconsin," *National Tax Journal*, September 1962, p. 297–307.

State payments to local governments in Wisconsin are larger than the state payments to local governments of other States of comparable wealth. The Wisconsin situation is also different in that Wisconsin uses shared taxes more than other states. Shared taxes help correct the distortion of financial burdens caused by aids.

Harriss, C. Lowell, *Handbook of State and Local Government Finance*, Tax Foundation, Inc., 1966.

III. Intergovernmental Fiscal Experience in Other Countries

Bhargava, R. N., *Indian Public Finances*, George Allen and Union, Ltd., London, 1962.

The book is a general discussion of public finance in India with chapters on tax policy, resources, revenues, expenditures and planning.

Chapter II is concerned with Federal Finance. It gives a description of the Federal fiscal system and an analysis of some of the problems within it. Inherent in a system of tax sharing is the divorce of the revenue raising power from the spending power. The distribution is based on population, which is not necessarily equitable due to the diversity of the States. Too often local disputes are settled at the Cabinet level. A discussion of the Finance Commission is included.

Burns, R. M., "Recent Developments in Federal Provincial Fiscal Arrangements in Canada," *National Tax Journal*, September 1962, p. 225–38.

The article discusses intergovernmental fiscal transfers in Canada, including background information of the Federal system. The increasing needs of the provinces and the depression accented the need for more cooperation, which led to the rental agreeements, attempts to equalize provincial income, the withdrawal of the Federal government from personal and corporate income taxes to allow States to levy the tax, and an increase in conditional grants.

"General Payments to Other Governments," *The National Finances, 1965–66*, Canadian Tax Foundation, 1965.

Chapter X gives a description of Federal payments to provincial and local governments. It discusses grants and tax rental agreements from 1941–1957 and the changes leading to tax sharing in 1957–62 and 1962–67. It describes the equalization and stabilization policies, the Atlantic Provinces adjustment grants, youth allowances, student loans, pension plans, and medicare.

Dehem, R. & J. N. Wolfe, "The Principles of Federal Finance and the Canadian Case," *Canadian Journal of Economics and Political Science*, February 1955, p. 64–72.

The thesis of the article is that Federal organization is dependent upon national objectives. It gives a critique of the Canadian Federal system and presents two proposals for financial organization, which would respect Federal principles.

Due, John F., "Tropical African Contributions to Federal Finance," *The Canadian Journal of Economics and Political Science*, Feb. 1964.

This article is a discussion of Federal finance in the Federation of Rhodesia and Nyasaland, Nigeria, Kenya, Tanganyika, and Uganda. It includes the formation of the tax structure, the present tax structures, the income tax management act, surcharges, customs, and excises. It covers the means of revenue allocation within the Federal structure, tax sharing, the origin of revenue and the formula for distribution. It further discusses the consequences of the structure.

Garmany, J. W., "Revenue Allocation in a Federal State: the experience of Rhodesia and Nyasaland," *South African Journal of Economics*, March 1962, p. 50–60.

The article discusses Federal finance in underdeveloped countries with particular emphasis on the Federation of Rhodesia and Nyasaland. It presents a classification of criteria used in allocating revenue and an account of allocation in Rhodesia and Nyasaland. The income and profits tax and external loan finance proceeds are shared according to a formula based on costs of the functions handed over from the Territorial to the Federal Government.

Hanson, E. J., "Federal State Financial Relations in Australia," *Canadian Public Administration*, March 1962, p. 9–22.

The article describes Federal-State relations in Australia with a history of grants and a description of the Grants Commission.

Hicks, U. K., *Federalism and Economic Growth in Underdeveloped Countries*, 1961.

Chapter II discusses the political implications of federalism in the new States. Chapter V concerns the intergovernmental financial relations in the new federations. It discusses the theory of fiscal federalism. The customs, income tax, and grants in Malaya, Rhodesia and Nyasaland, India, Nigeria, and the West Indies are examined.

Hong, H. T., "The New System of Revenue Allocation to State and Settlements in the Federation of Malaya," *Malayan Economic Review*, April 1957, p. 79–83.

The article is a description and criticism of the new (1956) system of revenue allocation in Malaya, telling of the changes and principles of the system.

Nagarajan, P., "Financial Dependence of the States on the Centre," *Indian Journal of Economics*, January 1963, p. 167–73.

The purpose of the article is to examine whether or not the dependence of the States on the Federal government of India is increasing. It concludes that it is, but that unconditional grants would not contribute to dependence and lack of autonomy.

