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90th Congress } JOINT COMMITTEE PRINT
1st Session }

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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 I:

LESSONS OF EXPERIENCE

JULY 1967

Printed for the use of the Joint Economic Committee

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U.S. GOVERNMENT PRINTING OFFICE
80-491 WASHINGTON : 1967

For sale by the Superintendent of Documents, U.S. Government Printing Office
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LETTERS OF TRANSMITTAL

JULY 17, 1967.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
Congress of the United States,
Washington, D.C.

DEAR MR. CHAIRMAN: Transmitted herewith for use of the Joint Economic Committee and other Members of the Congress is a three-volume compendium, entitled "Revenue Sharing and Its Alternatives: What Future for Fiscal Federalism?" The compendium includes invited papers; selected surveys of Federal, State, and local—as well as foreign—experience in intergovernmental fiscal relations; and reprints of related scientific analyses and research which has been completed over the past few years.

The Subcommittee on Fiscal Policy is grateful to the many outside experts who gave generously of their time and talent in the preparation of papers and other materials for the compendium. We also express appreciation to the Legislative Reference Service of the Library of Congress for advice, assistance, and cooperation.

The study was prepared under the general supervision of Mr. James W. Knowles, director of research for the Joint Economic Committee, with the major responsibility for planning, coordinating, and editing being done by Prof. Harley H. Hinrichs, of the University of Maryland, and the committee staff.

The views expressed in these volumes do not necessarily represent the views of the Subcommittee on Fiscal Policy or individual members thereof.

MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy.

JULY 14, 1967.

Hon. MARTHA W. GRIFFITHS,
Chairman, Subcommittee on Fiscal Policy,
Joint Economic Committee,
U.S. Congress, Washington, D.C.

DEAR MADAM CHAIRMAN: Transmitted herewith is a compendium in three volumes, entitled "Revenue Sharing and Its Alternatives: What Future for Fiscal Federalism?" This collection includes invited papers, and reprints of selected articles by Government officials, social scientists, and research institutions, analyzing and evaluating the issues involved in intergovernmental fiscal relations. It also includes excerpts from reports and recommendations of earlier Government commissions and committees that have faced related issues.

These volumes provide a comprehensive survey of the state of knowledge and opinion on the timely—but ever present—issues of fiscal federalism in the United States. Volume I examines the "Lessons of Experience" with fiscal federalism from the debates in the *Federalist Papers* to the developments of the past two decades; the changing role and performance of the Federal grants-in-aid system; experience and evaluations of intergovernmental fiscal relations and revenue sharing at the State-local level; and lessons that might be drawn from fiscal federalism experience of other countries, such as Canada, Australia, Germany, India, Malaysia, Nigeria, and Argentina. Revenue sharing is not a new idea; many countries and indeed many American States share revenues with other units of governments.

Volume II spells out the "Range of Alternatives for Fiscal Federalism." If considerable fiscal dividends are generated by the present highly elastic revenue system of the Federal Government, what are their alternative uses? Or, what may be some "optimum mix" of policies? The major focus is on various methods for sharing federally collected revenues with individuals and/or with State and/or local governments. The distinctive issue of local needs and limitations is treated in a special section. Other alternatives are included to provide a broader choice among alternatives, substitutes, and complements. Fiscal federalism involves not only the possibility of shifting revenues, but also the choice of shifting functions: the ultimate sharing of Federal revenues with individuals rather than government units would involve such proposals as the "negative income tax" approach which would reduce State and local payments for welfare and poverty programs. Other possible variations in fiscal federalism would involve Federal tax credits for State income tax payments and/or increased coordination of the Federal and State income tax systems. Within the context of the existing system of grants-in-aid there are a number of possible changes and improvements such as consolidation or incorporation within a broader benefit-cost allocation mechanism. A final alternative that is examined is the case for Federal tax reduction.

Volume III assembles the various fiscal projections of revenues and expenditures at the Federal, State, and local levels.

It should be clearly understood that the views expressed in these papers are those of the individual contributors and do not necessarily represent the positions of the organizations or agencies they may represent (unless otherwise stated), the Joint Economic Committee, members thereof, or the committee staff.

This study is a natural outgrowth of both recent and prospective work of the Joint Economic Committee. The committee has recently published "U.S. Economic Growth to 1975: Potentials and Problems," with its own set of Government sector projections and policy issues. The committee's hearings and report on the "Economic Effect of Vietnam Spending" helped set the stage for consideration of post-Vietnam fiscal policy formation. Earlier, the Subcommittee on Economic Progress produced a two-volume study of "State and Local Public Facility Needs and Financing" that treated in detail projected public sector needs at the State and local level over the next decade. Prospective studies include an extensive analysis of the urban environment by the Subcommittee on Urban Affairs, analysis of negative income tax, guaranteed annual income, and other proposals for income maintenance by the Subcommittee on Fiscal Policy.

Many persons have contributed generously to the papers, organization, and editing of this compendium. Prof. Harley H. Hinrichs, of the University of Maryland and the staff of the Joint Economic Committee undertook the major responsibility for planning, coordinating, and editing this study. Richard F. Kaufman, also of the committee staff, made many contributions in its development. Miss Carole Houghton undertook much of the administrative task of publication while Miss Gail Larson did much of the initial research and wrote the annotated bibliography.

JAMES W. KNOWLES,
Director of Research.

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

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

VOLUME I: LESSONS OF EXPERIENCE

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Part 1

FEDERAL AID TO STATE AND LOCAL GOVERNMENTS

Section A: HISTORICAL SURVEY

THE FISCAL IMPACT OF FEDERALISM IN THE UNITED STATES*

BY JAMES A. MAXWELL

PROLOGUE

> In contemplating the causes which may disturb our union it occurs as matter of serious concern that any ground should have been furnished for characterizing parties by geographical discriminations—*Northern, Southern, Atlantic* and *Western*—whence designing men may endeavor to excite a belief that there is a real difference of local interests and views. . . . You cannot shield yourselves too much against the jealousies and heart-burnings which spring from these.
>
> *Washington's Farewell Address.*

When the American colonies broke with Great Britain they were not ready for a strong federal union. Their population, scattered over a vast area, was not homogeneous in economic interests, political institutions, or religion. Within regions, as distinct from colonies, there was, indeed, more cohesion. The Southern colonies were bound together by slavery and by the importance in their economic life of tobacco and indigo; the Middle Atlantic colonies produced foodstuffs; New England looked to external commerce and to fishing. This economic regionalism stood as a barrier to a national union.

Against these elements making for separatism, other influences pulled the colonies together. A common language, law, and tradition were, with minor exceptions, the heritage of all. The growth of intercolonial trade after 1754 was rapid, and the colonies, by building roads and by improving their postal system, recognized their mutual interests. In time of crisis, they had joined together in protecting their frontiers and after 1754 they drew together in common enmity against Great Britain.

How these centripetal and centrifugal forces would have balanced had the mother country been prepared to allow the colonies to develop complete self-government, nobody can know. In fact, this course was not followed, and in 1774 the colonies were sufficiently cohesive to join in a loose association. But not until July 1776 did a committee of the second Continental Congress report a scheme of confederation. For a year and a half thereafter Congress debated the scheme, and a further three and a half years elapsed before the Articles of Confederation were ratified by all the 13 States. When independence had been won, not a few Europeans, and even some Americans, anticipated that the confederation would fall apart. Perhaps this danger was exaggerated, but in any even *improvement* in the scheme of government was to be very difficult to secure.

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*Reprinted from *The Fiscal Impact of Federalism in the United States*, Harvard University Press, Cambridge, Mass., 1946, Chapter I.

THE FEDERAL GOVERNMENT SECURES STRONG FISCAL POWERS

It was inevitable that the finances of the revolting colonies during the war should fall utterly into disorder. Taxation had always been light, and external commerce, the easiest source of revenue for immature governments, was dislocated by the war. Revolutionary assemblies were not likely to impose, or a people in revolt against authority to pay, heavy taxes. A Rhode Island protest which said that "taxation, or contribution for the support of the government, ought to be free and voluntary" [1] expressed a typical attitude. Even when taxes were levied, they were inefficiently collected; and people seeing their neighbors escape were provoked to evasion.

The ratification in 1781 of the Articles of Confederation, while establishing a national government, did not improve the public finances. The functions placed in the hands of the Congress were not inconsiderable; the lack was in the power, particularly the fiscal power, to administer them. For its revenue Congress was left in complete dependence upon the States. The States, at the call of the Congress, were to levy taxes through their own officers "in proportion to the value of all land within each State, granted to or surveyed for any Person, as such land and the buildings and improvements thereon shall be estimated according to such mode as the United States in Congress assembled, shall from time to time direct and appoint." [2] Every schoolboy knows how badly this worked. From 1781 to 1789 Congress ordered the States to pay as requisitions $6,630,000 in specie and $8,733,000 in indents; it received $3,384,000 in specie and $1,542,000 in indents.[3] The public lands were given to the government of the confederation by the Articles, but actual cession was slow. Interest on domestic and foreign debt fell into arrears, and the ability to borrow nearly vanished. So impotent was Congress and so great was the aversion to taxation in the States that the Nation seemed close to an inflation which would wipe out all war debt.

The first attempts to strengthen the fiscal power of Congress were blocked. Rhode Island in 1781 refused to give Congress the right to levy a 5 percent duty on imports—and amendment of the Articles required unanimous consent. In 1783 Congress asked for the right to levy a limited range of duties on imports for 25 years, the duties to be collected by State officers and to be used only to pay interest on the public debt. By 1787 12 of the States signified acceptance of this innocuous measure, but New York was recalcitrant. Meanwhile, the States had begun to levy tariffs—sometimes to raise a revenue, sometimes to enourage State trade, and sometimes in retaliation for duties imposed by a neighbor. Against these divisive forces all men of property, and all those who desired a strong and united nation, prepared to move.

Nothing seemed clearer than that Congress needed the power to levy taxes of its own, but the power actually given by the new Constitution in 1788 went far beyond the proposals mentioned above. Con-

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[1] W. G. Sumner, *The Financier and Finances of the American Revolution* (New York, 1891), I. 18.
[2] Article VIII.
[3] C. J. Bullock, *Finances of the United States, 1775–1789* (Madison, 1895), p. 162.

gress received the power "to levy and collect taxes, duties, imposts and excises . . . ,"[4] which meant that, besides the exclusive control over customs, it was to have a concurrent jurisdiction with the States in practically all fields of taxation. To many contemporaries this seemed excessive, and the advocate of the plan, while insisting that such a broad Federal power was desirable, protested that there was no practical likelihood of its extended use. Thus Hamilton argued that "the sense of the people, the extreme hazard of provoking the resentment of the State governments, and a conviction of the utility and necessity of local administration for local purposes, would be a complete barrier against the oppressive use of such a power."[5] He went on to affirm that, with the sole exception of duties on foreign trade, the States would retain an independent right to raise revenue "in the most absolute and unqualified sense; and that an attempt on the part of the National Government to abridge them in the exercise of it would be a violent assumption of power, unwarranted by any article or clause of its Constitution."[6] Why, then, was it needful to *give* the National Government such a broad power? Because upon it fell the duty of defense. Wars and rebellions were the "two most mortal diseases of society." The expenditures of the National Government, if it were blessed by peace, would be small. But since the danger of war was incalculable, the Federal power of taxation should not be limited. Even to separate out and divide Federal and State sources of revenue would be to sacrifice "the great *interests* of the Union to the *power* of the individual States."[7]

Hamilton had his way, and certainly he was right. But the forecast has been fulfilled of those who declared that, given this extended power of taxation, Federal exercise would follow. For 60 years any extension of the Federal revenue beyond customs was gingerly handled. Then, under stress of emergency, came a great surge forward with no reversion to the former position.

The other fiscal provisions of the Constitution can be passed over lightly. Congress was given the power to levy "direct" taxes, but only by apportioning them among the States "according to their respective numbers."[8] What was a direct tax? The Constitution did not say. When, by judicial interpretation, it turned out that important taxes—notably the income tax—were direct, this provision limited the Federal taxing power. The reason was that apportionment according to population placed an undue burden upon the States with a low per capita wealth. Another provision of the Constitution prohibited levy of export duties. Behind this lay the fear of the South that its staple exports might be taxed. In a few other features the Constitution bears evidence of sectional apprehensions, but these need not be discussed here.

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[4] Art. I, Sec. 9, No. 4.

[5] *Federalist*, edited by Henry Cabot Lodge (New York, 1888), p. 185.

[6] *Ibid.*, p. 186.

[7] *Ibid.*, p. 200. Hamilton's opinion of what should be State functions is given in the following quotation: "The expenses arising from those institutions which are relative to the mere domestic policy of a State, to the support of its legislative, executive and judicial departments, with their different appendages, and to the encouragement of agriculture and manufactures (which will comprehend almost all the objects of State expenditure), are insignificant in comparison with those which relate to the national defence." *Ibid.*, p. 197.

[8] This was a carryover from the Articles of Confederation by which Congress could impose taxes upon the States according to the value of their lands and buildings.

Consolidation of Federal Power During the First Quarter-Century

When at last the United States had a national government with adequate fiscal power, everyone watched eagerly to see how that power would be used. Urgent tasks had to be undertaken at once, but any solution of them was bound to raise up latent regional animosities.

At no time in the history of the United States was governmental debt—Federal and State—so serious a problem as in 1789. The Federal debt, foreign and domestic, was estimated at $54,124,500, of which $14,670,300 was arrears of interest. About the proper method for handling the foreign portion of the debt ($11,710,400) there was little dispute: it should be settled according to the letter of the contract. About the domestic debt, however, no such unanimity prevailed. Many people felt that some distinction should be drawn between original holders of the securities and the speculators who had acquired them by recent purchase. Against the proposal of discrimination Hamilton took a forthright position. The securities had been issued as negotiable so that the holder could sell them in the market and the buyer could be safe in his purchase. That contract should not be broken. Hamilton stressed also the practical difficulties in the way of effective discrimination. How trace back the various holders of a security and how ascertain the motives behind sale and purchase? His own simple plan of outright Federal assumption would, he conceded, permit some individuals to make speculative profits; but this damage was irreparable, and to strive after would not be to secure a more exact justice. Here again Hamilton had his way.[9]

Even more controversial was the question of State debts, amounting to $18,271,800.[10] These also were war debts—they were "the price of liberty"—and Hamilton argued for Federal assumption. All public creditors, in his opinion, should be treated alike, as they would not be if the States were left to their own resources. The States were unequal in the debts which they had amassed and in their ability to carry these debts. All of them, however, had been deprived of customs, and, therefore, of their chief source of revenue. The Federal Government, equipped with this revenue, could assume the debts without great inconvenience.

For weeks the question was savagely debated. On several occasions assumption was voted down only to be revived in another form. At this same time Congress was deadlocked also on the issue of the permanent location of the national capital; and finally the two chief antagonists, Hamilton and Jefferson, made a bargain. Hamilton secured a few votes in support of the new city of Washington; Jefferson secured a few in favor of assumption. And although speculation in the State debts was even more greedy and deplorable than that in the Federal debt, assumption was a wise step.[11]

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[9] But some alteration in the contract was made by funding. Upon the U.S. domestic debt, interest at 6 percent was paid only upon two-thirds of the principal; upon the remaining one-third of the principal interest began after 10 years. Upon arrears of interest, interest was paid at the rate of 3 percent.

[10] Hamilton estimated them at $21,500,000, but this amount was not assumed.

[11] By the terms of the funding, interest upon four-ninths of the total principal was to begin at once, upon two-ninths after 10 years, and upon three-ninths the rate was to be 3 percent. A. S. Bolles, *Financial History of the United States, 1789–1860* (New York, 1885), II, 28.

It is not generally realized that, for the first decade, the fiscal position of the Federal Government appeared far from being secure. When in 1790 Hamilton made his report on the public credit, he estimated that, out of a total annual expenditure of $2,839,200, nearly 80 percent would be required to service the public debt. For the first decade interest ate up 41 percent of the Federal revenue, a figure never approached in any subsequent period. The revenue rested almost entirely upon customs, and, therefore, upon foreign trade. What if the Government became involved in war? This would disrupt collections and force borrowing in a narrow domestic market. Hamilton and his friends hoped to improve the fiscal position of the Government by building up a system of internal revenue.[12] Something was done, and in the first decade excises produced about 8 percent of the total revenue. But the expense of collection was high, and opposition was intense, the most dramatic display being the Whisky Rebellion in Western Pennsylvania.[13] One other fiscal resource was tried out, with results which indicated its slight value. In 1798 Congress apportioned a direct tax of $2 million among the States. Collections came in very slowly. By the end of 1801 over one-third was uncollected, and the accounts were not closed until 4 years later.

It is, therefore, not surprising to find that at the end of the first decade contemporary observers were quite unimpressed with the fiscal progress which had been made. The Federalists, who had been in power, were unimpressed because what had been done fell short of their aims. The Republicans, morbidly afraid of centralization, were naturally unappreciative of the accomplishments of their opponents. In fact, the achievements were remarkable: a heavy war debt had been put in order, the State finances had been established on a sound basis, the Federal revenue system had been enlarged. With the advantage of hindsight, we can see that the Nation had been fortunate in the nature of governmental policies. Beyond question, the Republicans had a sounder perception of the perplexities of federalism than had Hamilton. But at the outset too great a sense of difficulty, too strict a regard for the feelings of the States, would have paralyzed action.[14] The Federalists, driven by the genius of Hamilton and buttressed by the decisions of John Marshall, established the power of the Federal Government over the forces of localism. By 1800, however, it was time for a

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[12] In a frank letter to Washington, Aug. 18, 1792, Hamilton stated the case for an excise system as follows: "Some able men thought it well to lay hold of so valuable a resource of revenue before it was generally preoccupied by the State governments. . . . They supposed that it was not amiss that the authority of the National Government should be visible in some branch of internal revenue, lest a total nonexercise of it should beget an impression that it was never to be exercised. It was supposed, too, that a thing of this kind could not be introduced with greater prospect of easy success than at a period when the Government enjoyed the advantage of impressions, when State factions to resist its authority were not yet matured, when so much aid was to be derived from the popularity and firmness of the actual Chief Magistrate." *Complete Works*, edited by Henry Cabot Lodge (New York, 1885–86), II, 247–48.

[13] A petition from this area protested that a duty on spiritous liquors was immoral, "dangerous to liberty," and unequal, as "laid on the common drink of a nation." The petitioners were "apprehensive that this excise will by degrees be extended to other articles of consumption, until everything we eat, drink, or wear be, as in England and other European countries, subjected to heavy duties and the obnoxious inspection of a host of officers." Albert Gallatin, *Writings*, edited by Henry Adams (Philadelphia, 1879), I, 3.

[14] Fisher Ames, writing in March 1792, declared: "We hear incessantly from the old foes of the Constitution, 'This is unconstitutional and that is,' and indeed, what is not? I scarce know a point which has not produced this cry, not excepting a motion for adjournment. If the Constitution is what they [the Republicans] affect to think it, their former opposition to such a nonentity was improper. . . ." *Works of Fisher Ames* (Boston, 1854), I, 114–15.

change, and it was the great good fortune of the Nation to secure an administration which, in the main, consolidated the positions occupied by the Federalists.

The next 12 years were to demonstrate the true fiscal strength of the Federal Government. The internal duties were abolished on the ground that it was wise to abstain from taxing "those subjects over which the individual States possess a concurrent right." [15] Yet the revenues continued to grow, and in 1808 Gallatin made the following optimistic statement: "The geographical situation of the United States, their history since the Revolution, and, above all, present events, remove every apprehension of frequent wars. It may, therefore, be confidently expected that a revenue derived solely from duties on importations, though necessarily impaired by war, will always be amply sufficient, during long intervals of peace, not only to defray current expenses, but also to reimburse the debt contracted during the few periods of war." [16] The Louisiana purchase, at a cost of $15 million, had been arranged in 1803 without the least financial difficulty, and both Jefferson and Gallatin began to think of Federal projects which were Hamiltonian in scope. In his sixth annual message (1806), Jefferson favored Federal expenditure on roads, rivers, and canals, because better methods of communication would obliterate "the lines of separation" among the States and cement the Union "by new and indissoluble ties"; [17] and he suggested also the establishment of a national university. These steps were to be taken, however, only after "the constitutional enumeration of Federal Powers" had been augmented. Yet in earlier years expansion of the Federal powers as such had seemed to be a Federalist doctrine.

Advancement of these schemes was halted first by the embargo and then by the War of 1812. Although the war policy as a whole was lamentably fumbling, the Treasury showed that, on the administrative level, it had made progress. A series of excises, called explicity war taxes and thus marked for prompt repeal, was imposed, and proved quite productive. Even the levy of three direct taxes was handled fairly well.

Growth of "Geographical Divisions"

Not long after the Treaty of Ghent, the forces of sectionalism, constrained within moderate limits by good fortune or design, began to gain new strength. The obvious force behind them was the geographic growth of the Nation. A tide of settlement poured over the mountains, and between 1816 and 1821 the number of States grew from 17 to 23. These new areas were not wishful to extension of the Federal authority; on the contrary, their people wanted freedom to pursue their own interests in their own way.

It is little short of remarkable how every President after Monroe, no matter what his party, harped on the responsibilities and dangers of federalism. John Quincy Adams had no fear of party squabbles over "speculative opinions" or "administrative policy." But, he declared, those "founded on geographical divisions, adverse interests of soil,

[15] *American State Papers, Finance*, I, 734–35.
[16] *Report of the Secretary of the Treasury*, 1808 (vol. I, 1789–1814), p. 377.
[17] *Messages and Papers of the Presidents, 1789–1902*, edited by James E. Richardson (Washington, 1903), I, 409.

climate and modes of domestic life are more permanent, and therefore, perhaps, more dangerous. It is this which gives inestimable value to the character of our Government, at once Federal and National. It holds out to us a perpetual admonition to preserve alike and with equal anxiety the rights of each individual State in its own government and the rights of the whole Nation in that of the Union."[18] The words of Andrew Jackson are similar: "That there are diversities in the interests of the different States which compose this extensive Confederacy, must be admitted."[19] Twenty-three years later, in 1853, Franklin Pierce evinced the deterioration in sentiment which had taken place. "It is evident," he said, "that a confederation so vast and so varied, both in numbers and in territorial extent, in habits and in interests, could only be kept in national cohesion by the strictest fidelity to the principles of the Constitution as understood by those who have adhered to the most restricted construction of the powers granted by the people and the States. . . . The minimum of Federal Government compatible with the maintenance of national unity and efficient action in our relations with the rest of the world should afford the rule and the measure of construction of our powers under the general clauses of the Constitution. A spirit of strict deference to the sovereign rights and dignity of every State . . . should characterize all our exercise of the respective powers temporarily vested in us as a sacred trust from the generous confidence of our constituents."[20]

At no time in the history of the United States did the touch of the Federal Government bear so lightly upon the citizens, at no time were its functions so light, as in the 40 years before the Civil War. Although the problems of which the Presidents spoke made it seem desirable that the Federal Government should do little, the overflowing condition of the Treasury made it difficult for it to do little. Except for brief stretches the Government had more revenue than it could easily spend; and, as a result, a philosophy of Government which frowned upon extension of Federal functions had to struggle against the temptations which a full Treasury put before Congress. In 1826 a Senate committee spoke, without levity, of "the serious inconvenience of an overflowing Treasury."[21]

Let us glance hastily at the evidence. For a period of 21 years, 1816–36, the Treasury had surpluses in 18 and the three deficits were of insignificant amounts. By the early thirties the Federal debt was practically extinguished, and Mr. McLane, the Secretary of the Treasury, could, in all candor, make the following report: "Seventeen years ago the country emerged from an expensive war, encumbered with a debt of more than 137 millions and in a comparatively defenseless state. In this short period it has promptly repealed all the direct and internal taxes which were imposed during the war, relying mainly upon revenue derived from imports and sales of the public domain. . . . The frontier has been extensively fortified, the naval and maritime resources strengthened, and part of the debt of gratitude to the survivors of the revolutionary war discharged. We have, moreover, contributed a large

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[18] *Messages and Papers of the Presidents*, II, 297: Inaugural Address, Mar. 1, 1825.
[19] *Ibid.*, II, 513: Address, Dec. 6, 1830.
[20] *Ibid.*, V, 224: Address, Dec. 5, 1853.
[21] *American State Papers* (Washington, 1932), V, 502.

share to the general improvement, by the purchase of the valuable territory of Florida, and finally acquired the means of extinguishing the heavy debt in maintaining the late war, and all that remained of the debt of the Revolution."[22] What was left to be done? Obviously the Federal Government might enlarge the scope of its expenditures, particularly by entering upon a system of internal improvements. Or, as another broad alternative, it might somehow cut down on its revenues by lowering the import duties, or by donating the public lands to the States, or by distributing Federal revenues. Each of these propositions was debated at great length, but constitutional and sectional objections were not easy to overcome. Although the propositions are closely interrelated, it will be convenient to discuss first those to reduce the Federal revenues.

The tariff history of this period is so familiar that little discussion is necessary. After 1824, although with some wavering, New England and the West joined the Middle Atlantic States in support of protection. The South, of course, was adamant in opposition, and the threat of nullification in 1832 brought home to Congress the gravity of the sectional cleavage. When the compromise tariff of 1833 was passed most people breathed more easily. Here was a scheme which would reduce the duties to modest levels and which might, by 1842, solve the problem of the surplus. In the middle 1830's this tariff was regarded "as a sort of temporary appendix to the Constitution."[23] For the time being most people were unwilling to touch the tariff.

Reduction of the Federal revenues by donation of all or part of the public lands, or the revenue from them, was less sacrosanct. In 1832 Clay pushed a bill through Congress[24] which distributed the proceeds from the sales of public lands among the States in proportion to their Federal representation in Congress (with the restriction that these proceeds should be used for internal improvements or for education). The bill was vetoed by Jackson, who stressed unconstitutionality. The lands had been ceded to the Federal Government for the common benefit of all the States, and they could not, therefore, be alienated to secure particular benefits. The bill, moreover, appropriated Federal revenue for objects of a local nature and made for national supremacy over the States. "It appears to me," he said, "that a more direct road to consolidation cannot be devised. Money is power, and in that Government which pays all the public officers of the States will all political power be substantially concentrated." Congress should not be "the tax gatherer and paymaster" of the State governments.[25] Other proposals encountered other objections, all cloaked in the garb of unconstitutionality, but in reality the product of sectionalism. Distribution of the *proceeds* of the sales appealed to the Northeastern States because they would get most of the proceeds; but it did not appeal to the Southern States, which feared that the loss of this Federal revenue would mean a higher tariff, or to the Western States, which desired outright cession of the lands to them.

[22] *Report of the Secretary of the Treasury*, 1831 (1829–36 volume).
[23] E. G. Bourne, *The History of the Surplus Revenue of 1837* (New York, 1885), p. 18.
[24] Roy M. Robbins, *Our Landed Heritage, the Public Domain, 1776–1936* (Princeton, 1942), pp. 55–58.
[25] *Messages and Papers of the Presidents*, III, 67 : Dec. 4, 1833.

Distribution of the Surplus

A proposal more general in scope than distribution of the proceeds from the public lands was that the *surplus* Federal revenue be given to the States. This had the advantage of being a less irrevocable alienation of the Federal revenue, and to some people it seemed less subject to the blight of unconstitutionality. At one time—1829—even so strict a constructionist as Andrew Jackson favored distribution, although by 1836 he had changed his mind.[26]

Ultimately, in 1836, Congress did pass the distribution measure which has been criticized by so many historians. We should, however, appreciate the background. By 1835 the last remnant of the Federal debt had been paid off, and the world was presented with the unique spectacle of a national government with a budget unburdened by interest charges. The revenue was derived from a moderate tariff which, by existing legislation, was becoming still more moderate, and from sales of public lands at a low price. Yet the revenue which flowed in was too abundant. Increased Federal expenditure was no solution. Enlargement of the *scope* of Federal expenditures would encounter a Presidential veto, and it would arouse State jealousies. Within the limited range of subjects regarded as appropriate, Federal expenditure was extravagant rather than deficient, and further increase was undesirable. Investment of the surplus revenue was not practicable. The only available securities were those of the States, and to select them would involve invidious comparisons and would provide bad investment.[27] This was the set of circumstances which made distribution appear attractive. Such a step would empty the Federal Treasury and it would relieve the many States which, at this time, were spending heavily for internal improvements.

The Distribution Act of 1836 had many peculiar features. It provided for apportionment among the States, according to their Federal representation and in four quarterly installments, of the surplus revenue in the Treasury on January 1, 1837.[28] But since outright distribution might bring a Presidential veto, the sums were explicitly declared to be on deposit; and the Secretary of the Treasury was given certificates which the States were to be obligated to meet if the Treasury was in need of funds. It was an open secret that all of this was a false front, and yet President Jackson glossed over his reluctance to sign the bill by pretending that the deposits were genuine and by asserting that to use them as gifts would be a "violation of public faith and moral obligation." [29]

On January 1, 1837, the sum of $37,469,000 was available and three quarterly distributions, totaling $28,100,000, were made. Before the third installment the nation had been stricken by depression. Almost

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[26] *Ibid.*, II, 452 : Dec. 8, 1829. In a message of Dec. 5, 1836, Jackson stated the doctrine of financial responsibility in unqualified fashion : "If the necessity of raising taxes be taken from those who make the appropriations and thrown upon a more distant and less responsible set of public agents, who have the power to approach the people by an indirect and stealthy taxation, there is reason to fear that prodigality will soon supersede those characteristics which have thus far made us look with so much pride and confidence to the state governments as the mainstay of our Union and liberties." *Ibid.*, p. 244.

[27] At this time the Federal Government did place trust funds in State securities, many of which, according to Ratchford, "were later defaulted or scaled down." *American State Debts* (Durham, N.C., 1941), pp. 84, 242–245.

[28] Less $5 million.

[29] *Messages and Papers of the Presidents*, III, 240.

all banks suspended, the government revenue shrank, and the treasury was rapidly emptied. President Van Buren called Congress in special session in May, and, after long debate, deposit of the fourth installment of the surplus was postponed until January 1, 1839.[30] In fact it was never to be made.

INTERNAL IMPROVEMENTS AND "A DEFECT OF CONSTITUTIONAL AUTHORITY"

Before the full significance of this episode can be appreciated, it will be necessary to look briefly at the history of internal improvements during this same period. As has already been noticed, internal improvements had been favored by Jefferson and Gallatin. In 1802, when Ohio was admitted to the Union, provision was made for applying 5 percent of the proceeds from the sale of public lands in the State for construction of roads connecting the eastern rivers with the Ohio; and this precedent was followed when other Western States were created. The Cumberland Road was begun in 1806 and ultimately it stretched westward for 834 miles.[31]

But constitutional doubts loomed up early, and by none were they more meticulously stated than by President Madison. He favored internal improvements. "No objects," so he informed Congress, "within the circle of political economy so richly repay the expense bestowed upon them; . . . none do more honor to the governments whose wise and enlarged patriotism duly appreciates them."[32] The national government, however, was debarred from this field by "a defect of constitutional authority";[33] and he supported his opinion by examining, with careful subtlety, the argument that the general welfare clause authorized Federal action. Acceptance of this argument would, he averred, leave no "adequate landmarks" separating the powers of the Federal and State Governments. It would "have the effect of excluding the judicial authority of the United States [the Supreme Court] from its participation in guarding the boundary between the legislative powers of the General and the State Governments, inasmuch as questions relating to the general welfare, being questions of policy and expediency, are unsusceptible of judicial cognizance and decision."[34]

For a time during the early 1820's the abundant Federal revenue seemed to be softening the hearts of the constitutional purists. But this ended with the election of Jackson. Although he did not know just

[30] At the same time Congress declared that only it, and not the Secretary of the Treasury, should have the right to call for repayment of the sums already deposited. This amounted to explicit recognition that they were a gift.

As a historical curiosity it is interesting to notice that 46 years later, in 1883, Virginia attempted to secure the final installment. In 1884 a decision of the Supreme Court adverse to Virginia settled the debate. (See Bourne, *History of the Surplus Revenue of 1837*, pp. 42–43.)

[31] In this instance Congress was careful to pacify the States through which the road ran. State consent was required, and Pennsylvania made conditions which took the road off a direct route. Congress exercised no jurisdiction in the construction and upkeep of the road, and after construction was finished there was continuous debate over the right and duty of Congress to allocate money for maintenance. Finally the road was turned over completely to the States and they raised most of the necessary revenue for maintenance by tollgates.

[32] *Messages and Papers of the Presidents*, I, 567 : Dec. 5, 1815.

[33] *Ibid.*, p. 268.

[34] *Ibid.*, p. 585. The statement was made (Mar. 3, 1817) in a veto of a bill setting aside certain Federal revenue for internal improvements.

where the line should be drawn between improvements of a national and a local nature, he held that grants for improvements lying entirely within a State and subscription to the stock of "private associations" were surely unconstitutional. They were, in his opinion, "the entering wedge" of a system which "might soon become strong enough to rive the bands of the Union asunder." [35]

Federal Intervention Repulsed

While this debate was going on, the finances of many of the States had undergone a veritable revolution. After Federal assumption of their debt in 1790, they had been left in a strong fiscal position with modest expenditures and taxes so light as to be insignificant. For nearly 30 years no important changes occurred. Then, beginning in the 1820's, many States ventured into economic activities on an extended scale, and this at a time when a laissez-faire philosophy was dominant and in a nation where the doctrine of rugged individualism was widely avowed. What explains this dichotomy of practice and theory? By 1820 a population of over 2½ million had poured into the West, and streams of internal commerce had begun to take shape. Internal improvements would swell this commerce; they would bring prosperity to the States which participated. Why did not private enterprise furnish the improvements? Because the ventures were too risky and on too large a scale.[36] And since the Federal Government was debarred, State support by guarantee, or direct State enterprise, was inevitable.

A favorable tissue of events enabled the States to borrow with unprecedented ease. The prosperity of the Nation after 1820 permitted some accumulation of domestic capital, and in addition foreign capital—especially British capital—was attracted by State securities. The Federal Government by retiring its debt with great celerity forced investors to look elsewhere for employment of their funds, and it also provided a remarkable example of financial conservatism. No wonder British investors, unacquainted with the intricacies of federalism, turned eagerly to State issues. And the British investor who enquired about the use of the funds might be further reassured, because internal improvements were, in his experience, profitable ventures.[37] State debt, which did not total more than $13 million in 1820, was $174 million in 1837. With the crash and prolonged depression which followed, it turned out that the improvements had saddled the States with a heavy burden of deadweight debt. "Between 1841 and 1842 eight States and one territory defaulted on their interest payments." [38] The plain fact was that the States had stretched their functions beyond their fiscal resources. Their predicament was, in short, just opposite to that of the Federal Government.

The history of this period throws light upon the fiscal problems of

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[35] *Ibid.*, III. 120; II. 487. 509.

[36] According to Callander ("The Early Transportation and Banking Enterprises of the States in Relation to the Growth of Corporations," *Quarterly Journal of Economics*, 1902–03, p. 136), there had not been up to 1815 "an industrial undertaking in the country that called for as much as a million dollars capital."

[37] A good many States, especially in the southwest, used their credit for banking purposes.

[38] R. C. McGrane, *The Economic Developmennt of the American Nation* (Boston, 1942), p. 228. For a full account see, by the same author, *Foreign Bondholders and American State Debts* (New York, 1935).

federalism, since it gives a clear example of a maladjustment of governmental functions and resources. The Federal Government, because of constitutional restrictions and still more because of the political pattern, had a range of functions more limited than its fiscal resources; the States had undertaken duties which were more extensive than they could finance.

In this sorry situation a new and vehement plea went up for Federal intervention. Coercion of the defaulting States was out of the question—although this was beyond the comprehension of many British investors. Federal assumption of State debts seemed more feasible. But how treat the States which were not in fiscal difficulty? Nobody ventures to suggest that *only* those in difficulty should be aided. And aside from details, Federal assumption was not practical politics.[39] The Secretary of the Treasury, Mr. Bibb, expressed the pious hope in his report for 1844 that "the immutable principles of justice and moral obligation . . . and the virtuous precepts and bright example of the Federal Government might not go unheeded" by the States.[40] His hopes and regrets, however, had doubtless been inspired merely by the adverse effect which repudiation had, especially in Europe, upon Federal credit.

"The Minimum of Federal Government"

The bitter experience of these years had a tremendous influence upon State finance. In a spirit of reaction against the mistakes which had been made, new State constitutions were drawn up and in them severe restrictions were imposed upon legislative borrowing. The States as a whole withdrew from their old economic ventures and they resolutely refused to enter into new ones.

The Federal finances were, of course, much less affected. For a time there was temporary embarrassment as deficits succeeded surpluses. A government which had no debt now had to borrow, and yet it found a market which was singularly skeptical. Investigation of Federal expenditures disclosed also a number of gross scandals. The relatively few jobs being handled by Federal officers were being handled badly. Federal money was being wasted, not through grandiose projects, but by ignorant spoilsmen each striving for a share of petty graft.

Gradually, with the return of prosperity, surpluses again became the rule, and beginning in 1850, the Federal Government again faced the problem of excessive revenues despite a tariff which approached free trade. As in the 1850's, the restricted range of Federal functions left no scope for expenditure. The principal use for the surplus was reduction of the Federal debt, and since the flow of maturities was inadequate, the Treasury had to rely on purchase in the market. This proved to be an expensive business. Thus on stock certificates retired in 1851–52, amounting to $2,523,200, the premiums were almost 13 per-

[39] Senator Benton, in a series of resolutions, denounced assumption as "a gross and flagrant violation of the constitution," as "unjust and therefore inexpedient," as designed to bring about a complete "consolidation" of the government and the "crowning mischief" of foreign interference. United States, 27th Cong., first sess., S. Doc. 1839–40, No. 153; *Congressional Globe*, 1839–40, appendix, pp. 86–92.

[40] Page 659. In 1842 an attempt to float a loan in Europe at 6 percent had failed. President Tyler commented as follows: "The mortifying spectacle has been presented of the inability of this government to obtain a loan so small as not to amount to more than one-fourth of its ordinary annual income, at a time when the Governments of Europe, although involved in debt and with their subjects heavily burdened with taxation, readily obtained loans of any amount at a greatly reduced rate of interest." *Messages and Papers of the Presidents*, IV. 208: Dec. 6, 1842.

cent. In 1853 the Secretary of the Treasury offered premiums ranging from 8½ to 21 percent to induce creditors to give up their stock.[41] By 1857 the total of the Federal debt was down to $28,700,000.

As the sectional rift deepened, President after President solemnly repeated the warning in Washington's Farewell Address against geographical parties.[42] A corollary to this was "a spirit of strict deference to the sovereign rights and dignity of every State."[43] Two familiar instances of the outcome of this philosophy may be recalled. In 1854 Congress passed a bill providing that the proceeds from the sale of 10 million acres of public lands should be divided as a capital fund among the States for the support of the indigent insane.[44] President Pierce interposed a veto. If Congress had the power to provide for the indigent insane, it would have "the same power to provide for the indigent who are not insane." The upshot would be "to transfer to the Federal Government the charge of all the poor in all the States," which would be "subversive of the whole theory upon which the Union of these States is founded." "If," he concluded, "the time shall ever arrive when, for an object appealing, however strongly, to our sympathies, the dignity of the States shall bow to the dictation of Congress by conforming their legislation thereto, when the power and majesty and honor of those who created shall become subordinate to the thing of their creation, I but feebly utter my apprehensions when I express my firm conviction that we shall see 'the beginning of the end.'"[45] President Buchanan, less rhetorically, expressed a similar fear in vetoing the Morrill bill granting aid to the States for establishment of colleges for the benefit of agriculture and mechanical arts. "Should the time arrive," he said, "when the State governments shall look to the Federal Treasury for the means of supporting themselves and maintaining their systems of education and internal policy, the character of both Governments will be greatly deteriorated."[46]

In ways like these a philosophy of Federal impotence was elaborated. "The minimum of Federal Government," said President Pierce, "should afford the rule and measure of construction of our powers under the general clauses of the Constitution."[47] Such a fatal paralysis set in that no statesman of moderate position espoused anything but drift. As late as January 28, 1861, President Buchanan is to be found protesting his constitutional scruples against any interference with the warmaking power of Congress. Exaggerated constitutionalism is certainly a feature of federalism, and certainly the belief is not without foundation that a nation so large and diverse as the United States can best be kept in cohesion by "the minimum of Federal Government." Yet in 1860, at the end of a long trial, the situation contradicted the doctrine, and after the Civil War a reunited nation was never to go back so completely to the old philosophy.

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[41] *Annual Report*, 1853. appendices D. E. F.

[42] Alexis de Tocqueville, writing in the 1830's, thought that the federal government had lost and would continue to lose ground. "Far from participating in [the current] dread of the consolidation of power in the hands of the Union, I think the Federal Government is visibly losing strength." Predicting that within a century the Nation would have a population of over 100,000,000 scattered unequally over 40 States, he declared that "the continuance of the Federal Government can only be a fortunate accident." *Democracy in Action*, translated by Henry Reeves (New York, 1900), I, 410, 403.

[43] *Messages and Papers of the Presidents*, V, 224 (President Pierce, Dec. 5, 1853).

[44] See Helen E. Marshall, *Dorothea Dix* (Chapel Hill, 1937), pp. 138–39, 148–51.

[45] *Messages and Papers of the Presidents*, V, 248–51: May 3, 1854.

[46] *Ibid.*, 544: Feb. 24, 1859.

[47] *Ibid.*, 224: December 1853.

Economic Development and Fiscal Laissez-Faire

The finances of the United States during the Civil War give no important background for this study. The war settled the old debate about national supremacy; it forced Federal exploitation of new sources of revenue; and it cleared the way for new avenues of Federal expenditure. But for a considerable period the new philosophy was not fully reflected in the public finances. The Federal Government at first was busy with postwar readjustment, and then with policies which made for the economic development of the Nation. It, and the State governments also, aimed at providing fuller opportunities for private enterprise.

Most observers were astonished at the speed with which the purely financial difficulties confronting the Federal Government were resolved. Beginning in 1866 and stretching to 1893, the Treasury had a long series of surpluses, broken only by a small deficit in 1874. In 1882 the Secretary of the Treasury was making the same complaint as had his predecessors in the 1820's and 1830's—that he had too great an annual revenue. Congress required his advice not to get revenue into, but to get it out of, the Treasury. During the war new sources of revenue—income tax, death duties, a wide range of excises—had been added. Because of inexperience and because the United States is a federalism, these had been slow in getting underway. Their productivity was not mobilized until the war was nearly over and then, with the decline of military expenditure, surpluses became too large. Repeal of income and death taxes was prompt; excises, except on a few luxury articles, were gradually dropped. Reduction of customs duties, however, was not feasible,[48] and they, together with luxury excises, provided more revenue than was needed. Retirement of the debt was, of course, an obvious step, and it was taken. But maturities were not adequate in amount and the Treasury was forced to buy in the market at prices which gave large premiums to bondholders. An astonishing lack of imagination over ways to spend was manifested by Congress. Expenditure for pensions, river and harbor improvements, and public buildings did grow; the old expedient of distributing the Federal surplus was discussed. The political philosophy of neither party, however, authorized any important expansion of Federal functions.

The fact is that, at this time, monetary issues obscured all other, and when in 1892–93 the Nation fell into depression, these complicated the job of the Treasury. Not only had the crackpot legislation of the silverites frightened investors at home and abroad, it had also brought a stream of paper money to the Treasury for redemption, and suspension of the specie payments was narrowly averted.