Perry, J. H., "What Price Provincial Autonomy?" *Canadian Journal of Economics and Political Science*, November 1955, pp. 432–45.

The article gives some background of Federal-provincial financial relations discussing the evolution of taxing powers and the grants system. It discusses the concept of fiscal and tax autonomy and the advantages and disadvantages of the present system. It further discusses whether or not it is possible to have provincial autonomy without fiscal autonomy.

——— "The Historical Background and Development of Federal Provincial Financial Relations," *Canadian Public Administration*, March 1962, pp. 23–27.

This short article gives a brief history of Federal-provincial financial relations and the development of tax organization. It divides the history into three phases from 1867 to World War I, World War I and World War II, and from the Rowell-Sirois Report to the present.

Prest, W., "Federal-State Financial Relations in India," *Economic Record*, April 1960, pp. 191–219.

The article describes intergovernmental fiscal relations in India. It discusses the allocation of fiscal powers, which are well-defined by the Constitution. Sixty per cent of income tax and excise duties are shared, based on national collection. The distribution is based on population. Grants-in-aid are used to help States with particular needs. The grants are not uniform and are made for five years. There are also public purpose grants, which are used mostly for community development.

"Union State Financial Relations—Our Basic Approach," *Report of the Finance Commission 1965*, pp. 6–11.

This chapter is an excellent brief description of India's approach to intergovernmental fiscal relations.

Robson, P., "Patterns of Federal Finance in the Newer Federations," *Finanz Archiv*, April 1962.

Seers, D., "Federation of the British West Indies: The Economic and Financial Aspects," *Social and Economic Studies*, June 1957.

The article describes and discusses the financial arrangements in the West Indies. The central government is weak and cannot levy income tax for the first five years. The West Indian economy is not expanding as rapidly as the Canadian and United States economies were during the beginning years of federation.

Smiley, D. V., "The Rowell-Sirois Report, Provincial Autonomy and Post-War Canadian Federalism," *Canadian Journal of Economic and Political Science*, February 1962.

Wells, R. H., *The States in West German Federalism: A Study of Federal State Relations, 1949–1960*, 1961.

IV. Alternatives for Fiscal Federalism

Brazer, Harvey, "Our Hard-Pressed State and Local Governments," Reproduced in the *Congressional Record*, April 26, 1966, pp. A2253–A2255.

The article favors tax sharing to meet the increasing financial needs of the States. It argues that grants-in-aid cause distortions in State budgets and fails to see any advantage in lowering Federal tax rates so that the excess can be taken up by the States.

Cahn, Robert, "U.S. Studies Tax-Sharing Plans," *Christian Science Monitor*, January 6, 1966, p. 5.

The article is opposed to unrestricted gifts. It advocates continuing and expanding grants-in-aid.

Curran, Donald J., & John Shannon, "Positive and Negative Tax Credits—A New Dimension in Intergovernmental Relations," *National Tax Journal*, March 1966.

Dale, Edwin L., "Subsidizing the States," *The New Republic*, November 28, 1964, pp. 11–12.

The article supports revenue sharing on the basis of State needs. It describes revenue sharing as exciting.

"Dollars from D.C.," Federal Reserve Bank of San Francisco, *Monthly Review*, February 1965, pp. 26–29.

Freeman, Roger A., "Grants Without Strings," An article reproduced in the *Congressional Record*, June 25, 1959, pp. A5506–07.

"Government for Tomorrow: A Proposal for the Unconditional Sharing of Federal Tax Revenues with State and Local Governments," A research paper issued jointly by the Republican Governors' Association and the Ripon Society, July 1965.

The paper proposes a plan of revenue sharing on the basis that States need more funds, which are difficult to raise. Revenue sharing would give the State and local governments an opportunity to be creative and would make a more pluralistic society.

Harriss, C. Lowell, "Sharing Federal Revenues with the States," an article reproduced in the *Congressional Record*, April 19, 1966, pp. A2109–A2111.

The article states that States could probably meet their needs if they received more funds from the Federal Government. It says that the funds should be unconditional grants. It discusses some problems in revenue sharing: achieving a desirable distribution; providing for fluctuations; States will have a vested interest and therefore oppose tax reform.

Heilbroner, Robert L., "The Share-The-Tax-Revenue Plan," *New York Times Magazine*, December 27, 1964.

Heller, Walter W., *New Dimensions of Political Economy*, Harvard University Press, Cambridge, Mass., 1966.

The proposal for revenue sharing.

Hitch, Thomas K., "Why a Negative Income Tax Won't Work," *Challenge*, July/Aug. 1966, pp. 13–15.