The most notable phenomenon to the student of Federal finance was, however, the income tax of 1894. Behind it were radical sentiment, which favored taxing the rich, and the fear of the Democrats that lowering the tariff might injure the Federal revenues. The act as passed had many defects, but when taken before the Supreme Court in 1895 it was not struck down because of them. By a most unfortunate decision the Court held that a tax on income was a "direct

[48] Purely revenue duties could, of course, be reduced. The McKinley tariff actually was called "an act to reduce the revenue."

tax," which had, therefore, to be apportioned among the States according to population. The words of Justice Harlan, in dissent, were not too strong when he said that the decision "strikes at the foundations of national authority, in that it denies to the General Government a power which is, or may become, vital to the very existence and preservation of the Union in a national emergency." [49]

When in 1895–96 prosperity returned to the Nation, the monetary heretics soon lost their audience. The Spanish-American War in 1898 was readily financed, and with the 20th century the Federal Government began to engage in activities which were out of the old grooves. The most spectacular was the building of the Panama Canal, but others of less scope were indicative of a new attitude. Reclamation of dry lands was begun, a Federal Forest Service was set up and extended, the Department of Agriculture offered many new services to farmers, Washington began to be made a city of magnificent buildings. Most of these, indeed, aimed at improving the economic productivity of the Nation, and, in this sense, were comparable to the aid given earlier to railway building. In 1913, however, the Department of Labor was established, and this was a symptom of a new interest in social legislation. In this same year adoption of the 16th amendment, by removing the income tax from the category of "direct" taxes, made possible the utilization of an important source of revenue; and this also was a token of Federal expansion.

The Decline and Rise of the States

If details are omitted and attention is concentrated merely upon broad outlines, the financial history of the American States for three decades after the Civil War appears remarkably static. In 1870 State debt (less sinking funds) per capita was $9.15; in 1900 it was $3.10. This may, perhaps, seem to indicate a satisfactory trend, but it did not. Partly because of constitutional limitations and partly because of the tradition of laissez-faire—the one reinforced the other—the States as a level of government had lost ground. One contemporary observer—H. C. Adams—insisted in 1887 that the State governments, by their passivity, had allowed corporate development to get out of hand. The corporations, he said, "arose upon the ruins of the States as centers of industrial administration, and it is because the States have failed to retain a proper control over them that they now menace the permanency of popular government." [50] Adams preferred expansion of State rather than Federal functions; but he warned that, if the States failed to move, Federal intervention was bound to come. Other observers held a similar view. Richard T. Ely even surmised that perhaps "the position of mayor of a great city will soon become a more enviable office than that of Governor of an American Common-

[49] 158 U.S. 671.

[50] H. C. Adams, *Public Debts* (New York, 1887), p. 393. Adams believed that two steps were necessary to rejuvenate the States: (1) restoration of borrowing power by removal of the self-imposed constitutional restrictions, and (2) repeal of the 11th amendment. The 11th amendment is itself a curious relic of federalism. In 1792 the States as sovereign bodies were shocked to find that they could be brought into court by a citizen of another State (*Chisholm* v. *Georgia*, 2 Dallas 419). The 11th amendment was adopted to remedy this defect of sovereignty. After the repudiation of State debts following 1837 and after the Civil War, many people deplored the amendment and regarded it as a deterrent to creditors. More recently, however, this aspect of the amendment has been forgotten.

wealth."[51] Certain it was that urbanization had forced upon the cities new duties with respect to health and sanitation, education, hospitals, protection to life and property.

The fears of these men did not materialize. Slowly the States recognized their concern with the new functions, usually by establishing supervisory and regulatory bodies—a State board of health, for instance. Education, in particular, received State assistance by grants-in-aid; and State penal, reformatory, and charitable institutions grew in number and importance. And with the 20th century, the growth of State social and regulatory expenditures accelerated, as shown in table 1. State debt per capita grew from $3.03 in 1903 to $3.57 in 1913, and although this change was not great, it did represent a reversal of the previous trend. State revenue systems had become somewhat more diversified. The general property tax still was by far the dominant source, but the inheritance tax and business taxes had become important. Moreover, tax administration began to be centralized. State boards of equalization and State tax commissions had come into existence with power to supervise local assessment of property and actually to take over assessment of public service corporations.

TABLE 1.—*State expenditures per capita* [1]

	1903	1913	Increase
General government	$0.32	$0.42	$0.10
Education	.80	1.38	.58
Charities, hospitals, and corrections	.65	.90	.25
Highways	.06	.14	.08
Other	.29	.43	.14
Total	2.12	3.27	1.15

Not including expenditure for public service enterprises, interest, and outlays.

THE RECENT MALADJUSTMENT OF GOVERNMENTAL FUNCTIONS AND RESOURCES

Before the outbreak of World War I, Federal-State finances in the United States were in fair equilibrium. A close scrutiny could discern tendencies which, perhaps, threatened to bring an upset; but these lay in the future. Separation both of sources of revenue and of functions was nearly complete. The Federal Government in 1915 relied predominantly on indirect taxes—customs, excises on liquor, and tobacco. An income tax had, indeed, been started; but exemptions were high, rates were low, and as a result, it produced only 11 percent of the total ordinary receipts in 1915. The field of revenue open to the States still seemed large. With respect to expenditures, the States were beginning to realize that the governmental duties which fell upon them were growing in importance, and State grants to the localities were expanding. But Federal grants to the States were insignificant, amounting in 1915 to approximately $10,400,000.

The war dislocated this governmental pattern. During its course the Federal Government greatly expanded its tax system, and after its close less reversion took place than after the Civil War. As the Federal

[51] R. T. Ely, *Taxation in American States and Cities* (New York, 1888), p. 263.

fiscal position gradually eased during the 1920's, some new duties were assumed. The States, however, were confronted with revolutionary demands for expenditures, of which the most important was highways. In 1919 the ordinary highway expenditure of the States was $.59 per capita; in 1930 it was $2.06. In this same period, State debt per capita had nearly doubled,[52] and over 60 percent of this debt was for highways. Only the fact that this voracious type of expenditure carried with it a method of finance—gasoline tax and motor vehicle taxes—kept the States from a critical fiscal position. The contrast between Federal and State financial positions was striking. Federal debt was shrinking, while State debt was going up; Federal taxes were being reduced, State taxes were being increased. Some people attributed these results to the presence or absence of fiscal prudence, but the causes lay deeper. The States, with a few exceptions, were not being extravagant. They were responding to sober and well-founded public demands.

It took the great depression after 1929 to show the many and important governmental duties which had been neglected in the United States. And this knowledge did not come easily. For 2 years Congress and the President hoped that prosperity was just around the corner and they held tenaciously to the opinion that the problem of unemployment was a State and local responsibility. The kernel of truth in this opinion allowed able men to forget that the States and localities could not possibly handle *finance*. They had too many duties and too few revenues. The growth in duties was the consequence of a shift in social philosophy which had been stimulated by the depression. Social welfare functions, including the relief of unemployment, had seemed unimportant in an expanding and prosperous economy. But when economic collapse brought unemployment and destitution on a scale beyond all precedent in American experience, a powerful public sentiment insisted that governmental fumbling should cease. Since relief was necessary, and since only the Federal Government had the fiscal strength to provide relief, debate over responsibility seemed irrelevant. This public reaction brought into office at Washington a reform administration which was prepared to act. Social welfare and relief measures were passed; the traditional division of governmental responsibilities was cut across and sometimes ignored. The general direction of this new trend may be approved, and yet one may feel certain that in detail there has been confusion and error. For example, a principal instrument of the shift in fiscal responsibilities has been the conditional grant-in-aid.[53] One may believe that this sort of grant is a powerful

[52] Net state debt per capita: 1919, $7.70; 1930, $15.03.

[53] The amount of Federal aid grew as follows:

[In millions of dollars]

	Total	Public assistance	Highways	Education	Agriculture	Other
1925	113.6		92.1	11.8	7.4	2.3
1932	217.1		118.5	13.2	12.2	2.6
1941	744.2	331.2	168.3	88.0	24.8	131.9

Source: U.S. Department of Commerce, State and Local Government Special Study No. 19, Federal and State Aid: 1941.

and a beneficial device, and yet be critical of specific schemes. Moreover, the evidence is unambiguous that no logical system of grants has been built up. In short, improvisation has been the rule. Whatever should be the redistribution of functions and sources of revenue in the American federalism, that redistribution has not yet been achieved.

This brief historical prolog may serve to bring out the difficulties faced by a federalism in achieving a coherent fiscal system. Only after bitter experience in the critical period did the Federal Government secure strong fiscal powers, and only after a sharp struggle did it venture to exercise them in a manner which secured the Federal credit. The perplexities of federalism were constantly in men's minds until it seemed to so forthright a centralizer as Fisher Ames that any governmental move produced the cry of unconstitutionality, "not excepting a motion for adjournment." And as the tide of settlement poured over the mountains, the forces of sectionalism gained new strength. Every President was conscious of these forces, and Pierce merely epitomized the common thought when he declared for "a minimum of Federal Government" and "a spirit of strict deference to the sovereign rights and dignity of every State."

This it was which produced the curious and unique episodes which enlivened the financial history of the 30 years prior to the Civil War. How could the Federal revenue be reduced? Since there was a limit below which the tariff could not be lowered, perhaps the proceeds from the sale of the public lands could be distributed to the States; or perhaps the Federal surplus could be deposited with them. This surplus could not be used to reduce the debt because in 1836 no Federal debt existed; and it could not be used to enlarge the scope of Federal expenditure because that would be incompatible with "a minimum of Federal Government." Yet at this very time when the Federal Government was inhibited against expansion of its functions, the States were embarking upon tasks which overtaxed their limited fiscal resources.

The period before the Civil War illustrates a typical difficulty of a federalism. This is the lack of balance in the distribution of governmental functions and revenues. The tendency is for the States as a whole to have a plethora of duties in relation to the revenues at their effective disposal. The case of the Federal Government tends to be the other way round. This situation is, however, obscured in two ways. Some of the States are always able to handle their governmental duties even when their weaker brethren cannot. And sometimes periods of crises arise which strain the fiscal strength of the Federal Government and raise doubts in some minds of its power to expand its peacetime functions. These doubts have been falsified. The exercise of new tax powers in the crisis, or the more vigorous exercise of old tax powers, brings to light a latent strength and leads to a permanent expansion of Federal sources of revenue. The net result is, therefore, a narrowing of the fiscal power of the States and a growth of Federal functions.

This pattern was very obvious in the years after World War I. The States, expanding their expenditures in response to deep-seated public demands, had difficulty in securing a parallel expansion of their revenue systems. With the great depression the maldistribution of governmental functions and revenues became manifest. Only the Federal Government had the fiscal power and the national outlook requisite to handle the welfare and relief measures which the times demanded.

What will be the pattern after World War II? Some people, impressed by the vast fiscal problems facing the Federal Government and by the current buoyancy of the State finances, are inclined to doubt that the sphere of Federal action will be expanded. The opinion is ventured here that this doubt is unwarranted. Exercise of its wartime powers is likely to augment permanently the position of the Federal Government as compared with the States. If the public demand for governmental services continues to grow, the State governments will soon appear to have more duties than they can handle effectively, and Federal intervention will be indicated.

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FEDERAL-STATE FINANCIAL RELATIONS, 1790–1860*

BY PAUL B. TRESCOTT**

Financial relationships between the Federal Government and the States were a critical matter in the founding and early operations of the Federal Government under the Constitution, with the settlement of the Revolutionary War debt the object of chief concern. When the debt was ultimately secured, other matters arose to keep funds passing from one level of government to another. Some of these were of major political importance, while others involving substantial sums made little political impact, being less controversial. The purpose of this paper is to provide a systematic review of the areas of Federal-State financial contact from 1790 to 1860 and to provide more details on some lesser known areas that are of more than technical interest. Table I lists the various programs that involved transfers of cash or securities between Federal and State governments during this period, with the dates and the sums involved.

TABLE I.—*Federal-State financial transactions, 1790–1860*

[In thousands]

Program	Date	States to Federal	Federal to States
Assumption of State debts	1790-94		$18,272
Funding Continental debt	1790		[1] [2] 6,100
Settlement of accounts	1794		4,221
Grants to District of Columbia	1791–96	$191	
Maryland loan to District of Columbia (principal)	1797–1808	[1] 250	250
Interest to States on U.S. securities	1791–1834		[2] 6,000
Miscellaneous land transactions	1801–60		1,256
Public-land funds (3 to 5 percent funds)	1810–60		6,110
Direct tax	1814–16	3,160	
Militia, defense, etc	1815–60		6,616
Purchase of State securities (net)	1830–60		[2] 5,400
Interest on State securities	1830–60	[2] 4,000	
Virginia claims	1832		381
Surplus revenue	1837		28,101
Distribution of land proceeds	1842-54		637
Provisions for Texas debt	1850–60		[3] 12,560
Interest on U.S. securities held by Texas	1850–60		[2] 1,700
California debt	1857–60		901
Total		[2] 7,600	[2] 98,500

[1] Payment made in securities rather than cash.
[2] Approximate.
[3] Payment made in securities and cash.

I

The debt program adopted by Congress in 1790 under Hamilton's influence consisted of three parts, each of which intimately concerned Federal-State relations. Federal assumption of the States' debts was

*Reprinted from *The Journal of Economic History,* Vol. XV, September 1955, No. 3.
**Kenyon College.

the most controversial part of the debt program. The Funding Act authorized the Federal government to receive certificates of State war-incurred debts and to issue Federal securities in exchange. For every $90 (face value) of securities turned in (counting both principal and arrears of interest), the United States was to issue $40 of 6 percent stock, $30 of 3 percent stock, and $20 of stock bearing no interest until 1801, then 6 percent thereafter. No dates were fixed for redemption.

A total of $21.5 million of State debts were authorized for assumption, and a quota was assigned to each State. But not all the quotas were filled, so the total assumed was only $18.3 million. Effects of this on individual States are shown in table 2.

TABLE 2.—*Funding, assumption, and settlement*

[In thousands]

State	Total debt outstanding [1]	Federal "aid": Debt assumed by United States	Federal "aid": Securities received from United States: For Continental securities funded [2]	Federal "aid": Securities received from United States: Under settlement of accounts [3]	Federal "aid": Total
New Hampshire	$343	$283	$150	$90	$523
Massachusetts	6,316	3,982	(270)	1,499	5,751
Rhode Island	694	200	38	360	598
Connecticut	1,914	1,600	7	743	2,350
New York	1,224	1,184	2,107	----------	3,291
New Jersey	807	695	----------	59	754
Pennsylvania	1,175	778	2,535	----------	3,313
Delaware	59	59	----------	----------	59
Maryland	729	517	927	----------	1,444
Virginia	3,725	2,934	(35)	----------	2,969
North Carolina	2,370	1,794	(29)	----------	1,823
South Carolina	6,600	4,000	----------	1,447	5,447
Georgia	700	246	(50)	24	320
Total	26,656	18,272	6,148	4,222	28,642

State	Debt remaining after assumption [1]	Total securities from United States	"Net position" [4]	Debts due under settlement of accounts [3]
New Hampshire	$60	$240	C $180	----------
Massachusetts	2,334	1,769	D 565	----------
Rhode Island	494	398	D 96	----------
Connecticut	314	750	C 336	----------
New York	40	2,107	C 2,067	$2,075
New Jersey	112	59	D 53	----------
Pennsylvania	397	2,535	C 2,138	77
Delaware	----------	----------	----------	612
Maryland	212	927	C 715	152
Virginia	791	35	D 756	101
North Carolina	576	29	D 547	501
South Carolina	2,600	1,447	D 1,153	----------
Georgia	454	74	D 380	----------
Total	8,384	10,370	C 1,986	3,518

[1] Total debt outstanding equals Hamilton's estimate of September 1791 plus debt previously assumed. Debt remaining after assumption estimated by taking amount Hamilton estimated outstanding in September 1791 and subtracting debts subsequently assumed.
[2] Figures in parentheses are uncertain.
[3] Upper column exceeds lower by amount of interest credited.
[4] C=creditor; D=debtor.

Sources: Ratchford, "American State Debts," pp. 60, 63; data on Continental securities funded obtained from sources listed for table 3.

The second important part of the Funding Act provided for the funding of securities issued by the Confederation into new Federal issues. State governments had acquired about $9 million of the $27.5 million (principal) of Confederation debt outstanding in 1789.[1] The law provided that for every $90 worth of principal turned in, there should be issued $60 worth of 6 percent stock and $30 of deferred (bearing interest after 1801.) Arrears of interest were funded into 3 percent stock. State governments received a total of about $6 million from this provision, representing $3.5 million principal and $2.6 million arrears of interest, distributed as shown by table 2.[2]

The third part of the funding program was the settlement of accounts between the States and the National Government, completed in 1793. This was intended to equalize the per capita burden of war expenditures among the States. Each State was credited with sums it spent for the war or related purposes and debited for sums received from the National Government, including debts assuming under the funding program. Each State's net contribution was compared to a quota based on population. The final accounting showed that seven States had contributed more and six less than their quotas. A total of $3.5 million was due from the latter group to the former. In 1794 the Federal Government issued this amount of securities to the creditor States, two-thirds in current 6 percent stock, one-third in deferred stock, plus $0.7 million of accrued interest in 3 percent stock, as shown in table 2. The settlement failed of complete equalization because of the failure of the debtor States to pay up the amount of their deficiency.[3]

Table 2 summarizes the effects of the funding program on the individual States. The column headed "Net Position" shows the difference between each State's initial debt and the total Federal "aid" it received. For all States combined, Federal aid exceeded initial indebtedness. But the distribution varied widely. Massachusetts and South Carolina, which had the biggest debts to start with, received the most aid but still ended up debtors. Virginia, North Carolina, and Georgia were also substantially net debtors in the end. On the other hand, New York and Pennsylvania emerged with large creditor positions, reflecting their large holdings of Continental securities. The fact that New York's net gain was just about equal to its large unpaid balance due under the

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[1] Pennsylvania, New York, and Maryland had funded the Continental certificates held by their citizens, issuing State certificates in exchange, and had also accepted Continental securities in payment for lands. They acquired $6.1 million, $2.3 million, and $650,000 respectively. Several other States had acquired lesser amounts in similar fashion. See E. James Ferguson, "State Assumption of the Federal Debt During the Confederation," *Mississippi Valley Historical Review,* XXXVIII (1951), 416–422.

[2] Pennsylvania and New York did not fund all their large holdings, but returned some to the previous owners who funded them.

[3] See B. U. Ratchford, *American State Debts* (Durham: Duke University Press, 1941), pp. 62–66, for subsequent developments; *American State Papers: Finance,* I, 26, 479, for discussion. A detailed account of the settlement is given in an unpublished doctoral dissertation by Whitney K. Bates, "The Assumption of State Debts" (University of Wisconsin, 1951), pp. 62, 193–231.

settlement of accounts caused considerable criticism. Maryland, New Hampshire, and Connecticut also enjoyed comfortable creditor positions.

In some States, holders of eligible State securities were reluctant to turn them in. The terms of exchange were not particularly favorable—for every $90 worth of State securities turned in, the creditor received Federal securities worth about $72 in the market.[4] Consequently, several of the States took steps to improve the terms of exchange for their former creditors. Maryland, Pennsylvania, and New York used for this purpose the securities they received from funding Continental certificates.[5]

Many States were also enabled to deal more generously with their remaining creditors. Pennsylvania, Connecticut, and Maryland redeemed all the State debt they could find either by exchange for U.S. securities or with cash obtained by selling some of their holdings. Rhode Island reduced its debt from $0.5 million to $0.1 million in the same manner.[6]

Four States did not deal so favorably with their remaining creditors. South Carolina and Massachusetts held on to their Federal securities, using the income from them to service their substantial remaining debts, but redemptions of the latter were made only at figures well below par.[7] North Carolina and Georgia also preferred to retain their smaller holdings of U.S. securities and to continue redeeming their debts below par.[8]

The most controversial aspect of Hamilton's debt program was the large benefits allegedly reaped by speculators—especially by the assumption of State debts. Many States' securities sold in the open market for 10 percent of their face value or less at the time the Funding Act was being debated.[9] This furnished considerable scope for speculative gains. To be sure, Federal assumption did not provide the speculator with the face value of his securities in cash.[10] Even so, some securities rose as much as sixfold in value.

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[4] Hugh H. Hanna, *Financial History of Maryland* (Baltimore: The Johns Hopkins Press, 1907), pp. 28–31.

[5] Maryland gave her former creditors current United States 6 percent stock in exchange for the deferred and 3 percent stocks they received.—*Ibid.* New York gave current 6 percent stock for deferred.—Don C. Sowers, *Financial History of New York State* (New York: Columbia University Press, 1914), pp. 254–257. Pennsylvania issued additional stock to former creditors to cover the depreciation of their claims resulting from the deferred and 3 percent stocks. About $360,000 was issued.—Raymond Walters, Jr., "The Making of a Financier: Albert Gallatin in the Pennsylvania Assembly," *Pennsylvania Magazine of History and Biography,* LXX (1946), 261–266; reports of the state treasurer appended to *Journal* of the Pennsylvania State Senate, 1791–1796.

[6] *Acts and Resolves of the Rhode Island General Assembly,* February 1797, pp. 25–26.

[7] Ratchford, *American State Debts,* pp. 69–70; Charles J. Bullock, *Historical Sketch of the Finances and Financial Policy of Massachusetts* ("Publications of the American Economic Association," VIII, No. 2, 1907), pp. 20–25.

[8] Ratchford, *American State Debts,* p. 68.

[9] See quotations in Nathan Schachner, *The Founding Fathers* (New York: G. P. Putnam's Sons, 1954), p. 120.

[10] The Federal securities received in exchange for $100 of State securities would have sold in the open market for about $67 in December 1790 and $80 in July 1791. See prices in Joseph S. Davis, *Essays in the Earlier History of American Corporations* (Cambridge: Harvard University Press, 1917), II, 340.

However, one cannot attribute all of this to Federal assumption, for much of it would have occurred anyway. Low security prices prior to 1790 reflected in part the general economic depression and monetary stringency of the times and the use of paper money by the States for debt service.[11] These causes of depreciation would have been ameliorated after 1790. Furthermore, some of the States would have dealt generously with creditors if no Federal assumption had occurred.[12] So not all the rise in security values can be attributed to Federal assumption of the State debts.

Shedding most of their debt burden enabled the States to reduce taxes—but this principally took the form of the shift of the tariff from State to Federal jurisdiction. Some States did reduce internal taxes about this time—New York, Maryland, and Pennsylvania all ceased to levy general property taxes and Virginia and Massachusetts reduced theirs. Pennsylvania and Massachusetts also lowered excise taxes, but this was associated with imposition of similar taxes by the Federal Government.[13]

However, Hamilton's program furnished many of the States with a substantial source of revenue from the Federal securities which they received in the funding and settlement operations. States held as much as $7.5 million of the Federal debt—about 10 percent of the total—in the 1790's. Income from this source made up nearly one-fifth of total State revenue in 1795–1800, averaging about $225,000 a year—this not counting redemption installments. Table 3 shows the distribution of State holdings for selected years prior to 1834, when all were redeemed. Figures include subsequent open-market purchases by Pennsylvania, Maryland, New Jersey, and others.

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[11] See Allan Nevins, *The American States During and After the Revolution* (New York: The Macmillan Co., 1924), pp. 519–522, 534; Merrill Jensen, *The New Nation* (New York: Alfred A. Knopf, 1950), pp. 319–321; Ferguson, "State Assumption of the Federal Debt . . .," pp. 416–419, 421–423.

[12] See Albert Gallatin, *Sketch of the Finances* [1796] in *Writings*, ed. Henry Adams (Philadelphia, 1879), III, 131. Judging from pre-1789 experience, Massachusetts, Rhode Island, North and South Carolina, and possibly Georgia would have had difficulty with their debts in the absence of Federal assumption. But, of these, all except North Carolina would have been helped by the settlement of accounts. See Ratchford, *American State Debts*, pp. 42–59; Jensen, *The New Nation*, pp. 308–309; Bates, "Assumption of State Debts," p. 31.

[13] See *American State Papers: Finance*, I, 425, 427, 431: Bullock, *Finance of Massachusetts*, pp. 19, 138; Leland D. Baldwin, *Whiskey Rebels* (Pittsburgh: University of Pittsburgh Press, 1939), p. 78; W. F. Dodd, "The Effect of the Adoption of the Constitution Upon the Finances of Virginia," *Virginia Historical Magazine*, X, No. 4 (1903), 368.

TABLE 3.—*State holdings of Federal securities, selected years*

[Par value in thousands, Dec. 31]

State	1791	1795	1803	1807	1813	1820	1830
New Hampshire	$150	$244	$222	$203	$164	$129	$66
Massachusetts	(270)	1,535	(1,400)	712	533	(365)	----------
Connecticut	7	553	420	364	250	118	55
Rhode Island	38	(10)	----------	----------	----------	----------	----------
New York	2,107	2,119	777	779	780	----------	----------
Pennsylvania	2,535	416	330	25	----------	----------	----------
New Jersey	----------	59	53	47	36	76	126
Delaware	----------	(8)	36	54	----------	----------	----------
Maryland	927	763	837	1,267	935	470	335
Virginia	35	35	----------	----------	14	14	----------
North Carolina	(29)	42	46	58	----------	----------	----------
South Carolina	----------	1,447	1,290	1,147	593	----------	----------
Georgia	(49)	73	62	52	33	7	4
My total	6,147	7,306	5,473	4,708	3,338	1,179	586
Treasury total	----------	----------	[1] 5,809	[2] 4,928	[3] 3,380	[2] 1,284	----------
Estimated interest	220	255	275	235	155	50	15

[1] June.
[2] September.
[3] March 1814.

NOTE.—Figures in parentheses are uncertain.

Sources:
An asterisk (*) before the source indicates that State holdings of old 6 percent and deferred stocks were interpolated by use of redemption formula appearing in "American State Papers: Finance, I," p. 383.
*New Hampshire: Journal of the State House of Representatives, 1788–1815; Niles Register.
*Massachusetts: Bullock, Finances of Massachusetts; Reports of State Treasurer, 1792–1800 (MSS, Massachusetts State Library), 1803–18.
*Connecticut: Treasurer's Office, Reports, 1790–1818 (MSS, Connecticut State Library); Niles Register.
Rhode Island: Acts and Resolves of the General Assembly, 1789–1805.
New York: Sowers, Financial History of New York State; Reports of State Treasurer, 1789–1812, in Journal of the State Assembly; American State Papers: Finance.
Pennsylvania: Reports of State Treasurer, 1790–1810, appended to Journal of the State Senate.
*New Jersey: Reports of State Treasurer, 1801–36, in Votes and Proceedings of the General Assembly.
Delaware: Auditor's reports in Journal of the State House of Representatives, 1796–1812.
*Maryland: Hanna, Financial History of Maryland; reports of State Treasurer in Votes and Proceedings of the House of Representatives, 1789–1812; Niles Register.
*Virginia: Stock ledgers of Virginia loan office (MS, National Archives); annual reports of Literary Fund in Journal of the House of Delegates, 1819–35.
*North Carolina: Stock journals of North Carolina loan office (MS, National Archives); Journal of House of Commons, 1804–12.
*South Carolina: Reports of State Treasurer, 1805–19, in Acts and Resolutions of the General Assembly.
*Georgia: Schedules and Statements of Georgia Loan Office (MS, National Archives).
Totals of my figures for individual States can be compared with figures compiled by the U.S. Treasury appearing in Adam Seybert, Statistical Annals (Philadelphia, 1818), pp. 736, 757; Register of the Treasury, Estimates and Statements, XIII, 18, 203–208 (MSS, National Archives). Comparison indicates my figures subject to a margin of error of about 10 percent.

Many States used their Federal securities directly to promote banking and other economic enterprises.[14] Pennsylvania sold $1 million of its original holdings to raise funds for transportation projects, and in other States, redemption of Federal securities was contemporaneous with investments either in securities or in capital projects.[15] Maryland used some of its U.S. securities to make a loan in 1796–1800 of $250,000 to the Federal commissioners who were preparing Washington as the Nation's Capital.[16]

[14] Pennsylvania subscribed $0.5 million of its stock to the Bank of Pennsylvania in 1793, bought $0.4 million more as an investment in 1795 and, in turn, subscribed that to the bank's capital in 1802–1804 (sources in note 15). North Carolina subscribed its $40,000 of U.S. securities to a bank in 1812, and South Carolina subscribed $200,000 in 1819. Virginia's stock, amounting to $35,000, was transferred to an insurance company in 1803, possibly as a capital subscription. (Sources for these states listed in table III.)

[15] *Papers of the Governors of Pennsylvania, 1785–1817, Pennsylvania Archives,* Ser. IV, pp. 261, 349–350; State Treasurer, *Reports,* 1791–1805. New York sold $1.4 million of U.S. stock in 1797 and was buying bank stock as the proceeds came in. When the remainder was sold in 1818, the State had begun the Erie Canal. In Connecticut, Delaware, New Jersey, and to some extent Maryland and Massachusetts liquidation of U.S. securities was accompanied by purchase of bank or other corporation stock. (Sources for table 3.)

[16] See below, p. 244.

At the time, the funding program was criticized as a measure to expand the influence of the Federal government at the expense of the States. But looking beyond the decade of the 1790's, one finds a contrary tendency. The States, relatively debt free, were in a strong position to expand their functions in the direction of "internal improvements" of many descriptions. In particular, New York, Pennsylvania, and Maryland, all of which benefited substantially from the funding program, soon went in for extended investment programs. The Federal Government, on the other hand, was inhibited from such expansion by the large burden of the debt, which reinforced the strict-construction views of Jefferson, Monroe, and Jackson.

The long-run effects of Hamilton's program on the States may have been detrimental. Critics have pointed out that relieving the States of their debts also relieved them of responsibility and sometimes led to extravagance in the incurring of debts later on.[17] Furnishing the States with such a large quantity of Federal securities may also have encouraged a cameralistic type of thinking that stressed financing Government from earning assets rather than taxation.[18]

II

When Texas was admitted to the Union in 1845 a debt problem arose that paralleled in many respects that of 1790. The Texas Republic (1836–1845) had financed heavy war and defense expenditures by issuing a great variety of claims and paper money, most of which had depreciated greatly and become an object of speculation. By 1846 its total debt amounted to $10 million.[19]

After annexation, the State adopted a debt program that was very unfavorable to the creditors. Most of them refused to accept it and exerted strong pressure for Federal assumption of the debt.[20] In 1850 Congress voted to pay $10 million to Texas for relinquishing one-third of the republic's original territory and for certain other property. Of this, $5 million in U.S. 5 percent securities was turned over to the State, with the intention that the State would use them to settle some of the unsatisfied claims, and would receive the remaining $5 million from the United States upon turning in the securities redeemed. But the law was worded ambiguously, and the State simply held most of the securities as an investment. Consequently, the other $5 million remained unpaid.[21]

In 1855 Congress voted that the United States should pay the unsatisfied creditors of Texas. The sum of $7.8 million was to be prorated among them, giving each 76.9 percent of the face value of his securities. These securities were redeemed in cash as fast as the creditors turned them in over the next few years. Since the securities had sold for 10 to 15 percent of par in the early 1840's, and for 25 to 40 percent in

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[17] See Ratchford, *American State Debts*, pp. 67–68.

[18] *Ibid.*, pp. 78–79; Hanna, *Financial History of Maryland*, pp. 40–45. One other payment arose out of pre-1789 accounts. In 1832 Congress authorized payment of $381,000 to reimburse Virginia for pensions paid to Revolutionary officers and provided for Federal payment of future claims of that nature.—See *United States Statutes at Large*, IV, 563.

[19] Edmund T. Miller, *A Financial History of Texas* (Austin: University of Texas, 1916), pp. 12–82. The population of the State was then about 136,000.

[20] *Ibid.*, pp. 118–120.

[21] See *ibid.*, pp. 121–123: William M. Gouge, *The Fiscal History of Texas* (Philadelphia, 1852), pp. 190, 204–205.

1850, the Federal payment allowed for substantial speculative gains.[22] However, the State of Texas was the chief beneficiary of the Federal actions. Not only was it relieved of its debt, but it retained $3.5 million of Federal securities as an earning asset, of which it still held $2.5 million in 1860. Texas received about $1.7 million in interest on its holdings from 1850 to 1860—more than all its other revenues for that period combined.[23]

III

The largest regular program of Federal subsidies to State governments was adopted because of the extensive Federal holdings of public lands in the new Western States. To compensate for the tax disadvantages this entailed, the Federal Government adopted the policy of sharing with each State the proceeds of Federal lands sold within the State. These grants were nominally earmarked either for transportation projects or for education and may be considered the original forerunner of the grant-in-aid.[24]

The first such fund was established in 1803 when Ohio was admitted into statehood as the first public-land State. Eleven other States were given similar grants when they were admitted to the Union subsequently. The standard grant was 5 percent of the net proceeds of Federal lands sold within the State.[25]

These funds constituted a regular item of Federal expenditure from 1810 on. About $6 million was paid to States down to 1860. Alabama, Missouri, and Mississippi each received just under $1 million, while Ohio, Illinois, Indiana, and Iowa got about $0.6 million each. The largest payments came in 1836, when $964,000 was distributed. After 1845, the Federal Government withheld the shares of States that defaulted on interest due to the United States on State securities in Federal trust funds.[26]

Compared with the total volume of State expenditures, these payments were not very large. But for newly formed frontier States, with limited tax resources and uncertain credit, they sometimes made up a substantial part of total receipts.[27] However, as the States lost their frontier status, the grants dwindled both absolutely and relative to other revenues.

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[22] Miller, *Financial History of Texas*, pp. 73–74, 128. On the extent of speculation, see Elgin Williams, *The Animating Pursuits of Speculation* (New York: Columbia University Press, 1949), pp. 138–192.

[23] Miller, *Financial History of Texas*, pp. 405, 416–421.

[24] Benjamin H. Hibbard, *A History of the Public Land Policies* (New York: The Macmillan Co., 1924), pp. 84–85.

[25] Ohio was to receive 3 percent of the land proceeds in cash, to be spent for roads, while the other 2 percent was to be spent by the Federal Government to build a road to Ohio from the East (this was the origin of the Cumberland Road). States subsequently admitted received either 3 or 5 percent in cash, depending on whether they benefited from the Cumberland Road or not. Grants to five states were earmarked for education, the others for transportation. See Hibbard, *Public Land Policies*, pp. 84–85; *Statement of Appropriations and Expenditures for Public Buildings, Rivers and Harbors, Forts, Arsenals, Armories, and Other Public Works, from March 4, 1789, to June 30, 1882*, U.S. 47th Cong., first sess., S. Doc. 196 (1882).

[26] See below on defaults. In addition, Wisconsin was docked $101,000 for misappropriating that sum from the proceeds of federal land grants for canal construction. See Raymond V. Phelen, *Financial History of Wisconsin* (Madison: University of Wisconsin, 1908), pp. 455–459.

[27] Some approximate percentages of grant to total revenue are as follows: Ohio, 15 in 1810–20; Iowa, 20 in the late 1850's; Illinois, 7 in 1818–35; Missouri, 30 in 1931–36.—Ernest L. Bogart, *Financial History of Ohio* (Urbana: University of Illinois, 1912), pp. 118–119; *Biennial Report of the State Treasurer of Iowa*, 1859; F. C. James, *Growth of Chicago Banks* (New York: Harper and Brothers, 1938), p. 109; *Niles Register*, XLIII, 387; James N. Primm, *Economic Policy in the Development of a Western State: Missouri, 1820–1860* (Cambridge: Harvard University Press, 1954), p. 85.

There is no indication that any Federal supervision was exercised over the expenditures of these funds. In Ohio the money was turned over to the counties to spend for roads and apparently was not applied efficiently. Missouri adopted a similar procedure in 1833.[28] Indiana, Mississippi, Louisiana, and Arkansas had extensive State projects to which the grants contributed; most of these ended unsuccessfully. The grants for education probably did more good: Michigan, Iowa, and Wisconsin had special school funds into which their grants were paid.

Several minor Federal-State transactions also related to lands. Of these, the most important was the settlement made with Georgia for cession of that State's western lands to the United States in 1802. The United States agreed to pay Georgia $1,250,000 out of the proceeds of selling the lands, of which $1 million was paid in cash in 1814–18 and the rest was covered by other credits.[29]

IV

Under the Constitution, responsibility for a major element of national defense, the militia, was divided between Federal and State Governments. On several occasions, State governments used their own funds for expenditures contributing to national defense and were subsequently reimbursed by the Federal Government. A total of $6.6 million was paid over to States for defense claims. These claims were the subject of numerous acrimonious controversies, some of which have not entirely died out.[30]

Most of the claims arose out of the War of 1812, because of the extensive use of militia troops, and also because the financial straits of the Federal Government made it necessary for many localities to undertake their own defense. The United States started settling these with payments of over $2 million in 1817–19, but many claims were not settled for many years. At first, only the principal sums were repaid; but this policy was modified to allow interest to the date of Federal reimbursement. In all, 10 States had received by 1860 $4 million principal and $750,000 interest for claims out of the War of 1812.[31]

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[28] E. L. Bogart, *Internal Improvements and State Debt in Ohio* (New York: Longmans, Green and Co., 1924), pp. 9–10; Primm, *Missouri, 1820–1860*, pp. 76–77, 86.

[29] See Hibbard, *Public Land Policies*, p. 12: *American State Papers: Public Lands*, III, 279–280. Georgia in turn paid part of the money back to the Federal Government to cover its quota of the direct tax. The rest went into expanded internal-improvement expenditures.—Milton S. Heath, *Constructive Liberalism: The Role of the State in Economic Development in Georgia to 1860* (Cambridge: Harvard University Press, 1954), pp. 237–238, 371, 441. The Federal Government also paid $4.3 million direct to individuals to settle disputed land titles in this area.—P. J. Treat, *The National Land System, 1785–1820* (New York: E. R. Treat and Co., 1910), pp. 355–366. On other transactions involving lands, see Hibbard, pp. 237–238, 269–271.

[30] See B. U. Ratchford, "The Settlement of Certain State Claims Against the Federal Government," *Southern Economic Journal*, IV (1937), 53–75, on claims for the War of 1812; also Leonard D. White, *The Jeffersonians* (New York: The Macmillan Co., 1951), pp. 528–545.

[31] Ratchford, "Settlement of Certain State Claims . . .," pp. 56–57, 74; Raymond Walters, Jr., *Alexander James Dallas* (Philadelphia: University of Pennsylvania Press, 1943), p. 223; *American State Papers: Finance*, III, 174; Virginia House of Delegates, *Journal*, 1824–25. Documents Accompanying the Governor's Message, p. 12. An additional $1.3 million of claims for the War of 1812 were paid after 1860.—Ratchford, *ibid.*, pp. 56–57.

Other State claims arose out of the northeastern boundary controversy with Great Britain prior to 1842, the Seminole hostilities in Florida in 1816–18 and 1835–40, the Mexican War, and various Indian hostilities. In the years 1857–60 the United States paid out $0.9 million for the principal and interest of securities issued by California to finance Indian hostilities.[32]

V

The financial exigencies of the War of 1812 led the Federal Government to impose direct (property) taxes on lands, houses, and slaves, aggregating $12 million in 1814–15. In accordance with the Constitution, a quota of the tax was specified for each State in proportion to population.[33] However, each State government was authorized to assume payment of the quota of its residents, in exchange for which a discount of 15 percent would be allowed for expenses of collection. Eight States did this at one time or another, paying a total of $3.2 million into the Federal Treasury, and earning a discount of about $0.6 million.[34]

VI

From the mid-1820's on, the subject of Federal-State financial relations underwent considerable scrutiny. The prospective elimination of the Federal debt reduced Federal spending obligations, but strong States' rights sentiment opposed any expansion of other Federal activities. Those who wanted the Federal tariff kept at protective levels, or who wanted internal improvements expanded, sought some program to unite Federal revenues and State expenditures. Numerous official proposals were made and at least two bills to pay some sort of regular subsidy to the States passed Congress to meet a presidental veto.[35]

The extinguishment of the Federal debt and the great increase of Federal land sales in the 1830's caused the Federal surplus to mount at an alarming rate. In June 1836, Congress voted that all funds in the Treasury as of January 1, 1837, less $5 million, should be divided among the States in proportion to their electoral vote. Although called a "deposit," it was generally understood that the funds would never be recalled.[36]

The total authorized for distribution was $37.5 million, and the first two quarterly payments of $9.4 million each were made on schedule. But the banking situation was becoming increasingly shaky in 1837, and by the time the third installment came due, most of the banks had suspended specie payments and some States had to accept depreciated bank credits. In October 1837 the emergency session of Congress postponed payment of the fourth installment and subsequently revoked it entirely.[37]

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[32] William C. Fankhauser, *A Financial History of California* (Berkeley: University of California, 1913), pp. 311–313.

[33] See Adam Seybert, *Statistical Annals*, pp. 513–514.

[34] *American State Papers: Finance*, III, 43, 219–220.

[35] For the Bonus Bill of 1817, see *Annals of Congress*, XXX (1817), 185–186: *A Compilation of the Messages and Papers of the Presidents, 1789–1897*, ed. James D. Richardson, I, 584–585. For Clay's bill to distribute the proceeds of public-land sales among the States, see Hibbard, *Public Land Policies*, pp. 179–183. For other proposals, see *Annals of Congress*, XXX, 933: *American State Papers: Finance*, V, 501–505.

[36] See Edward G. Bourne, *The History of the Surplus Revenue of 1837* (New York: G. P. Putnam's Sons, 1883), pp. 21–23.

[37] A detailed description of how the Treasury handled the distribution is given in *Report of the Secretary of the Treasury . . ., in Relation to the Execution of the 13th and 14th Sections of the "Act to Regulate the Deposits of the Public Money," Adopted June 23, 1836*, U.S. 26th Cong., first sess., S. Doc. 14 (1839).

No restrictions were placed on what the States might do with their shares, and the dispositions varied widely. Where extensive public works projects were underway, the funds were generally applied to them, and in the case of Michigan and Illinois, such projects were begun in anticipation of the Federal funds. Most of the States deposited their shares in banks, and several used the funds to make subscriptions to bank capital. In the Northeast the common practice was to turn the money over to local governments, which might loan or invest it, apply it to general public purposes, or distribute it among the citizens. In a few cases, the funds were used to retire State debt.[38]

The allocation of funds to different uses is summarized in Table 4.

TABLE 4.—*Application of the surplus by the States*

Use:	*Millions*
Banks[1]	$8.7
Loans	8.5
General Government (including interest)	4.9
Internal improvements	3.7
Distributed to citizens	1.1
Debt reduction	1.2
Total	28.1

[1] Much money invested in banks went in turn into loans to internal improvement projects (probably about $2,000,000.

Source: Computed from Bourne, *Surplus Revenue, passim.*

Most of the money served to promote capital formation, either through direct State investment or through banks and loan programs. However, one may entertain reservations about the productivity of the investments. Illinois and Michigan were encouraged to undertake projects that were almost completely waste, and elsewhere Federal aid stimulated continuation of projects of dubious merit—in Pennsylvania, Maryland, and Indiana, especially.

Perhaps the most permanently beneficial effect of the surplus was the encouragement given to State educational programs. At least 13 States provided that the income from investments made with their shares should be devoted to schools. Often these investments turned sour, but in most cases the State continued expenditures for education out of general funds to fill the deficiency—expenditures that might otherwise not have been undertaken.[39]

At the same time the surplus was being disposed of, the Federal Government provided a smaller, but still substantial, contribution to the States by purchasing State securities for Federal trust funds. The chief purchases were for Indian tribes, representing the investment of proceeds of land ceded by tribes who moved west in the 1830's. The Government bought $2 million of State securities in 1836 and another $1 million each in 1837 and 1838. This inaugurated an investment policy that was continued until after 1860.[40]

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[38] North Carolina used $0.3 million to redeem bonds held by Federal trust funds.—Bourne, *Surplus Revenue*, p. 92.

[39] *Ibid., passim.*

[40] The first Federal security-holding trust fund was established in 1796 for the Seneca Indians. In 1800, the Navy Pension Fund was established, followed by the Privateer Pension Fund in 1815. These funds combined owned about $1 million of securities in 1816–32, mostly those of the United States. After 1832, the trust-fund device was greatly expanded for the benefit of the many Indian tribes that were moved west by the Government. Since the Federal debt was being extinguished, the older funds, as well as the new, were invested chiefly in State securities. For historical details and a list of source materials, see my unpublished doctoral dissertation, "Federal Finance and the American Economy, 1790–1860" (Princeton University, 1954), pp. 504–513, 520–521. Most of the purchases of State securities in 1836–38 were direct from the States, but in later years most were bought in the open market.

The purchases in 1836–38 were widely diversified, covering 10 different States, with two more added by 1840. Alabama was the principal beneficiary, a total of $1.7 million going for its securities. Tennessee and Arkansas also received large sums. Federal holdings for selected years are shown in table 5.

TABLE 5.—*Federal ownership of State and city securities, selected years*

[Par value in thousands]

State	1833 [1]	1836	1840	1845	1850	1855	1860
Alabama	----------	$397	$1, 697	$1, 697	$1, 697	----------	----------
Arkansas	----------	----------	774	634	631	$631	$631
Florida	----------	----------	----------	----------	----------	----------	132
Georgia	----------	----------	----------	----------	----------	----------	4
Illinois	----------	----------	49	73	73	73	73
Indiana	----------	187	328	272	272	272	347
Kentucky	----------	244	410	260	260	183	----------
Louisiana	----------	----------	----------	----------	----------	----------	37
Maryland	$224	260	379	241	241	211	146
Michigan	----------	64	75	75	75	72	----------
Missouri	----------	----------	63	63	63	213	548
New York	----------	30	30	----------	----------	----------	----------
North Carolina	----------	300	----------	----------	----------	----------	562
Ohio	----------	----------	100	118	118	118	168
Pennsylvania	----------	----------	90	85	----------	----------	96
South Carolina	----------	----------	----------	----------	----------	----------	125
Tennessee	----------	500	567	567	442	566	491
Virginia	----------	----------	----------	----------	----------	797	850
Cincinnati, Ohio	100	100	----------	----------	----------	----------	----------
Washington, D.C.	59	66	----------	----------	----------	----------	(2)
Railroads [3]	----------	----------	----------	----------	----------	612	612

[1] Figures are for Dec. 31 through 1840, then June 30.
[2] Less than $500.
[3] Includes $100,000 bonds of Richmond & Danville RR., guaranteed by Virginia, and $512,000 bonds of Nashville & Chattanooga RR., guaranteed by Tennessee.

Sources: Reports and records of Federal trust funds. See note 40.

This program, like the surplus and the 5-percent funds, was strictly fair-weather aid. The three programs combined paid the States over $33 million in 1836–38.[41] But as hard times closed in, the Federal surplus disappeared and land sales dwindled. The drying up of foreign capital supplies left many of the ambitious States with incomplete or unremunerative projects and with tremendous debts, service of which required sums in excess of feasible tax programs. As a result, eight States permitted interest on their debts to fall into arrears, and Arkansas, Mississippi, Michigan, and the territory of Florida repudiated payment of all or part of their debts.

These actions affected the Federal Government both as creditor and as potential benefactor. On the one hand, there was considerable support for some sort of Federal aid, the most extreme proposal being for Federal assumption of the State debts.[42] This was too strong for public opinion, but in 1841 the Whigs succeeded in passing Clay's old proposal to distribute among the States the proceeds of Federal sales of public lands. The Distribution Act of September 1841 increased the share of land proceeds going to the public-land States from 5 percent to 15 percent. The remaining land proceeds, after deducting costs of surveying and selling, were to be divided among all the States on the basis of

[41] Compare this with total State borrowing of over $100 million in 1835–38.—Ratchford, *American State Debts*, p. 79.

[42] See Reginald McGrane, *Foreign Bondholders and American State Debts* (New York: The Macmillan Co., 1935), pp. 23–40. This is the best survey of State projects and the financial difficulties attending them.

population. However, the law provided that no funds should be distributed if tariff rates were raised above 20 percent. When the tariff was increased in 1842 the distribution program was suspended after 8 months of operation and was never revived.

The total sum authorized for distribution was $691,000.[43] Although disbursements were scheduled to occur semiannually, some States refused their shares in protest against the program. However, once the program had lapsed, all but Virginia claimed their shares.[44]

This ended Federal efforts to provide some sort of general financial relief to the States. The Federal Government then turned its attention to the other side of the problem, for it was the owner of a large amount of State securities that were in default—bonds of Arkansas, Illinois, Indiana, Michigan, Maryland, and Pennsylvania, totaling $1.4 million in 1843. The Distribution Act authorized the United States to withhold the share of any State defaulting on debts owed to the United States, and the shares of Arkansas and Maryland were withheld.[45]

In March 1845, Congress authorized the Treasury to withhold the 5-percent fund of any State in default, and this was done for Arkansas, Indiana, and Michigan.[46] Eventually most of the recalcitrants resumed normal debt service.[47] Indiana, however, adopted a complicated debt reorganization that the Federal Government did not accept, and, as a result, the State made no payments to the United States on its defaulted bonds down to 1860.[48] Arkansas, which had incurred its debt by issuing bonds to banks, refused to accept responsibility for the bonds and made no payments after 1842. The United States owned one-fifth of the Arkansas debt.[49]

Purchasing State securities as a trust-fund investment could be defended in 1836 because there was no Federal debt. But the Federal Government continued to buy State securities even after the reincarnation of the funded Federal debt in 1841. After redemptions and transfers had reduced Federal holdings to below $3 million, another large purchase of $1.4 million was made in 1858. From a financial point of view, these investments were very unsuccessful, because of the high

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[43] Details of calculation and shares of individual States are shown in *Report of the Secretary of the Treasury, Showing, . . ., the Amounts Paid and now Due to the State of Mississippi, with the Correspondence Relating Thereto,* U.S. 28th Cong., first sess., S. Doc. 75 (1844).

[44] See the following protests: *General Assembly of South Carolina, Report of the Committee on Federal Relations, on . . . the Distribution of the Sales of the Public Lands,* U.S. 27th Cong., second sess., H. Doc. 101 (1842) ; *Resolutions of the Legislature of Alabama on the Subject of the Act for the Distribution of the Proceeds of the Sales of the Public Lands,* U.S. 27th Cong., second sess., H. Doc. 104 (1842) ; *Preamble and Resolutions of the Legislature of New Hampshire, Declaring the Distribution Act, the Tariff Act, and the Bankrupt Act, to be Inexpedient and Unconstitutional, . . .,* U.S. 27th Cong., third sess., H. Doc. 63 (1843). Virginia's share was paid to the "restored" (Union) Government of the State in 1862.—*Receipts and Expenditures of the United States,* 1862, p. 88.

[45] The law exempted debtor balances of 1793 and the surplus "deposits" of 1837. On Maryland, see John B. McMaster, *History of the People of the United States* (New York: D. Appleton and Co., 1883–1913), VII, 5 ; on Arkansas, see *Bonds of Arkansas Held by the United States,* U.S. 51st Cong., second sess., H. Report 3314 (1890), p. 2.

[46] *Letter from the Secretary of the Treasury, Transmitting Information . . ., Relative to the Two or Five Per Cent Fund with the State of Arkansas,* U.S. 29th Cong., first sess., H. Doc. 47 (1845). The sums withheld were: Arkansas, $70,000 ; Indiana, $108,000 ; Michigan, $31,000. Illinois resumed payments in 1846 before any Federal funds were withheld. Michigan resumed in 1854.

[47] See McGrane, *Foreign Bondholders, passim,* on programs of the various States.

[48] See *Report [of] the Committee on Finance, to Whom was Referred Bill No. 10, "To Provide for the Surrender of Certain Bonds of the State of Indiana,"* U.S. 33d Cong., first sess., S. Rept. 64 (1854). Indiana's account with the United States was finally settled in 1868.—See *Letter from the Secretary of the Interior, Communicating, . . ., Information in Relation to Certain Indiana State Bonds, Held by Him as Trustee for Certain Indian Tribes,* U.S. 41st Cong., third sess., S. Doc. 12 (1871).

[49] See McGrane, *Foreign Bondholders,* pp. 245–264. The account was finally settled in 1898.—See *Bonds of Arkansas Held by the United States; U.S. Statutes at Large,* XXX, 367–368.

incidence of default and repudiation, and were a source of friction and ill feeling between the governments involved.[50]

VII

Establishment of the National Capital in Washington led to several interesting financial incidents. The States of Maryland and Virginia, in addition to ceding the land for the District of Columbia, also granted $72,000 and $120,000 respectively to the United States to be used for public buildings. Since the development of the Capital was a political stepchild, the project was soon in financial difficulties, and Congress, unwilling to advance funds directly, authorized the Commissioners in charge to borrow if they could. Maryland then lent them $250,000 in U.S. 6-percent stock in 1797–98 and 1800. This loan was repaid out of the United States Treasury in 1804–1808.[51]

In addition to all these measures involving intergovernmental transactions, the Federal Government entered jointly into several canal projects with States. Federal funds were subscribed to the capital of four canal corporations in 1825–33. Of these, Maryland and Virginia joined it in the Chesapeake and Ohio Canal; Maryland, Pennsylvania, and Delaware participated in the Chesapeake and Delaware, and Virginia entered into the Dismal Swamp Canal Co.[52]

VIII

The aggregate of all the transactions we have discussed brought a net flow of about $90 million from the Federal Government to the States (see table 1). Not all of this can be considered gift or subsidy.

[50] Further difficulties soon arose. In 1860, it was discovered that $870,000 of securities had been stolen.—*Report [of] The Select Committee, . . . in Relation to the Fraudulent Abstraction of Certain Bonds, Held by the Government in Trust for the Indian Tribes, From the Department of the Interior . . .*, U.S. 36th Cong., second sess., H. Rept. 78 (1861). Soon afterward, about $2 million of the trust-fund securities were defaulted by seceding States.

[51] Maryland and Virginia petitioned for refund of their grants in later years on grounds that the money was only lent, but they were unsuccessful.—See *Payment of Certain Moneys Advanced by Virginia and Maryland to the United States*, U.S. 60th Cong., first sess., S. Rept. 480 (1908). The District of Columbia Commissioners sold the stock lent to them at a discount of about 15 percent. Maryland thereupon bought back $20,000 of it for $16,600. See *American State Papers: Miscellaneous*, I, 219–221, 245–246; Wilhelmus B. Bryan, *A History of the National Capital* (New York: The Macmillan Co., 1914), I, 206.

[52] The division of stock ownership in these canals was as follows (thousands):

Investor	C. & O.	C. & D.	D.S.
United States	[a] $2,500	$450	$200
Maryland	5,000	50	
Virginia	250		190
Delaware		25	
Pennsylvania		100	
Private investors	609	1,625	96
Total	8,360	2,250	486

[a] Includes $1.5 million invested by the cities of Washington, Georgetown, and Alexandria, D.C., taken over by the United States when it assumed their debts.

Sources: *Report [of] The Committee on Roads and Canals, to Whom was Referred the Application of the State of Maryland for a Surrender and Transfer of the Stock Held by the United States in the "Chesapeake and Ohio Canal Company,"* U.S. 27th Cong., second sess., S. Doc. 313 (1842); *Letter from the Secretary of the Treasury Transmitting an Opinion by the Attorney General Relative to a Proposed Sale of the Stock Held by the United States in the Dismal Swamp Canal*, U.S. 40th Cong. second sess., H. Doc. 135 (1868); *Hearings on H.R. 20776*, U.S. 60th Cong., first sess. (1907).

This amount may be compared with Federal expenditures of somewhat over $2 billion in the years 1790–1860. The total receipts of the States during this period, including net borrowing, were probably on the order of $3 billion.

To particular States at particular times, Federal funds bulked large. In the 1790's, Delaware, New Hampshire, and Connecticut derived from 20 percent to 50 percent of their revenue from Federal securities, and Texas received over 50 percent from this source in 1851–60. Newly formed frontier States not uncommonly derived 10 percent to 20 percent of their revenue from their share of Federal land sales. The combined effects of Federal programs had a major influence in the States in 1790–1800 and in 1836–38. Otherwise, the Federal-State transactions were not important economically.

As we have seen, these transactions were related to State experiments with transportation and banking enterprises, and to the development of public education. The funding program helped arouse State interest in investing in earning assets. The 5-percent funds, the surplus revenue, and Federal security purchases all promoted internal-improvement projects. The surplus provided a major stimulus to the development of educational systems, and five States also received their 5 percent grants earmarked for education, totaling $1.5 million down to 1860.

Whatever their immediate economic importance, these programs are of interest in showing the continuing attention paid to the problem of reconciling the superior revenue-raising ability of the Federal Government with the desire for local autonomy and self-determination in Government expenditures.[53]

[53] See James A. Maxwell, *The Fiscal Impact of Federalism* (Cambridge: Harvard University Press, 1946), p. 18.

FEDERAL-STATE COLLABORATION IN THE NINETEENTH-CENTURY UNITED STATES *

BY DANIEL J. ELAZAR**

FEDERALISM: COOPERATIVE OR DUAL

The operation of the American Federal system in the 19th century has been the subject of much discussion and some examination since the New Deal and the so-called "rise of cooperative federalism." It has generally been assumed that federalism in practice, like federalism in theory in the 19th century (which is here taken to include the entire period between 1790 and 1913) has been dual federalism, in which the Federal and State Governments pursued virtually independent courses of action during a period when government activity was, in any case, minimal.[1]

This essay is based on a study of intergovernmental collaboration in the 19th century United States, conducted under the auspices of the Workshop in American Federalism, University of Chicago, and financed by the Ford Foundation. The major product of the study is the writer's book, *The American Partnership* (Chicago, 1962) which presents the data summarized below in greater depth and detail. Particular acknowledgment is due the Institute of Government and Public Affairs, University of Illinois, which provided me the time and facilities with which to prepare this essay.

Dual federalism has been defined by Clark, among many others, as "two separate Federal and State streams flowing in distinct but closely parallel channels." Perhaps the best definition of the term was that given by Chief Justice Roger B. Taney in the name of the U.S. Supreme Court, in *Ableman* v. *Booth* (21 Howard 506), at the height of the era of dual federalism, in 1858: "The powers of the General Government, and of the State, although both exist and are exercised within the same territorial limits, are yet separate and distinct sovereignties, acting separately and independently of each other, within their respective spheres." Dual federalism as a doctrine has been expounded at various times by Presidents of the United States (particularly while vetoing Federal aid measures); [2] by the U.S. Supreme Court (particularly in opinions restricting the powers of government—Federal or State—to

*Reprinted from *Political Science Quarterly*, vol. LXXIX, June 1964, No. 2
**University of Minnesota.

[1] This thesis has been most persuasively stated by George C. S. Benson in *The New Centralization* (New York, 1941) and Jane Perry Clark in *The Rise of a New Federalism* (New York, 1938), and has been repeated by such eminent authorities as Arthur N. Holcombe in *Our More Perfect Union* (Cambridge, Mass., 1950). A variant thesis, which argues that Federal-State administrative cooperation existed in the early days of the Republic and was then replaced by strict dual federalism, has been advanced by Edward S. Corwin (inventor of the term "dual federalism") in *The Twilight of the Supreme Court* (New Haven, 1934) and in other books and by Leonard D. White in his great four-volume study of American administrative history, *The Federalists* (New York, 1948), *The Jeffersonians* (New York, 1951), *The Jacksonians* (New York, 1954) and *The Republican Era* (New York, 1958).

[2] See James D. Richardson (ed.), *Messages and Papers of the Presidents* (Washington, D.C., 1908), for exemplary statements by Thomas Jefferson, James Madison, James Monroe, Andrew Jackson, Franklin Pierce, James Buchanan, and Grover Cleveland, among others.

act);[3] by spokesmen for the South (particularly when justifying slavery, segregation, or secession);[4] and by conservative business interests (particularly when seeking to avoid government regulation). The doctrine has been expounded as representing classic American federalism so long and so forcefully that it has been accepted, by students of American institutions and others, as fact.

The central hypothesis of this study is that the traditional picture of 19th-century American federalism is unreal, that federalism in the United States, in practice if not in theory, has traditionally been cooperative, so that virtually all the activities of Government in the 19th century were shared activities, involving Federal, State, and local governments in their planning, financing, and execution. The pattern of sharing in American federalism was established, in its essentials, in the first decades after the adoption of the Constitution. This study seeks to explain how that pattern has continued to evolve since then. Its central conclusions are that the theory of dual federalism was not viable when applied to concrete governmental problems in specific situations even in the early days of the Republic; that dual federalism when interpreted to mean demarcation of responsibilities and functions has never worked in practice; and that, while the amount of governmental activity on all planes in relation to the total activity of American society (the "velocity of government") has increased, the governmental activity that existed in the 19th century was shared in much the same manner as governmental activity in the 20th century. All this is true despite formal pronouncements to the contrary, made by the political leadership of the day who spoke in terms of demarcation but practiced cooperation.

THE ELEMENTS OF COOPERATIVE FEDERALISM

The roots of cooperative federalism are entwined with the roots of federalism itself. It was during the colonial period that the four elements which later coalesced to form the pattern of intergovernmental cooperation first appeared on the American scene. Among these elements were a federalist theory of government,[5] a dual governmental structure, some specific cooperative programs, and some administrative techniques for intergovernmental collaboration.[6]

These four elements of theory, structure, program, and technique can be traced through the subsequent evolution of the American governmental partnership. They were first combined under a general American Government by the Second Continental Congress after the declaration of American independence in 1776. Consequently, the patterns of intergovernmental cooperation that developed informally

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[3] See, for example, *Collector* v. *Day* (11 Wallace 113), the *Slaughterhouse* cases (16 Wallace 36), *Munn* v. *Illinois* (94 U.S. 113), *Hammer* v. *Dagenhart* (247 U.S. 251), and *Ponzi* v. *Fessendan, et al.* (258 U.S. 254).

[4] The classic statement of the Southern viewpoint is that of Alexander H. Stephens, *A Constitutional View of the War Between the States* (Philadelphia, 1868).

[5] For a discussion of this theory of federalism, see Carl Becker, *The Declaration of Independence* (New York, 1958), ch. III. Part of the theoretical debate over the nature of the British Empire prior to 1776 centered on specific cases of parliamentary agents engaging in unconstitutional unilateral action within the colonies rather than conforming to the constitutional patterns of crown-colonial cooperation as they were conceived by the colonists, though the discussions were not phrased in those terms.

[6] For a discussion of land grants in the colonial period, see Mathias N. Orfield, *Federal Land Grants to the States, With Special Reference to Minnesota* (Minneapolis, 1915), pt. I, 5–30.

during the Revolutionary War antedate even the Articles of Confederation. That document, the first written constitution of the United States, implicitly provided for collaboration in a manner highly reminiscent of the then recently sundered relationship between colonies and crown, as it had been viewed in American political theory and as it was embodied in the structure of colonial government institutions. Even the programs requiring collaboration (defense, taxation) were much the same. With the development of a national policy of grants-in-aid based on the western lands in the Northwest Ordinances of 1785 and 1787, the creation of the Confederation-sponsored Bank of North America in 1784, and the general reliance of the Confederation Congress on State officials to execute its actions, the colonial techniques of collaboration were also embraced by the Confederation.

It is unquestionably true that collaboration under the Articles was overdependent on the actions of the States and often failed in practice. This was, of course, purposely changed with the adoption of the Constitution in 1789 and in the course of its translation into action during Washington's first administration. While the "intentions of the framers" are always subject to dispute, it seems safe to say that the Constitution is oriented to neither cooperative nor dual federalism per se. It provides for dual institutions, some cooperative programs, and a wide range of concurrent powers which can either be divided between the Federal Government and the States or shared by them in various cooperative programs. By and large, the decision of the American people has not been to separate functions by government but to maintain dual institutions which share responsibility for the implementation of specific functions. This "decision" has not been made through a prior conscious design but through a continuous series of specific decisions involving concrete programs. The continuing evolution of the theories, structures, programs, and techniques of the federalism that emerged from this process is what we today term cooperative federalism.

The Architects of Cooperative Federalism

Just as the Founding Fathers did not perceive the future role of political parties in the United States, it seems that they did not plan on the development of cooperative federalism as we know it. The majority of the theoretically oriented founding fathers either viewed the federal system as dual and separate with the States having the dominant role and the powers of the Federal Government confined to those objects specifically enumerated in the Constitution or as one in which the National Government would have the dominant role while the States were to become relatively weak repositories of residual local powers.

The men who became the architects of American federalism did not view the Federal system as one in which there was to be either a perpetual struggle between the Federal and State governments for dominance or an irrevocable separation of their respective functions for the sake of amity between them. Avoiding the premises of legalistic thought, they did not view the two planes as rivals, but as partners in government who were to share responsibility for a wide range of activities for the mutual benefit of the Nation as a whole and for its constituent States.

These architects did not leave a formally organized and recognized body of theory behind them because they wrote of their theories almost exclusively in response to specific practical problems. Nevertheless, examination of their official reports and other documents which they produced during their public careers does reveal some coherent patterns of thought on the proper nature and goals of American federalism.[7]

Foremost among the men who led the movement toward intergovernmental cooperation to meet the problems of a dynamic society were Albert Gallatin and John C. Calhoun, who pioneered the formulation and implementation of cooperative programs during the first four decades of the Republic. Aside from these two principal architects of American federalism, many people made major contributions to the development of the Federal system as we know it. Other top-ranking officials in the Federal executive branch, particularly in the Treasury, War, and Interior Departments, led the Federal Government into the field of specific cooperative activities when cooperation, as such, was not popular as a doctrine. The professionals in the Federal and State Governments, who were interested in promoting specific programs for the benefit of the whole Nation and its constituent parts, provided cadres for the initiation and implementation of cooperative programs in undramatic ways while the rest of the country virtually ignored them and the governments they served. The advocates of specific programs, who were not in or of government at any level but who wanted to see the development of certain public activities at all levels (or regardless of level), provided a basis for the mobilization of popular support in those cases where government did take part. Finally, much of the development of the system was stimulated by the members of the Congress of the United States and the several State legislatures who, because of their interest in the general welfare or as an outgrowth of their local concerns, supported intergovernmental cooperation in those fields of endeavor which seemed most necessary to them despite an overall theoretical disposition to limit government in general and to separate by level those few activities that were considered to be of legitimate governmental concern.

Cooperative Federalism Between 1789 and 1848

American federalism has evolved over three historical periods, all bound together by the thread of intergovernmental collaboration. A strong case can be made to demonstrate that the three periods of federalism correspond to the three major periods in postcolonial American history generally. The particular characteristics of federalism in these three periods can be identified by the forms of intergovernmental collaboration that predominated in each, though in every period the

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[7] Some of the most important of these documents setting forth the cooperative approach are: Albert Gallatin, "Report on Roads and Canals," *American State Papers: Miscellaneous*, I, 724–921 (Apr. 4, 1808); John C. Calhoun, "Report on Roads and Canals, Communicated to the House of Representatives, Jan. 14, 1819," in Calhoun, *Works* (New York, 1855), V, 40–54; Calhoun, "Report on the Condition of the Military Establishment and Fortifications, Communicated to Congress by the President, Dec. 7, 1824," *ibid.*, 141; Mahlon Dickerson, *Report on the President's Message as Respects the Distribution of the United States Surplus*, 21st Congress, first sess., December 1830.

other forms of cooperation existed alongside the predominant ones. The difference between the three periods is not a difference in the nature of intergovernmental cooperation but in the predominant forms by which such cooperation was effected.

The first period encompassed the formative years of the American Nation and its Federal system, including the Revolutionary and Federalist eras, the fluorishing and subsequent decline of the Jeffersonians, and the rise of "Jacksonian Democracy." When it came to a close in the mid-1840's, the United States had fought its second war of independence, turned its back on Europe to concentrate on westward expansion, and was just completing the continental expansion of the Nation's boundaries.

This was also the period in which the mercantilist orientation of the American economy which openly allotted to government a major share in the economic development of the Nation persisted and finally declined, to be replaced by the laissez-faire persuasion which, at least in theory, denied Government any but a minimal role.[8] In fact, the last decade of this period was marked by the fluidity and confusion characteristic of a change in eras, both in the economic and governmental realms, since the changes in the forms of federalism coincided with the changes in economic organization.

This first period contributed refined versions of the vital ideas of natural law and constitutionalism to the American mystique, as expressed in the basic documents that emerged from the Revolutionary era. As part of this set of ideas, the concepts of federalism were defined and refined as well. Dominant in this formative period were the activities of the major architects of pre-20-century cooperative federalism, Gallatin near the beginning and Calhoun near the end.

The major vehicles of intergovernmental cooperation in this period were the joint stock company (in which Federal, State, and local governments, as well as private parties, joined to invest in corporations established to undertake specific projects, usually in the realm of internal improvements and banking) for long-term cooperative projects, and the cooperative survey (in which the Federal Government would send or lend Army Engineers to the States to survey and plan internal improvement projects) coupled with the widespread use of Federal technicians by the States as a means of providing Federal services-in-aid to the latter. During this period the majority of the States then in the Union did not have extensive Federal lands within their boundaries, so the tone of cooperation was set by programs designed for the States without public lands. Cooperation in the field of banking was the most formally structured on a nationwide basis. Internal improvement programs usually involved formal arrangements, but were almost always tailored to specific situations in each State and even for each project. Federal aid to education was vital, but generally consisted of "back-door financing" through Federal "reimbursement" of certain State-incurred expenditures with the implicit understanding that the funds would be used for education. The major continuing programmatic concerns of American Govern-

[8] For a discussion of the mercantilist approach in American political economy during this period, see Curtis P. Nettels, "British Mercantilism and the Economic Development of the Thirteen Colonies," *The Journal of Economic History*, XII (1952), 105–114.

ment had already emerged during the first period. They were the extension of internal improvements, the maintenance of a sound nationwide fiscal system, the establishment of appropriate educational facilities, and, to a more limited extent, the provision of necessary public welfare aids.

In the field of internal improvements, the first period was given over, in the main, to water transportation, primarily through canals, and, to a lesser extent, to overland transportation via wagon roads. One of the best examples of federal-state collaboration in canal construction was the opening of the Dismal Swamp Canal, connecting Norfolk, Virginia, with Albermarle Sound in North Carolina. In 1816, after several abortive local attempts to construct a canal through the Great Dismal Swamp of Virginia, the State of Virginia joined the State of North Carolina, the city of Norfolk, and private investors in the creation of a joint stock company to implement a canal plan prepared by the Army Engineers in 1808 as part of a national blueprint for internal improvement.

Informal cooperation between State and Federal officials was developed to advance construction. This included Federal assistance in securing a supervising engineer for the State (1816), as well as a second survey by qualified Federal engineers (1817). This cooperation involved the highest administrative levels of both the Federal Government and the State, including the President of the United States; the Secretaries of State, Treasury, and War; the diplomatic corps; Government bureaus such as the Army Engineers, the Governor of Virginia, his agents, and the Virginia Board of Public Works. Some of this cooperation came about through direct interlevel contracts made through the normal administrative channels. Part of it came about through the State officials' use of the services of their Senators and Representatives in Washington.

Ten years later, despite the company's efforts and further informal Federal-State collaboration, the canal had still to be completed. Despite periodic State subsidies, the company still lacked the requisite funds. In 1826, the Virginians, with the active assistance of the War Department, were able to persuade Congress to invest $150,000 in the project and, in that way, to acquire 600 (out of a total of 1,240) shares in the company. Once the Federal Government became a partner in the enterprise, it provided the additional professional and administrative services, as well as the needed funds, for the completion of the project. Despite the oratorical denunciations of "States'-rights" Virginians, this Federal "intervention" succeeded in bringing the canal to a state of readiness by 1828. For the next three decades the Federal Government and the State of Virginia continued their cooperative efforts to maintain and improve the canal. Though the formally cooperative aspects of the program came to an end with the coming of the Civil War, the canal is still in use as an important part of the Intracoastal Waterway system.

Closer examination of the details of this program reveals the three major areas of Federal-State cooperation characteristic in projects of this nature: construction of the canal, maintenance and improvement of its facilities, and control over the administration of its operations. The first two areas involved both fiscal aid and the services of governmental personnel. The third involved cooperation between Federal and State officials. While the Federal Government did not become a full partner in this enterprise until it was already under construction, once it did enter the partnership its role became a crucial and even dominant one. Yet this did not come about through the lessening of the State's power but through a coincidence of interest (often made explicit in the correspondence between State and Federal officials at the time) between the State and Federal Governments. To insure this coincidence of interest the State as a whole and the locality involved both had means of influencing Federal policy and actions through their Senators and Representatives.

Administration of the canal was a joint Federal-State venture. The Federal executive delegated the power of proxy (to represent the Federal interest in the project's administration) to the collector of the port of Norfolk and detailed other Federal personnel to aid in the construction of the canal. The State executive, pursuant to earlier acts of the legislature, provided for the State board of public works to act as proxies and supervisors for the State which, through its greater direct role in the company (which was a quasi-official State agency) became primarily responsible for actual construction. Cooperative procedures were then developed by the two sets of officials involved. Construction and, later, maintenance proceeded under the direction of the company, supervised by the State board of public works and utilizing Federal engineers and equipment. The company reported to the State and to the Federal Government and the State board also reported to the Treasury and War Departments. Company policy was decided by its board of directors dominated by the United States and the State of Virginia, whose representatives operated in concert within a community of interest. The few attempts to change company policy that were made were in every case directed against both governments by the nongovernmental shareholders rather than by one against the other.

The case of the Dismal Swamp Canal is typical. By the third decade of the 19th century, the pattern of intergovernmental cooperation was already clear in projects such as this one, of which there were many. Changes were indeed made in subsequent years but they were changes designed to improve the mechanisms rather than to modify the basic relationships. While Federal control over standards tended to grow, State control over processes grew as a counterbalance.

Collaboration under the Constitution in the fiscal field may be said to have begun with Federal assumption of the States' Revolutionary War debts in 1790. During the 1790's, Federal reimbursement of State debts already paid, coupled with the sale of State lands, furnished sufficient income for most of the States to maintain themselves without resorting to taxation.[9] Though the level of State governmental activities was low prior to 1816, the States began to develop a tradition of spending money with relatively little responsibility for raising revenues. This was coupled with a developing, albeit unrecognized, reliance on the Federal Government for funds to initiate and support the major programs of each era. While it may be argued that the reimbursement funds "rightfully" belonged to the States in the first place,

[9] William J. Shultz and M. R. Caine, *Financial Development of the United States* (New York, 1937), pp. 117–118.

in the last analysis they came from the Federal Treasury and were used for projects which the States would not have been able to finance alone because of local opposition to increased taxation.

Two other major cooperative fiscal programs were established by the first Congress. The first involved the levying of a direct tax among the States, which were given quotas based on the constitutional formula and required to raise and deliver the taxes to the Federal Government. Direct taxes were levied in the above manner intermittently over the next century. The second program involved the inauguration of a central banking system for the United States through the chartering of the first Bank of the United States as a Federal-controlled agency.

Federal involvement in the banking system is almost as old as banking as an institution in this country. When the first Bank of the United States was established in 1791, only four other banks existed in the entire United States and one of these four, the Bank of North America, had been chartered by the Confederation Congress as a quasi-nation bank.[10]

In the early period, the great majority of banks were either State-owned, joint stock companies in which the State was a major shareholder, or controlled by the State through special charter provisions. The Bank of the United States, a Government-controlled bank under Federal auspices, served as the fiscal and banking arm of the Federal Government and manager of the Federal deposits. In this capacity it dominated the American financial scene prior to 1800. According to Shultz and Caine, "Through its branch organization it cooperated with and to some extent controlled the newly created State banks throughout the country." [11]

Under this first and subsequent national banking programs, a significant amount of intergovernmental cooperation developed. Some of this cooperation was formally written into law by both Nation and State, while some of it evolved informally in response to obvious situations and needs. The directors of the Bank, which was located in Philadelphia, did not originally intend to establish branches in other parts of the country, but pressures from stockholders in other cities soon forced them into widespread branch banking, primarily because so few banks existed outside of the Northeast. Four branches were opened in the spring of 1792 after some attempts were made to absorb the four existing State banks. This latter move was resisted by many of the same people who had previously supported creation of the national bank against those who felt it to be a threat to States' rights as well as a corrupting influence in an agrarian society. Just as they recognized the need for some centralized banking institution, they also feared too much centralization and resisted any attempts to eliminate the system of dual institutions which makes cooperative federalism possible.

The U.S. Bank soon began to function as a clearing house and source of capital for the various State banks, as well as serving as fiscal arm of the Federal Government. As such it was accepted as an asset by the

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[10] Bray Hammond, *Banks and Politics in America, from the Revolution to the Civil War* (Princeton, 1957), p. 144.
[11] Shultz and Caine, 125.

more conservative banks and as an undesired threat by the more reckless and speculative ones. Hammond describes its operation in these words:

> Being the main Government depository and having offices in the principal commercial cities, the Bank was the general creditor of the other banks. It had the account of the largest single transactor in the economy—the Federal Government—and the receipts of the Government being mostly in the notes of State banks and these notes being deposited in the Bank, it could not help being their creditor. By pressing them for payment of the notes and checks received against them, the Bank automatically exercised a general restraint on the banking system . . . The restraint upon bank lending came later to be designated central bank control of credit.[13]

Congress allowed the Bank's charter to expire in 1811, despite administration support for its renewal, as a result of the opposition generated by a coalition of extreme States'-rights conservatives and spokesmen for eastern businessmen interested in speculation on the frontier, where less control over fiscal matters would aid their highly speculative ventures. As in the debate of 1791 and in many subsequent debates over similar subjects, the arguments this coalition used against the Bank were those of constitutionality, but the motivations were those of business. On the other hand, the new agrarians, primarily westerners, wanted to maintain the National Bank precisely because the State banks had already proved their inability to meet what were, in essence, national needs, in particular those related to westward expansion.

The Nation soon discovered how useful the central bank had been. The War of 1812 brought with it serious fiscal problems for the Federal Government and the States, many of which could have been avoided had a central bank been in existence. In 1816 Congress reversed itself and voted the establishment of the second Bank of the United States. The reversal was made possible by a parting of the speculator-States'-rights coalition. While the speculators continued to oppose central banking as interfering with their opportunity to manipulate the Nation's fiscal affairs, a number of States'-rights advocates supported the new Federal bank as an aid to the States in their struggle, often against the speculation interests, for fiscal solvency. They were led to take this position as a result of the contrast between their experiences with the intergovernmental collaboration that had developed between the States and the first Bank and their experiences with "free" banking between 1811 and 1816. Indeed, their major demand in preparing the charter for the second Bank was that its collaborative aspects be strengthened. Cooperative federalism in the banking field was already being used to develop a system in which the duty and ability of the States to take action was both stimulated and guaranteed by the Federal Government.

The most forceful argument for Federal responsibility in monetary matters, from the constitutional point of view, came from John C. Calhoun, who had assumed Gallatin's role as leading architect of cooperative federalism in his generation. His statement, in this case as in so many others, has a most modern ring. It was Calhoun's view that when any private enterprise (in this case the financial interests) grows strong enough to exercise a power granted to the Federal Gov-

[13] Hammond, pp. 198–199.

ernment under the Constitution (in this case, control over the soundness of the currency) it must be subject to regulation in the public interest. This regulation is best achieved by reassumption of the power by the Federal Government, in the interests of the public and of the States.[13]

The charter that was finally enacted made it quite clear that the second Bank was a continuation of the first. Thus it may be said that the same national banking system served the country for 40 of the 45 years between 1791 and 1836. The new charter gave the Federal Government the power to require the Bank to establish at least one branch in each State, under certain conditions. In addition, the bank was specifically designated as the principal depository of the U.S. Treasury, though the State banks, which had inherited the Federal deposits after the demise of the first Bank, under a different cooperative program were allowed to keep some deposits because they were so dependent on them to stay solvent.

Even without the National Bank, cooperative relationships had developed between the U.S. Treasury and the State banks. The latter served as Federal depositories and disbursing agents during periods when the National Bank did not exist and also parallel to it when it did. As long as the mercantilist view of the role of Government in the economy prevailed for a majority of the Nation, this cooperation continued. It was only when this view was abandoned due to changing times that the forms of cooperation created under it became inadequate.

After 1828 the operations of the U.S. Bank centered around forcing the State banks to adopt more conservative banking practices. This attempt came just as the more radical and speculative business elements were attaining political power under the Jacksonian Democracy. As a result, their cries that the Bank was strangling business expansion in the interests of a few wealthy eastern capitalists fell on willing ears and doomed the second Bank in much the same manner as the first had been. Even so, the political struggle that led to Jackson's veto of the recharter bill in 1832 sealed the fate of the Bank more because of conflicts between persons in the political arena than for reasons of principle, and certainly did not imply a rejection of Federal-State collaboration.

Beginning in 1833 the $6,500,000 in Federal deposits were gradually withdrawn as the funds were spent (gradually, to prevent a sudden collapse of the Nation's finances, a tribute to the role played by the Bank as the central force in the national monetary system). Newly received funds were deposited in the State banks once again, as they had been after the demise of the first Bank, where they remained until the establishment of independent Federal depositories in the 1840's.

The first century of the American Republic witnessed a struggle between advocates of a national banking system designed to bring some measure of national order to the fiscal scene and advocates of maximum local control over the money system. For 40 years prior to the administration of Andrew Jackson, the nationalists were successful in perpetuating a centralized, cooperative, banking system.

[13] Calhoun, *Works*, II, *passim*.

In the 1830's the tide turned and the localists were able to decentralize the system. During the Civil War, the passage of the National Banking Act of 1863 signified another turn in the direction of order through the creation of a uniform national currency and nationally applied bank standards which in themselves gave rise to a new cooperative regulatory program in which the Federal and State Governments shared in the regulation of the newly created national banks. Finally, the creation of the Federal Reserve System in 1913 brought both the national and local approaches together in a workable compromise.

Collaboration in the field of education in the States without public lands was less direct in the early period. Before 1837, one major means by which Federal assistance for the establishment of public schools was made available was through the reimbursement process. It has already been indicated that Federal assumption of the States' Revolutionary War debts and the General Government's reimbursement of those debts already paid by the States provided the bulk of the states' revenues prior to the War of 1812. During that conflict, and subsequent ones through the Spanish-American War, the Federal Government again had to rely upon the states for a major share of the immediate financing of the Nation's war effort. Whenever necessary, the States raised, equipped, and supplied their troops with the promise of Federal reimbursement after the cessation of hostilities. While the War of 1812 marked the high point in the role of the States in financing a war effort, reimbursable State defense expenditures continued to be made for Indian conflicts, international border disputes, and even for major national wars, throughout the 19th century.

Federal reimbursement of war expenditures provided the States with larger amounts of revenue for use in providing domestic services than would otherwise have been possible for the States to raise through universally unpopular taxation. Furthermore, in the negotiations for reimbursement, the States' Washington agents and congressional delegations were often able to have expenditures of less than strict legitimacy included in the final accounting. This was possible because it soon became widely understood and accepted that Federal reimbursement funds would be used by the States wholly or partly to finance the establishment of free public educational systems. Here, as in the case of internal improvement and fiscal organization, the problem of education was simultaneously of both local and nationwide concern and, consequently, was attacked by all planes of government. In the public land States, the Federal-State-local partnership could operate through the medium of the land grant by which the Federal Government provided potentially handsome endowments for public education from elementary school through the university. Constitutional scruples on the part of a strong and determined minority prevented the direct, overt extension of Federal aid to those States without public lands. However, since the felt need for Federal assistance and stimulation in the field of education remained, the reimbursement system was seized upon to provide an acceptable alternative to formal grants-in-aid.

Thus it was that the States would file claims for reimbursement with the War Department, with the necessary substantiating documents, and then would secure congressional approval for any out-of-the-ordinary claims by letting it be understood that the funds involved would be used to promote education, often through the creation of a permanent fund that would provide annual benefits. In some States, such as Virginia, the interest on the invested reimbursement funds provided the State's sole contribution to public education for decades. Even in New England they were influential and important, particularly in stimulating the States to enforce their own compulsory school laws which were often ignored when left entirely to the local communities.

In 1837, the U.S. Treasury surplus was distributed among the States by a formula based on each State's population. While the strict constructionists prevented formal earmarking, a provision was inserted in the act of Congress making the distribution a loan and providing for recall of the funds should the Federal Government deem it advisable (that is, if the funds were used by the States for purposes other than the two implicit options of education or internal improvement). Through the Panic of 1837 ended the surplus distribution in less than a year, and the one attempt to revive it in 1841 also failed in a year's time, the amount of funds accruing to the more populous Eastern States did much to offset the national imbalance that resulted from Federal grant-in-land assistance to the Western States. Furthermore, by Federal and State law as well as through local custom, the surplus distribution monies, like the proceeds of the land grants (and, in most cases, the reimbursements), were placed in earmarked permanent investment funds whose incomes were used for the support of education year after year. In a majority of the States, these permanent funds have remained in existence, albeit with the original Federal funds diluted by other increments. During the 19th century they became administrative devices which stretched the impact of Federal aid to education over the years, renewed its impact annually, and gave the States a lever by which to gain control over school systems and educational endeavors in order to raise educational standards.

While social welfare programs were fewer in the early period, significant advances in that field were also made through Federal-State-local collabortion. A few examples will suffice. Government support for education for the handicapped had its origins in the Hartford Asylum for the Deaf and Dumb founded in 1817 under private, church-supported, auspices and transformed into a public institution in 1819 through a Federal land grant and cooperative arrangements with the six New England States. The successful Federal-State partnership in this pilot project stimulated the creation of schools for the deaf and dumb in other sections of the Nation. The drive for better treatment for the insane led to the development of State insane asylums in the mid-19th century, many of which were initially constructed through the use of Federal land grants, reimbursement funds, or the surplus distribution. Veterans of the Nation's wars were awarded lands, the pre-Civil War equivalent of pensions, through Federal-State cooperative projects. Less formally, a network of marine hospitals for the Nation's seamen was constructed and maintained along the sea coasts and inland waterways by joint Federal-State action. Each of these early welfare programs involved not only a sharing of fiscal responsibility, but the development of routinized administrative collaboration to bring the programs to fruition. It was this routinized administrative collaboration which set the tone and the pace for cooperative federalism in the period.