"If Washington Shares Revenue with the States," *U.S. News and World Report*, December 5, 1966, pp. 86–87.

The article states that tax sharing will become an issue as the present grants-in-aid system is unsatisfactory. It points out that State and local revenue raising abilities are limited.

Javits, Jacob K., "Federal-State-Tax-Sharing Plan," Remarks on S2619, *Congressional Record*, October 11, 1965, pp. 25608–19.

The speech contains Javits' remarks on his tax sharing proposal with tables showing how much each State would receive under his plan.

Laird, Melvin R., *Tax Sharing with the States: A Way Out*, Keynote remarks before the National Conference of State Legislative Leaders, Nov. 17, 1966.

The speech gives the proposal and rationale for tax sharing.

———, "Too Much and Too Little," *N.AM Reports*, Feb. 20, 1967. Mr. Laird proposes a system of tax sharing to replace grants-in-aid.

Lutz, Harley L., "Tax Sharing. Plan Raises Doubt About the Whole Federal Grant System," *Wall Street Journal*, Dec. 12, 1966, p. 18.

The article argues that instead of either revenue sharing or conditional grants the Federal Government should reduce taxes to allow the States to levy the taxes themselves.

———, "State and Surpluses, Why Federal 'No Strings' Distribution Would be Unwise," *Wall Street Journal*, Dec. 28, 1964, p. 6.

The article opposes revenue sharing on the grounds that money distributed by the Federal Government means Federal control. It argues that any surplus that may result from the income tax could be spent in other ways.

Maxwell, James A., *Tax Credits and Intergovernmental Fiscal Relations*, The Brookings Institution, Washington, D.C., 1962.

The book begins by giving some history of government finance. It discusses types of tax credits, including the death tax, unemployment insurance tax, and income tax. It suggests replacing deductions with credits. It discusses other intergovernmental fiscal transfers such as grants and tax sharing.

McBreen, Maureen, *Federal Tax Sharing: A Resume of Proposals*, Library of Congress, Legislative Reference Service, Washington, D.C., July 29, 1966.

———, *Analysis of President Johnson's Proposal to Share Rising Tax Revenue with State and Local Governments*, Library of Congress, Legislative Reference Service, Washington, D.C. November 23, 1964.

Otten, Alan L., & Charles B. Seib, "No-Strings Aid for the States?" *The Reporter*, January 28, 1965, pp. 33–35.

The article summarizes the Heller plan and gives the arguments pro and con.

Pechman, Joseph A., "Financing State and Local Govenments," Proceedings of A Symposium on Federal Taxation, The American Bankers Association, New York, N.Y., 1965.

The article describes the needs of State and local governments. It proposes a general assistance program based on population with some part of the funds reserved for low income States in order to effect redistribution.

Republican Coordinating Committee, *Financing the Future of Federalism: The Case for Revenue Sharing*, Task Force on the Functions of Federal, State and Local Governments. Prepared under the direction of the Republican National Committee, Washington, D.C., March 1966.

The paper presents a specific proposal for revenue sharing. It outlines the needs of the States, the proposal, and the purposes of the sharing.

Riggert, D. W., "Federal Grants-in-Aid and Shared Revenue Briefly Defined," *National Tax Journal*, March 1961, pp. 104–08.

The article defines the difference between grants-in-aid and shared revenue. Some States do get shared revenue due to Federal land holdings. If the shared revenue figures are included in figuring grants per capita, there is a substantial distortion in the case of some of the western States such as Wyoming.

"Sharing the Wealth," *News Front*, April 1967, pp. 14–17.

"Should Uncle Share the Wealth?" *Nation's Business*, April 1967.

Strout, Richard L., "Clash Looms on Tax-Sharing Plans," *Christian Science Monitor*, November 30, 1966, pp. 1–23.

The article describes the Goodell and Reuss plans for tax sharing.

Tyson, Robert C., "Federalism or Federalization?" *Tax Review*, Tax Foundation, April 1967.

The author argues that government spending is inflationary; therefore, nondefense expenditures should be cut. He further states that Federal aid means Federal control and there should not be tax sharing because the States can meet their own needs.

Ulmer, Melville, "The Tax-Sharing Fallacy," *The Progressive*, May 1967, pp. 17–20.

Worsnop, Richard C., "Federal-State Revenue Sharing," *Editorial Research Reports*, December 23, 1964, pp. 943–60.

The article describes the development of the grants-in-aid system. It explains the States' need for increased revenue and explains how revenue sharing would fill this need. It tells of State-local tax sharing and explains the problems tax sharing would create.

O