Cooperative Federalism Between 1848 and 1913

The landmark that comes closest to marking the end of the formative period and the beginning of the second era in American federalism was the Mexican War. After the war the questions of manifest destiny, commercial expansion, and political democracy that had provided the impetus for Government activities during the first period gave way to concern over slavery, industrialization, and the settlement of the newly acquired Far West, opening up a new set of problems for Government.

While the great land-grant programs which dominated the second period were created during the formative period, and even antedated the other forms of cooperation, they were almost entirely confined to the public-land States, which did not become major factors on the American political scene until the Age of Jackson and did not begin to set the national pace until the middle of the 19th century. The second period can be considered to begin from the time when land-grant programs became the predominant form of intergovernmental cooperation, that is, when their impact on Government became greater than any other form of cooperative federalism and other forms of cooperation began to be measured in relation to the level of collaboration in the public-land States. The transition from the formative period began during the Jackson administration, with the demise of the U.S. Bank, the greatest of all the joint stock companies, and the distribution of the surplus revenue in 1837 which was partly designed to balance the land grants to the Western States. By midcentury, the States admitted to the Union after ratification of the Constitution outnumbered the Original Thirteen. Though not all of the former were public-land States, the majority shared in the problems of the West. They provided the support necessary for the establishment of the land grant as a major means of implementing national policy. The Land Grant College Act of 1862 marks the triumph of this policy, in that it was applied without distinction to all the States, east and west.

The second period lasted for the remainder of the 19th century. During this period the patterns of American democracy evolved after 1775 were subjected to their greatest domestic tests. In the political realm, there was the challenge of classical States'-rights, secession, disunion, and reconstruction. In the economic realm the complex of radical individualist and anti-Government doctrines known as laissez-faire was the order of the day. The slavery issue and its outgrowth, segregation of the Negroes, tore at the fabric of American democratic ideals. Politically, this was the Republican era. The Democratic party, in power as the Nation's majority party at midcentury, was already declining. During the first decade of the second period, the Republican party wooed and won more or less of a majority of the voters who turned to it as the best vehicle available to respond to the era's major issues. Though challenged by Populists from its own ranks and by a Democracy led by the resurgent South, the Republican party managed to maintain its position throughout the period.

Between 1848 and 1913 the hope of the American people lay in the West as never before or since. The West, whatever it may have been in reality, became the shining haven of the American dream. It was this period that added the refined idea of the frontier to the American mystique and, in reality, it was in the West that cooperative federalism flourished and matured. The great land grant programs set the tone for intergovernmental cooperation in the older states because of their expansion in the new ones. Uniformly structured land grants for internal improvements and education dominated the stage, supplemented by various types of Federal subsidies, new cooperative developments in the regulatory field, and by an increasing amount of informal cooperation among professionals on all levels of government. Through the land grant the impact of the Federal Government was felt in almost every field of activity throughout the West and in most of the East.

During the second period, as in the first, problems of internal improvement, fiscal organization, education, and public welfare were the dominant continuing concerns of government on all planes. However, during this period, there was a paradoxical intensification of support for the theory of dual federalism simultaneous with a sharpening of the structures and techniques of cooperative federalism and an expansion of collaborative programs into new fields.

The actual transfer of Federal lands to the States under the terms of a grant-in-land was begun in 1802, with Ohio's achievement of statehood. Under the terms of the Northwest Ordinance of 1785, Ohio received a grant of one section of land per township, designed to go directly for the establishment and support of public schools. This school grant was subsequently extended, with some modifications, to every new public-land State. Experience soon demonstrated that the purposes of the grant would be better achieved if it were administered by the States rather than by local government and if a minimum price for the lands were established in the Federal grant. The grant was also expanded to include up to four sections per township by the end of the century. Later conditions imposed by Congress included the requirement that any lands sold be disposed of at advertised public sales only.

This first land-grant program contained within it the seeds of many of the principles and procedures that were evolved in later Federal grants-in-aid, both land and cash. The grant was a general one, applicable to all States carved out of the public domain as a matter of course, though, because it was applied to new States only as they were organized, specific legislation was necessary to apply the grant in each case. The amount of the grant was set down in the general law and was uniform for all the States organized while the general law was in effect. Finally, the grant was not a gift. It came with specific conditions attached, including an obligation on the part of the State to create township or State-administered permanent trust funds based on the proceeds of the sale or leasing of the granted lands to be used exclusively for the promotion of public elementary education and an obligation on the part of the Federal Government to provide indemnity lands where the designated school sections were otherwise preempted. It is true that the conditions attached to this first grants were rudimentary; however, these rudimentary conditions were expanded and tightened as experience proved necessary.

Ohio also received the first land grants for higher education and for internal improvements. As the first State to be carved out of the Federal public domain, it was the testing ground for many of the early land-grant programs. Yet Ohio was only the first of the 30 public-land States to receive grants-in-land for programs falling within the scope of all four continuing concerns of Government. Of the other 20 States, all, with the possible exception of Hawaii, have received land grants for programs in two or more categories. It would not be amiss to say that virtually every major governmental function in the public-land States benefited from Federal land grants directly or indirectly. The grants directly stimulated, financed, or helped to finance vital governmental operations. Indirectly, the pervasiveness of the public domain, and the need for its proper disposition to enable a State to grow, served to involve the State government either formally or informally through the political process in all Federal land activities that took place within its boundaries. In this manner the public domain came to serve as the integrating factor in the development of cooperative action between the Federal Government and the States.

Federal land distribution programs fell into three basic categories. First was the system of land grants made by the Federal Government to the various States to aid them in developing education, internal improvement, and welfare programs. Over the years grants were made to the States for elementary education, higher education, general internal improvements, land reclamation, river and harbor improvements, public buildings, public institutions, and veterans' benefits. These grants were designed to make basic contributions to the growth of vital public services in the various States in a manner closely resembling the monetary grants-in-aid of the 20th century.

There was also a system of Federal land grants for education and internal improvements made through the States to private companies, primarily for roads, canals, and railroads, but also for academies and colleges. Under such arrangements, the States became the implementing agencies for the Federal Government administering the distribution and proper use of the grants.

Finally there were the Federal programs designed to dispose of the public domain without formally including the States. These programs in the main consisted of the various homestead, mineral, and tree culture acts; grants to certain western railroads primarily situated outside of State boundaries at the time of the grants; and some townsite and local improvement grants that generally were made to embryonic towns prior to statehood. Even those programs did not function outside of the sphere of Federal-State cooperation, since the States either developed concurrent "matching" programs of their own which were then coordinated with the Federal grants or were able to gain a say in the formulation and execution of the Federal programs through their influence in Congress.

The real import of cooperative federalism in the second period can best be understood when the full impact of Federal-aided programs in a single State is assessed as a unified whole. Minnesota is a case-in-point. Federal land-grant programs encompassed almost every field of governmental activity in Minnesota. There were grant programs for education (common school, university, agricultural, and mechanical college grants); internal improvements (general internal improvements, railroad construction, river and harbor improvements, and public buildings grants); welfare (salt spring and public institutions grants); reclamation (swamp and overflowed land grants); and conservation (Itasca State Park grant). In addition, funds from the unearmarked Federal land grants were instrumental in the founding and maintenance of almost every public institution in the State.

Though few cash grants were in existence, Minnesota did receive money for internal improvements (from the Five Per Cent Fund);[14] welfare (grants for the support of the Minnesota Soldiers Home); defense (militia grants); and education (the Hatch Act and the second Morrill Act). Goods and materials were granted to the State for programs in science (weights and measures, specimens from U.S. scientific expeditions); agriculture and conservation (seed distributions, fish stocking); education and welfare (distribution and exchange of documents for libraries, schools, and public institutions). Cooperative activities involving coordination of services included the fields of education (exchange of information); science (meteorological reports, geological surveys); law enforcement (cooperation in hunting law violators, jailing of Federal offenders); conservation (protection of forests); land settlement (homestead and tree culture programs); and agriculture (cooperation in grasshopper eradication, exchange of experiment station research reports, exchange of information).

The financial impact of these programs on the State of Minnesota was generally greater than that of the mid-20th-century grants-in-aid. In the latter third of the 19th century, a greater portion of the State's revenues came from Federal sources than in any subsequent period. At times, revenues from Federal sources, including direct Federal payments to the State and income from Federal grants, represented over 40 percent of the total annual revenue of Minnesota, and after 1865, never fell below 20 percent.[15] The analogous percentage in 1959 was 25.3, actually somewhat lower than the apparent annual average in the late 19th century.

In the 19th, as in the 20th century, Federal aid stimulated matching State contributions. In some cases there were formal matching requirements attached to the Federal grants. For example, the first Morrill Act required the States to appropriate funds for construction of buildings for their agricultural colleges in order to retain the principal of the Federal grant intact for the support of actual instructional activities. In this way, Federal-originated funds involved State funds in the development of joint collaborative programs. Between 1862 and 1900, identifiable cooperative programs claimed an apparent average of 50 percent of the State's total expenditure, ex-

[14] The Five Per Cent Fund was an annual Federal grant of 5 percent of the proceeds from the sale of Federal lands within the State to the State for internal improvements. This grant was originated in 1802.

[15] The percentage of income from Federal sources between 1865 and 1900 at selected intervals was: 1866, 37.6; 1875, 38.0; 1880, 38.6; 1885, 41.8; 1890, 22.2; 1895, 30.6; 1900, 30.6.

cluding amounts spent by the State in informal collaborative arrangements and for the general expenses of executives, such as the Governor, who were directly and continuously involved *ex officio* in the administration of cooperative programs.[16]

The impact of Federal aid was statewide and Federal funds penetrated into every county. The State's major activities were clearly dependent on Federal aid. Minnesota's military establishment, important in defending the State's settlers against marauding Indians, relied heavily on Federal funds. State and local internal improvements were almost entirely Federal-supported. Minnesota's railroads were almost entirely the products of formal Federal-State collaboration and even the Northern Pacific Railroad, recipient of a direct Federal land grant that ostensibly bypassed the State, was brought into the sharing arrangement in several ways.

At the instigation of the territorial legislature, Minnesota's major roads were constructed by the Army Engineers even prior to statehood and were then transferred to State control, while the Federal Five Per Cent Fund furnished most of the money for county roads and bridges before the advent of the automobile. In 1875, for example, the Five Per Cent Fund paid for 27 internal improvement projects in 20 countries. Ten years later, the annual distribution of the Fund was used for 51 projects in 38 counties. At the same time, the land grant endowed internal improvement permanent fund was also being used for local roads, bridges, and like improvements.

Minnesota's school system benefited greatly from the semiannual subsidy distributed from the earnings of the common school land grant. In 1866 schools in 42 counties with a total enrollment of 50,564 met the State educational requirements and received grants from the permanent school fund. Subsequently, schools in every county in the State shared in the annual distributions from the funds. By 1895, some 276,000 students were benefiting from the Federal grant. In addition, the Permanent School Fund was used as a revolving fund to provide capital loans for the construction of elementary and high school buildings in every school district and town in the State. In 1895, loans totaling $224,906 were made to 249 school districts in 72 counties. The State university's operating costs were almost entirely borne by the earnings of the university land grants and direct Federal appropriations, including the budgets of the Agriculture Experiment Station and the State geological survey. A major proportion of the operating costs of the Minnesota Soldiers' Home also came from direct Federal matching grants. Intermittent but vital aid was also given to the State normal schools and public institutions from the various permanent funds and land grants.

Perhaps the major cooperative effort in 19th-century Minnesota, as in all the public-land States created after 1816, revolved around the construction of railroads, designed to open up the interior of the State for settlement and to connect the State with the outside world. Between 1857, when the first Federal grants were made, and 1907, when the last link in the State's internal railroad network was completed,

[16] The percentage of total State "matching" expenditures between 1862 and 1900 at selected intervals was: 1862, 47.6; 1866, 49.1; 1875, 44.7; 1880, 52.4; 1885, 51.3; 1890, 50.1; 1895, 44.3; 1900, 48.3.

supervision of the railroad land grants was a major activity of the State government, one which involved almost daily contacts with the appropriate Federal officials and departments. On the basis of Federal and State legislative authorizations, Federal and State administrators shared responsibility for approving the railroads' construction plans; supervising the selection of railroad lands along the federally prescribed rights-of-way; securing Federal patents for the selected lands; transferring the lands to the railroads as they met the conditions laid down in the Federal and State legislation; harmonizing the interests of the railroads and beneficiaries of other land-grant programs when they came into conflict; and supervising the relinquishment and replacement of improperly transferred lands. In each case, the Commissioner of the General Land Office and his deputies in Washington and in the field were required to oversee the actions of the Governor and his agents to insure compliance with the conditions set down in the land-grant legislation by Congress.

All six major railroads operating in present day Minnesota were beneficiaries of Federal-State land grants, receiving, all told, 11,173,920 acres valued at approximately $48,812,000. Even the Northern Pacific Railway, which received 1,905,897 acres in Minnesota from a direct Federal land grant, was the recipient of 2,167,918 acres through the Federal-State program as it absorbed smaller land-grant railroads. In addition, the Federal grants were matched with bonds valued at $5,875,000 issued by the State and its local governments. Some idea of the magnitude of the cooperative railroad construction program may be gathered from the percentage of the State's total revenue paid by the railroads in taxes between 1875 (over 10 percent) and 1900 (over 15 percent).[17]

The types of coooperative activities and the means of their administration in Minnesota were familiar in the other States as well. All the land-grant programs except those designed to aid in the reclamation of arid lands were in operation. Direct Federal aids to individuals and groups were subject to State influences much as elsewhere. Cooperative exchanges of goods and services in Minnesota were recognizable as parts of the national pattern. So were the paraphernalia of administration—in land-grant matters an *ex officio* State land board and its agents; the General Land Office and its local land officers; local school and county officials. Indeed, it seems that very few Federal and State offices in Minnesota were not involved in the cooperative programs.

Since the scope of cooperative programs and the administration of sharing were no different from the standard nationwide pattern, it is reasonable to project the Minnesota pattern of fiscal sharing onto other States as well. This does not mean that all States benefited equally from Federal financial support. As in the 20th century grant-in-aid programs, Federal aid provided a proportionately larger share

[17] The land grant railroads' share of the State's total revenue for selected years between 1875 and 1900 was

	1875	1880	1885	1890	1895	1900
Total State revenue (thousands)	$981	$1,417	$2,078	$3,296	$5,427	$6,903
Land grant railroad tax (thousands)	107	209	673	621	729	1,106

of the budgets of the smaller States, the newer States, and the poorer States, though the differences between States may actually have been less pronounced than in the 20th century because of greater State reluctance in the 19th century of finance local programs with tax money obtained locally.

The central fact that emerges from an analysis of the development of sharing in a single State over several decades is the sheer weight of political time devoted to intergovernmental cooperation. Not only were the administrators heavily involved in cooperative activities, but the programs that were most highly developed as shared programs also preempted the bulk of the policymakers' time. Minnesota Governors and legislatures together were preoccupied with the cooperative programs throughout this entire period. The already enumerated programs should indicate why this was so, since no aspect of internal improvements, education, or general disposition of the public domain in the State escaped involvement in the sharing process. Furthermore, even defense against the Indians and the recruitment of an army for the defense of the Union during the Civil War became shared functions. By the end of the second decade of statehood, the regulatory functions of government were also being shared, partly because the fields of regulation were tied to already cooperative programs (as in the case of railroad regulation) and partly because it was simply more convenient to cooperate (as in the case of regulating state and federal-chartered banking institutions). A survey of the Governor's messages, the legislative journals, the statute books, and the attorney generals' opinions reveals the extent of this concern with programs that were cooperative in character, a concern not over the general theory of collaboration but over the procedural aspects of the various programs. Federal-State cooperation was a fact of life, hence the policymakers rarely referred to it directly in their deliberations. The system of sharing is all the more impressive because of its implicit acceptance as part of the process of government.

Cooperative Federalism Since 1913

The last major land-grant program was inaugurated in 1894. Selection of lands under the land-grant acts has persisted through the mid-20th century and the extension of the traditional grants to Alaska upon its admission as a State in 1958 has revived the land-grant era in one State. Nevertheless, since 1913 the cash grant, coupled with the rising impact of cooperation among professionals at all levels of government, has become the dominant form of intergovernmental cooperation. The modern cash grants had their origins in the later years of the land-grant period. They rose to predominance with the adoption of the specific programs embodied in Woodrow Wilson's New Freedom and were notably extended with the rise of the New Deal. The third period of American federalism does not fall under the purview of this study. Beginning in 1913, it is generally considered to be the era of cooperative federalism. In this period, formally structured grant-in-aid programs of internal improvement have had to share the center of the stage with the "new federalism" of welfare. The less visible areas of intergovernmental collaboration expanded apace. As government has become more pervasive, so has intergovernmental cooperation, to the point where the 20th century has been labeled the century of cooperative federalism, while the intergovernmental cooperation of the 19th century has faded into obscurity.

THE ROLE OF THE PUBLIC DOMAIN

As long as the land frontier lasted, the public domain served as the greatest single source of national wealth, the foundation of the American economy. Even the development of major industries of the 19 century, agricultural implements, railroad and telegraphs, machines for processing the produce of the land, and the like, was directly tied to the development of the public domain. It is not surprising, then, that the land, owned, as most of it was, by the Federal Government, should have served as the foundation for intergovernmental cooperation in the expanding Nation.

The public-land States differed from their non-public-land counterparts in the nature of their cooperative relationships with the Federal Government only insofar as the existence of the public domain within their boundaries made it less difficult to justify major cooperative programs under the strict constructionist terms then dominant in constitutional interpretation. Certainly the States without public lands were at no time excluded from the operations of cooperative federalism. Considering only formal grants-in-aid, it is possible that the public-land States did receive more benefits than the others, and so it was argued on the floors of Congress when the States possessing no public lands wanted to gain additional benefits from the Federal Government for themselves. Yet, when the benefits derived from the other forms of intergovernmental cooperation and direct Federal aid to localities are included, the balance seems to have been rather adequately redressed and the amount of cooperation generally equalized. To take but one example, the protective tariff was unquestionably a great aid to eastern manufacturing interests, often to the detriment of the West and the South. It was as much a subsidy as a Government defense contract is in 1964, and was so considered by both its proponents and opponents.[18] The eastern railroad companies coupled benefits gained from the protective tariff (or exemptions from the tariff, as was sometimes the case) with Federal mail subsidies (whose cooperative impacts were great, particularly in those Eastern States, North and South, which participated in the construction of their railroads as owners or investors, during the era of railroad building) and more direct State and local subsidies to construct the network of railroads east of the Great Lakes. They began to take advantage of these benefits even before the major railroad land grants were made and continued to do so subsequently as well.

Frederick Jackson Turner, in stating his renowned frontier hypothesis, made a major point of the influence of the West, the States carved out of the public domain, in the development of nationalism and governmental centralization. He maintained that the growth of the Federal Government was greatly fostered by the demands of the

[18] For a discussion of this aspect of the protective tariff, by one of the men who best understood its nature, see Charles Wiltse, *John C. Calhoun* (New York, 1944, 1949), vols. I and II.

western settlers and their early experiences with Federal officials, who preceded State governments in almost every new territory.[10] Turner's point is generally valid, but it is considerably more accurate to say that not only did westward expansion increase Central Government activity in Washington, but that it did so primarily by increasing intergovernmental cooperation, formal and informal, thus also increasing the central governmental activities of the States. The public domain served as a vehicle for the development of the role of the Federal Government in promoting national expansion while at the same time providing a means for the States and localities to share in this task. The pattern of relationships that emerged from the cooperative manipulation of the public domain was carried over into the 20th century cooperative programs. It was the prior existence of this pattern that made it possible to integrate the increased velocity of government into the Federal-State framework without major alterations in the operation of the Federal system.

Indeed, the newer States developed a tradition of intergovernmental cooperation that antedated their admission to the Union. If the Federal Government did not always precede the first settlers into new territory, it almost invariably preceded the State government. From this arrangement emerged an implicit conception of the rightness of the role of the Federal Government as a major participant in the development of new territories and new frontiers. This conception was carried over within each State after statehood was achieved and, ultimately, became dominant in a majority of the States in the Union. The movements to attain statehood reflected the impact of the land grant and the general tradition of intergovernmental cooperation upon the newly settled territories of the West. On one hand there were certainly attempts to gain more power for local self-government. Even more important, the desire for statehood was linked to the perceived greater ability of States than territories to gain more benefits from Washington. In almost all cases, land grants were not available until statehood was achieved. Lack of voting power in the national elections and full representation in the Congress meant that a territory would be dependent on favors from Washington over which its citizens had only a minimum of influence and control. Statehood came to mean the right to participate in national policy formation as much as the right to manage one's local affairs.

Control Over the Grant Programs

The organization of control over the grant programs was another matter that tended to obscure the nature of the cooperative relationships in the 19th century. The evolution of formal Federal controls did not signify changes in the fundamental policy of congressional supervision of the programs, but did indicate that the Congress and the States represented in it learned from experience. The principle of Federal control existed from the days of the earliest grants. At first it was assumed that mere incorporation of certain principles into the State constitutions in order to secure congressional approval prior to achieving statehood would be sufficient to insure compliance with the

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[10] Frederick Jackson Turner, *The Frontier in American History* (New York, 1920).

spirit of the program in question. To some extent, this method was successful and has continued to be so. If for no other reason than the continued increase in the scope of government activity, this method came to be too cumbersome. As it was seen that more specific controls were necessary, they were added by the representatives of the very States that would receive the grants. In addition, as administrative complexities increased and new methods of enforcement outside the courts had to be found, they too were added, not as changes in policy but as improvements in method.

The question still arises as to the degree of enforcement of these provisions. There is no doubt that grants were not often revoked, or lands often withheld, though enough cases of revocation and withholding lands can be found to indicate that Federal control could be carried to its ultimate implications in this manner. The absence of large-scale revocation programs is due less to the failure of the Federal Government to enforce the terms administratively than to the political power of the States in the Halls of Congress. This is no less true in 1964 than in 1864. Students of government have noted that since the rise of the great cash grant programs following the New Deal, little money has been withheld from any of the States for maladministration or violation of the terms of the program in question. Attempts have been initiated by the Federal executive to withhold funds from individual States for a number of reasons. In almost every case these attempts have been overruled in the Congress or suitable compromises have been negotiated with congressional help. When State violations of Federal regulations do occur, they are dealt with in less drastic ways because the Congress will not often allow the drastic solution and the Federal bureaucrats know this.

Only once in American history was massive revocation of Federal grants because of misuse even considered. Between 1870 and 1900 the question of revoking some of the unfulfilled transportation land grants became a matter of some political importance. Congressional investigations into the uses of land grants by railroad companies were widespread during this period. Ultimately, Federal-State land grants to eight railroad companies were revoked in whole or in part and steps were taken to withhold lands from the great transcontinental railroads as well.[20]

While other Federal grants to the States were not often revoked, specific lands within the different land programs were frequently withheld by the Federal Government. Not infrequently, the states were even forced to re-cede lands already patented to them because of conflicts with other Federal grant programs or land policies. As the available public domain diminished and the number of land-grant programs increased, the amount of control and intensity of supervision grew also, leading to greater exercises of Federal authority, subject always to the formal and informal limitations attached by Congress. Ultimately these controls were transferred, modified, and expanded to provide adequate supervision for cash grants-in-aid as they began to emerge.

[20] Federal Coordinator of Transportation, *Public Aids to Transportation* (Washington, D.C., U.S. Gov't. Printing Office, 1938), vol. II, pt. I, sec. A.

Cooperative Federalism: The Alternate Hypothesis

Cooperative, or collaborative, federalism can be defined as the sharing of responsibilities for given functions by the Federal and State governments. In this sense it is conceived to be the opposite of dual federalism which implies a division of functions between governments as well as a division of governmental structures. While the theory of cooperative federalism assumes a division of structures, it also implies a system of sharing that ranges from normal federal-state agreements covering specific programs to informal contacts on a regular basis for the sake of sharing information and experience.

Even during the 19th century, when the ethos of the times called forth a theory of dualism that was based on a functional demarcation between governments, the actual exigencies of the operation of the system of necessity demanded cooperation. Consequently, Federal-State cooperation was developed in a wide variety of cases. Though it was usually opposed in theory, it persevered in many forms and under different guises. Its procedures were refined through trial and error, often subtly since it was, in the main, unrecognized. Officially recognized or not, a system of intergovernmental collaboration was evolved to serve the dual purpose of maintaining the Federal balance while providing needed governmental services. Where cooperation did not develop and should have, both the system and the programs in question suffered. In a sense, a substantial share of the history of American Government has been the search for methods to provide for the necessary collaboration of the various parts of the Federal system while at the same time preserving and strengthening those parts as separate bases for such collaboration. Much of what historians have mistaken for rejection of intergovernmental cooperation in the 19th century was, in reality, the rejection of certain methods of interaction as failing to meet one or both of these criteria.

On the basis of this evidence, it would seem necessary to develop a new theory to explain the nature of the American Federal system and its character over time, a theory which takes into account the continuous existence of an amount of intergovernmental collaboration equal to, and in fact greater than, the amount of separation (as traditionally defined) in the Federal system. Within the large area of concurrent powers provided, explicitly or implicitly, by the Federal Constitution, the Federal and State Governments have been able either to divide responsibility among their separate jurisdictions, with each responsible only for its own share of the divided responsibility ("dual federalism"), or to divide the works of government cooperatively, sharing responsibility in specific programs, with all units directed toward common goals that extend along the entire chain of concurrent powers ("cooperative federalism") and generally overflow into the ostensibly "exclusive" preserves.

The actual division of responsibility under the concurrent powers is primarily determined anew for each case through the political process, rather than through legal decisions. That is, the decisions as to the distribution of the areas of concurrent powers are made either on the political level or by constitutional interpretations based on political realities. Such decisions are recognized in constitutional law either after a political decision has been made or as a result of a constitutional interpretation that, sooner or later, must follow the polls.

In understanding our Federal system, there is a basic conflict between simple rationalities and the logic of political experience. Simple rationalities demand a Federal structure with a clearcut division of powers that can easily be measured, while political experience, dealing with reality, demands a concurrent approach to problem solving. While the conflict between rhetoric and practice has to a certain degree obscured the image of federalism, the result has nevertheless been the development of that complex mechanism of intergovernmental relations, characteristic of the American federal-state-local partnership, known today as cooperative federalism.

Section B: RECENT TRENDS AND DEVELOPMENTS

RECENT TRENDS IN FEDERAL-STATE-LOCAL FISCAL RELATIONS

BY WILLIAM H. ROBINSON*

The underlying tensions of our Federal system have surfaced once again. Periodically, the Nation pauses in its frenetic search for answers to substantive problems, and reexamines the *process* by which these answers are derived and implemented.[1] We are now in such a period. This does not imply a lack of substance; rather, it represents a shift in emphasis from *what* we do to *how* we do it.

This period of self-appraisal is often characterized by dark forebodings of doom. Yet, the Federal system seems notably resilient. It "... is always in danger and it is always rising anew from the ashes of its earlier existence."[2] Despite the fact that our national soul-searching has only infrequently led to dramatic action,[3] the process serves a useful purpose by focusing our attention on the need for gradual, ad hoc revisions in the system where the problems are most acute. Some contend that the number of problem areas has so multiplied recently that more drastic measures are required.

This is the issue explored in this paper. Briefly, the approach taken here will be to: (1) describe the present system of intergovernmental fiscal relations in outline form; (2) trace the development of recent trends in the system (including an impressionistic picture of common elements underlying its development, and a synopsis of efforts to coordinate the many new programs undertaken in recent years), and (3) review and evaluate proposals for further reforms in the *existing* categorical aid system.[4]

*The views expressed in this paper are the sole responsibility of the author. They do not represent (nor, perhaps, even reflect) the opinions of the Bureau of the Budget, official or otherwise.

[1] The last full-blown reviews of the grant-in-aid system were made nearly a decade ago. See, for example, the report to the President of *The Commission on Intergovernmental Relations*—the so-called Kestnbaum Commission—issued in June 1955. See also "Federal-State-Local Relations: Federal Grants-in-Aid," *Thirtieth Report by the [House] Committee on Government Operations*, (Government Printing Office: Washington, D.C.), 1958. For current developments, see "Creative Federalism," *Hearings Before the [Senate] Subcommittee on Intergovernmental Relations* (1967), and "The Federal Role in Urban Affairs," *Hearings Before the [Senate] Subcommittee on Executive Reorganization* (1966).

[2] Monypenny, Phillip. "Federal Grants-in-Aid to State Governments; A Political Analysis," *National Tax Journal* (March 1960), p. 1.

[3] For a recent recapitulation of the rather dismal record of the Joint Federal-State-Local Action Committee, see George Break, *Intergovernmental Fiscal Relations in the United States* (Brookings: Washington), 1966, p. 31.

[4] This paper is confined to an examination of the existing system. To include other "reforms" would take us far afield.

I. Description of the Existing System of Federal Aids.[5]

The advantages of painting with a broad brush are obvious: it's quick; it requires less technical expertise; and it avoids minutiae. In skeletal form, the principal characteristics of the present system of Federal aid to State and local governments are enumerated below:

A. Large scale and rapid growth

Total Federal aid is estimated to reach $17.4 billion in fiscal year 1968. This amount is more than triple the level which prevailed only a decade earlier.[6] Federal aid constitutes a growing share of both Federal outlays and State and local revenues.[7] It may be argued that we have a dynamic form of revenue-sharing already in effect.

B. Growing emphasis on individual and community development

While grants for education, health, labor, and welfare purposes were 46 percent of total aid in 1960, these "human investment" programs will account for an estimated 60 percent of the total in 1968. Pacing this rapid rise are economic opportunity programs and efforts to upgrade the educational opportunities available to children of low-income families. Each of these relatively new programs will increase by nearly $1½ billion between 1965 and 1968.[8]

Similarly, grants for housing and community development will swell from 4 percent of total Federal aid in 1960 to 7 percent of the total in 1968. However, this *direct* urban assistance is only a fragment of what we devote to meeting the needs of cities. A growing share of other assistance programs is making its way into urban communities. As a result, total Federal aid benefiting large metropolitan areas will scale an estimated $10.3 billion in 1968.[9] A growing recognition of the Nation's urban fiscal plight is a noteworthy characteristic of recent discussions of Federal-State-local relations.[10]

C. Complex and varied administrative structure

Nearly all the Federal-aid funds are distributed in the form of grants. A relatively small amount is provided through loans and shared revenues.[11]

There are varying estimates of the number of Federal aid programs. However, a recent count by the Library of Congress revealed roughly 400 separate authorizations, grouped into more than 160 major programs. More than 45 percent of these programs were in the Department of Health, Education, and Welfare alone.[12]

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[5] This section borrows heavily from "Special Analysis J: Federal Aid to State and Local Governments," *Special Analyses, Budget of the United States, 1968*, pp. 145–161.

[6] The average annual rate of growth for Federal aids (about 13½ percent) will more than double that of the economy (i.e., gross national product) over the same period.

[7] In fiscal year 1967, Federal aid will constitute about 10 percent of total Federal payments to the public—up from 5 percent in 1967. (The same percentages for "domestic" payments are 19½ percent and 12½ percent, respectively). As a percentage of State and local general revenues, Federal aid is estimated to rise from 10½ percent in 1957 to 16 to 17 percent in 1967. See "Special Analysis J," *op. cit.*, p. 148.

[8] *Ibid.*, p. 146. Grants administered by the Office of Economic Opportunity will rise by $1.3 billion between 1965 and 1968. Those for the new elementary and secondary education program will enjoy an increase of $1.4 billion over the same period.

[9] *Ibid.*, p. 155.

[10] See, for example, the section on "Cities" in the *Economic Report of the President* (January 1967), pp. 153–160, and "The Federal Role in Urban Affairs," *op. cit.*

[11] The "shared" revenues are generally receipts from sales or use of natural resources, which are, in turn, shared with the State or county in which the resource is located.

[12] Labovitz, I. M., *Number of Authorizations for Federal Assistance to State and Local Governments Under Laws in Force at Selected Dates During 1964–66.* The precise figures are unimportant (and nonexistent); the order of magnitude is nonetheless impressive. The study has not yet been updated.

Nearly three-fifths of the total number of programs involve *project grants*. These are provided on the basis of applications received from prospective recipients. On the other hand, *formula grants*, while smaller in number, account for most of the money. In determining the distribution of funds under these formulas, population and per capita personal income frequently play an important role. The latter measure is becoming increasingly popular as greater use is made of the notion of "equalization" of fiscal capacity. Equalization is often important in both the *allocation* and *matching* provisions of grants.[13] Allocation provisions determine how much money will be made available to a given area; matching requirements specify what share of the total program costs the recipient must bear.

II. Recent Trends

The growth and complexity which characterize the present grant system are neither the result of mysterious forces, nor inherent perversity on the part of the Federal Government. The factors which explain the recent trends in intergovernmental fiscal relations constitute a catalog of the determinants of government spending generally—with a few notable variations. These pressures influenced the pattern of Federal aid because they have ". . . swelled the demand for public services which are regarded as primarily the responsibility of State and local governments—both by tradition and by the preference of the American people for keeping government as close to home as possible." [14]

(1) *Population growth*, especially in those age groups most in need of public services—the very young and the aged;

(2) *Urbanization*, which increases the costs and demands for certain services, and creates wholly new needs as well;

(3) *Rising standard of living*, which provides the resources to solve problems, creates demands for higher quality public services, and pricks the social consciences of those who see the squalor of poverty in the midst of such plenty;

(4) *Inability to realize all the benefits of investment*, whereby the community may "underinvest" in education unless provided an incentive not to do so, simply because the costs of education are borne fully by the local community while the "benefits" may be lost when trained people leave the area; [15]

(5) *Paucity of resources relative to requirements*, with outside assistance needed to fill the gap for individual States and localities, and for State and local finances in the aggregate;

(6) *Recognition of the complexity of social problems*. The latter element merits elaboration. "Creative federalism" is a complex system because the problems with which it must cope are inherently intricate and involuted. The extent of this complexity didn't really manifest itself until we decided that the maximum development of each individ-

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[13] Advisory Commission on Intergovernmental Relations, *The Role of Equalization in Federal Grants* (January 1964), pp. 77–80. An example of equalization in the *allocation* formula is aid to elementary and secondary education—which only makes funds available to low-income school districts. Equalization in the *matching* formula is found in the Hill-Burton hospital construction program, which varies the recipient's share of total program cost inversely with per capita income.

[14] *Economic Report of the President*, p. 161.

[15] In technical parlance, this is the well-known problem of "spillover" costs and benefits. This topic is treated at somewhat greater length in sec. III.

ual and the pursuit of economic growth were legitimate objects of social policy. Once committed to those goals, and after some initial forays in the war against poverty, the full force of these problems—and their bewildering "interrelatedness"—came home. Which link in the chain of poverty is the weakest? Should we attack the lack-of-income link through public assistance, or should we strike first at inadequate education, or a squalid home environment? Or must we take them all on simultaneously to be truly effective? In the face of such uncertainty, we fall back instinctively on pragmatic and incremental approaches.

This behavior was aptly described in a recent statement by Budget Director Charles Schultze before the Senate Subcommittee on Intergovernment Relations.[16] In order to deal with multifaceted social problems, it is necessary to fashion multiple corrective tools—each one suited to the particular problem to which it is addressed. Single, simple solutions—like all panaceas—offer little hope of success. Moreover, dealing with these problems in the context of our decentralized Federal system further complicates the administration of adequate remedies. Of necessity, a multijurisdictional approach must be employed, combining the resources and competence of Federal, State, and local governments, and private businesses and foundations. Only in this manner can such problems as air and water pollution, economic development, and metropolitan transportation be solved. "It is this multijurisdictional approach that—as much as anything else—describes creative federalism."[17]

The problem which may result from such a pragmatic orientation are recognized. Decentralization of both power and administration require large doses of coordination and cooperation. Yet, in order to obtain the benefits of *effective* decentralization, we must be willing to tolerate its costs in terms of ". . . irreducible quotas of anomalies and errors which inevitably accompany decentralization."[18]

It is precisely because we have been making increasingly heavy use of our Federal system that strains on it have become noticeable. The last 3 years have been an incomparable volume of problem-solving legislation adopted. It is no wonder that the system has been hard-pressed to adapt the administrative demands placed upon it in such a brief period. Nevetheless, it can be argued that our instinctive American brand of pragmatism makes us more inclined to accept an "administration" gap, than an "unmet social needs" gap. The Director of the Bureau of the Budget cogently addressed this choice:

> We could have sat on our hands and played it safe. There would certainly be fewer complaints. There would also, however, be an even worse gap—that between mounting social costs and responsible policy initiatives. In closing one gap, we opened another, but it is the one we prefer. I dislike to see evidence of faulty coordination, spinning wheels, frustrating delays, failures of communication, and all the other dross that comprises the symptoms of uneven administration and program execution. At the same time, it would be surprising if everything clicked smoothly in the wake of such an immensely productive period of legislations. . . .[19]

[16] "Creative Federalism," *op. cit.*, pp. 388–399. See, especially, pp. 388–390.
[17] *Ibid.*, p. 389.
[18] *Loc. cit.*
[19] Charles L. Schultze, *op. cit.*, p. 389.

In this welter of complexity and ceaseless change, it is almost impossible to reach agreement on the nature of emerging trends. Therefore, the following discussion of common strands which appear to be woven into the system recently is a highly impressionistic one.

A. Emerging trends in intergovernmental fiscal relations

Many of the distinguishing features listed below have already been treated implicitly in the preceding discussion. Many of them are crosscutting, since they are directed at several problems simultaneously.

(1) *Emphasis on investment.*—The first section already touched on the growing proportion of Federal aid which is being channeled into social investment—both in individual, and in community, development. The most noteworthy feature of the growth is in the field of education, with its particularly long-term payoff period. Since 1960, education has risen from 5 percent of total Federal aids to an estimated 14 percent in 1968. Even the "War on Poverty" is not a passive welfare support program, but partakes freely of this same investment spirit—with a heavy emphasis on education (Head Start, adult education), and job training (Neighborhood Youth Corps, work experience, adult work training and "special impact" programs).

(2) *Equalization of opportunity.*—This characteristic of recent aid programs has several constituent elements. First, educational assistance to low-income areas and the economic opportunity program strive to provide equal opportunity for the most deprived citizens in our midst to help them realize their maximum potential development. Secondly, aid to Appalachia and various other development areas or regions attempts to put entire geographic areas on a self-sustaining basis—to enable them to provide their citizens with a broad range of services. Thirdly, the aforementioned equalization provisions in specific grant programs attempt to underwrite a certain floor for some particular services, below which no State or community should have to descend as a result of inadequate resources.

As the author interprets these signs, there is increasing evidence that the American people are beginning to take Donne's words to heart and conclude with him that "no man is an island." In many instances, the people's representatives have decided that, whether a given situation directly affects anyone else or not, the mere existence of certain problems anywhere in the country is a moral affront.[20]

(3) *Comprehensiveness of approach (with respect to both program and area).*—The "systems" approach to complex scientific problems is beginning to have its influence on Government programs. The emphasis is on viewing the problem in its totality, rather than attacking separately each of its components. Such an approach aids in the identification of interrelated problems and *suggests* where to begin most effectively. Examples of comprehensive programmatic efforts include the new Model Cities, "Community Action" programs, and the recently molded "Partnership for Health" program. As an important part of these recent ventures to attain a genuinely comprehensive approach, they all stress the *blending of all available resources* (both pri-

[20] I will leave discussion concerning the validity or desirability of the new-found "ethics of affluence" to the philosopher or theologian. Its causes I leave to the psychologist. The topic is a paper in itself. Around it must revolve the central concern of federalism: Where does one strike the boundary line between the national interest and the right of the State or locality to pursue its own chosen preferences?

vate and public), as well as melding governmental programs into broader tools.

Equally vital in attacking complex problems in a federal system is the stress placed upon *areawide cooperation.* All too often, States or communities find that their geographical boundaries are too narrowly circumscribed to mount an effective attack on such regional concerns as air and water pollution, economic development, metropolitan transportation, and similar "spillover" problems. The Federal Government has recently extended a number of financial incentives to States and localities to band together under such circumstances to solve common problems.[21]

(4) *Flexibility of implementation.*—Several relatively new programs permit considerable latitude in selecting local emphases and initiatives. Model Cities, community action, and Partnership for Health programs all fall into this category.[22] These efforts share a common characteristic; they offer special funds to mesh the resources of other categorical aids and the private sector into a unified program at the local level. Such monies go some distance in overcoming any administrative problems inhering in categorical assistance.

(5) *Emphasis on coordination.*—As mentioned earlier, one of the principal means to avoid undue waste in a Federal system of government (requiring multijurisdictional action), is to place heavy emphasis on coordination and cooperation. The number of coordination measures adopted in the last year or so is truly impressive; it indicates both interest and concern on the part of the Federal Government. Because of its importance, this topic will be dealt with at greater length in the ensuing section.

B. Recent coordination efforts

Much can be done to overcome the adverse effects of program fragmentation simply through the use of coordinating devices. Awareness of the existing administrative problems and a desire to alleviate them constitute a good share of the reform battle. We have already seen how a few recent aids provide an umbrella under which the local agency can gather whatever assortment of other assistance measures which it desires. There are a number of other signs which point in the direction of future improvements and greater rationalization of the present aid system.[23]

(1) *High-level liaison with State and local officials.*—Any attempts to resolve the administrative difficulties of intergovernmental fiscal relations presuppose a knowledge of what those problems are. To

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[21] The "Partnership for Health" program is an interesting blend of all these features. It is comprehensive in several respects: (*a*) *geographically,* by encouraging statewide, regional, and community planning and services; (*b*) *functionally,* in that it blends almost a dozen categorical grants into one health package; (*c*) *by character of spending,* since it includes funds for both planning and services; and (*d*) *financially,* by taking into account the efforts of all levels of public and private endeavor.

Other inducements for areawide cooperation include the Appalachian and other economic development regions, the 10 percent bonus for carrying out certain metropolitan development programs in accordance with metropolitan planning, the incentives for joint construction and State participation in the construction of waste treatment facilities, and several others.

[22] Some of the flexibility has been removed from the two latter programs—at least at the national level—by the earmarking of funds by purpose. The new health program carries earmarked amounts for mental health (15 percent), and by level of spending (70 percent at the local level)—even before going through the appropriations process. It will be interesting to see how it emerges from its first encounter with the Appropriations Committees.

[23] This section also borrows heavily from the section on "Measures to Coordinate Federal-aid Programs" in Special Analysis J of the 1968 budget. See pp. 150–151.

provide an institutional awareness of the needs of the States and localities, the Vice President and the Director of the Office of Emergency Planning have been designated as liaison agents between the Federal Government and the Nation's local officials and Governors.[24] These administration representatives are in constant touch with their State and local counterparts; the resultant exchange of views and information provides a valuable feedback mechanism for evaluating the workings of the Federal system.

The President recently issued a letter to all departments and agency heads similiarly requesting them to consult State and local chief executives more frequently. He specifically asked that they "advise and consult [these officials] in the *development and execution* of programs which directly affect the conduct of State and local affairs." [25] [Emphasis supplied.] The points of access to decisionmaking have increased significantly for these officials. They should play a significant role in shaping the future contours of Federal-State-local relations.

(2) *Organization and role of the Executive Office of the President.*—The Bureau of the Budget is augmenting its long-term interest in intergovernmental relations by giving increasing attention to the fiscal and administrative problems of joint governmental programs. Its budget for the coming year provides for an increase in these activities, and new efforts to coordinate Federal programs in the field. The Budget Bureau recently completed a survey of five urban areas to gain a firsthand knowledge of the problems of "creative federalism." [26]

(3) *Organization of Federal agencies.*—The organization of Federal departments and agencies administering grant programs can have an important impact on the actual provision of assistance. The organizational structure influences the amount of coordination which takes place among related programs, the flow of information concerning these efforts, and their efficiency of operation. The creation of the Departments of Transportation and Housing and Urban Development should add cohesion to the programs in these areas.

Internal reorganizations within the major grantor agency—the Department of Health, Education, and Welfare—should also be beneficial. The Public Health Service and Office of Education have both been extensively overhauled and strengthened. Furthermore, Secretary Gardner has established an Office of Intergovernmental Relations with staff in Washington and in each of the HEW field offices. This Office has been instructed to maintain close communications with the State Governors.[27] Similar responsibilities for intergovernmental coordination have been provided for in the Department of Housing and Urban Development and the Office of Economic Opportunity.[28]

(4) *Mechanism for interagency coordination.*—Illustrative of the degree of Presidential interest in intergovernmental relations is the

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[24] The present incumbents are, respectively, ex-mayor of Minneapolis and ex-Governor of Florida. They bring with them not only a knowledge of, but a sympathy for, the problems of local governments and States.

[25] Presidential letter of November 11, 1966. See "Creative Federalism," *op. cit.*, p. 397.

[26] The areas were Seattle, Nashville-Davidson, Philadelphia, Columbia (S.C.), and Denver. The Budget Bureau was accompanied by representatives of Federal agencies and public interest groups. See "Creative Federalism," *op. cit.*, p. 395.

[27] *Ibid.*, p. 274.

[28] *Ibid.*, p. 91. Furthermore, the Department of Agriculture has had a Special Assistant to the Secretary for Intergovernmental Relations for a number of years.

fact that almost a score of Executive orders on this subject have been issued just since 1961.[29] Certainly, the "convenor orders" must be counted among the most significant issued to date. Executive Orders 11297 and 11307 dealt, respectively, with the coordination of Federal urban programs and Federal programs affecting agricultural and rural development. The Department of Housing and Urban Development is charged with the responsibility for convening agencies operating in a given city whenever the need for coordinated effort is essential to the achievement of national purposes. A similar assignment has been given the Department of Agriculture for bringing together interested parties, as the need arises, to work jointly on specific problems in rural areas. The existence of these simple mechanisms, coupled with a growing recognition that greater coordination is needed, increases the likelihood that Federal agencies will meet together to coordinate their efforts and resolve any administrative problems.[30]

(5) *Strengthening State and local governments.*—President Johnson recently noted that ". . . nowhere is the magnitude of government manpower greater—and the accompanying challenge more critical—than at the State and local levels." [31] In response to this challenge, the President outlined a plan of attack in his message on "The Quality of American Government" (March 17, 1967). The Public Service Education Act and the Intergovernmental Manpower Act of 1967 constitute a two-pronged effort to increase the quantity and quality of public service personnel.[32] The former proposal envisages $10 million in grants to provide fellowships, university support, and other encouragement to improved education and training for those planning careers in government service. The Intergovernmental Manpower Act would provide fellowships for State and local employees and grants to help States and localities develop and implement comprehensive training plans and strengthen their personnel administration programs. It would also permit Federal agencies to admit State and local employees to Federal training programs, and facilitate the interchange of Federal, State, and local personnel for periods of up to two years.

Some programs already in existence attempt to improve the delivery of public services in certain functional areas. For example, the comprehensive health grant, and title V of the Elementary and Secondary Education Act of 1965, both seek to strengthen State performance in the health and education fields, respectively.

Actions of this nature serve to increase the capabilities of State and

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[29] For a complete listing, see "Creative Federalism," pp. 425–426.

[30] In addition to the general coordinating responsibilities vested in the Departments of Agriculture and Housing and Community Development, there have developed a series of more specific *ad hoc* arrangements to improve the coordination in certain functional areas. For example: (1) the President's Committee on Manpower set up three-man teams in some 30 cities—comprising key personnel from the Departments of Labor, Health, Education, and Welfare, and the Office of Economic Opportunity—to work towards increased interagency and intergovernmental coordination across a broad array of manpower and related programs; (2) five agencies (the three above plus the Department of Housing and Urban Development and the Bureau of the Budget) are now arranging pilot demonstrations in 14 cities for multiservice "one stop" neighborhood centers; and (3) a similar interagency coordinating approach is being used in launching the first phase of the President's Concentrated (Slum) Employment Program in selected urban core centers.

[31] "The Quality of American Government." Presidential message to Congress on Mar. 17, 1967, in the *Weekly Compilation of Presidential Documents* (Monday, Mar. 20, 1967), p. 488.

[32] For a more detailed description of these measures, see "The Quality of American Government," *op. cit.*, pp. 488–490, and the bills as they have been introduced in Congress (H.R. 8175 and H.R. 8233, respectively).

local personnel and better equip them to assemble public service packages suited to their needs.

(6) *Simplification of grant programs and administration.*—Nearly a dozen small grants for health purposes have been consolidated in the "Partnership for Health" program. The Department of Health, Education, and Welfare is currently working with the Bureau of the Budget to review its numerous remaining grants to determine whether additional action can be taken to simplify our Federal-aid system without sacrificing important objectives. Moreover, the President recently instructed the Budget Bureau to study the entire spectrum of grant programs to determine where further consolidation and simplification might be appropriate.

In the meantime, an effort is being made to simplify the procedures for the application, administration, and financial accounting involved in existing grant programs. The objective of this undertaking is to facilitate the pooling of Federal funds for closely related purposes at the State or local level—thus simplifying the administration and accounting of these programs for recipients while leaving undisturbed the substantive legal requirements and appropriations associated with each individual grant.[33]

(7) *Coordination of planning.*—Budget Bureau Circular A–80 deals with a common complaint among State and local officials: The frequently inconsistent bases, requirements, and boundaries of Federal planning provisions. The circular has instructed the agencies to set up a checkpoint procedure whereby, insofar as feasible, they will attempt to utilize common planning boundaries, statistics, and staff, and will strive to harmonize separate functional plans with comprehensive planning for the area.

This brief discussion is, by no means, an exhaustive description of coordination efforts in the executive branch. The items listed, however, are illustrative of the number and nature of actions currently being taken in this field. The interest in extending these efforts is high and will probably grow even more in the next year or so.

Finally, it should be noted that increased use of the newly instituted Planning-Programming-Budgeting System in the Federal Government will probably identify a number of additional areas requiring attention. By specifying program objectives and collecting the resources to be applied (*regardless of where financed*), the system can point to overlapping and inconsistencies of programs.

III. Reforming the System: Problems and Prospects

All the necessary ingredients for reshaping public policy appear to be present: Presidential interest, congressional concern, State and local complaints, and public awareness. The President recently announced his commitment to some change in one of the major Presidential policy documents—the budget message. "Our agenda must give high priority to a stronger and more effective Federal system of government in the United States . . . [The] Federal Government has a responsibility to examine and improve the grant-in-aid system, making it more flexible

[33] *Ibid.*, pp. 491–492, for a more complete description of these projects.

and responsive to State and local fiscal realities." After alluding to the Model Cities and Partnership for Health programs as possible prototypes, he went on to say, "In the coming year we will examine other areas of Federal aid to determine whether additional categorical grants can be combined to form a more effective tool for intergovernmental cooperation." [34]

There appears to be a consensus on the general proposition that there are too many narrow grants. Budget Director Schultze emphasises that Federal aid"... is being provided through too many narrow categorical grant and loan programs. Our system of grants-in-aid has long been overly complex . . ." [35] Noting the "excessive categorization," he graphically depicted our problem as needing to strike a reasonable middle ground between extending aid in "teaspoons" or in "buckets." [36] Selma Mushkin, in a recent address before the National Association of State Budget Officers, judged the present number of grants "excessive" whether the total was 100, 200, or 300. Sheer numbers alone cause States and communities considerable problems in simply ". . . sorting out what is available . . ." [37] These authorities are joined by similar complaints emanating from Capitol Hill, the National Governor's Conference, and elsewhere.

However, in moving from the general proposition that some reform is needed to particular measures, any semblance of unanimity quickly fades. The symmetrical lines of the old Hoover Commission grant edifice are soon eroded by a rash of qualifications and hedging. There appear to be significant obstacles in the path of wholesale reforms which would yield a grant system "... based on broad categories—such as highways, education, public assistance, and public health—as contrasted with the present system of extensive fragmentation." [38] The one shining example of progress in this direction, the Partnership for Health program, had a gestation period of some 17 years—being first proposed in almost its present form in 1949! [39] After some thought on this topic, and faced with the manifest lack of progress, the author was forced to concede that there must be something to say in *favor* of our much-maligned categorical aid system. Or, at least, one must judge that there are almost insurmountable obstacles to significant revisions in the present grant structure. (In this context, the outlook for more radical changes in the system is dark indeed!)

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[34] "The Budget Message of the President," *The Budget of the United States Government—1968*, p. 34.
[35] "Creative Federalism," *op. cit.*, p. 390.
[36] *Ibid.*, pp. 410–411. One "horror" story will suffice to demonstrate the extent of overlapping and fragmentation which can exist in some Federal program areas. While there may be defensible reasons justifying the continued existence of such splintering, the area of health in the Department of Health, Education, and Welfare can be awesomely bewildering to the prospective recipient. For example, the bulk of health assistance programs are vested in the Public Health Service. Yet, four other HEW agencies are also involved in the health field; the Social Security Administration, Vocational Rehabilitation Administration, Office of Education, and the Welfare Administration. Furthermore, *within* the Welfare Administration, health programs are being carried out by *two* of its constituent elements: the Children's Bureau, and the Bureau of Family Services.
[37] "Intergovernmental Fiscal Relations: Prescriptions," an address prepared for the 1966 Annual Meeting of the National Association of State Budget Officers, Hawaii (Aug. 4, 1966), p. 19.
[38] Commission on Organization of the Executive Branch of the Government. *Overseas Administration, Federal-State Relations, Federal Research,* Report to Congress (March 1949), p. 36.
[39] See Selma Mushkin, "Barriers to a System of Federal Grants-in-Aid," *National Tax Journal* (September 1960), pp. 193–198, for a discussion of this general topic. See, especially, p. 194 for the block health grant proposal.

A. Obstacles to generalized forms of assistance

The formidable problems lying in the path of general forms of aid are outlined below. Looking at the positive side, the list constitutes an impressive array of advantages to be claimed for categorical aids.

(1) *National needs.*—There are certain objectives which take on national importance. Rather than undertaking these activities directly, the Federal Government frequently chooses to stimulate State and local efforts to meet those needs through the financial incentive provided by conditional grants. This is in accordance with our revealed preference for the benefits of a decentralized system of government.

To be most effective, the aid stimulus should be applied to a restricted area of activity, increasing its attractiveness to prospective recipients. The common criticism that categorical aids "distort" State and local budgets only indicates that the incentive to action is effective, and that nationally defined goals are being pursued. Despite disclaimers to the contrary, no governmental unit is forced to subscribe to most of these services. There are still some assistance programs which a few States forego on the basis of principle. On the other hand, large-scale provision of generalized assistance would dilute the Nation's ability to focus on specific national needs.

Highly specific approaches to meeting national needs constitute one of the main reasons for the present fragmentation of Federal-aid programs. Few reformers will settle for a single "general" health grant, for example. Inevitably, someone will point to the overriding need for more doctors, nurses, etc., and decide that we need a separate program for training health manpower. Looking at the complex problems of long-term funding, and the voter appeal inherent in construction projects of any type, someone else will advocate separating construction from regular operations. Certainly, planning is also a unique activity which ought to be especially encouraged. As a result fragmentation by function is overcome; fragmentation by object is rampant. The casual observer may be hard-pressed to choose which of these two kinds of fragmentation is least confusing and inhibitive to effective programing at the State or local level.

Finally, the Kestnbaum Commission cited the national purposes often pursued through the use of Federal aids. "The National Government has used the grant-in-aid primarily to achieve some national objective, not merely to help States and local governments finance their activities. . . . When used effectively, the grant not only has increased the volume of State and local services, but also has promoted higher standards both in service and administration." [40]

(2) *Adjustment of "spillover" costs and benefits.*—In many State and local programs there are costs and/or benefits which accrue outside the bounds of the decisionmaking jurisdiction. As a result, analysis of the need and formulation of a program to meet it tend to become fragmented—and the true relationship between program costs and benefits is clouded. Consequently, there is some justification for a more comprehensive unit of government to evaluate the relative cost-benefit balance and provide grants to adjust the differences.[41] The extent of

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[40] *Op. cit.*, pp. 119, 126.

[41] See Albert Breton, "A Theory of Government Grants," *The Canadian Journal of Economics and Political Science* (May 1965), pp. 175–187. He argues, for example, that a ". . . higher level of government and only a higher level of government can compute the marginal social utilities and the marginal social costs of the benefits that spill over the frontiers of jurisdictions and only that government can equalize them" (p. 183).

"spillover" will probably vary from program to program, and from area to area. (Contrast, for example, the differing relationships among such programs as water pollution, air pollution, education, and welfare.) As a result, the Federal grant must be flexible in order to adjust the differing cost-benefit relationships. Prof. George Break concludes 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." [42] [Emphasis supplied.] It could be argued that general purpose grants could not accomplish the necessary refined adjustments. Hence, we would be faced either with a less-than-optimal allocation of resources, or pressures for more categorical aids in addition to general assistance.

(3) *Need for planning.*—Without getting into all the other purposes which merit separate support, planning has several attributes which place it high on any such categorical list. It can encourage more effective use of program support funds—whether such support stems from general aid or categorical aid. Planning assistance is also needed to mesh multiple functional plans (e.g., for highways, urban renewal, etc.) into comprehensive areawide plans—to insure their compatibility and combined effectiveness.[43] Finally, planning funds can promote the regional cooperation which so many multijurisdictional problems require. The grants may be tailored to the jurisdictional boundaries appropriate to different problems.

(4) *Innovation and demonstration.*—The National Government is in a unique position to encourage the research and demonstration of new techniques that will improve the efficiency and quality of public services throughout the country. It alone possesses the resources, proper time horizon, and geographical comprehensiveness which large-scale innovation requires. A local community reasonably may balk at incurring the large capital costs (and great uncertainty) of demonstrating new techniques in urban mass transportation. Even a State may hesitate to do so, because the demand for such services within its own boundaries may be limited, or because it possesses no technique for recouping its costs from outlying interested areas (which, recognizing the utility of the innovation, have already borrowed it for their own use at little expense to themselves). On the other hand, the Federal Government through *specific project grants* can encourage multiple attacks on public problems, and then disseminate the most useful findings. Unrestricted general grants will not suffice for the purposes of innovation. The needs, abilities, and interests associated with innovation are not distributed according to population or any other single index; they vary both geographically and functionally.

(5) *"Practical" political problems.*—The categorical grant system is rooted in the political structure of a pluralistic society. Divided by a thousand different loyalties, effective political action is contingent on bargaining, compromise, and the search for specific, limited areas of agreement. "Viewed in this light, the grant-in-aid programs make

[42] Break, *op. cit.*, p. 24. See also his section on "Optimizing Grants," pp. 77–79.

[43] Senator Muskie revealed some hesitance to adopt any form of tax-sharing or block-grants until assured that cross-functional planning is taking place at the State level, and unless "we can be sure they are approaching their total requirements in some rational sense and with some sense of priorities . . ." See "Creative Federalism," *op. cit.*, p. 283.

sense. Each is the product of a specific coalition and the terms of that coalition are evident in the statute and in the administrative practices which result from it." [44]

Most general aid proposals, then, will run afoul of this basic feature of our political system. This is true of efforts to restructure completely our existing categorical aid system, and of those which would supplant it altogether. Specific grants are a means whereby a Congressman may support national action on a particularly pressing problem, without foregoing decentralized administration of the remedy. To remove categorical grants (or even reduce them in number) is a twofold political loss: it reduces the opportunity for an elected representative to demonstrate concretely his responsiveness (to the demands of his constitutents and interest groups); and it limits his opportunities for public exposure by reducing the number of announcements he can make to his constituents concerning his advancement of their interests. As a result, reforms in the categorical aid system face formidable obstacles in the very basis of politically representative government, covering those elected, their constituencies, and the other groups which try to influence them.[45]

Finally, for the reasons cited above, broad-ranging assistance measures may fail to generate the requisite political support to secure adequate program funding. There appears to be much less "voter appeal" in general welfare proposals, for example, than for efforts to aid crippled children, the blind, or the disabled.[46] The one mitigating factor (albeit a highly uncertain one) is the possibility that the growing cumbersomeness, complexity, and consequent criticism of our fragmented aid system will simply overwhelm the opposition. The extent of public support for reform would have to be exceedingly high to accomplish a *coup* of this magnitude, however.[47]

(6) *Scope of national controls.*—As a general rule, broader program objectives (including general assistance) would be accompanied by larger amounts of funds. In turn, these larger grants for broad purposes would entail the application of Federal standards and requirements to a wider range of State and local activities. For that reason, among others, the Kestnbaum Commission concluded that "... the National Government's conditional grants represent a basically sound technique, despite their piecemeal development and hodgepodge appearance. It is the only technique that is in any sense self-limiting, both as to objectives and amounts of expenditures and as to extent and nature of national control." [48] To argue that these broad controls and

[44] Monypenny, *op. cit.*, pp. 14–15. Also see Mushkin, "Barriers . . . ," *op. cit.*, p. 199 and Weaver, "Creative Federalism," *op. cit.*, p. 88. The House Committee on Government Operations noted in 1958 that it was "appreciative of the strong legislative reasons for confining grants to narrow segments of a general activity." (*Op. cit.*, p. 51.)

[45] For example, in the field of education, there are imposing forces rallying to the causes of vocational education, school science equipment, and guidance and counseling. The grant programs in each of these areas are both the result of, and continuing *raison d'etre* for, the activities of these groups. It should be noted that even the "revolutionary" Partnership for Health program has 15 percent of its funds earmarked for mental health purposes. Moreover, the comprehensive health program has not faced its first acid test yet—the Appropriations Committees of the Congress.

[46] The old "general health" grant may be a useful case in point. Its scale was gradually whittled away, until it was only half as large as it was in the mid-1950's before being merged into the health partnership consortium.

[47] The effects of such a reform would probably be transitory, since the old pressures would reexert themselves and the system would lapse back into its preferred way of doing business.

[48] *Op. cit.*, p. 122. See also Mushkin, "Barriers . . .," *op. cit.*, pp. 204–205.

sanctions would never be applied because of their controversial nature, is only to recognize another political obstacle in the path of adopting more "flexible" forms of assistance.

B. Concluding observations

What conclusions can be drawn from this rather pessimistic assessment of the outlook for substantial reforms in the categorical aid system? First, and most obvious, is the conclusion that *any* changes in such a structure are difficult to obtain. A reasonable corollary would be that the extent of opposition to such change is directly proportional to the scale of the reform (i.e., "radical" changes stand the least chance of approval; incremental revisions enjoy a more favorable prognosis). In short, holistic approaches are unsuited to pluralistic politics. (In this regard, "tax-sharing" proposals which would completely *supplant* the existing categorical aid structure may foreclose the adoption of *any* form of such general assistance—by serving as a catalytic agent for consolidating the diverse opposing forces.)

Secondly, despite these obstacles, some reform is both necessary and possible. To be effective, these proposals must be appropriate to the actual problems encountered and in harmony with existing political "styles" (i.e., at least *appear* to be incremental). Without wanting to sound overly sanguine about the chances for favorable evolution in the system, the author believes the factors cited in an earlier section document a movement in the right direction. Moreover, the political obstacles in the way of more comprehensive measures, and some of the advantages of categorical assistance, make the prospect of evolution (rather than revolution) somewhat more bearable and a great deal more likely.

There are a number of areas which would bear further exploration as avenues of such a manageable reform package:

(1) *Marginal consolidation.*—There is some latitude for combining additional categorical grant programs. However, most of the prospects appear to be in one agency—the Department of Health, Education, and Welfare. The Department and the Budget Bureau are now examining those programs to see what can be accomplished. In the other functional areas, the number of separate programs does not seem nearly so overwhelming.[49]

(2) *Single grant authority for demonstration and research.*—Dr. Selma Mushkin's proposal to group innovative grants into a single grant for each department is an interesting possibility.[50] Since most of the 226 project grants are of this nature, consolidation would eliminate nearly half of the total number of grant authorizations. Furthermore, the purposes of such research and demonstration could then be broadened to encompass an entire program area, while not sacrificing the ability to focus funds on specific problems.

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[49] After subtracting project grants, the following number of aid programs remain:

National defense	4
Agriculture and agricultural resources	7
Natural resources	37
Commerce and transportation	18
Housing and community development	10
Veterans benefits and services	2
General Government	5

On the same basis, programs for health, labor, and welfare totaled 56, and education had 34 programs.

[50] Mushkin, ". . . Prescriptions . . .," p. 21.

(3) *Reexamination of allocation, matching, and other grant provisions.*—As times change, logic demands a periodic reevaluation of programs and methods to determine their suitability to current requirements. Differing allocation and matching provisions should be justified on the grounds of differing priorities, not historical accident. The demands for a single State agency to administer grant programs at the State level should be similarly reviewed.

(4) *More information and assistance to States and communities.*—Since the categorical aid system can never really be made "simple," more information in useable form must be provided to States and local governments to ensure effective use of Federal assistance funds. Other possible forms of support include increased technical assistance, training, and "overhead" funds to strengthen general management and coordination abilities at the point of impact of Federal programs.

Much work along these lines has already been undertaken and has reached the point of implementation. Other projects have just begun, but offer considerable promise. In short, the pragmatic forces which molded our current fragmented aid system are now at work to "rationalize" it and remove some of its most deleterious features.

BARRIERS TO A SYSTEM OF FEDERAL GRANTS-IN-AID*

BY SELMA J. MUSHKIN**

Two major proposals to improve Federal grants to the States have been advocated in recent years. The first is a proposal to block or consolidate specific grants within a broad program area so that a single grant would be made. The second is to make grant procedures, plan requirements, and formulas more nearly uniform.

This paper seeks to examine these proposals and to set forth the issues and problems which hinder their acceptance. Barriers to their adoption are in part those that face any proposal for change in established financial practices. However, these proposals implicitly require difficult choices between conflicting objectives. By clarifying the issues and choices the objectives sought through coordination may be sharpened and new recommendations may be developed which would be more consistent with the objectives—and with the taxpayers' vote on the allocation of public funds.

I. BACKGROUND OF THE PROPOSALS

While block grants have a long history, the block grant proposals as currently advanced emerged from the review of Federal grants-in-aid by the Commission on Organization of the Executive Branch of the Government (the first Hoover Commission). The term "block grant" was applied, not as earlier to an unconditional fiscal grant, but to a grant restricted to a broad program purpose.

THE HOOVER COMMISSION

In its report to Congress in March 1949, the first Hoover Commission set forth the assets and liabilities of Federal grants-in-aid. Among the liabilities were: (*a*) the removal of discretionary power from State officials, (*b*) the alteration and distortion of State budgetary policies, (*c*) imbalances between programs nationally supported and those not so supported and, (*d*) the retarding of State initiative in meeting public service responsibilities.[1]

To overcome these liabilities, at least in part, the Commission recommended that "the grants-in-aid plan and program be clarified and systematized." It urged that "a system of grants be established based upon broad categories— such as highways, education, public assistance,

*Reprinted from *National Tax Journal*, Vol. XIII, No. 3, September 1960.

**The views expressed are the author's own and do not necessarily reflect the position of the U.S. Public Health Service, the agency in which she is employed. The author is indebted to members of the Interdepartmental Group on State-Local Finance for their comments on an earlier draft of the paper.

[1] Commission on Organization of the Executive Branch of the Government, *Overseas Administration, Federal-State Relations, Federal Research*. Report to Congress, March 1949, pp. 31–32.

and public health—as contrasted with the present system of extensive fragmentation."[2]

This recommendation and others in the supporting reports on public welfare[3] and Federal-State relations[4] stimulated two lines of national action: first, a formulation of administrative procedures for greater uniformity of grants, and second, legislative proposals for block grants for health and for public welfare.

In 1949 officials of the U. S. Bureau of the Budget met with a committee of the National Association of State Budget Officers. Among the problems relating to improving Federal grants which were discussed were: (*a*) the advisability of adopting objective criteria for grant apportionment formulas giving greater emphasis to equalization, and (*b*) a block grant for public health services.[5] State representatives urged that the grants-in-aid for control of venereal disease, tuberculosis, cancer, and heart diseases as well as those for general health assistance and mental health activities be consolidated into a single block grant in preference to the continuation of the categorical aid for each program. Consideration of this suggestion, along with the activities of this joint committee, lapsed with the outbreak of the Korean war.

Federal agencies took steps during the latter part of the forties to review their grant programs in order to achieve a greater measure of coordination. The Office of Federal-State Relations of the agency which subsequently became the Department of Health, Education, and Welfare was asked to develop and coordinate policies, methods, and procedures concerning Federal-State relations involved in the various grants-in-aid, and other programs. The work of this Office clarified many of the detailed issues involved in Federal aid programs, and brought greater uniformity to State plan requirements.

Because of the interrelation of the grant programs administered by the Public Health Service and by the Children's Bureau, these two Federal agencies have worked closely together. In the fiscal year 1953, a joint State plan submittal was begun, and before then, a joint State budget, joint State fiscal reporting and joint statistical reports had been implemented.

In addition to these small but significant steps toward meeting the objectives of the Hoover Commission, legislative action was sought to achieve greater coordination. Prior to 1953, major legislative proposals were before the Congress to consolidate the categorical programs of public assistance and also grants for public health work. For example, in the 80th Congress[6] and again in the 81st Congress[7] an omnibus health bill, sponsored by the administration, provided for a single grant for public health services and called for a single allotment of funds to

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[2] *Ibid.*, p. 36.
[3] Brookings Institution, *Functions and Activities of the National Government in the Field of Welfare*. Prepared for the Commission on Organization of the Executive Branch of the Government, 1949, pp. 164–168, 531–533.
[4] Council of State Governments, *Federal-State Relations*. Report of the Commission on Organizaiton of the Executive Branch of the Government, 1949, pp. 134–136.
[5] Committee of the National Association of State Budget Officers and the U.S. Bureau of the Budget on Grant-in-Aid Problems. Summary of Proceedings of Joint Meetings, May 10–11, 1949, and Aug. 30, 1949.
[6] U.S. Congress, Senate, Committee on Education and Labor, *National Health Program*. Hearings, 80th Cong., first sess.
[7] U.S. Congress, House Committee on Interstate and Foreign Commerce, *National Health Plan*. Hearings, 81st Cong., first sess.

the States and a single matching requirement. The Cooper-Forand bill, introduced first in the 79th Congress, authorized the States to determine whether they would continue categorical programs for public assistance or would combine their programs into a generalized public welfare program. The public welfare bill introduced in the 81st Congress at the request of the President also followed this same pattern, although the State matching requirement was somewhat altered.

Congressional debate on the health bills centered largely on a national health insurance program, the issues of which were extraneous to the proposals for consolidating the public health grants. The debate on the public assistance program, however, illuminated the issues posed by a block grant.

The administration-sponsored public welfare proposal sought Federal aid for a comprehensive public welfare program. In addition to grants for medical assistance and for welfare services for adults and for children, the bill provided for: (*a*) Federal aid for cash assistance payments up to specified maximums for each recipient (with reduced maximums for the third and each additional individual in the family; (*b*) Federal matching of individual assistance payments within the maximums on a variable basis determined for each State by its relative income position, with a minimum Federal matching of 40 percent in the highest income States and a maximum of 75 percent Federal funds in the lowest income States; (*c*) A Federal matching formula which would yield about 55 percent Federal support in the average income States; (*d*) State determination of the basis of aid to individuals. (States could retain the existing categories of recipients, adopt new categories, or abandon the categories in favor of a more general approach.[8])

Besides giving the States more authority in determining the classes of recipients and their groupings, the proposal called for increased Federal welfare expenditures, and was devised so that no State would receive in the aggregate less Federal aid thait it had been receiving. The bill was supported by both labor and public welfare groups.

Among the arguments advanced in support of the proposal were—

—wider latitude for States to determine program;

—a better balance of public support for classes of needy persons;

—removal of hampering restrictions on classes of recipients for which Federal support could be provided, and

—a more rational system of Federal aid varying inversely with the fiscal capacity of the States.

The increases in Federal aid under the proposal were neither evenly distributed among the States nor among assistance categories. More particularly, the proposal called for reductions in Federal funds for old-age assistance. In response to these problems, the Ways and Means Committee reported out a new bill which became the Social Security Act Amendments of 1950. Congressional and public opposition to the reduction in Federal support for old-age assistance under the comprehensive program, despite the assurances that no State would receive less for the total package, led to the rejection of the block grant approach. In lieu of a more generalized system of welfare aids, the

[8] U.S. Congress, House, Committee on Ways and Means, *Social Security Act Amendments of 1949*. Hearings, 81st Cong., first sess.

Social Security Act Amendments of 1950 set up a fourth category of Federal aid; namely, aid for the needy disabled, and authorized matching of funds spent for payments to providers of medical care within the maximum amounts payable to needy persons. The Ways and Means Committee in reporting the bill out emphasized: "The bill would strengthen the old-age assistance program by providing increased Federal funds . . ." [9]

While the block grant proposals for public health and welfare were rejected, an Administration-supported measure to consolidate grants for agricultural extension work was enacted by the Congress. In 1953, the "Consolidation of Existing Laws Relating to Cooperative Agricultural Extension Work" was passed to simplify procedures and to provide for a single allotment of funds from the amounts appropriated by Congress. However, the act froze the allocation to each State as of fiscal year 1953 (with a minor exception) so that no State would get less than it had prior to the passage of the new legislation. Any additional funds appropriated in the future would be allocated by a special formula.[10]

Thus, as an aftermath of the Hoover Commission recommendations, steps were taken through legislative or administrative action to coordinate Federal grants-in-aid by consolidating grants or by adopting more uniform administrative procedures. The major proposals for consolidating public welfare grants and public health grants failed to be enacted because of the resistance to cutbacks in funds for a special category within the welfare programs, and because of issues in health programs unrelated to consolidation.

KESTNBAUM COMMISSION

Recommendations of the Hoover Commission led to the subsequent enactment of new legislation setting up the Commission on Intergovernmental Relations (the Kestnbaum Commission).[11] The Kestnbaum Commission in its report to the President in 1955, took a different position on coordination from that of the earlier Hoover Commission. The Kestnbaum Commission stated: "There are strong reasons for confining grants-in-aid to fairly small segments of broad activities." [12] In more specific recommendations the Commission urged that grants to States be consolidated for agricultural experiment stations and indicated that some broadening of grant programs, particularly in public health, would be desirable. The Commission also urged more consistent use of grant allotment formulas in place of administrative allocations and, in general, greater uniformity in grant formulas and administration.

Action on Federal grants-in-aid during and since the Kestnbaum Commission may be summarized as follows: (1) there has been some consolidation of grants; (2) a major effort was made to achieve greater uniformity in grants and to consolidate some of the categorical aids.

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[9] U.S. Congress, House, Committee on Ways and Means, *Social Security Amendments of 1949*. Report, 81st Cong., first sess.

[10] U.S. Congress, Senate, Committee on Agriculture and Forestry, *Appropriations for Cooperative Agricultural Extension Work*. Hearings, 83d Cong., first sess.

[11] Commission on Intergovernmental Relations, *Report to the President for Transmittal to the Congress*, June 1955.

[12] *Ibid.*, p. 133.

The Commission's recommendation that the various statutes authorizing grants for agricultural experiment stations be consolidated into a single law was put into effect by enactment of the Experiment Station Consolidation Act of 1955. This act, like the earlier measure to consolidate statutes on agricultural extension work was designed to simplify budgeting and accounting. Like the earlier measure, too, it froze allotments to each of the States so that no State would lose any funds, and it set up a formula for the allocation of any increase in Federal appropriations.[13]

Beginning in 1954 the Department of Health, Education, and Welfare began to reasses its grants-in-aid programs and proposed new legislation on grants for public health services, child health and welfare services, vocational education, and vocational rehabilitation. The new legislation would have authorized the use of a uniform grant formula, a uniform approach in each of the programs, and would have combined the specific categorical aids into broader grants. The proposed coordinated program for grants-in-aid, in the words of the Secretary of the Department, represented a concerted effort to simplify the structure and administration of 14 major grant-in-aid programs.

The pattern of this coordination proposal may be illustrated by the public health recommendations. By this proposal, the categorical aids for venereal disease, tuberculosis, mental illness, heart disease and cancer control would have been consolidated into a general grant for public health services. In lieu of the aids for specific disease categories, grants of three types were to be made: *support grants*, *extension and improvement grants* and *project grants for experimental and demonstration purposes*. Funds for support were to be allotted among the States on the basis of a formula incorporating population and per capita income. The allotments were to be matched on a variable percentage basis (varying inversely with the income of the States) within a maximum Federal share of 66⅔ percent and a minimum of 33⅓ percent. Extension and improvement grants were to be allocated to the States on the basis of population and matched on a project basis, with a sliding scale depending upon the period elapsing; that is, 75 percent the first 2 years, 50 percent the second 2 years and 25 percent in the fifth and sixth years. Project aid was to be distributed administratively to public and nonprofit agencies. The consolidated public health grant program did not call for increased Federal funds. Cutbacks were projected for many States. But in combination with the several related bills proposed, no State would have lost funds under the total package.[14]

The public health proposal passed the House of Representatives in the 83d Congress with an amendment excepting mental health from the block grant for a 5 year period. The amendment grew out of the strong opposition to combining mental health with other public health services, especially because of the developing separate State mental health agencies which are independent of State health departments. The companion Senate bill was not reported out of committee. Members of the committee, during the course of the hearings indicated their

[13] U.S. Congress, House, Committee on Agriculture, *Consolidation of Agricultural Experiment Station Appropriations*. Report, 84th Cong., first sess.

[14] U.S. Congress, House Committee on Interstate and Foreign Commerce, *Public Health Service Act*. Hearings, 83d Cong., second sess.

concern that the specific purposes for which the categorical aids were designed were no longer spelled out and that appropriations for public health work were endangered by the absence of an identification of funds sought with purposes of expenditures.

Of the legislation introduced to effectuate the Administration's recommendations the only measure enacted was the new vocational rehabilitation program. This proposal, combined with the new threefold grant-in-aid—support, extension, and project aid—not only a vastly enlarged appropriation authorization but also included a transition grant formula so as to assure each state that it would lose no funds.

JOINT ACTION COMMITTEE

Another major committee on Federal-State relations originated as a consequence of the President's proposal to the Governors at their annual meeting in June 1957. The President proposed that the Governors and the Federal administration form "a task force for action" for the purpose of seeking ways and means to strengthen the federal system by strengthening State governments. In its first report to the President and to the chairman of the Governors' Conference, the Joint Federal-State Action Committee emphasized transfer of waste treatment works construction and vocational education functions to the States in return for relinquishment of a part of the Federal tax on local telephone service to the States.[15] In its second report the Committee stated that had it "examined the general aspects of grants-in-aid and agreed to analyze, among other possibilities, the feasibility of replacing *specific grants* with the *block* grant in combination with, or as an alternative approach to revenue source relinquishment, and the practicability of revising present grant formulas to relate grant payments to per capita incomes." [16] With the establishment in September 1959 of a new statutory agency, the Advisory Commission on Intergovernmental Relations, active operations of the Joint Federal-State Action Committee ceased.[17]

II. Block Grants—Issues and Choices

The repeated rejection of block grants leads us to the conclusion that the assumptions on which the block grant proposal rests are not valid in all instances or, at least, run counter often to other objectives which are more compelling. A detailing of these assumptions may help to clarify the issues.

These assumptions include at least the following:

—that the primary purpose of Federal aid is to provide States with financial support to carry out a program's objective;

—that the alinements and pressures for political action are different at the National level from those at the State and local levels;

—that Federal controls (e.g., standards, audits, and other reviews) would be substantially reduced if the purpose of the program were broadened;

[15] Joint Federal-State Action Committee, *Progress Report No. 1*, December 1957.
[16] Joint Federal-State Action Committee. *Progress Report No. 2*, December 1958, p. 13.
[17] U.S. Congress, House Committee on Government Operations and Senate Committee on Government Operations *To Establish an Advisory Commission on Intergovernmental Relations*. Joint hearings, 86th Cong., first sess.

—that more effective and efficient use of public funds will result if States have wider latitude in directing expenditures.

SUPPORT VERSUS STIMULATORY GRANTS

Is the national interest met simply by providing States with funds for a broad program area? An affirmative answer assumes that the National Government has no interest in direction of program content and no more interest in one part of the broader program than in another.

Most Federal aid programs, however, originate in rather specific public needs and are designed primarily to stimulate states to meet these needs. Pressures for action have centered on concerns of the citizen and of the interest groups with which he associates himself for political action: clean water, school hot lunches, training practical nurses, control of cancer, efficient interstate highways, and scientific apparatus in classrooms. In this setting, categorical aids have become an important instrument by which national action is identified with these interests, thereby stimulating necessary State and local actions, and, yet, keeping administration and programing as much as possible at the State and local levels. An alternative to a grant program is often a direct nationally administered program, which bypasses the States.

It may be useful to look more closely at the purposes of Federal grants and to do so within the context of their historical development. Federal grants in 1900 were small, whether measured as a percentage of total expenditures of the National Government, of State and local revenue, or of State revenues. Federal aid to States and localities accounted for less than 1 percent of the national budget in 1900, contributed less than 2 percent of State revenues, and less than 1 percent of State and local revenues combined.

Over the 60 years that have elapsed, Federal aid has increased both in amount and scope. In the fiscal year 1959 Federal grants totaled $6.4 billion (table I), including $2.6 billion of payments to States financed from the special highway trust fund.[13] Federal aids in the

TABLE I.—*Federal grants-in-aid*

Fiscal Year:	*Expenditures for grants (in millions)*
1952	$2,393
1953	2,781
1954	2,986
1955	3,126
1956	3,642
1957	3,943
1958	4,831
1959	6,355
1960 estimate	7,090
1961 estimate	6,812

Source: Bureau of the Budget, *Special Analysis of Federal Aid to State and Local Governments in the 1961 Budget.*

fiscal year 1959 (grants plus $458 million shared revenues and loans) represented 7 percent of total Federal cash payments to the public,

[13] Federal aid expenditures from Bureau of the Budget (*Special Analysis of Federal Aid to State and Local Governments* in the 1961 Budget of the United States Government) include shared revenues and net loans and repayable advances in addition to direct grants-in-aid.

and accounted for about one-sixth of all State and local general revenue, and about one-quarter of State general revenue.[19]

The present money grant payments to the States and localities reflected in these dollars had their origins in such specific program objectives as, for example, distribution of educational material for the blind, promotion of agricultural research, and resident instruction in land-grant colleges. Federal grants-in-aid for these specific purposes were enacted before 1900. Over the years the same pattern of special encouragement has been followed (table II). To illustrate, since 1955 a number of new stimulatory grants have been enacted. These include grants for library services in rural areas, waste treatment facility construction, water pollution control, expansion of teaching in educating the mentally retarded, air pollution control, and national defense education activities. The last is essentially a composite of separate categorical aids rather than a single grant program.

TABLE II.—*Federal grants-in-aid to State and local governments, 1959* [1]

Program	Year established	Federal department or agency administering program	Amount of grant, 1959 [2] (in thousands)
Distribution of educational materials for the blind.	1879	(3)	$400
Agricultural research	1887	Department of Agriculture	31,071
Aid to State soldiers' homes	1888	Veterans' Administration	6,244
Resident instruction in land-grant colleges	1890 [4]	Department of Health, Education, and Welfare.	5,052
Assistance to state marine schools	1911	Department of Commerce	332
State and private forestry cooperation	1911	Department of Agriculture	12,425
Agricultural extension work	1914	do	60,624
Highway construction	1916	Department of Commerce	2,613,897
Vocational education	1917	Department of Health, Education, and Welfare.	38,353
Vocational rehabilitation	1920	do	45,373
Donation of surplus agricultural commodities.	1933	Department of Agriculture	206,703
Employment service and unemployment compensation administration.	1933 [5]	Department of Labor	297,261
School lunch	1933 [6]	Department of Agriculture	143,793
Child welfare services	1935	Department of Health, Education, and Welfare.	11,833
Crippled children's services	1935	do	16,401
Maternal and child health services	1935 [7]	do	16,494
Public assistance	1935	do	1,973,322
Old-age assistance	1935	do	1,149,311
Aid to dependent children	1935	do	624,441
Aid to the permanently and totally disabled.	1950	do	151,695
Aid to the blind	1935	do	47,875
Public health services	1935 [8]	do	29,541
General health	1935	do	14,924
Tuberculosis control	1944	do	3,995
Mental health	1946	do	3,986
Cancer control	1948	do	2,171
Heart disease control	1948	do	2,075
Venereal disease control	1938 [8]	do	2,390
Fish and wildlife restoration and management.	1937 [9]	Department of the Interior	19,847
Public housing, low-rent (contributions)	1937	Housing and Home Finance Agency	110,849
Agricultural marketing services	1946	Department of Agriculture	1,160
Airport construction	1946	Department of Commerce	56,578
Hospital and medical facilities survey and construction.	1946	Department of Health, Education, and Welfare.	[10] 135,159
Major disaster relief	1947	Office of the President	4,139

See footnotes at end of table.

[19] In the fiscal year 1958 Federal funds amounted to $4.8 billion, or 22 percent of State general revenue; based on compilation of the Governments Division, U.S. Bureau of the Census. This figure includes, in addition to grants, shared revenues, payments to States and local governments for services, payments in lieu of taxes and other intergovernmental payments. In 1957, $4.5 billion of the total $4.8 billion Federal payments to States and local governments represented grants-in-aid.

TABLE II.—*Federal grants-in-aid to State and local governments, 1959* [1]—Continued

Program	Year established	Federal department or agency administering program	Amount of grant, 1959 [2] (in thousands)
Slum clearance and urban renewal (capital grants).	1949	Housing and Home Finance Agency	$75,537
Civil defense	1950	Office of Civil and Defense Mobilization.	8,955
School construction in federally affected areas.	1950	Department of Health, Education, and Welfare.	66,097
School operation and maintenance in federally affected areas.	1950	do	132,073
Defense community facilities and services [11]	1951	Housing and Home Finance Agency	157
Flood prevention and watershed protection	1954	Department of Agriculture	22,912
Special milk	1954	do	72,535
Urban planning	1954	Housing and Home Finance Agency	1,834
Library services for rural areas	1956	Department of Health, Education, and Welfare.	5,362
Waste treatment facilities	1956	do	36,429
Water pollution control	1956 [12]	do	2,591
Defense educational activities	1958	do	44,153
Science, mathematics, and foreign language instruction.	1958		33,748
Guidance, counseling, and testing	1958		6,289
Area vocational programs	1958		3,750
State statistical services	1958		366
Teaching in education of the mentally retarded.	1958	Department of Health, Education, and Welfare.	

[1] Based on a compilation of grant programs in "Federal-State-Local Relations: Federal Grants-in-Aid," H.Rept. 2533, 85th Cong., 2d sess., table 1.
[2] Fiscal year expenditures as reported by the Bureau of the Budget in the Budget of the U.S. Government for the fiscal year ending June 30, 1961, and in "Special Analysis of Federal Aid to State and Local Governments" in the 1961 budget.
[3] Operated by the American Printing House for the Blind, a private, nonprofit corporation accountable to the Department of Health, Education, and Welfare for its use of Federal funds.
[4] Established as a continuing program of annual cash grants by the Morrill Act of 1890. The first Morrill Act in 1862 provided a nonrecurring land grant.
[5] Employment service administration, 1933; unemployment compensation administration, 1935.
[6] Originated in 1933 as part of emergency relief program. Established as a continuing program of cash grants (supplemented by commodity donations) in 1946.
[7] Grants for this purpose were initiated by Sheppard-Towner Act of 1921 but discontinued in 1929.
[8] Grants for control of veneral disease were initiated by the Chamberlain-Kahn Act of 1918, but discontinued after a few years.
[9] Wildlife restoration, 1937; fish restoration, 1950.
[10] Of this amount $74,337,000 was granted for construction of private, nonprofit institutions.
[11] Program discontinued July 31, 1955; expenditure represents disbursement on previous commitments.
[12] Grants were made previously for the years 1950 through 1952 under a 1948 act.

While the line between support and stimulation is difficult to draw, there is a point in the relative sharing of total program expenditures at which the major national objective is, or becomes, financial. At this point the withdrawal of national support would seriously threaten the fiscal stability of the program and also pose substantial alternative revenue problems for States and localities. Thus defined a support program is sufficiently large to necessitate readjustment of State and local revenue systems if aid is withdrawn.

Some programs originally designed to stimulate State action have become over the years largely support programs. Federal aid for highways in the early days of the grant program stimulated the establishment of State highway departments and concentration on selected road systems. This program, today, falls into the category of a support program, as do the public assistance grants. The largest part of Federal aid now goes out to the States for these support purposes—public assistance and highway grants.

The effectiveness of categorical aid as a stimulus to State action is implicit in some of the criticisms of these grants. For example, it is charged that the categories distort State programing and budgeting by pressuring the State and local governments to act on programs for which categorical aids are made available, at the expense of the non-aided categories. Mr. I. M. Labovitz in a recent paper takes up the question: "Do Federal grants-in-aid stimulate the State and local governments to support services they would otherwise neglect?" While emphasizing the difficulties of a statistical demonstration of an affirmative or negative answer to this question, he summarizes the experience under selected aid programs. State and local expenditures for vocational education have increased over the period of operation of the vocational education program faster than Federal aid. Similarly, State funds for vocational rehabilitation and for public health have increased more than Federal moneys. These relative changes are reflected in reduced Federal shares of cost. To illustrate, Mr. Labovitz points out that during the period 1940–57 total expenditures for the three grant-in-aid programs administered by the Children's Bureau—maternal and child health services, crippled children's services, and child welfare services—increased by 450 percent, from less than $31 million to more than $170 million. Despite this marked increase, the Federal Government's share dropped from more than one-third of the total funds in 1940 to less than one-fourth in 1957. Under the Library Service Act, approved in 1956, Federal grants of $2,050,000 were made available to the States for the fiscal year 1957. In the first year, 35 States not only matched the Federal allotment but overmatched it by putting up more than 3.3 times the minimum matching funds required.[20]

Thus, to the extent that the grant mechanism is used to pinpoint a national objective and to encourage State and local action in a specific direction, block grants are a substitute for categorical aids.

PRESSURES FOR POLITICAL ACTION

Advocates of the block grant assume that citizens concerned with specific programs benefiting themselves and the groups with which they aline themselves for these purposes will turn exclusively to the States or communities for remedy or relief. They assume that if there is a block grant groups will not turn to the National Government for aid for specific categories.

But the special interest groups concerned about mental health, crippled children, agricultural extension work, school lunches and so forth do not limit their political avenues of redress in this way. Pressures for specific program action are brought to bear on each of the representative governments. The grant program offers a way for the Congress to respond to these pressures by financial inducements to the States to join with the National Government in achieving a nationwide provision of a public service. The process of congressional study and debate

[20] I. M. Labovitz, *Stimulative Effect of Federal Grants-in-Aid; Some Illustrative Data* (Library of Congress, Legislative Reference Service, July 1958).

itself serves to focus national attention on a problem area. If the Congress is convinced of the need for a nationwide service, the choice is between a direct national operation and a cooperative National-State program—and not inaction.

A sharp differentiation between State and national action accordingly cannot be made. The result of joint pressures on National and State Governments is a complex set of functional interrelationships among governmental units which is, in the phrase of Prof. Joseph McLean, a "marble cake." [21] National, State, and local governmental contributions and responsibilities run together in a varied and indefinite pattern.

Weaknesses of State and local governments reinforce but are not exclusively responsible for the pressures for national action and the use of the grant-in-aid as an instrument to alleviate and remedy specific social problems. It has been noted repeatedly that corrective State and local action is urgently needed to improve representation in each of the States so that the voter and the interest groups have a better chance of being heard closer to home. Inadequate representation of urban groups in the State legislatures and constitutional restrictions on taxing and borrowing powers impair the operation of States and localities. These weaknesses do not end in fewer public services but rather encourage a shift from the State to the National Government.

FEDERAL CONTROLS AND STANDARDS

Block grants have been urged as a way of reducing Federal controls over State and local program activities. It is assumed that by broadening the program area for which aid is provided detailed program requirements will be eliminated, and the complexity of Federal audits of grant expenditures and of matching requirements will be reduced.

Block grants for each of the broad program areas would certainly require a reexamination of some of the detailed standards and program requirements now present in some of the older grant programs, such as vocational education. They would do away with some of the restrictions arising from the limited purpose of the categorical grants. For example, a block grant for public assistance would end the restrictions on age groups for which Federal funds may be expended under the present old-age assistance and aid to dependent children programs. States would not be required to keep separate financial records of the operations of each of the categorical programs.

Certain aspects of block grant administration, however, would work in an opposite direction from that intended. A block grant which encompasses program areas broader than the sum of the categorical aids also would widen the area in which national standards and controls would be applied. In a sense, a categorical grant limits the "interference" of the National Government to the specific program aided. States are not restricted in their choices in carrying out the broader program objectives. Furthermore, the application of sanctions for failure to comply with Federal standards becomes more onerous in a

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[21] Joseph E. McLean, *Politics Is What You Make It* (Public Affairs Pamphlet No. 181, 1952), p. 5.

block grant, simply because the size of the grant is enlarged. The broader the purpose of the grant and the larger the pot that holds the moneys, the more severe becomes the sanction of withholding Federal funds. The severity of the sanction is likely to deter its use.

Within the categorical aids there are alternatives to a block grant which could materially reduce the limitation on State and local activities resulting from Federal standards and requirements. First, and perhaps most important of these, is a careful reassessment of legislative standards and regulatory requirements to determine what is essential as a minimum for furthering the national program. Abandoning standards and requirements which are outmoded or unduly restrictive would be an essential first step. Second, opportunities exist for simplifying Federal audits. Wherever feasible this simplification should be undertaken. Third, in grant programs administered by a single national agency and generally by a single counterpart State agency, steps can be taken and have been taken in some instances to provide greater flexibility in the use of Federal funds. For example, it has been noted that States in their administration of health funds are permitted to consolidate their plan submissions into a single State plan and budget. States are permitted to submit consolidated financial reports of grants and matching expenditures. Furthermore, States are authorized to use portions of categorical grant moneys to finance organizational services and salaries for individuals who devote only a part of their time to a given program. By way of illustration, States are permitted to use part of tuberculosis grant funds to pay a proportionate share of laboratory expense and nursing services.

ECONOMY IN THE USE OF RESOURCES

The block grant proposal also is advanced on the assumption that States given greater latitude in use of grant moneys will direct resources into those programs which urgently require emphasis because of special needs within the State. Discretionary use of a block grant permits variation more nearly in accord with different public service needs in the States. This greater flexibility and the concomitant ease of shifting program emphasis with changes in circumstances are major arguments in favor of block grants for broad program areas.

Control over use of funds.—Wide latitude in use of Federal grant moneys is consistent with an objective of national support of functions administered by the States and local governments. It is not consistent however, with a national objective of directing public services into specific channels. Among the questions raised in justifying national support and the method of support are: Is the need nationwide and will the extending of a "carrot" encourage action on the part of most, if not all, States? The price of the "carrot" is the start or further development of a specific public service.

Recourse may be had to administrative rather than legislative direction of the special funds within a general grant program, but when large sums are involved the delegation of responsibility becomes a serious matter. Even within categorical programs, steps have been taken administratively to pinpoint funds to emphasize a need in the achievement of a program's goals. To illustrate: at one time funds from the grants for crippled children were set aside for rheumatic fever cases to gain a nationwide "push" in reducing the crippling effects of this disease. At another time, a part of the funds were set aside to apply newer surgical techniques to certain cases of congenital heart disease in children. These "earmarkings" permit the National Government to combat special health problems in cooperation with established State agencies.

Moreover, the limited categorical aids, through the appropriation process, direct use of economic resources in accord with the desire of the voter and his affiliated groups. Categorical aids facilitate a review of appropriated items in terms of the specific purpose of each program. The delimited grants have a built-in mechanism to clarify the purposes for which funds are sought—public libraries, school lunches, cancer control, and so forth. Concern has been expressed frequently in congressional debates on block grants that the consolidation of grants into broader purpose programs will impair the expression of voters preferences in the amount and allocation of Federal moneys. While a block grant may reduce the number of appropriation items, the amount of funds requested may appear unduly large in terms of the vague and broadly defined need.

It has sometimes been said in jest that the best way to deal with this manysided issue is to seek action on appropriations from the U.S. Congress on the basis of special categories, but to turn about and distribute the funds to the States without categorical restrictions. If representation in State legislatures were improved, there would be much merit in this seemingly improper conduct of the public business. The alinement of public pressures for State fund allocations, of which the Federal funds become a part, could be relied upon to obtain the desired allocation of resources.

Whether the National Government as well as the States or the States alone should determine the use of the funds within a broad program, and how best to achieve a proper allocation of Federal appropriations among specific needs are but two questions within the more general problem of effective use of public funds. Review of the allocations to States under some of the small stimulatory grant programs indicates that amounts of grants to some of the States are so small as to require direct justification. An annual grant to a State for particular programs may amount to less than $10,000 or sometimes even to less than $1,000. Patently, these small sums can at best finance only part of the salary of one or two State officials responsible for a program.

Demonstration grants.—The size of the expenditure alone, however, cannot be taken as the sole index of the usefulness of a grant. Many of these small sums represent "seed moneys" to focus attention on a public service through an educational program or through a demonstration of new techniques. Innovation in public services as a device for improving their efficiency is gaining increased attention. New ideas, new methods, new arrangements are required. They are needed to improve administrative techniques, to revamp organizational structures so that they facilitate the application of scientific advances, and to coordinate the provision of services when the same family or individual is eligible for different public services. These innovations and demonstrations often require only small sums.

One device for stimulation is the "project" grant, a grant made directly by the National Government to a public or private agency which formulates an acceptable and approved project. At present project grant authority is included in programs for hospital construction, air pollution control, vocational rehabilitation education, and others. This type of grant is classified by the Treasury Department in its annual report as a part B category, "Federal aid payments to individuals, etc.," within the States and not as a grant to the States.

Under these project grant programs, Federal funds go directly to support of projects with the State participating only nominally. A State's direction of public services is weakened, especially when project funds are granted to a public agency directly by the Federal agency. While the amounts are small the importance for programing are potentially considerable. And all too little attention has been given to an alternative approach; namely, Federal grants to States for demonstration purposes, with the State in control of the funds.

Reduction in grants.—At times the block grant for a broad program has been urged primarily as an "economy" measure; that is, as a way to reduce the Federal share of costs of a specific program. Where Federal grants account for 80, 85 or even a higher percentage of total program expenditures in a State, concern about responsibility for expenditures is warranted. Experience with State grants to local governments certainly suggests sizable local sharing of the costs to check spending.[22]

One part of the problem is the relative Federal share, another is the aggregate size of Federal outlays. Block grants may require larger rather than reduced Federal outlays. If Federal aid is restricted to specific segments of a program, the funds may be limited to sums required to encourage States and localities to act on these particular segments. If the program area is enlarged, as it often would be under a block grant, increased Federal support commensurate with the broader program objectives would be implied. Moreover, as suggested in the review of congressional action on block grant proposals, the transition from categorical aids to any block grant that will be acceptable to Governors and Congress will itself require an increase in Federal funds.

Increased Federal support will be required to assure that no State will lose any funds and that some States acquire additional funds to accomplish the broader program. The alternative course is to freeze allotments as of some base period. Such a freeze impairs the application of rational principles in allocating grants and introduces rigidity in the national program. This rigidity may encourage new categorical aids since the social and economic problems for which cooperative National-State action is sought change from time to time.

SUMMARY

The foregoing discussion has set forth several assumptions on which the block grant proposal rests. A block grant in a broad program area gains the necessary Federal support and permits the States greater

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[22] Mabel Newcomer, "Critical Appraisal of Federal and State Aid." In *Federal-State-Local Tax Correlation* (Princeton: Tax Institute, 1954), pp. 87–98.

flexibility in directing funds into specific channels. Enlargement of programs supported by the Federal Government is the prescription desired in some instances. For example, in public welfare if nothing is done to enlarge the scope of the program, groups of needy will continue to be ineligible for payments under the Federal-State cooperative programs.

The characteristics of the block grant which make it fit the purposes of some programs make it singularly inappropriate in others. Stimulating State action on specific public needs requires categorical aids to be used. For only by categorical aids can the National Government respond to the special interests of voters. Only in this way can appropriations be tailored to apparent needs and to preferences of voters. In any case, a block grant offered as an economy measure is likely to be voted down. More likely to be adopted is a program which calls for increases in funds commensurate with the enlarged scope of the cooperative Federal-State programs.

III. Uniformity in Grants—Issues and Choices

The objectives in gaining a system of Federal grants by means of greater uniformity in formulas and in other requirements are not the same as those of the block grant. One objective of the block grant, which is to give States greater flexibility in directing the use of funds, is replaced by the more limited objective of neutralizing the interprogram competition for Federal funds. Another objective, which would reduce detailed Federal program requirements, is replaced by the more limited purpose of standardizing procedure. While the block grant proposal calls for a reduction in the number of Federal grants, coordination through greater uniformity would not change the number of grants, nor would the leadership of the National Government in providing specific public services be diminished.

In the discussion which follows, only one aspect of uniformity is considered; namely, uniform methods of allotment and matching.[23] The proposal for uniform methods of allotment and matching presumes that—

—the role of the National Government is about the same in each of the nationally aided programs;

—grant-induced transfers originate in variable Federal sharing of program expenditures;

—States will make the changes necessary to effect a uniform Federal policy.

INTERPROGRAM DIFFERENCES IN FEDERAL PARTICIPATION

A major problem in the diversity of Federal grants arises out of differences in Federal sharing of the expenditures for joint Federal-State programs under existing grants. For example, if the National Government offers more dollars per State dollar for public assistance than it

[23] Uniform method of allotment is used here to mean a uniform formula design and uniform weighting of factors of need and fiscal capacity; uniform matching is defined as a uniform amount of Federal dollars per State (and local) dollars in a State.

does for public health. States may be tempted to divert their funds from public health to public assistance. Financially induced transfers of this type can be avoided in State budgetary decisions by offering the same Federal share to a State for each of the aided programs.

The earlier discussion has pointed up the different Federal role in support and in stimulatory grants. This role is different in the public assistance programs from what it is in health. It is still different in education. Even within the construction grant programs, such as highways, airports, hospitals, waste treatment works, and slum clearance, Federal aid is designed to achieve goals which are set at different levels of adequacy and which have diverse timetables.

Variations from program to program in large part stem from the historical development of public services and the historical allocation of functions among the governmental units. In some instances cooperative Federal-State programs have been developed; in others, direct national programs. A review of the statistics of Federal aid quickly points up the areas in which the grant device has primarily been employed to establish and operate programs of national interest. Almost all Federal expenditures for public assistance go out as Federal grants; when considered along with social insurance benefits however, only about 18 percent of social security expenditures represent grants-in-aid. Grants to States account for about 26 percent of Federal health expenditures, 40 percent of Federal outlays for education and scientific research, 70 percent of expenditures for transportation (water, highways, and aviation) and 56 percent of all civil public works.

Public welfare programs were poorly developed before Federal assistance grants were initiated. In a sense these grants inaugurated public aid to the needy as we know it today. Increasingly over the years the Federal share of the cost has been enlarged. In the fiscal year 1937 the Federal government met 42.8 percent of the total costs of public assistance, exclusive of general assistance. By 1942, this had increased to 47.0 and in the fiscal year 1959 it was 58.7.

In health programs Federal aid from the beginning was restricted to narrowly defined public health services and excluded hospital and medical care, which are major activities of States and localities. The grants were purposely stimulatory rather than supportive even within the boundaries of "public health services." Federal aid now accounts for 3.2 percent of the $3.6 billion spent by States and localities for health purposes. In education, despite the early precedent of land grants, Federal aid has been restricted to stimulating specific types of educational activities (such as vocational education, counseling services, scientific apparatus in the classrooms), or to an indirect compensation for loss of State and local taxes due to Federal activities, as in federally affected school districts. Of the total $15.9 billion now spent by States and localities for education only 3.1 percent comes from Federal funds.

The part of total expenditures financed by Federal funds varies from public service to public service and from State to State. Table III shows the share financed by Federal funds in each of the States as reported in the *1957 Census of Government*.

TABLE III.—*Federal funds as percent of State and local expenditures, 1957*

States ranked in order of average of 1956-57 per capita income	Education	Highways	Health and hospitals	Public welfare	Natural resources
United States	3.0	12.4	3.5	45.5	11.5
Delaware	2.3	13.8	4.9	34.6	30.4
Connecticut	1.2	1.8	1.9	30.8	10.3
New York	1.3	7.4	.9	32.5	2.4
California	7.1	15.0	1.5	41.3	2.4
New Jersey	1.2	4.4	1.4	30.5	6.5
Illinois	2.5	8.7	2.0	42.1	9.2
Nevada	2.6	41.8	8.2	41.1	11.8
Massachusetts	1.8	3.6	1.0	33.6	11.8
Ohio	1.5	11.1	2.7	35.4	12.5
Michigan	3.3	10.4	2.4	37.8	12.1
Maryland	2.2	8.0	3.2	41.2	13.4
Washington	2.7	8.2	1.7	44.7	12.8
Pennsylvania	2.1	8.8	3.9	32.1	13.8
Rhode Island	2.3	17.3	6.3	36.5	18.4
Indiana	1.9	8.7	2.9	40.9	15.5
Wyoming	2.3	37.6	7.3	42.3	11.1
Colorado	2.3	20.3	4.5	37.4	24.5
Oregon	2.1	19.1	2.5	35.2	14.4
Missouri	2.4	19.3	4.2	57.8	22.1
Wisconsin	3.3	10.1	1.9	31.1	15.0
Montana	2.2	34.8	7.2	42.5	14.1
New Hampshire	2.7	7.9	4.2	33.5	14.6
Minnesota	3.8	13.8	4.5	39.1	14.3
Florida	2.3	9.6	3.8	63.5	4.8
Texas	2.0	17.9	7.5	68.0	14.0
Kansas	2.6	12.3	3.9	45.0	24.1
Iowa	4.1	11.1	4.8	40.7	19.9
Arizona	3.0	19.3	5.6	56.2	5.3
Nebraska	2.4	21.9	3.0	49.3	14.8
Utah	4.6	27.0	9.7	41.8	19.2
Maine	2.3	13.6	5.1	50.1	17.3
Virginia	3.1	10.1	4.7	54.2	19.5
Vermont	4.4	14.3	6.5	44.4	23.5
Idaho	2.5	23.7	11.9	52.3	12.5
New Mexico	6.5	37.4	13.0	63.9	24.6
Oklahoma	2.5	16.1	8.1	49.2	27.1
Louisiana	2.0	12.0	6.5	56.1	8.5
West Virginia	2.8	6.6	9.3	66.0	26.7
Georgia	3.3	11.9	7.6	62.9	23.4
North Dakota	3.1	21.2	7.3	52.1	18.6
South Dakota	3.2	25.8	9.6	59.3	24.3
Tennessee	3.4	12.8	7.8	67.7	28.0
Kentucky	3.1	11.3	7.0	66.9	17.9
North Carolina	3.5	33.1	9.4	71.5	25.3
Alabama	4.2	17.7	14.3	65.7	29.2
South Carolina	2.9	15.0	9.3	70.1	17.5
Arkansas	6.2	17.1	13.5	66.7	27.8
Mississippi	5.6	18.4	12.9	66.8	29.1

Source: Computed from U.S. Bureau of the Census, "1957 Census of Governments, Compendium of Government Finances," table 31; U.S. Bureau of the Census, "Compendium of State Government Finances in 1957," table 8.

General aid for elementary and secondary education sharply defines the problem. Before World War II the Treasury Committee on Intergovernmental Fiscal Relations in assessing Federal grants wrote: "Of all the functions of government which might be candidates for national minimum status general education has the strongest claim." [24] Education, however, remains the financial responsibility of State and local governments. Moreover, the grant programs which have been advanced do not contemplate any major shift in responsibility between the National Government and the States. What is intended basically is an increase of educational expenditures either in all States or in the "poorer" States. In no Federal grant program has tax relief for States and localities been considered as an acceptable objective even when the higher tax effort of the poorer States has been taken into account. In fact, when shifts from State taxes to

[24] U.S. Treasury Department, Committee on Intergovernmental Fiscal Relations, *Federal, State, and Local Government Fiscal Relations*. Senate Document 69, 78th Cong., first sess.

National taxes have been discussed, moves have been made to prohibit such substitution. So-called floor provisions or minimum effort requirements have been especially designed to assure that Federal taxes do not replace State taxes.

First definition of costs—We have thus far considered uniform Federal sharing in the cost of programs without defining what the Federal funds are a share of. Program costs for this purpose may be defined in at least two ways. First, cooperative program costs may be considered as the sum of the grant and of the minimum amount required as a condition for a State's receipt of the full allotment to a State. In this sense the early grant-in-aid programs fully met the objective of uniform sharing. The typical grant formula called for an allotment in proportion to population and a matching on a dollar-for-dollar basis. The National Government's share in the cost of each program so defined was uniformly 50 percent.

Today, there is a wider variation in Federal grant formulas. In part, these variations reflect the differences in grant formulas between the older and newer grants. Grants started since the 1930's and especially since World War II often have built-in equalization-type formulas which call for an apportionment of funds on the basis of a combined index of program need and financial ability; matching is in direct relation to the State's fiscal capacity. Federal grant funds are distributed in these newer grant programs so that a larger proportion of the funds goes to States which have the greatest need for public services and the least capacity to provide them. In grants for construction of hospitals and related health facilities, school lunches, vocational rehabilitation, waste treatment works, and rural libraries the National Government assumes more of the financial burden in States of lower capacity than in the more prosperous States. In 1958, Congress adopted for the first time a modified version of a variable grant for public assistance payments.

Thus, the newer Federal grant formulas use grants as a tool to equalize both the level of public services and the State fiscal burdens required to finance these public services. The implementation of these newer formulas is reflected in the fact that more than half of Federal grant funds now goes to States with incomes below the U.S. average, rather than to the high income States. In contrast, before World War II, the largest share of Federal grant funds went to States with incomes above the U.S. average.[25] A positive correlation between State per capita income and per capita Federal grants has been replaced by a minor negative correlation.[26]

Steps taken within governmental departments to bring about a more uniform approach to concepts of need and fiscal resources and the formulas applying such indexes were mentioned earlier. As a consequence, major legislative proposals for Federal grants for health, education, and welfare often follow a common formula pattern. (In a subsequent section I shall discuss some of the technical problems which militate against a uniform sharing of costs in a State for each of the aided programs within this common pattern.)

Second definition of costs.—The use of formulas which call for

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[25] V. O. Key, Jr., *The Matching Requirement in Federal Grant Legislation in Relation to Variations in State Fiscal Ability.* Social Security Board, Bureau of Research and Statistics Memorandum No. 46, February 1942.

[26] Selma Mushkin. "Federal Grants and Federal Expenditures," *National Tax Journal,* vol. X, No. 3, September 1957, p. 204.

Federal sharing in some minimum level of public services in each of the States opens up questions of minimum program standards and of the cost of implementing such minimum standards. Thus, a second definition of program costs has come into use; namely, the cost of a standard minimum program in which the Federal Government participates. The Hill-Burton hospital construction program, for example, defines program need by an objective statistical index. For general hospital beds the program limit in which the Federal Government participates is set at 4.5 beds per 1,000 population in States with a population density of 12 or more persons per square mile. This proportion is increased to 5.5 beds per 1,000 in States with low population density. "Intended as the limits for Federal participation, the ceilings have, through the force of Federal regulations and instructions to the State agencies, tended to become established as definite and fixed standards of bed needs." [27]

Many of the newer programs, however, have no clearly defined minimum standards. In public assistance, for example, one, although not the major stumbling block to moving from an open end to a closed end grant, has been the complexity of formulating and pricing such a standard. Even in programs with minimum standards, such as hospital construction or highways, Federal appropriations are often substantially below the annual amounts required to meet program goals within a time schedule. Program standards are pitched at different levels of performance, and appropriations are authorized to finance differing parts of even the defined standards.

Federal shares as a consequence are not always the same even when identical matching ratios are used. In one program, for example, the Federal Government may allot a State the full amount, which together with the required dollar-for-dollar matching could finance a standard minimum program. In another it may allot only 20 cents of each $1 of minimum program costs. The effective Federal shares are not the same even though the matching ratio may be. Matching requirements may even become inoperative, in a sense, except in those States whose programs are substantially below the national minimum.

GRANT-INDUCED STATE BUDGET TRANSFERS

We have taken almost for granted that differential Federal reimbursement ratios are a factor in State budget decisions. *A priori*, if a State can get 90 cents on each $1 of expenditures on interstate highways and only 33⅓ cents on each $1 spent to build hospitals, the State will exhaust its Federal highway fund allotment before spending anything on hospitals. Governments, however, do not act like individuals, they do not take maximum advantage of Federal grant offerings. Some allotments of Federal funds even at fairly favorable matching ratios are not taken up. There are States which still do not have a special categorical program for payments to the needy disabled. States sometimes adopt and finance programs which the State legislatures know will not qualify for Federal funds because the State law does not meet the Federal requirements. Additional research is required to answer the question: "Does differential Federal sharing induce States to transfer funds among programs?"

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[27] Louis S. Reed and Helen Hollingsworth, *How Many General Hospital Beds Are Needed?* (U.S. Public Health Service Publication 309, 1953), p. 2.

The Kestnbaum Commission in discussing State budget distortion commented: "Neither the nature nor the extent of distortion, however, is entirely clear. . . . It is questionable whether any State, today, spends more of its own funds on major activities supported by grants-in-aid than it would were there no Federal support of these activities." [28]

We know all too little about State budgetary decisions and the impact of Federal grants. Two illustrations of State budgetary distortion arising from Federal grants are usually given. First, general assistance payments are contrasted with payments under the four aided categories—aid to the needy aged, blind, disabled, and dependent children. Second, staffing for vocational education is contrasted with that for general education. But these contrasts are between programs which are aided and those not aided. Unless the National Government is to participate in all public services in States and localities, there will continue to be some such contrasts.

Even in those instances in which there is some Federal aid for one program and none for a related program, it is not clear that Federal aid is the cause of differential State action. States may be spending more for old-age assistance payments than for general assistance, not because State funds are matched in the first instance and not in the other but because the aged are a strong political force. Political alinements responsible for Federal grants for old-age assistance may be reflected in higher State appropriations for the aged. As Professor Anderson has suggested in another context, the functional interest groups "have not plumped strongly for one level of government as against another, or for one method of getting results in preference to another." [29] The pressures are directed at all levels of government as uniformly as representation permits.

There are a number of indications that state revenue raising potentials, as measured crudely by their incomes, determine the amounts spent for each of the public services. Correlations between per capita income and per capita expenditures tend to be high for functions in which Federal aid has not played a significant part in raising the level of public services in low income States. As shown below correlations of per capita expenditures in the States in 1957 and per capita personal income are higher for functions without substantial Federal support than for functions which are so supported:

Correlation of per capita expenditures and per capita income

Functions:	
Local school systems	0.64
Hospitals	—.67
Health	—.40
Highways	—.20
Public welfare	—.00

While differential Federal grants lessen interstate variations in levels of public services by giving larger proportionate support to the poorer States, the program effort of the States out of their own taxing resources is not necessarily affected. Table IV shows the expenditures from State and local funds (exclusive of charges and fees) as a percent of personal income for four categories of public

[28] Commission on Intergovernmental Relations. *Op. cit.*, p. 129.
[29] William Anderson, *The Nation and the States, Rivals or Partners?* (Minneapolis: University of Minnesota Press, 1955).

functions. Some of the high income States, like Delaware, make a comparatively low effort for each of the programs whether aided substantially by the Federally government or not. Others in the high income group of States, such as California, make a higher relative effort for the programs with less Federal support than those with larger support. In the low income groups there are illustrations of the same diversity in response of State program effort to Federal aids. The comparatively higher program effort in the poorer States reflects in part the limitation of their resources, for despite Mississippi's above average effort for education, highways and public welfare, per capita expenditure levels are substantially below the average for the nation.[30]

TABLE IV.—*Expenditures from State and local funds as percent of personal income, 1957*

States ranked in order of average of 1956–57 per capita income	Education	Highways	Health and hospitals	Public welfare
United States	3.6	1.9	0.7	0.5
Delaware	3.1	1.0	.5	.3
Connecticut	3.0	3.6	.7	.4
New York	3.3	1.2	1.2	.6
California	4.1	1.5	.8	.7
New Jersey	2.9	1.1	.6	.3
Illinois	2.9	1.6	.6	.4
Nevada	3.6	2.1	.6	.4
Massachusetts	2.8	2.4	1.1	.9
Ohio	3.1	1.7	.5	.5
Michigan	4.2	1.9	.8	.5
Maryland	3.3	2.2	.8	.3
Washington	4.5	2.3	.9	.8
Pennsylvania	3.0	1.3	.6	.5
Rhode Island	2.8	1.5	.8	.7
Indiana	3.8	1.6	.5	.3
Wyoming	5.3	2.8	.5	.5
Colorado	4.3	2.1	.5	1.4
Oregon	4.7	2.3	.6	.6
Missouri	2.9	1.4	.5	.6
Wisconsin	3.5	2.5	.7	.6
Montana	4.8	2.7	.6	.6
New Hampshire	3.3	3.4	.8	.6
Minnesota	4.7	2.4	.9	.7
Florida	3.2	2.3	.7	.3
Texas	3.9	2.0	.4	.3
Kansas	4.3	3.8	.7	.7
Iowa	4.2	3.1	.4	.7
Arizona	5.3	2.2	.5	.4
Nebraska	3.7	2.2	.6	.4
Utah	5.0	1.7	.5	.6
Maine	3.2	2.6	.6	.6
Virginia	3.2	2.4	.6	.2
Vermont	4.2	3.6	.8	.7
Idaho	4.4	2.7	.6	.5
New Mexico	5.3	2.4	.7	.4
Oklahoma	4.4	2.6	.5	1.4
Louisiana	4.9	2.7	.9	1.3
West Virginia	3.5	1.7	.3	.4
Georgia	4.0	1.9	.7	.5
North Dakota	4.8	3.9	.8	.5
South Dakota	4.6	3.6	.4	.4
Tennessee	3.5	2.1	.6	.3
Kentucky	3.4	2.1	.5	.4
North Carolina	4.0	1.7	.6	.3
Alabama	3.4	2.7	.4	.6
South Carolina	4.8	1.8	.5	.3
Arkansas	3.5	2.4	.5	.6
Mississippi	3.9	3.1	.6	.6

Source: Computed from U.S. Bureau of the Census, "1957 Census of Governments, Compendium of Government Finances," Tables 22 and 31; U.S. Bureau of the Census, "Compendium of State Government Finances in 1957", table 8.

[30] The agreement in ranks of program effort in a State for each of the four program areas shown in table IV is statistically significant. Kendall's coefficient of concordance was computed for the State program effort ranks (based on unrounded percentages) in the four expenditure series. $W = .415$; $x^2 = 78.0$. The agreement in ranks is significantly greater than would be expected by chance.

While the budgetary effects of differential aids may not be those supposed, there is still reason for questioning differential Federal sharing of costs.

Certainly the present grant formulas do not properly represent differences in national interest in the different programs. The need for coordination is especially urgent in programs which are closely interrelated. When related programs are administered by different local agencies and are supported by varying amounts of Federal dollars for each non-Federal dollar, the problems of working out effective coordination become even more difficult. For programs not so closely interrelated a uniform set of formula guidelines would help to improve the public understanding and acceptance of grants.

CAPACITY—NEED MEASURES IN GRANT FORMULAS

Newer grant-in-aid formulas now in use (or proposed) which seek to vary the amount of a Federal grant with the need for public services and with a State's capacity are more complex than the formulas enacted earlier. The increase in the number of factors means more variables which can be modified in the legislative process.[31] These grant formulas have three objectives:

—A uniform level of program throughout the Nation as a minimum or foundation.

—A uniform fiscal effort on the part of each State to support such a minimum program.

—An equal (or other designated) sharing with the States (or States and localities combined) in the costs of the program for the country as a whole, on an average dollar-for-dollar (or other) basis.

METHODS OF EXPRESSING A FORMULA

The operation of such a formula can be expressed in several ways:

(1) One way is to define total program need. (Usually, as indicated earlier, this measure is determined indirectly through the appropriation process by the amount of Federal funds made available and the required State and local matching shares.) If, then, each State is called upon to contribute a uniform percentage of its capacity toward financing this program (the percentage set so that, for the country as a whole, States raise, for example, one-half the total cost), the difference between program need in each State and the State's share of costs would represent the amount of Federal grant. The total of these Federal grants would represent one-half the nationwide costs of the program. For each State the grant would vary directly with need

[31] Professor Musgrave, in a 1959 paper on "Theoretical Aspect of Fiscal Federalism" for the National Bureau of Economic Research Conference on Public Finance, outlines a number of equalization formulas and examines these with regard to their distributional results, and their incentive or disincentive effects. In each of these schemes he makes explicit the state of origin of the central grant funds and assumes that the amounts collected by the central fisc from all the States for subsidy purposes exactly equals the total amount of the subsidy. In the formula presented below the source of the Federal grant is not considered; in other respects the elements which determine the size of the subsidy are similar to those included in Professor Musgrave's plans 5 and 9.

and inversely with State capacity in such a way as to achieve the stated objective.[32]

(2) Another way of stating at least a part of the formula is to emphasize the relative share of the Federal Government in a given State's total program expenditures, rather than the relation of one State's share of program expenditures to total funds contributed by all States.[33]

In such a statement the percentage share nationwide is set so that the Federal Government will contribute the designated share of all money spent to meet minimum program needs. The proportion of Federal funds in the minimum program cost for each State is varied from this average share inversely with the relative capacity per unit of need in accordance with a combination of an index of need and an index of capacity.

(3) Still another method of stating the formula is to express both need and capacity in terms of a unit of need; for example, per person in a State. The basic statement is otherwise similar to the first method presented above. In converting to either total program need, total State share, or total Federal grant, the figure for need per unit would have to be multiplied by the total number of such units in the State. This method is expressed in various education proposals as a grant sufficient to finance a minimum program of a specified number of dollars per capita in each State, assuming a State effort equal to a specified uniform proportion of per capita income.

Why express the formula in one way rather than another? The problem in part must be resolved in terms of ease of understanding, familiarity to State and local governments, applicability to a variety of programs, and convenience of expression. The first method appears to

[32] The formula may be expressed as:

$$G_S = 2G\frac{N_S}{N} - G\frac{C_S}{C}$$

where G = Total Federal grant; also total State expenditures, and G_s the grant to a State;
N = Total need, and N_s the need of a State;
C = Total Federal grant; also total State capacity of a State;

$G\frac{C_S}{C}$ = Share of a State in relation to total State expenditures;

$2G\frac{N_S}{N}$ = A State's share of total need.

[33] The relation of the Federal share in a State to the total cost would be:

$$1-\tfrac{1}{2}\left[\frac{C_s}{N_s}\div\frac{C}{N}\right],$$

which is equivalent to the relative shares derived from the first method of statement.

The Federal grant in a particular State, when expressed as a percentage of total expenditures from Federal and State funds combined for the State's program, would be

$$2G\frac{N_s}{N} - G\frac{C_s}{C}$$

or alternatively as,

$$\left[\frac{2\frac{GN_s}{N}}{\frac{2GN_s}{N}}\right] - \left[\frac{\frac{GC_s}{C}}{\frac{2GN_s}{N}}\right];$$

this is equivalent to:

$$1-\tfrac{1}{2}[(C_s/C)\div(N_s/N)]\text{ ; or }1-\tfrac{1}{2}[(C_s/N_s)\div(C/N)]$$

follow more closely than do the other two the program objectives, namely, uniform minimum program and uniform State effort. However, the second method points up the matching ratios, or the relative Federal shares, which could be used across the board from program to program. Many other arguments have been advanced in favor of the matching ratio formulation. Some of these arguments are:

The first two variable grants enacted, the Hill-Burton Act and the National School Lunch Act, use a method which emphasizes Federal-State matching ratios.

Allotment formulas provide a measure of maximum Federal grant offered to a State. States may decide to raise an amount less than the full share required to take up the maximum allotment and accordingly the amount of Federal grant must be reduced. This step requires that the relation of Federal participation to State participation be established for each State even if the allotment formula is expressed in other terms.

The Federal percentage formulation can be applied in grant programs for which there is no allotment; the Federal Government simply matches the amounts spent by the States, as, for example, in the public assistance grants.

Measures of need in relation to use of capacity measures.—One has a choice of emphasis between two sets of objectives in the design of such a grant formula—(1) the achievement of a nationwide minimum program with uniform State tax effort, and (2) the achievement of uniform matching ratios from program to program to reduce the problem of interprogram competition for each State's funds. This choice arises despite identical results derived from different ways of expressing a formula because of the different measures of need appropriate to the various Federal grant programs. For example, children of school age are used in the school lunch program, all children under 21 years of age in the grant programs of the Children's Bureau, needs for hospital beds in the Hill-Burton program. These different measures of need result in differences in the index of capacity of the States *per unit of need* and, therefore, different matching ratios.

Since measures of need vary from program to program, however, equalization of State tax burdens to finance these minimum needs can be achieved only at the price of differences in matching ratios among different grant programs within a State; or, conversely, uniform matching ratios from program to program can be achieved only at the cost of differences in fiscal burdens among the States.

Perhaps of even greater importance in explaining the variations in Federal grants is the number of components of a single formula which may be combined in different ways. The concepts and arithmetic of a formula are obscured in the process of applying such criteria as the following: What is the resulting grant to each State? How much would each State have to raise as its share of costs? How does this relate to its current expenditures? To this list must be added for an ongoing program the question: Which States gain and which States lose Federal funds?

STATE PROGRAM ACTION

Even if each issue is resolved in favor of uniform Federal sharing in the costs of nationwide minimum programs in a State, the State may not fulfill the objectives of this uniformity. Let us assume each State (and local) dollar attracts the same number of Federal dollars whatever the program purpose. The impact of the Federal dollar thus is neutral as among programs. But a number of State fiscal practices tend to foster the support of some programs rather than others.

Among the fiscal practices which impede the achievement of a balance between programs in a State are: (a) program differences in distribution of financial responsibility between the State government and the localities, (b) differences in the extent that taxes for program support are earmarked, and (c) differences in intrastate aid formulas and in budgeting of State aid moneys.

The process of transition from the present differential Federal shares to more uniform shares would require intrastate finances to be adjusted. Assume first that the share for only one program is lowered to bring it into line with other aid programs. The impact of the reduced Federal funds might fall on the State government, on counties, or on other local governments depending upon the source of the program support within the State. The tax which would have to be raised to offset a reduced Federal share might be a State tax—typically a sales levy—or property taxes of local governments. If an earmarked tax is used to finance the program, the rate or the base of the earmarked levy would have to be changed so as to increase revenues.

Assume further that not one but many programs are affected by the implementation of uniform Federal sharing. Despite the fact that total Federal grants to a State might be increased, in some programs the State might gain from an enlarged Federal share, in others the localities might gain. Additional State expenditures might be required, while localities gain some tax relief. Or, States may gain tax relief at the expense of additional local expenditures and higher property taxes. State aid provisions for specific purposes sometimes embodied in constitutional or charter provisions make adjustment to changes in Federal aids even more complex. In some instances too, taxes are earmarked for special purposes by State constitutions.

SUMMARY

Differences in Federal shares of program cost may not be as serious a factor in State budgetary decisions as sometimes is assumed. For most programs, moreover, changes in the Federal share would necessitate considerable adjustment of internal State finances and probably also adjustment of State and local responsibility. Complete uniformity is not a feasible goal, given the diverse historical development of the various public services. However, greater uniformity could be achieved. Greater uniformity would doubtless contribute to a better understanding of the machinery of the Federal aid structure.

What seems to be indicated are general guidelines for the development and improvement of grant-in-aid formulas. Departures from these general rules would then require special justification. Such a justification would necessitate a careful assessment of the objectives of any specific aid program and of the detailed provisions for allotment and matching in relation to these objectives. It would also necessitate review of the relation of the specific program proposed to other Federal grants. Aid programs and their purposes, in the light of changing public service needs, also need to be reexamined periodically.

This suggestion assumes that categorical grants are desirable in that they facilitate the granting of Federal funds for narrowly circumscribed purposes of special national concern and permit appropriations to be tailored to the sums required to carry out these purposes. National leadership appears necessary to stimulate the development of some public services and to give direction to the content of these services for a period of time.

A word of caution on extending categorical aids, however, is necessary. It is patently possible to fragment each program area into a series of parts—to divide the needy into groups of needy, to divide disabilities into a large number of disease categories, to divide education into a number of subject matter fields. Each of these programs, in turn, can be divided by age groups, and into other special population groups. The greater the number of these segments which are aided, the more difficult becomes the task of coordination. The greater the number of delimited aids the greater the danger that existing programs will fail to meet a current problem when circumstances change.

DEVELOPMENT OF THE FEDERAL SYSTEM*

BY JAMES A. MAXWELL

> "Many considerations . . . seem to place it beyond doubt that the first and most natural attachment of the people will be to the governments of their respective States." James Madison, *Federalist Papers*, No. 46.
>
> "What is past is prologue." *The Tempest*, Act II, scene 1.

The United States is a Federal union, governed by a Constitution that splits the functions of government between a sovereign Central Government and sovereign States. The powers of the National Government are enumerated in Article I, Section 8 of the Constitution; the Tenth Amendment reserves to the States all powers neither delegated to the National Government nor prohibited to the States. Nowhere mentioned in the Constitution are many of the vital citizen needs that today dominate the domestic scene: education, relief, public health, highways, and so forth. These functions are neither granted to the National Government nor specifically prohibited to the States. The assumption is that these are residual State powers.

In addition to the National Government and the State governments, a great number (91,185 in 1962) and variety of local governments abound in the United States. Unlike the Federal-State relationship, the State-local relationship is not one between sovereign governments. The States are by law the complete masters of these local governments; that is, the relationship is unitary. This concept is known as "Dillon's Rule," after Justice Dillon of the Supreme Court of Iowa who declared:

> Municipal corporations owe their origin to, and derive their powers and rights wholly from, the [State] legislature. It breathes into them the breath of life, without which they cannot exist. As it creates, so it may destroy. It may destroy, it may abridge and control.[1]

The relations that now prevail, Federal-State and State-local, may not seem to conform to these neat legal divisions. Every citizen knows that the practical power of States to alter and control local government is limited, and that the Federal Government spends money on functions that might seem to belong to the States. In view of the great overlap in the performance of most governmental functions, it is not absurd to ask: What has become of the Tenth Amendment?

THE HISTORICAL BALANCE OF FEDERAL, STATE, AND LOCAL POWER

In the 180 years since the Nation was formed, National-State and State-local relations have not remained static. The power of the States vis-à-vis the Federal Government has waxed and waned as the

*Reprinted from *Financing State and Local Government*, The Brookings Institution, 1965, chapters I and III.

[1] *City of Clinton and Cedar Rapids* v. *Missouri River RR. Co.* (24 Iowa 475, 1868).

Federal structure adjusted to changes in social philosophy and environment. In this century, and particularly in the 1930's, major shifts in both absolute and relative terms have occurred in the functions, expenditures, and revenues of all levels of government. In the 1930's, many observers predicted the obsolescence of federalism; in postwar years, however, a new intergovernmental equilibrium has emerged in which State and local vitality is manifest.

These developments are reviewed in the following section, which focuses in particular on the relative contributions during this century of Federal and State-local governments to overall expenditures for civil purposes, and relates these to periods of significant change in the evolution of American federalism.

THE FIRST CENTURY OF FEDERALISM

In the years of the Confederation, 1781–88, the States were so strong that they threatened the survival of a National Government. Congress had no real power to administer, and especially to finance, its limited functions. Expenses of the National Government were allocated to the States; each State was supposed to raise its allotment through its own officers. The results were nearly disastrous, and yet attempts to strengthen the financial powers of Congress by amending the Articles of Confederation failed because of the requirement of State unanimity. The feeling grew that the Articles provided the wrong *kind* of government. A strong nation would emerge only with a government that could levy taxes for its own use through its own officers.

Federal powers were greatly increased in the new Constitution of 1788. Congress received the power "to levy and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States."[2] This meant that, in addition to exclusive control over customs, it was to have concurrent jurisdiction with the States in practically all fields of taxation. In the first decade of its existence, the National Government exercised—and even extended—its financial powers. The debts both of the Confederation and of the States were successfully refunded, customs duties were assessed by national officers, a system of Federal excises was established, and a Bank of the United States was created.

Despite these vigorous steps, the divisive forces latent in the new federalism revived. During the next sixty years the State governments gained such strength that, once again, they threatened the existence of the National Government. Geographic expansion brought into the Union new States with diverse sectional interests, and, in addition, the old cleavage between North and South was deepened by the spread of cotton and slavery. Most statesmen, obsessed with the perplexities of federalism, came to believe that national functions should be held to a minimum in order to preserve the Union.

The deference paid to the States did not succeed. Instead, the sectional rift deepened until the Nation drifted into the Civil War, which settled the issue of national supremacy by force. The Union was *not* a compact among the States; the National Government was entitled to enforce its constitutional decisions in the face of State objections.

[2] Subject to the qualification that "all duties, imposts and excises shall be uniform throughout the United States."

The effect of the Civil War and of events subsequent to it—such as carpetbag government in the South—was to diminish the prestige of the States. When in the last two decades of the nineteenth century, many Southern States remade their constitutions, extensive and crippling restrictions upon legislatures and executives were imposed. Scholars, observing these trends, had forebodings about the future of the States. They foresaw a continuing gravitation of power toward the National Government.[3]

What was Federal performance at this time? James Bryce, although aware of many defects, was favorably impressed, and certainly this judgment is correct if comparison is made with performance before the Civil War. But the scope and range of Federal activity were very modest, as the next section will indicate.

REVIVAL OF THE STATES

Around the turn of the new century, the State governments began to stir. A look at overall governmental expenditures in 1902 will provide a base from which change may be judged. Table 1–1 shows that Federal expenditure on civil functions was about one-fifth of the total, and local governments spent appreciably more than both Federal and State governments together. The relative importance of local governments is, perhaps, the striking feature of governmental expenditure at this time.

Only Federal expenditures for civil functions are considered in Table 1–1, since, in these pages, a major issue will be the intergovernmental balance of power. A decision to spend more or less for defense is, beyond dispute, a Federal function; no question is raised of encroachment on, or withdrawal from, the State-local sphere. Attention should therefore be focused on spending for civil purposes. In 1902 this totaled $1,243 million; Federal spending amounted to $230 million, and State and local spending to $1,013 million.

Table 1–1 hides a decision concerning the classification of *intergovernmental payments*, that is, payments by the Federal Government in the form of grants and shared taxes to State and local governments, and similar payments by the States to local governments. Against which level of government should these sums be charged? A choice must be made in order to avoid double-counting. The alternatives are: (A) to charge them to the level of government that makes the *final disbursement*, so that a Federal grant for highways is counted as an

[3] Several examples will suffice. John W. Burgess, Professor of Political Science at Columbia University, observed in 1886 that legislative and judicial powers were "gravitating toward the National Government," and that police powers were "passing over to the municipalities." This was not, in his opinion, a "pendulum-swing"; rather did he forecast that "in the twentieth century, the commonwealth will occupy a much lower place in our political system, the Nation a much higher, and the municipalities a much more distinct and independent sphere" ("The American Commonwealth, Changes in Its Relation to the Nation," *Political Science Quarterly*, 1886, pp. 32–34.) In 1890 Simon N. Patten, Professor of Economics at the University of Pennsylvania, found an economic explanation for the decline of the States. This was the absoluteness of the boundary lines—"the unchangeableness of the territorial extent of our States." The remedy would be to create "natural boundaries for each State" and thereby restore vitality. ("The Decay of State and Local Governments," *Annals of the American Academy*, July 1890, pp. 39–40.) In the opinion of other contemporary observers, the inert performance of the State governments was not compensated for by vigor at the local level. James Bryce, in 1888, critical as he was of the States, declared that "the government of cities is the one conspicuous failure of the United States." (*The American Commonwealth*, Vol. II [1899], p. 281.)

expenditure made by the State governments, or (B) to charge them to the *originating level* of government, so that a Federal grant is counted as an expenditure made by the Federal Government. If alternative (A) is used, the total expenditure of the final disbursing level of government (the level that *receives* the grant) is larger, while that of the originating level of government (the level that *pays* the grants) is smaller, than when alternative (B) is used. Table 1-2 shows the two sets of figures for 1902. Since Federal intergovernmental payments were not important then, the percentage distribution of Federal spending for civil purposes under alternatives (A) and (B) is almost identical. But the spread was to become greater as Federal grants expanded.

TABLE 1-1.—*General expenditure* [1] *for civil functions* [2] *by Federal, State, and local governments, 1902* [3]

[Money amounts in millions of dollars]

Level of government	Amount	Percentage of civil expenditure
Federal	$230	18.5
State	134	10.5
Local	879	71.0
All levels	1,243	100.0

[1] General expenditure excludes amounts expended on utilities, liquor stores, and insurance trusts. These are approximately offset by receipts.
[2] The Federal expenditure for civil functions has been calculated by deducting from total Federal expenditures ($565,000,000) the amounts spent on national defense, international relations, veterans (not elsewhere classified), and interest on the Federal debt ($335,000,000). All State and local expenditures are regarded as civil.
[3] In all tables and charts years are fiscal unless otherwise noted.

Source: U.S. Census Bureau, "Historical Statistics of the United States: Colonial Times to 1957" (1960), pp. 722-730. (Cited hereinafter as "Historical Statistics." Reference is to these pages unless otherwise noted.)

TABLE 1-2.—*General expenditure for civil functions by final disbursing level and originating level of Government, 1902*

[Money amounts in millions of dollars]

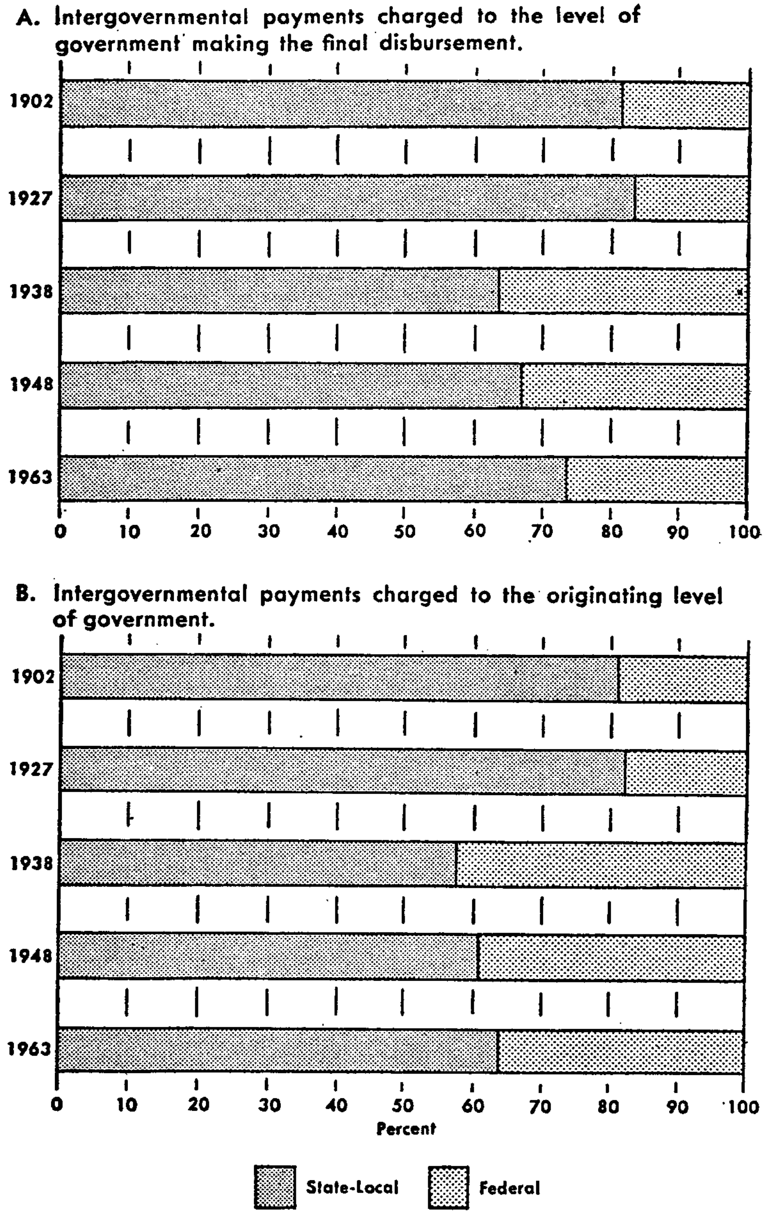
Level of government	Amount disbursed		Percentage of total	
	Final level (A)	Originating level (B)	Final level (A)	Originating level (B)
Federal	$230	$237	18.5	19.1
State-local	1,013	1,006	81.5	80.9
All levels	1,243	1,243	100.0	100.0

Source: Historical Statistics.

THE INTERGOVERNMENTAL DISTRIBUTION OF EXPENDITURE AND REVENUE, 1902 AND 1927

In the next quarter century the *absolute amount* of spending for civil purposes rose rapidly, but the *relative shares* of the levels of government—Federal versus State-local—changed little. (See Chart 1-1.) The

CHART 1-1. Percentage of General Expenditure for Civil Functions by Federal and State-Local Governments, Selected Years, 1902–63



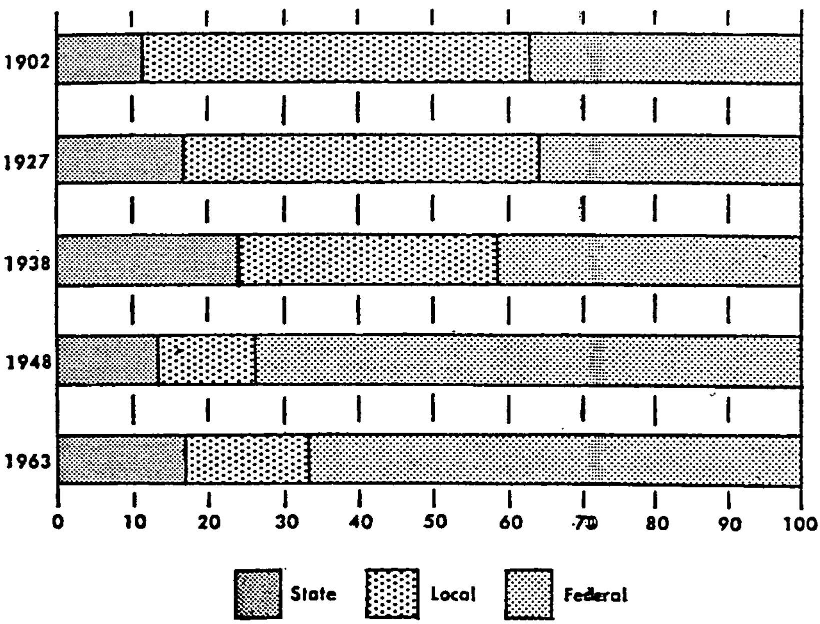
Sources: *Historical Statistics* and U. S. Census Bureau, *Governmental Finances in 1963* (1964), p 25. For actual expenditures, see Appendix Table A-1.

Federal share declined slightly because, in the 1920's, concern over the large war-related expenditures stimulated the feeling that citizen demands for new and better public services should be directed to State and local governments.

In the years from 1902 to 1927, there was little change in the proportion of total taxes *collected* by each of the three levels of government. The State share did increase somewhat. (See Chart 1–2.) Major alterations did take place, however, in the *structure* and *composition* of taxes. (See Chart 1–3.) In 1902, *income* taxation was so small that it was not recorded separately; by 1927 it accounted for 64 percent of Federal and 10 percent of State tax revenues. In 1902 taxes on *consumption* were dominant at the Federal level (95 percent of the total) and important at the State level (18 percent); in 1927 their importance at the Federal level was declining, and at the State level was increasing. Only at the local level was there little change in tax composition. Both in 1902 and in 1927 the property tax provided almost all of local tax revenues.

One main feature emerges from this summary of government finances before the great depression of the 1930's: with respect to expenditure for civil functions, the Federal Government, vis-à-vis State and local governments, played a small role, and one that seemed unlikely soon to increase. With respect to taxation, however, the Federal

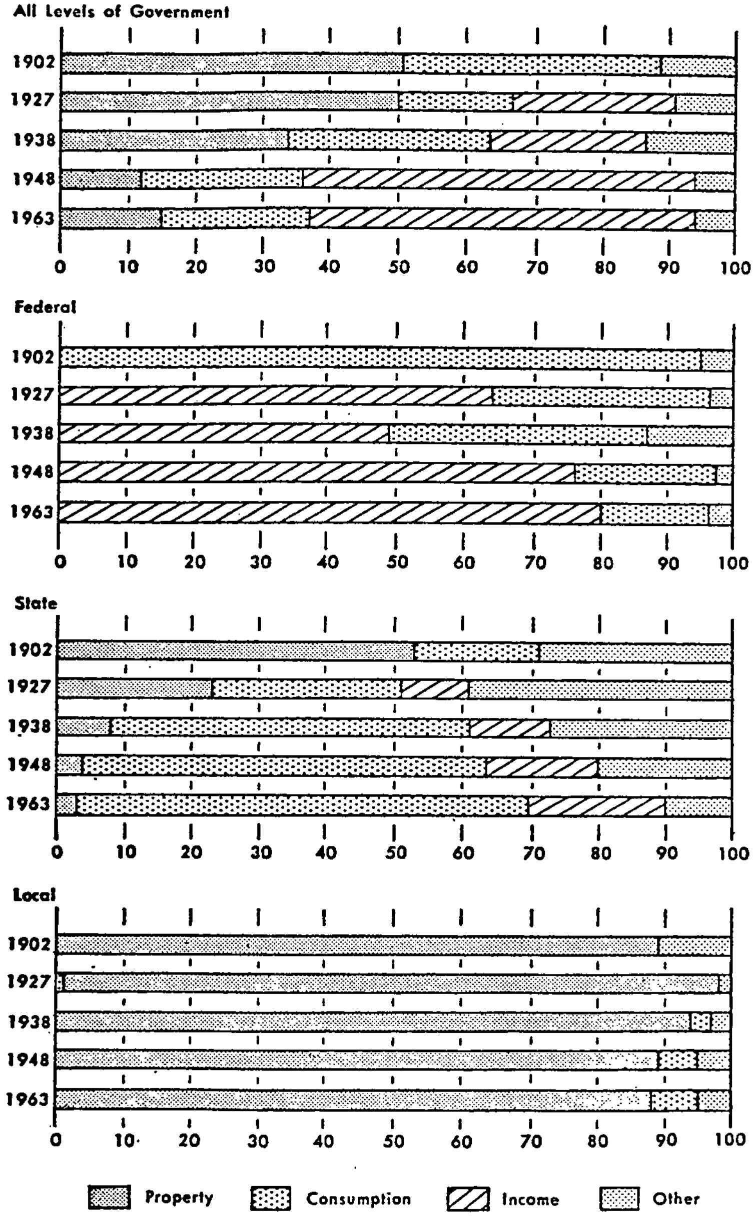
CHART 1-2. Percentage of Total Taxes Collected by Federal, State, and Local Governments, Selected Years, 1902–63



Source: Same as Chart 1-1. For specific figures, see Appendix Table A-2.

CHART 1-3. Relative Use of Types of Taxes by Federal, State, and Local Governments, Selected Years, 1902–63

(In percentage of total tax collections)



Source: Same as Chart 1-1. For specific figures, see Appendix Table A-2.

Government had been pushed by World War I to move strongly into taxes on income, both individual and corporate. In the 1920's the rates of these taxes were sharply reduced, but there was no repeal; the framework was retained. Nonetheless, State governments had reason to be content with their prospects. They were assuming new functions and extending their control over old ones. New and productive revenues in the form of taxation of motor fuel had been discovered and developed; since Federal rates were low, joint occupancy of income and death taxation with the Federal Government seemed practicable. For the most part, administrative decisions were left in local hands, subject to general State supervision.

THE DEPRESSION OF THE 1930'S

The decade of the 1930's brought more drastic change to the intergovernmental financial structure in the United States than had the preceding 140 years. The force behind the change was a depression without precedent in its intensity and duration. A powerful shift in social philosophy developed when it became clear that State and local governments could not cope with obvious relief and welfare needs. Local governments simply ran out of money as property tax collections declined and tax delinquencies rose, and as they found themselves unable to borrow. State governments came to the rescue, but their efforts were both laggard and inadequate. After 1933, Federal intervention took place on a large scale, at first mostly by emergency programs of public works, work relief, and direct relief. Then in 1935 the Social Security Act provided a Federal program of old-age insurance, a Federal-State system of unemployment insurance, and an extensive plan of grants for public assistance which pushed State and local governments into these programs and reimbursed them for about half of their cost. Other governmental programs proliferated. Sometimes the new expenditures was wholly Federal; quite often joint Federal-State financing was provided.

Thus, the 1930's brought a major intergovernmental redistribution of the expenditure for civil purposes. The most remarkable change was the increase in the Federal contribution. It was much larger in 1938 than in 1927, and the State-local share was correspondingly smaller. Much of this Federal increase was in the form of grants, that is, money was placed in the hands of State and local governments to administer and spend. As Chart 1–1, Section A, shows, however, direct Federal spending also grew.

Tax collections during the 1930's are less significant as a source of government revenue than hitherto. Federal borrowing, never before an important peacetime method of finance, took place on a large scale. Nonetheless, between 1927 and 1938 the Federal and State tax shares grew, and the local share declined. (See Chart 1–2.) Consumption taxes took on greater importance, notably at the State level, where such taxes in 1938 provided 53 percent of total tax receipts. (See Chart 1–3.) Property tax as a source of State revenue continued to lose ground, but it nearly held its place as a local source.

In the 1930's judicial doctrine also showed a centralizing bias. For half a century after 1880 the Supreme Court had marked out a fairly clear boundary between Federal and State activities; it stood as referee to solve jurisdictional disputes. Whether in response to shifts in social philosophy or as a reaction to contradictory precedents, a new judicial interpretation emerged in the 1930's which "accepted a reading of the general welfare clause that placed no discernible judicial limits on the amounts or purposes of Federal spending. . . ." [4] The Supreme Court became unwilling also to place restraints on Government regulation of economic affairs.

In the 1930's a critical chorus arose, repeating much more vehemently than in the 1880's that the States were obsolete and should be scrapped. Simeon Leland, a well known professor of public finance, believed that the States should become "administrative areas" of the National Government. It was, he avowed, anomalous to have forty-eight States fumble ineffectively with similar problems. An eminent political scientist, Luther Gulick, was equally specific. The States were no longer vital organizational units; "dual federalism" was an artificial concept since State governments could not deal "even inefficiently with the imperative, the life and death tasks of the new national economy." What had they done, what could they do, about regulation of utilities, about protecting bank deposits, about social insurance? These programs were "mostly national in scope. It is extremely wasteful, and in most cases impossible, to solve them State by State." [5] No one spelled out the timing of the dissolution of the States; fulfillment could presumably wait on the millennium.

Three decades later, the entire analysis and indictment seem unrealistic. The economic disaster which struck the United States in the 1930's required a reallocation and also an enlargement of governmental functions. Realization of this necessity did not come easily. A period of fumbling, of debate over governmental responsibilities, and of improvisation was inevitable. Only gradually could a new alignment of functions, and especially of governmental finance, evolve.

POSTWAR RESURGENCE OF STATE AND LOCAL SPENDING

Before this happened, World War II intervened. Even more than in World War I, State and local finances were put on a standby basis. As Federal spending in the years from 1940 to 1944 expanded tenfold (from $10.0 to $100.5 billion), State and local spending declined (from $11.2 to $10.5 billion).

But when the war ended the Federal Government rapidly dismantled its Military Establishment and prepared to reestablish its prewar pattern of activities.[6] State and local governments prepared to catch up on deficiencies in public construction resulting from depression and war. On the surface their finances seemed strong: revenues were abundant, and never had interest rates on State and local securities been so low. Two events soon impaired the optimistic outlook: (1) a sharp

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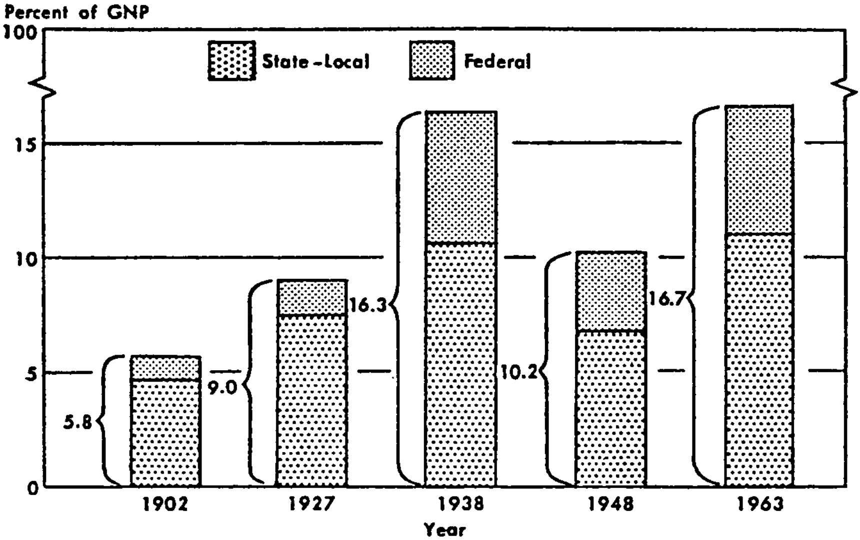
[4] Commission on Intergovernmental Relations, *A Report to the President* (1955), p. 29. This report is hereinafter referred to by its more usual designation, the *Kestnbaum Report*, so named after its chairman, Meyer Kestnbaum.

[5] These references and others of a similar tenor are given in W. Brooke Graves, *American State Government* (Heath, 1936), pp. 746–753.

[6] Through the Employment Act of 1946, the Federal Government assumed the new function of promoting economic stabilization. This did not, however, require provision of new Federal programs.

rise in prices and (2) the emergence of the cold war. The second was the more important and enduring because it brought to a halt, and then reversed, the drop in Federal tax rates. State and local governments instead of occupying sources of revenue vacated by the Federal Government, had to compete with the Federal Government for the taxpayer's dollar. Nonetheless, expenditures by all levels of government on civil functions have grown in relative, as well as in absolute, terms. (See Chart 1–4.) This trend was temporarily halted in postwar years, but by 1963 total expenditures had surpassed the 1938 peak.

CHART 1-4. General Expenditure for Civil Functions by All Levels of Government[a] as Percentage of Gross National Product, Selected Years, 1902–63



Source: Appendix Table A-3.
[a] Intergovernmental payments are charged to the level of government making final disbursement.

Postwar State-local expenditures, considered separately, also show a sizable relative and absolute increase. They represented 6.8 percent of the gross national product in 1948, and 11.1 percent in 1963. Higher standards of public demand for education, welfare, public health, highways, housing, and so forth, required State and local action. Even when intergovernmental payments are attributed to the originating level, the distribution of spending for civil purposes in 1948 and 1963 shows that State and local governments held their position. (See Chart 1–1.)

In the postwar years, 1948 and 1963, the Federal share of tax collections decreased somewhat, while the State and local shares grew. (See Chart 1–2.) With respect to types of taxes used, the surprising change was the recovery of the property tax. During the 1930's, as previously noted, it lost ground precipitously. After the war it was revived and showed surprising elasticity in yield. (See Chart 1–3.)

PROJECTIONS OF STATE AND LOCAL FINANCE

Projections of future State-local expenditures and revenues have been made by several scholars. Inevitably the assumptions differ in detail and, for this reason, the sets of figures are not strictly comparable.[7] One major assumption, which is both important and precarious, concerns the level of Federal spending, especially for defense. Since defense as a function of government must take precedence over all other duties, a pessimistic assumption would limit the expansion of all Government spending for civil purposes. But an optimistic assumption—that Federal defense spending will shrink, or even that it will not grow quite as fast as gross national product—allows opportunity for expansion of government spending, particularly by State-local governments, for civil purposes.

Projections which premise that the growth in defense spending will not outpace the increase in gross national product expect State and local spending in ten years to be double the 1963 level. Projected expansion of State and local tax revenues, based on present rates and bases, do not match the growth in spending because the yields of the major taxes—sales and property—are not very elastic. As a result, the rates and bases of State-local taxes will have to be increased. It seems likely that the financial well-being of State and local governments in the next decade will become increasingly difficult to maintain.

No such financial problem should arise for the Federal Government. Its tax system is quite elastic; an increase in the gross national product will automatically bring a more than proportionate growth of revenue, with no change in present rates or bases. If full employment were attained, for example, Federal revenue collections would be automatically increased by over $6 billion yearly, leaving a surplus unless Federal expenditures were increased or tax rates reduced.[8]

Functional Distribution of Expenditures

This brief historical review of governmental finances indicates that while the Nation has been buffeted by strong economic forces, federalism in the United States has been flexible. The division of *aggregate* governmental expenditure for civil purposes—Federal vs. State and local—changed in the 1930's with growth in the Federal share and decline in the State-local share. The shift is more emphatic when Federal grants are reckoned as Federal rather than State-local expenditure.

Division of Functions Between Federal and State-Local Governments

This section will indicate the *functions* that have been affected by these relative and absolute changes in government expenditures. Before examining the functional figures, a question should be asked. What rationale can be offered concerning the division of functions between the Federal Government on the one hand, and State-local govern-

[7] These have been reviewed briefly in James A. Maxwell, *Tax Credits and Intergovernmental Fiscal Relations* (Brookings Institution. 1962), pp. 8–10.

[8] *Annual Report of the Council of Economic Advisers* (January 1964), p. 42.

ments on the other? The framers of the Constitution had a rationale; they drew lines that set limits to the powers of the National Government. The lines were not clearcut in 1788, and they are much more blurred today. The scope of Government has grown, and the economy of the Nation is much more integrated. As a result, the concept of the separation of governmental functions, Federal versus State-local, has been replaced by another concept of Federal-State relations, "cooperative federalism." In 1955, the situation was summed up this way:

> Under current judicial doctrine, there are still limits on the coercive powers at both levels [National or State], but the National Powers are broad and the possibilities by means of spending are still broader. The crucial questions now are questions of policy: Which level ought to move? Or should both? Or neither? What are the prudent and proper divisions of labor and responsibility between them? These are questions mainly for legislative judgment, and the criteria are chiefly political, economic, and administrative, rather than legal. The emphasis is on mutual and complementary undertakings in furtherance of common aims.[9]

The case for decentralized decision and administration remains strong, but Federal participation in finance, coupled with modest Federal coordination of State performance, is currently thought to be consistent with performance at the State-local level.

A modern rationale for "cooperative federalism" can be developed through analysis of the *benefits* derived by people from governmental services. Some of these services are *collective* in nature. The clearest instance is national defense where Government considers the need of citizens in the aggregate, not individually. As a logical consequence, Government raises the revenue for this expenditure by general taxes which are assessed on individuals according to standards of equity. The collective nature of the benefits dictates that this substantial expenditure—absorbing, in 1963, 68 percent of Federal expenditure and 44 percent of total governmental spending—must be allocated among taxpayers according to whatever standards the legislature deems appropriate. At the other end of the spectrum, government renders services which are *semi-commercial* in nature: certain individuals are the direct beneficiaries, the government charges them prices or fees for units of the service, and individuals may choose to consume as many or as few units as they wish. A modest collective interest is present (else provision would be left in private hands), but it is veiled.[10] Examples are the Post Office, toll highways, and water supply.

Between these extremes all other governmental services may be ranged according to the relative importance of their collective, compared with their individual, interest. Thus, educational services are rendered to individuals who thereby receive direct benefits; but these services are also beneficial to the whole society. This spillover of benefits creates a strong collective interest of such importance that the cost of primary and secondary education is defrayed by general taxes, not by charges to the recipients. Many important features of public health

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[9] *Kestnbaum Report,* p. 33.

[10] In 1958 Congress passed a law (PL 85–426) which offers an interesting example of an actual attempt to separate these "semi-commercial" and "collective" benefits. The Post Office was required to split its services into two parts: (a) those that rendered divisible benefits to recipients and should, on this account, be covered by user charges, and (b) those that rendered indivisible benefits—public services—and should be paid out of General Treasury funds. Definition of "public services" has been controversial, and computation of their cost very difficult.

services also have a spillover of benefit to the whole society. Welfare services form another distinguishable group of the large in-between category. Here also the benefits accrue directly to recipients, but society is collectively benefited because provision of these services satisfies deeply felt humanitarian feelings. Moreover, linkage of individual benefit with individual payment would be absurd since the recipients are, by definition, without means. In short, finance by general taxation is inevitable and appropriate; Government provides the services as a collective duty.

How can these generalizations be applied in deciding between Federal or State-local provision of a particular government service? One which is rendered to the Nation as a whole (collectively)—defense, for example—is clearly Federal; so also is one which, although noncollective, should be provided uniformly to individuals in all States—postal services, for example. The outlook of each State and local government is, on the other hand, circumscribed; the services each provides are for individuals in a limited geographic area. Some variation of type and level of provision is acceptable, and even desirable. Sometimes, however, the benefits from a State or local service will spill over and have an impact outside its boundaries. Primary and secondary education is one obvious example. Although the spillover undoubtedly reaches beyond the boundaries of a locality or a State, this national interest has not until recently been recognized by Congress through Federal grants-in-aid. Provision is left mainly to local governments because direct benefits accrue to individuals in a locality and because local (and State) governments are strongly responsive and sensitive to the demands of citizens concerning details. The cost is provided through taxes levied at the local and to a smaller extent at the State level.

Public welfare services are another bundle of functions performed mainly at the State-local level of government. The benefits accrue directly to individuals; responsiveness of government to the variety of individual needs is vital; detailed administration is inevitable. The services are rendered mainly to needy persons, and, during the depression of the 1930's, the opinion emerged strongly that some minimum level of provision should be achieved over the Nation. Since this would not result if the States were left to their own devices, Federal assistance by conditional grants was enacted. Thereby, State and local governments were stimulated to offer welfare services, not indeed at a uniform level, but so that a minimum level for recipients was feasible even in poor States.

EXPENDITURES FOR CIVIL FUNCTIONS, 1902–63

What are the most important civil functions provided by Government over the past sixty years, measured by the relative expenditures these have absorbed? Table 1–3 shows that four functions have consistently accounted for about half the total. Education has always been far in the lead with highways a poor second. Expenditure for public welfare rose sharply in the 1930's, and remains substantial, although percentage expenditure has shrunk moderately.

TABLE 1–3.—*Percentage distribution of general expenditure for civil functions by all levels of Government, selected years, 1902–63*

Function	1902	1927	1938	1948	1963
Education	20.7	26.0	19.2	29.2	28.1
Highways	14.1	21.1	15.6	11.6	12.8
Public welfare	3.3	1.9	8.9	8.1	6.4
Health and hospitals	5.1	5.0	4.9	7.3	7.6
Other	56.8	46.0	51.4	43.8	45.1
All functions	100.0	100.0	100.0	100.0	100.0

Source: Appendix table A–4.

What shifts have occurred in the past sixty years in the level of government providing the most important civil functions? When Federal grants (intergovernmental transfers) are regarded as spent by State and local governments (which make the final disbursements), the shift appears to be very slight. (See Chart 1–5, Section A.) Except for health and hospitals, the State and local relative share is about the same in 1963 as it was in 1902.[11]

This approach conceals the growth of Federal grants in recent decades. By grants, the Federal level has absorbed part of the financial cost of certain functions (and it has also stimulated their performance). To emphasize the importance of grants, in Section B of Chart 1–5 intergovernmental transfers are regarded as spent by the *originating* level of government. The large contribution made by the Federal Government in grants for highways and welfare becomes apparent; the Federal contribution to health is also substantial. Nonetheless, the shift in sixty years is not great. And the extent of Federal direction which accompanied expansion of its grants was modest.

An overlapping of governmental activities now exists. Performance of certain functions remains at the State and local level, but the Federal Government participates in finances and, by specifying conditions for receipt of grants, gives a modicum of national direction. A mélange of Federal grants has emerged, modifying federalism without changing its essential characteristics.

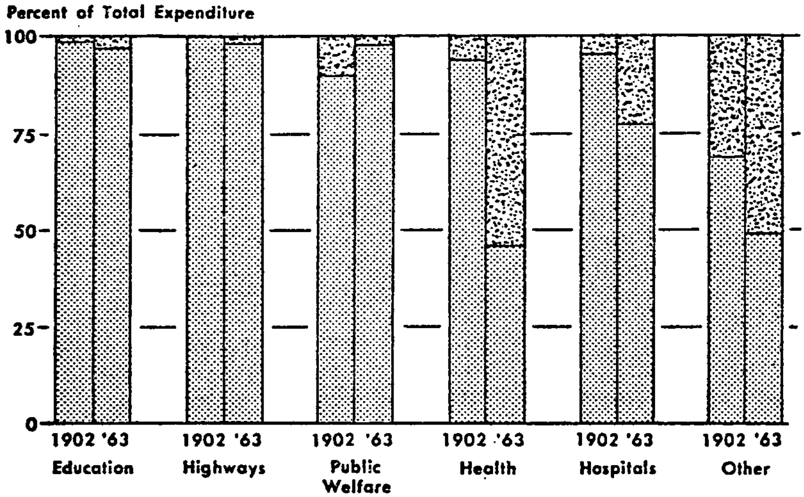
APOLOGIA FOR FEDERALISM

The situation is, then, that the expansion of Federal power, so forceful a trend in the 1930's has not continued; federalism has demonstrated a renewed vitality. The States are, so it seems, geographic units that can handle many functions more flexibly, and therefore more in accord with heterogeneous citizen demands, than the National Government. State boundaries must be accepted as immutable, and while the States are diverse in population, resources, and area, this diversity is no greater than that of many sovereign nations—and not

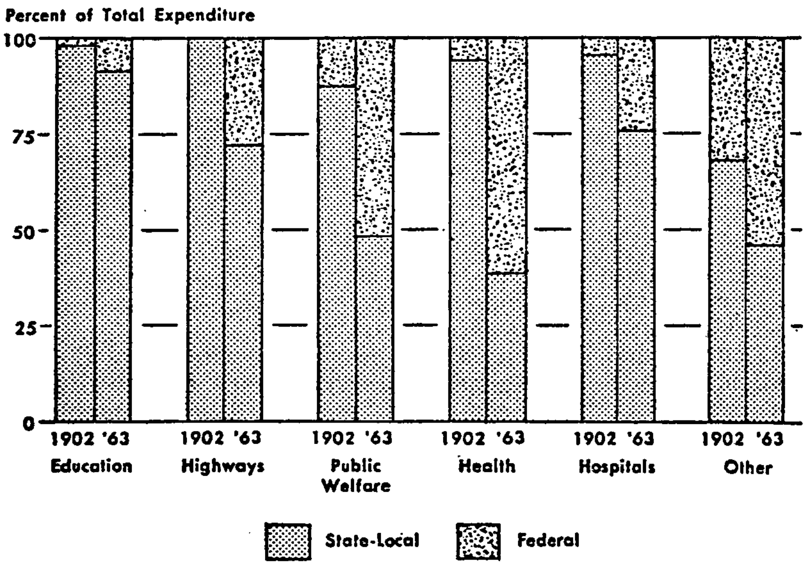
[11] On inspection, it turns out that 57 percent of Federal spending in 1963 for health and hospitals is for veterans. A few surprising shifts over the sixty years prove to have simple and episodic explanations. For instance, the drop in the State-local share of highway expenditure in 1938 is explained by WPA spending; the drop in the State-local share of expenditure for education in 1948 is explained by the surge of Federal G.I. benefits.

CHART 1-5. Percentage of General Expenditure for Selected Civil Functions Contributed by Federal and State-Local Governments, 1902 and 1963

A. Intergovernmental payments charged to the level of government making the final disbursement.



B. Intergovernmental payments charged to the originating level of government.



Source: Appendix Tables A-4, A-5, and A-6. These tables also include data on other years.

merely those newborn in the past decade.[12] Through their very existence the States, over the decades, have acquired loyalties and sentimental affection which lubricate the machinery of government.

More philosophical reasons may be advanced for a belief that, if the States did not exist, there would be need to invent them. One reason has been put cogently by Justice Holmes and Brandeis—that the States are laboratories in which limited, and therefore safe, experiments in government or administrative techniques can be made.[13] Such experiments, even when they fail, may have more than mere negative value. They may indicate why and what kind of Federal action is needed. An illustration of this laboratory value was the experiment of Oklahoma in guaranteeing bank deposits.[14] The scheme failed, but it and similar attempts by other States disclosed defects which could be, and were, remedied by a national scheme in 1933. In the early years of the twentieth century, State and local governments experimented with techniques of government budgeting and accounting. To these experiments the Federal Budget and Accounting Act of 1921 owed a great deal. The Wisconsin income tax of 1911 preceded the Federal income tax of 1913. The Federal Social Security Act of 1935 grew out of much State investigation and some experimentation with old-age insurance, unemployment insurance, and public assistance. Marked progress here had to wait on Federal intervention; yet with respect to unemployment insurance and public assistance, Congress chose to act through the techniques of cooperative federalism.

In a famous statement made more than three-quarters of a century ago, Woodrow Wilson wrote of the value of the States as training grounds in the practice of government. "The governorship of a State is very like a smaller Presidency; or, rather, the Presidency is very like a big governorship. Training in the duties of the one fits for the duties of the other." [15] The case for federalism, in the minds of many men, rests on a still more exalted and abstract merit; that State and local governments are bulwarks of democracy. Only where the people of a nation have adequate powers of decision can they develop a public spirit, and the specific knowledge and techniques that give life to free institutions.[16]

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[12] In this revealing list, some American States are paired with well-established nations of approximately equal populations in 1962:

State	*Population*	*Nation*	*Population*
New York	17, 498, 000	Canada	18, 600, 000
California	17, 029, 000	Colombia	14, 769, 000
Pennsylvania	11, 382, 000	Netherlands	11, 797, 000
Illinois	10, 098, 000	Australia	[a] 10, 508, 000
Ohio	10, 038, 000	Hungary	10, 060, 000
Texas	10, 122, 000	Belgium	9, 222, 000
Michigan	8, 029, 000	Chile	8, 001, 000
New Jersey	6, 357, 000	Sweden	7, 562, 000
Indiana	4, 663, 000	Finland	4, 509, 000
Tennessee	3, 652, 000	Norway	3, 640, 000
Iowa	2, 774, 000	Ireland	2, 824, 000

[a] 1961.

Source: *United Nations Demographic Yearbook,* 1962; U.S. Census Bureau, *Current Population Reports,* Series P–25, No. 272, September 1963.

[13] *Black* v. *Hirsh,* 256 U.S. 155 (1921). Justice Brandeis wrote: "It is one of the happy incidents of the Federal system that a single courageous State may, if its citizens choose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country."

[14] In the case of *Noble Bank* v. *Haskill* (219 U.S. 104), Justice Holmes wrote of "the insulated laboratories of the States."

[15] *Congressional Government* (Houghton Mifflin, 1885), p. 253.

[16] George C. S. Benson, in "Values of Decentralized Government," *Essays in Federalism* (Claremont Men's College, 1961), pp. 5–16, makes an eloquent case for federalism.

Despite a solid performance in postwar years, however, State governments have many structural flaws which need remedy. Nine years ago the Commission on Intergovernmental Relations was set up to reappraise federalism, to "study the means of achieving a sounder relationship between Federal, State and local governments." Its distinguished membership of twenty-five persons included fifteen appointed by the President, five by the President of the Senate, and five by the speaker of the House of Representatives. Its report—the *Kestnbaum Report*—contained important criticisms of State government. The six members who were, or who had been, State Governors did not dissent. Many State constitutions, the report declared, "restrict the scope, effectiveness, and adaptability of State and local action"; there was a "real and pressing need for the States to improve their constitutions." [17] State legislatures should provide a more equitable system of representation.[18] The power of Governors was unreasonably limited by the establishment of independent agencies and boards, by the election of numerous State administrative officers, and by the lack of control over budgeting. State legislature fettered their own power, and that of the localities, to tax and borrow; they earmarked too much revenue; they created, and should mitigate, tax conflicts.

These organizational defects impaired performance of government functions. They diverted to Washington demands from citizens which should be met at the State level; they cast doubt on the logic of federalism—that the State possess political and economic capacity appropriate to their political powers.

Another recent development, raising new doubts about the logic of federalism, has been the growth of metropolitan areas. Urban concentration of population and resources is an old phenomenon. But in postwar years disturbing trends have emerged which, if not new, strike the social conscience of the Nation more forcibly and aggravate the disparities between the service and tax areas inside the metropolis.

In the metropolis a core area, embracing the central shopping and business districts, shows signs of obsolescence. A suburban area sprawls outside, attracting business and residential units from the center. In or close to the core area fresh slums emerge which accelerate the decay and underline problems of health, welfare, and education. How should the governmental duties of the metropolis be handled? Measured in terms of per capita income, or property, or wealth, the metropolis appears to have a large fiscal potential. The difficulty lies in determining how the potential can be exercised: the metropolis is not a single governmental unit governed by one legislative body; instead, it embraces a large number of independent jurisdictions. The supply of services—such as water, sewage, disposal, and law enforcement—should be organized and administered with an eye to the needs of the whole area; in fact, decisions are often obstructed or postponed while fragmented jurisdictions debate their respective fiscal responsibilities. The resources of the area cannot be

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[17] *Kestnbaum Report*, pp. 37–38.

[18] On June 15, 1964, in six decisions, the majority of the Supreme Court held that the "equal protection" clause of the Fourteenth Amendment requires each State to have a legislature so that, in both houses, each member represents substantially the same number of people. The principles were set forth in an Alabama case (*Reynolds* v. *Sims*), and then applied in cases from Colorado, Delaware, Maryland, New York, and Virginia.

mobilized for an efficient assault on its problems. Sometimes the metropolitan area is multistate, necessitating negotiation and agreement by sovereign units.

Is Federal intervention indicated? If so, should it be through direct Federal programs, or through conditional grants? If the latter, should the grants be funneled through State governments, or should they go directly to local units? Has American federalism the flexibility to meet and to adjust to these new stresses?

No doubt can exist that rational solution of many urban problems often requires reform of State and local political and administrative structures. If reform is postponed, or fails, centralization will be encouraged because, in present circumstances, the separate interests of the States will not be allowed to transcend a strong national interest. The Federal Government will not be content to act merely "as the bracket to a series of algebraic symbols." [19] The centripetal forces of modern society demand a flexible federalism. Efficient governmental administration will not, in the long pull, be sacrificed for the sake of tradition.

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INTERGOVERNMENTAL TRANSFERS

"As a result of many developments, the grant has become a fully matured device of cooperative government." Commission on Intergovernmental Relations, *A Report to the President* (1955).

A very important development during the past forty years has been the proliferation of *intergovernmental transfers*, especially in the form of grants and shared taxes. These transfers of funds originate either with (a) the Federal Government, flowing to the States and, in a smaller volume, to local governments; or with (b) State governments, flowing to local governments.[1] In 1963 Federal payment totaled $8,507 million and State payments totaled $11,885 million. The likelihood is that the scope of both flows will be enlarged both absolutely and relatively.

FEDERAL INTERGOVERNMENTAL TRANSFERS

The dominant type of Federal intergovernmental transfer is the grant-in-aid which, in 1963, accounted for 96 percent of total Federal intergovernmental transfers. Small amounts are in the form of shared revenues (most of which go to the States with large Federal acreage), and net loans and repayable advances.[2] In the following pages attention will be focused entirely on grants.

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[19] Harold J. Laski, *Studies in the Problem of Sovereignty* (Yale University Press, 1917), p. 280.

[1] A modest flow from local to State governments—$247 million in 1963—will not be examined here.

[2] In 1963 shared revenues totaled $168.5 million; net loans and repayable advances $184.0 million. For a summary description of the shared revenues, see *Impact of Federal Urban Development Programs on Local Government Organization and Planning*, prepared in cooperation with the Subcommittee on Intergovernmental Relations of the Senate Committee on Government Operations by the Advisory Commission on Intergovernmental Relations (ACIR), 88th Cong., second sess. (1964 Committee Print), App. B, sec. QQ.

FEDERAL TO STATE GOVERNMENTS

The history of Federal aid for certain functions, notably road construction and education, is quite old. In 1802, when Ohio was admitted as a State, Congress declared that 5 percent of the proceeds from the sale of public lands in the State should be applied to the construction of roads, and this precedent was followed for other Western States. In 1816 Congress provided that States be given 5 percent of the net proceeds of land sales within their boundaries with the stipulation that 3 percent be used "for the encouragement of learning, of which one-sixth part shall be exclusively bestowed on a college or university." Thereafter, Congress ceded millions of acres as an endowment for public schools, and, by the Morrill Acts, gave both land and money to establish colleges in every State. These early grants were outright donations with no matching requirement and no Federal supervision. Not until 1887, when the Hatch Act made grants to each State to establish agricultural experiment stations, did Congress impose the modest condition that a financial report be submitted annually, and not until 1911, by the Weeks Act, which offered grants for forest fire protection, did Congress impose advance Federal approval of State plans and Federal supervision of performance. Several other Federal grants—vocational education (1917), highways (1916), and so forth—were provided in the next two decades.

The great upsurge came after 1932, and the end is not yet in sight. The number of programs in operation is reckoned from sixty to eighty-odd, depending on how the count is made. For the fiscal year 1963 Federal expenditure on grants was $1,566 million, a sum equal to 34 percent of State tax revenue.[3] This amount will assuredly grow rapidly because thirty-seven new programs have been enacted since World War II, many of which are not yet fully in operation.[4]

As Table 3–1 shows, however, in 1963, 75 percent of Federal grant expenditure was for public assistance and highway construction. Federal grants for the latter program soared after enactment of the Highway Aid Act of 1956, which greatly expanded Federal grants for a thirteen-year period in order to cover 90 percent of the cost of the Interstate Highway System.

TABLE 3–1.—*Federal grants to State governments, 1963*

[Money amounts in millions of dollars]

Purpose	Amount	Percentage of total grants
Public assistance	$2,752	36
Highway construction	2,981	39
Administration of employment security	342	5
Other	1,491	20
All purposes	7,566	100

Source: U.S. Census Bureau, "Governmental Finances in 1963" (1964), p. 24.

[3] One general caution is indicated in using the figures in this section. The figures show direct Federal payments to State governments, but some incalculable part of these payments is passed on indirectly to local governments.

[4] A chronological listing may be found in *Congressional Review of Federal Grants-in-Aid*, Hearings before the Subcommittee of the House Committee on Government Operations, 87th Cong., first sess. (1961), pp. 26–30. A current history and description is to be found in ACIR, *The Role of Equalization in Federal Grants* (1964), pt. III.

Congressional legislation concerning the annual amount to be appropriated for a grant, the allocation to each State, and the matching requirements, has become more sophisticated over the decades. In the early days Congress appropriated a sum without reckoning what might be required to meet the Federal objective which, presumably, justified the grant; it made allocations to the different States according to some simple basis such as population; it specified—if any specification was made—that the States should match the grant according to a fixed ratio, 50 percent/50 percent. Over time, bit by bit, these features have changed. Estimates of the amount needed to accomplish a Federal objective are often made, as well as of the amounts needed for each State. And Congress has framed a variety of matching formulas. Suppose, for example, that the annual "program need" in each of two States—one "rich" and one "poor"—is $1,000,000. In the rich State the annual Federal allocation might be $250,000, and the matching ratio 75 percent/25 percent; the State would have to spend $750,000 to earn all of the $250,000. In the poor State the allocation might be $750,000, and the ratio 25 percent/75 percent; this State would have to spend $250,000 to earn all of the $750,000. In this illustration the aid ratio is variable and equalizing.

Most Federal grants are "closed," that is, Congress specifies the maximum annual amount to be provided for each State according to formulas which include such factors as population, area, per capita income, incidence of specific diseases, road mileage, and so on. But some Federal grants are "open-end," for example, the annual amounts of old age assistance grants per State are determined by the number of needy persons 65 years and over placed on the welfare rolls, and the individual benefit payments (within specified maxima) made by each State. The annual amounts which Congress must appropriate are therefore determined mainly by the States rather than by Congress.

FEDERAL TO LOCAL GOVERNMENTS

Federal intergovernmental transfers to local governments totaled $941 million in 1963. Direct Federal-local aid originated, in the main, during the depression of the 1930's; it was administered by *ad hoc* agencies—the Federal Emergency Relief Administration, Public Works Administration, Works Progress Administration, and so on. Early in World War II the agencies were liquidated and the grants ceased. But in postwar years, as Table 3–2 indicates, a different set of grants has developed, mostly through a process of drift.

TABLE 3–2.—*Federal grants to local governments, 1963*

Purpose:	*Millions*
1. Education (school operation and construction in federally affected areas)	$342
2. Housing and community redevelopment	371
3. Airport construction	51
4. Waste treatment facilities	51
5. Other grants	126
Total	941

Source: See Table 3–1.

Each of the grant categories in table 3–2 is described below:

1. Education. The Federal Government provides payments to localities where a marked increase has taken place in school en-

rollment because of Federal activities, and to localities where local taxable resources have been much reduced because of Federal ownership of real property.

2. Housing and Community Redevelopment. Federal capital grants finance up to two-thirds (three-quarters by an alternative computation) of the net project cost of slum clearance and urban redevelopment activities. Local housing authorities build and operate low-rent public housing, receiving an annual Federal contribution which makes up the difference between the cost of operating a project and the rents.

3. Airport Construction. Most of the Federal appropriation—75 percent—is apportioned among the States on the basis of population and land area; 25 percent is granted at the discretion of the Civil Aeronautics Administrator. The purpose of this aid, which may be given either to a State or a local agency, is to establish a nationwide system of public airports.

4. Waste Treatment Facilities. These grants may go to a State or local agency to provide up to 30 percent of the construction cost of sewage disposal facilities. The State pollution control agency must approve such grants.

5. Other grants. This category includes numerous small grants which are certain to increase. Often they are for city projects, indicating congressional awareness of and interest in the problems of urbanization, and often they go to special-purpose units of government.

It is plausible to argue that direct Federal-local grants are not compatible with the logic of federalism, and are, moreover, administratively awkward. To work through fifty States would appear to be better than to work through thousands of local governments. But difficult cases have operated to impair this general position. For instance, when the Federal Government, by extensive construction and operation of defense facilities in small geographic areas, swells the school enrollment while not adding to taxable local real property, Federal grants to construct and operate schools seem justifiable. Debate over whether or not the State government should be the intermediary seems academic.

On their face, the other types of grants to local governments listed above offer less plausible grounds for direct Federal-local action. But the fact is that most State governments have *not* been interested in urban renewal, low-rent public housing, and airport construction. Irresponsive to urban needs, the States did not resist Federal-local action. Accordingly, a direct Federal-local relationship developed, Federal aid being provided on a contractual basis to numerous local agencies without an intervening State authority; the interests of the State in the activity, as well as its responsibility to its local governments, were sidetracked. The Kestnbaum Commission endorsed direct Federal-local relationships "where States have failed to take positive action in the field of housing and urban renewal." But it pointed out that the Federal Government had "deliberately sought direct relationships with local governments in the field of housing" without attempting to bring in State governments. The Commission recommended that the Federal Government should "take into full partnership those States willing to assume increased responsibilities." [5]

The problems, as well as the solution favored by Congress, are illustrated by the debate in 1946 over the law authorizing Federal grants for airport construction. The enabling legislation specified that any "public agency" (usually a municipality) could request Federal aid for airport construction. At issue was whether the State governments should be required to establish State aviation agencies through which the request was to be channeled. Should the Federal aid itself be channeled through the agencies? A precedent was the Federal aid program for highway construction where such requirements had worked well for many decades. With respect to airports, however, the fact was that many States had no agency and appeared uninterested. In 1946 the airport bill passed by the House did not, and the Senate bill did, require channeling. A compromise position emerged: if States chose to require the channeling of requests and Federal aid through a State agency, they could; if States did *not* wish to require such channeling, direct Federal-local dealing permitted.

This remains present policy. Congress prefers to operate grants through a State program and will defer to State opinion, but it recognizes also that an overstrict and doctrinaire position would impair or destroy some desirable programs. Moreover, many city officials want direct Federal-local grants, and they are supported by some interested Federal administrators. For example, Patrick Healy, Executive Director of the American Municipal Association, declared that "entirely too much stress was placed in the [Kestnbaum] report on maintaining a chain of command through the States for all Federal aid or grant programs. We do feel that there is considerable merit to a direct Federal-local, that is city, relationship, and we are, by and large, satisfied with this relationship on the basis of going Federal-aid programs." [6] And recently when the Advisory Commission on Intergovernmental Relations (ACIR) recommended that Federal grants for urban development programs be channeled through the States, minority dissent was expressed by Robert C. Weaver, Administrator of the Housing and Home Finance Agency; by Don Hummel, formerly Chairman of the American Municipal Association; by three city mayors; and by Senator Muskie.[7]

PROBLEMS RAISED BY GRANTS

The proliferation of grants, piecemeal, has raised problems which until recently were not perceived by Congress. Once put into operation, grants live on, even though the original national purposes behind

[5] Commission on Intergovernmental Relations. *A Report to the President* (1955), pp. 228–229. Hereinafter referred to as the *Kestnbaum Report*.

[6] *Federal-State-Local Relations*, Hearings before a Subcommittee of the House Committee on Government Operations, 85th Cong., first sess. (1958), p. 109.

[7] *Impact of Federal Urban Development Programs on Local Government Organization and Planning*, p. 30. The recommendations of the majority of the ACIR was to hold only where a State "(*a*) provides appropriate administrative machinery to carry out relevant responsibilities, and (*b*) provides significant financial contributions. . . ."

them have altered or been achieved. Over the decades, an unforeseen and unjustifiable diversity in specific conditions to be met by the States—in mode of apportionment in the basis for matching, in administrative rules, and so forth—grew up. In the future, Congress should appraise its objectives more carefully before inaugurating new grants.

Moreover, Federal grants altered the financial decisions of State governments; the bait of Federal money led State legislatures to spend more in directions chosen by Federal authority. The theory was that, in terms of the national interest, performance of specific services needed stimulus which Federal grants would provide. It was imperfectly realized that matching requirements of Federal grants would absorb larger portions of State-local tax revenues in poor than in rich States. In 1962, the portions for Delaware, Connecticut, New Jersey, New York, and California were under 6 percent; those for Mississippi, South Carolina, Arkansas, Alabama, and Tennessee ranged from 10 percent to 18 percent. And Congress did not appreciate that State legislatures, in order to finance the services eligible for Federal aid, would sometimes divert State money from services not eligible for Federal aid.

A notable illustration is found in expenditure for public assistance. State and local expenditure for four categories of public assistance—old age, dependent children, the blind, and the permanently and totally disabled—are eligible for, and receive, substantial Federal grants; expenditure for *general assistance*, a catch-all group covering needy persons not in the four categories, is ineligible. Beyond question State and local expenditure on general assistance is skimped, especially in the poor States. Some idea of the contrast in provision of public assistance among the States in 1962 is given in the following list showing the ratio of payments for old-age assistance to those for general assistance in three poor States and three rich States.[8]

Poor States		*Rich States*	
Mississippi	199:1	Delaware	0.6:1
Oklahoma	75:1	New Jersey	1.3:1
Tennessee	56:1	New York	1.6:1

[8] Social Security Administration, *Annual Statistical Supplement*, 1962, p. 111.

The ratio of payments for old-age assistance to those for general assistance was very much higher in Mississippi, Tennessee and Oklahoma—the poor States—than in New Jersey, New York and Delaware. For every dollar spent on general assistance in Mississippi, $199 is spent on relief to the aged. Recently an official in the Alabama Department of Pensions and Security, testifying before a congressional committee, agreed that potential recipients of general assistance were not adequately taken care of. Asked why this happened, she replied: ". . . It is the feeling of the legislative groups that such funds as are made available should be utilized in a manner to bring the best results to the greatest number of people. Therefore, they think they should be used for Federal matching purposes primarily."[9]

Political scientists are concerned because Federal grants often

[9] *Federal-State-Local Relations: State and Local Officials*, Hearings before a Subcommittee of the House Committee on Government Operations, 85th Cong., first sess. (1959), p. 1323.

impair the political powers of State legislatures and Governors. Undoubtedly Federal grants bring some loss of State self-government. Functions nominally in State hands come to be federally conditioned and defined; State money must be committed for purposes, and in amounts, beyond State decision; close liaisons are established between State and Federal technicians to the detriment of control by State legislatures and Governors.

EQUALIZATION

Inevitably Federal grants redistribute income among the States, not indeed as an explicit Federal objective, but as a by-product.[10] This equalizing effect is an important—and controversial—issue.

Through the use of grants, Congress has sometimes sought to enable all States to establish certain types of programs. It has therefore provided allocation and matching funds so that at least a minimum program is feasible, even for "poor" States. The interstate redistribution so produced may be called *formula equalization.* Explicit recognition is given to differences in the fiscal capacity of States by using some variable which takes account of relative capacity as a factor to determine the allocation of Federal funds, or the matching requirement, or both. The variable most frequently used is per capita income. In such case, the annual allocation of grant money to each State for a program is (within limits) inverse to State per capita income, or the matching ratio specified for a State with a low per capita income is smaller than for a State with a high per capita income. Only about one-third of the Federal grant programs in operation before 1963 contained explicit equalization provisions; in 1962 the amount distributed to State and local governments in this way was only 18.6 percent of Federal grants funds.[11]

Redistribution is produced also by the process of collecting through the Federal tax system, the money which is spent in grants. This may be called *tax equalization.*

A rough indication of the overall redistributive effect of Federal grants is provided by grouping States into three broad categories—on the basis of high, middle, or low income per capita—and then examining the per capita grants received by each group. As Table 3–3 shows, receipts of grants in 1963 was generally *inverse* to per capita income. Thus, the richest States received $2.36 per capita from the Federal Governemnt for educational purposes, and the poorest States, $3.58; the richest received $13.51 per capita for public assistance, the poorest $19.25. This pattern did not prevail for all types of grants: in particular, grants for employment security varied directly with per capita income. Nonetheless, *aggregate* per capita grants were larger for low-income than for high-income States.

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[10] One common criticism is that grants simply take money away from individual residents of States, bring it to Washington, and then redistribute the money among the States (after deducting "freight charges"). One implication is that the "freight charges" are an unnecessary cost. In fact, Federal costs of collection are much less than what it would cost the States to collect the same amount. Another implication is that the Federal allocation belongs to the State in which it was raised. This is to misunderstand the purpose of grants. Grant expenditure, like any other Federal expenditure, is aimed at national objectives; it should, therefore, be allocated to achieve these objectives.

[11] *Role of Equalization in Federal Grants,* pp. 71–72.

TABLE 3–3.—*Federal grants per capita to State and local governments, 1963, for selected functions by State income per capita, 1960–62*

Purpose of grant	Per capita grant			
	United States	Per capita income		
		17 highest States [1]	17 middle States	17 lowest States
Employment security	$1.76	$2.05	$1.41	$1.27
Education	2.82	2.36	2.64	3.58
Highway construction	16.23	14.09	18.99	18.30
Public assistance	14.64	13.51	12.89	19.25
Health assistance	1.79	1.33	1.93	2.72
Miscellaneous welfare services	4.74	4.19	3.96	6.92
Other	2.41	2.42	2.07	2.77
Total per capita	44.39	[2] 39.96	43.90	54.80

[1] Includes the District of Columbia.
[2] Due to rounding, columns do not always add up precisely.

Source: Sophie R. Dales, "Federal Grants, 1962–63," Social Security Bulletin (June 1964), p. 21. For further details, including State rankings in per capita income and grants, see appendix table A–12.

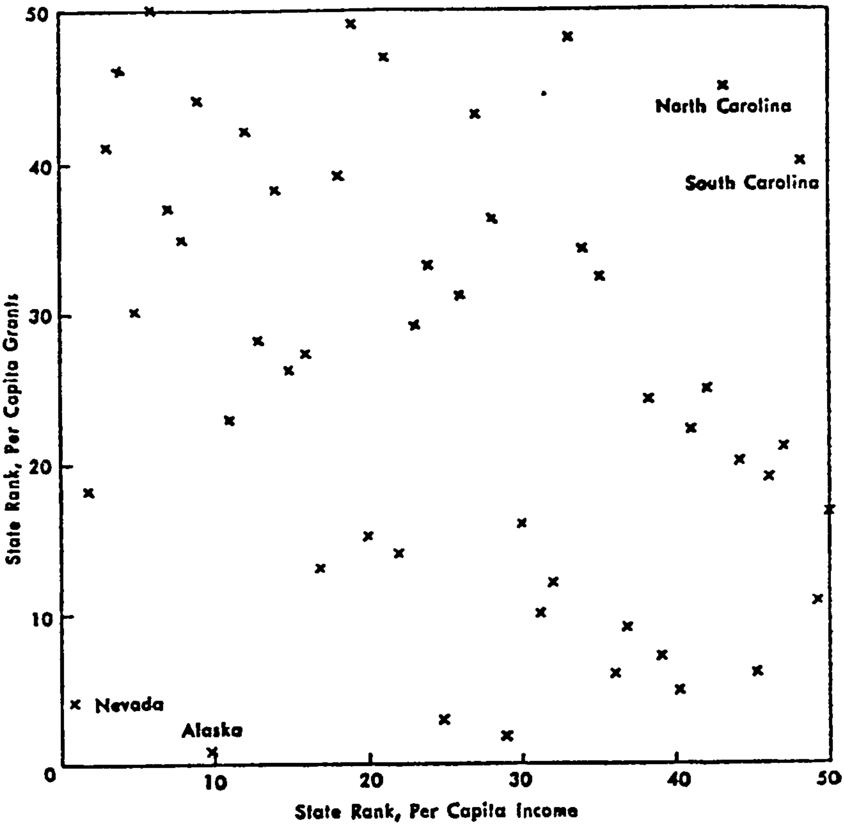
The pattern that emerges from the threefold grouping is impaired when a *State-by-State* ranking of per capita grants and per capita income is examined (see Chart 3–1 and Appendix Table A–12). Some high-income States—Nevada, Alaska, Wyoming—receive relatively *large* grants; some low-income States—Virginia, North Carolina, South Carolina—receive relatively *small* grants.[12] No single explanation of the deviations is adequate, but one major cause relevant to certain high-income States is that Congress has in several instances allocated grants to the States according to criteria—area, road mileage, and public land acreage, for example—which, while relevant to certain objectives of a grant program, are unrelated to State population or income. Another major cause of deviation from the overall pattern, relevant to certain low-income States, is that these States have chosen to make relatively small welfare expenditures.

Measurement of the redistribution.—A rough measurement of the relative strength, by States, of (a) tax equalization, and (b) formula equalization will be offered.

This measurement requires the use of estimates of State-by-State Federal *tax incidence*. Figures which show merely where taxes were collected do not, in many cases, indicate tax burden. The true burden of the sales tax, for example, falls on the consumer, although it is the seller who formally pays the tax. Unfortunately, calculation of incidence requires assumptions which are disputable and, accordingly, the results are approximations, dependent on the assumptions. Verification is not feasible, since the different results of estimates depend simply upon different assumptions. The figures offered here should therefore be interpreted with caution; quantitative expression does not remove limitations inherent in estimated figures.

[12] The ACIR states that the correlation between State per capita income for 1961 and per capita grants by States for fiscal 1962 is 0.041, that is, negative but not significantly so. When only grants disbursed on an equalizing basis are counted, the correlation is 0.389. When construction grants are excluded, the negative correlation is more marked, 0.601. *Ibid.*, pp. 62–63.

CHART 3-1. States Ranked by Per Capita Income, 1962, and Per Capita Grants, 1963



Source: Appendix Table A-12.

The figures of tax incidence used here were calcaulated by the Tax Foundation.[13] According to these data, in fiscal 1962 Delaware was the State with the highest per capita Federal tax incidence ($1,072), and Connecticut was the next highest ($801). The per capita incidence figure in Connecticut was 1.55 larger than the per capita figure for the Nation ($516): when, therefore, the Federal Government collected $1 in taxes from the average resident of the Nation, it collected $1.55 from the average resident of Connecticut (see Table 3–4). Mississippi and Arkansas were the lowest and the next to the lowest States in per capita incidence. When the Federal Government collected $1 in taxes across the Nation, it collected only $0.37 in Mississippi.

[13] *Allocating the Federal Tax Burden by State,* Research Aid No. 3, Revised (1964); *Facts and Figures on Government Finance* (1962–63), p. 112.

TABLE 3–4.—*Estimated per capita incidence of Federal taxes for the United States and selected States, 1962* [1]

State	Per capita tax incidence	Ratio of per capita tax incidence to average tax incidence
U.S. (average)	$516	1.00
Delaware	1,072	2.08
Connecticut	801	1.55
Arkansas	236	.46
Mississippi	196	.37

[1] For additional data on all States, see appendix table A–13.

Using the ratios of tax incidence, it is possible to arrive at a measure, State by State, of the redistributive effect of (a) Federal grants *to* States and (b) Federal taxes collected *from* States to pay for these grants. The following computation involves three steps: (1) calculating the *total* redistribution accomplished in fiscal 1963 by Federal tax collections *plus* grant formulas; (2) segregating the part of this total redistribution attributable to the differential granting formulas; and (3) subtracting (2) from (1) to estimate the redistribution attributable to Federal taxation *alone*. With these data, State-by-State comparisons of the redistributive effect of formula and tax equalization, taken separately or together, can be analyzed.

(1) In fiscal 1963 the Federal Government distributed $43.85 [14] per capita in grants to State and local governments; in order to provide the grants, it *collected* this amount from the average resident of the Nation. (The assumption is made here that taxes collected in 1962 provided the funds for grants distributed in 1963.) Thus, it is estimated that residents of Connecticut paid $69.97 per capita ($43.85 × 1.55); in fiscal 1963 Connecticut received $36.54 per capita in Federal grants. The negative differential between the two amounts ($69.97 and $36.54) was, therefore, $33.43 per capita. Mississippi, the State with the *lowest* per capita incidence of Federal taxes, was in the opposite situation. Its per capita collection of taxes for the grants was $16.22 ($43.85 × 0.37). Since in fiscal 1963 Mississippi received $59.14 per capita in grants, its positive differential was $42.92 per capita ($59.14 — $16.22).

(2) The next step is to calculate amount of redistribution in these figures attributable to the *formulas* used in the grant programs. A reasonable assumption is, perhaps, that a *neutral* formula would allocate grants according to population, that is, the amount per capita provided for each State would be uniform. Under such a scheme Connecticut and Mississippi in fiscal 1962 each would have received $43.85 per capita. In actual fact, their per capita grants were, respectively, $36.54 and $59.14. Therefore, the *allocation formulas* gave Connecticut a negative differential of $7.31 per capita, and Mississippi a positive one of $15.29.

(3) The allocation differential (2) is then subtracted from the *total* redistribution accomplished in fiscal 1963 by Federal tax collections

[14] The grant figures used here and in Appendix Table A–14 exclude shared revenues. This refinement seems desirable because, for a few States, shared revenues are fairly large.

plus grant formulas (1). The redistribution attributable to Federal *taxes* alone gave Connecticut a negative differential of $26.12 per capita ($33.43 − $7.31), and Mississippi a positive one of $27.63 ($42.92 − $15.29).

As Table 3–5 shows, the relative redistribution accomplished by Federal taxes was considerably greater than that accomplished by grants for both Mississippi, a "poor" State, and for Connecticut, a "rich" State. Scrutiny of figures for all the States (see Appendix Table A–14) indicates the greater weight of tax equalization, especially for the richer States. But exceptions are frequent because, as previously noted, the distribution of grants to the States is determined by numerous variables, many of which are not equalizing. Nevada, a State with a high per capita income, receives large Federal grants, and these outweigh the negative redistribution accomplished by Federal taxes. South Carolina, a State with a low per capita income, receives small Federal grants—less than it would receive if the grants were allocated per capita. Accordingly, the positive redistribution accomplished through Federal taxes is reduced.

TABLE 3–5.—*Per capita redistribution of income attributable to Federal grant formulas and tax incidence in Connecticut and Mississippi, 1962*

State	Grant formulas	Tax incidence	Total
Connecticut	−$7.31	−$26.12	−$33.43
Mississippi	+15.29	+27.63	+42.92
PERCENTAGE DISTRIBUTION			
Connecticut	23	77	100
Mississippi	36	64	100

Source: Appendix table A–14.

The interstate redistribution through taxes is, it must be emphasized, wholly an accidental by-product, since Congress shapes the tax system without consideration of any particular grant or of grants in the aggregate. Nonetheless, the knowledge that tax redistribution takes place does limit the willingness of Congress to provide much additional redistribution through grants. Moreover, the ACIR has pointed out that, while equalizing formulas are appropriate in welfare programs in order to enable "poor" States to achieve minimum service levels consistent with national objectives, they are inappropriate for grants aimed at encouraging planning and experimentation.[15] And when grants are developmental, such as those for highway construction, allocation of funds by States should not be on an equalizing basis, although equalizing matching-ratios may be appropriate. Highway construction, for example, should be determined by traffic needs. If, on this basis, approved highway projects in two States—one rich and one poor—are estimated each to cost $1 million, the Federal grant might, say, be set at 30 percent of cost for the former and 60 percent of cost for the latter.

[15] *Role of Equalization in Federal Grants*, pp. 56–60 and 74–75. The ACIR points out that other Federal expenditures, when allocated by States, greatly exceed the amounts of Federal grants (p. 52).

One other factor should be considered here. Federal grants are an alternative to Federal assumption of responsibility for an activity. Use of grants means that *some part* of the cost of the activity remains with State and local governments, and they provide this part through a regressive tax system. Such a procedure brings about less interstate redistribution of income than would complete Federal assumption of the activity.

FISCAL EFFORT AS A CONDITION OF RECEIVING A GRANT

In the future development or reform of granting procedures, Congress might well set requirements for eligibility by specifying (a) *the minimum level of program provision* that would be acceptable even in low-income States, and (b) the *fiscal effort* required of State and local governments in a State as a condition and determinant of the amount of the Federal grant. How fiscal effort should be defined has not been adequately explored. Not long ago academic opinion seemed prepared to express it as a percentage of personal income per State, but possibly this simple concept is inadequate. A recent staff report prepared for ACIR explored this problem, showing in particular that dissimilar results are obtained when capacity is measured by the "representative tax system"[16] and by income received by residents of a State. The report does not attempt to resolve the relative merits of the different approaches. It simply declares that "fiscal capacity and tax effort indexes can be constructed that would materially facilitate the formulation of public policies."[17]

APPRAISAL OF TYPES OF GRANTS

In spite of faults, the device of Federal grants has been strongly endorsed. The Hoover Commission in 1949 declared that, "in addition to decreasing inequalities of service [grants had] raised the level of all aided services, without transferring functions entirely to the National Government."[18] The Kestnbaum Commission declared that "the grant has become a fully matured device of cooperative government." It went on to state "broad principles" to guide future use of grants. Grants should be confined "to fairly small segments of broad activities" in order to secure a clearer definition of objectives, as well as closer supervision.[19] The Commission was, therefore, not in favor of unconditional grants or even of *block* grants, that is, those for a broadly defined function or activity of State and local governments.

The Committee on Government Operations of the House of Representatives in 1958 took a similar stand. It declared: "While aware of the administrative difficulties caused by the use of special categories within some programs, the subcommittee, nevertheless, is appreciative of the strong legislative reasons for confining grants to narrow segments of a general activity."[20] Narrow definition allowed precise application of a stimulus by the Federal Government, and any tendency toward rigidity could be offset by allowing "transfer of up to 20 per-

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[16] See ch. II, note 5, pp. 41–42.
[17] *Measures of State and Local Fiscal Capacity and Tax Effort*, p. 93. Several recommendations for reform of the equalization features of Federal grants are made in *Role of Equalization in Federal Grants*, pp. 75–81.
[18] *Federal-State Relations*, Report to the Congress by the Commission on Organization of the Executive Branch of the Government (1949), p. 30.
[19] *Kestnbaum Report*, pp. 120 and 133.
[20] *Federal-State-Local Relations*, p. 51.

cent of Federal apportionments between the special categories of any program, when such transfer is requested by a Governor and approved by the responsible Federal agency as being in the public interest." [21] On the other hand, the Hoover Commission favored block grants "based upon broad categories—such as highways, education, public assistance, and public health—as contrasted with the present system of excessive fragmentation." [22]

On what grounds might a choice be made between use of conditional specific grants and block grants? The former, as the name indicates, have conditions and controls by which the granting government defines the activity to be aided and guides the performance by the recipient government. Most obviously the *conditional* grant is meant to stimulate performance of specific activities. the assumption of the granting government—say the Federal—is that an activity is being underperformed at the State-local level. To some extent a national judgment is substituted for a State-local one, since more government resources are pulled toward the activity than would occur without Federal intervention. If the outcome is that the "right" total amount comes to be devoted to the activity, all is well. But sometimes distortion occurs—more is spent on the aided activity than on similar and other State-local activities, and indeed sometimes the latter may be deprived of State-local expenditure altogether. As noted above, for instance, Federal grants for old-age assistance have induced poor States to overspend on it in relation to the unaided activity of general assistance. Nonetheless, the conditional grant is aimed directly at definable and defined national objectives, and performance can be checked. The appeal of these features to Congress is great. Moreover, the pressures on Congress for grant programs come from groups interested in specifics.

A block grant, for example, one appropriated for public assistance as a whole rather than for specific categories of public assistance, would eliminate detailed provisions concerning categories in favor of broad provisions: it would also remove the stimulus to spending on specific categories in favor of spending on a group of categories. Allocation of expenditure within the group would be a *State* decision: each State could, within limits, apply its own set of priorities. Since some interstate variations in need, as well as variations over time, are to be expected, a block grant could provide flexibility of adjustment. The Federal Government could forego the provision of specific stimuli, and the imposition of specific standards. Indeed, the main advantage of a block grant, with a minimum of conditions, might be to lighten the financial load borne by some State-local budgets, rather than to stimulate larger expenditure on the function. To persons interested in applying a stimulus, this is a fault, but to those who only wish to shift part of the burden of functions from State and local shoulders, it is not. Block grants seem especially indicated as a technique to consolidate old grants for functions no longer in need of stimulus.

An unconditional grant is simply a block grant not tied even to a broadly defined State-local function. In the United States the Federal Government has eschewed this type of grant, but in Canada and Australia it has long been in use. In the most recent versions of un-

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[21] *Ibid.*, p. 43.

[22] *Federal-State Relations*, p. 36. See also H. F. McClelland, "Financing Decentralization," in *Essays in Federalism* (Claremont Men's College, 1961), pp. 79–82.

conditional grants in these countries, the Federal Government does not manifest an interest in specific State and local functions; rather it provides revenue which State and local governments may use as they choose. The logic of the grant is that the Federal Government has an interest in enabling all standard State and local functions to be performed at a foundation (or average) level.

This can be clarified with a simple illustration. Suppose, as in Australia, examination indicated that the governments of two States, even by exerting a tax effort somewhat greater than the other four States, could still only provide their citizens with governmental services somewhat below the average of the other States. The gap would be bridged by an unconditional grant to the two States. Technical decisions concerning relative tax efforts and expenditure standards are made annually by the Commonwealth Grants Commission. While Congress has, in the past, been unreceptive to the unconditional grant, the rationale behind it—limited fiscal equalization among governmental units—is worth attention.[23]

The Number and Structure of Local Governments

Before examining the second broad stream of intergovernmental transfers—the flow from State to local governments—a résumé of the number and structure of local governments will be relevant.

Local governments, constitutionally, are the creatures of the States, and the States have spawned a large progeny. When the first count was made, thirty years ago, the total number of all types of governmental units in the United States was approximately 180,000. By 1942 it had fallen to 155,116 and by 1962 to 91,236, as a result of a steep decline in the number of school districts. (See Table 3–6.) Undoubtedly, in many parts of the United States the number of governmental units is still excessive.

TABLE 3–6.—*Number and type of Governmental units in the United States, selected years, 1942–62*

Unit of government	Number			Change	
	1942	1957	1962	1942–57	1942–62
U.S. Government	1	1	1		
States	48	48	50		+2
Counties	3,050	3,047	3,043	−3	−7
Municipalities	16,220	17,183	17,997	+963	+1,777
Town and townships	18,919	17,198	17,144	−1,721	−1,775
School districts [1]	108,579	50,446	34,678	−58,133	−73,901
Special districts	8,299	14,405	18,323	+6,106	+10,024
Total	155,116	102,328	91,236	−52,788	−63,880

[1] This counts only the so-called "independent" school districts. Another 2,341 "dependent" school systems were in operation in 1962, administered by county, city, or town governments. In 4 States (Virginia, Hawaii, North Carolina, Maryland) there are no independent school districts; in 23 States independent districts are responsible for all public schools; in the remaining 23 States, the situation is "mixed." Ibid., p. 4.

Sources: U.S. Census Bureau, 1957 Census of Governments, Vol. 1, No. 1, "Governments in the United States," p. 1; 1962 Census of Governments, Vol. 1, "Governmental Organization," p. 1.

[23] In the summer of 1964 President Johnson created a Task Force on Intergovernmental Fiscal Cooperation to develop ways to strengthen the finances of State-local governments. According to press reports, the task force recommended the use of unconditional grants, to be distributed among the States according to population. *New York Times*, Oct. 28, 1964.

An important characteristic of many local governments is the overlapping of three or four—and occasionally seven or eight—layers of governmental units in the same geographic area. There may be school districts, sanitary districts, counties, soil conservation districts, drainage districts, and so on. The diversity among governmental units is apparent in Table 3-7 listing the five States with the lowest and the highest average population per unit, and square mileage per unit.

TABLE 3-7.—*States with highest and lowest population and square mileage per governmental unit, 1962*

Average population per governmental unit

Lowest:		Highest:	
North Dakota	212	Hawaii	33, 000
Nebraska	290	Virginia	10, 963
Mississippi	291	Maryland	9, 065
Kansas	410	Rhode Island	8, 826
Montana	511	Massachusetts	8, 792

Average square mileage per governmental unit

Lowest:		Highest:	
New Jersey	5. 6	Alaska	10, 287. 7
Pennsylvania	7. 3	Nevada	806. 9
Illinois	8. 7	New Mexico	397. 6
Delaware	9. 9	Hawaii	305. 9
Rhode Island	12. 4	Arizona	300. 5

Source: "Governmental Organization," pp. 27–28.

In terms of public finance, this diversity seldom makes sense. In *rural* areas, small and overlapping units often lack the resources to perform any function with efficiency. State governments have an important responsibility for these situations; certainly they should be careful not to waste resources and perpetuate inefficiency by grants to archaic governmental units. In *urban* areas, governmental units of very unequal financial strength cannot provide a uniform level of service; the infirm ones cannot even provide the minimum level needed for the whole of the urban community.

The problems are most acute and intractable in *metropolitan* areas, which are composed of a central city or cities and a variety of suburban units. In 1962 the 212 Standard Metropolitan Areas of the Nation contained about two-thirds of the total population; they had 18,442 units. The Chicago metropolitan area alone contained 1,060 units distributed as follows:[24]

Counties	6
Townships	114
Municipalities	246
School districts	340
Special districts	354
Total	1, 060

While unification is understandably difficult, problems of sanitation, water supply, police, and transportation do need coordination. Sometimes functional intergovernmental schemes which do not change the existing governmental structure have been put into operation, for example, the Metropolitan Water District of Southern California. But

[24] "Governmental Organization," p. 124.

more complete structural integration is often desirable even though annexation, the technique favored a few decades ago, has been halted in many States by the opposition of suburban areas.

In recent years a new type of local unit, the *special district*, has grown in numbers—from 8,299 in 1942 to 18,323 in 1962. These districts have peculiar features: they are created usually to perform a single function; they overlap geographically; except for school districts, most of them do not depend on taxation. Their growth, which is symptomatic of the local government's weakness in performing an activity, injures local government. While most of the blame is to be placed on the States, the Federal government must bear a share because a good many special districts have been created through its "direct advocacy." [25] Specialists in the Department of Agriculture prefer to deal with officials of soil conservation districts (2,461 in 1962) rather than with county officers. Federal specialists in housing prefer to deal with officials of housing and urban renewal districts (1,099 in 1962) rather than with city officers. The pragmatic tendency of Federal agencies to develop local counterparts has complicated local government structure and encouraged isolation of units within an urban area. Against the short-run convenience of special purpose districts must be set the long-run confusion arising out of uncoordinated area development.

The organization of local governments is not, to be sure, merely a matter of administrative and fiscal efficiency. In a democracy a wide variation in performance is—and should be—tolerated. The present variation, however, far exceeds acceptable limits. Moreover, the obstacles to change here are patent and powerful: local loyalties, vested interests, urban-rural antagonisms, the inertia of status quo. States have often made change difficult by constitutional and statutory provisions. Some State constitutions, for instance, prescribe a pattern of local government. Debt and tax limits for local governments are widespread, and their operation sometimes reinforces the maintenance of overlapping units because the pyramided separate limits of all the units in a given geographic area add up to a total beyond what might be allowable by the electorate if consolidation were put into effect.

Yet the record of recent years proves that, given the will, much can be done. In the twenty years from 1942 to 1962 the number of school districts declined by two-thirds.[26] A forward step would be for the States to remove the self-imposed constitutional and statutory inflexibilities which stand in the way of governmental reorganization. Another would be for them to make enlargement of financial aid to local governments condition upon progress in structural reorganization. More efficient local governments would allow a larger measure of local financial responsibility in provision of local services. And it is a truth, as well as a truism, to say that only when local governments are strong does democracy flourish.

Intergovernmental Transfers From State to Local Governments

There are two basic types of intergovernmental transfers from State to local governments: (*a*) grants, that is, appropriated funds

[25] John C. Bollens, *Special District Governments in the United States* (University of California Press, 1961), p. 250.
[26] See Table 3–6.

and (*b*) shared taxes, that is, portions of tax yields. The nature of the distinction between the two is important, even though (for reasons that will become apparent) no specific figures can be offered. State-local *grants* need no special explanation. In the case of *shared taxes*, one level of government—the one most fitted to make efficient collection—assigns all or part of the collections on some basis to the governments which give up the tax. For example, a State government might assume the sole right to tax the income from intangible property, promising to distribute all or some share of the proceeds to local governments according to the place of residence of the owners; or it might assume the sole right to tax motor vehicles as property, promising distribution of the proceeds to local governments according to where the vehicles were principally garaged.

Shared taxes frequently began when a State government withdrew from the base of the general property tax some types of property which could not be efficiently or equitably taxed by local governments. A *quid pro quo* as revenue was assigned to local governments to make the move palatable. In the first instance the States tended to use such criteria as location of the property, prior assessed value of the property, and prior local revenue from the property. Quite frequently it turned out that because of the greater efficiency of State administration, the amounts collected by the State were much in excess of the prior collections of the local governments. Moreover, distribution according to origin of the revenue favored rich localities. Accordingly, the basis for sharing was shifted, usually toward some measure of local government need, and specific directions for use of the revenue were added. A variety of formulas was framed, the particular outcome depending on the tug and pull between those local governments wanting to retain a favorable allocation and those wanting a change appropriate to their needs. As a result, the original basis for tax-sharing has been overlaid by numerous modifications which usually tend (a) to allocate the proceeds according to some measure of local need, and (b) to commit them to designated purposes.

In these two respects the original logic of the shared tax has been impaired and shared taxes, as now used, have come to resemble conditional grants. An important difference is, however, that the annual amount shared depends on the amount collected. It is therefore unstable, being larger in boom and smaller in recession years. This is awkward for local governments, since their spending has the opposite variation. Moreover, in many States, the criteria for sharing different taxes are varied and complicated. They have grown *ad hoc* over the decades. At the very least it would make sense to pool the State collections, to distribute them according to a single formula, and to reduce earmarking. In such case the shared taxes would become an unconditional grant *except* that the annual amount would depend on collections, whereas the amount of a grant would depend on an annual legislative decision.

The distinction between shared taxes and grants has become so blurred that the Bureau of the Census does not provide separate figures for them. Instead, figures for State intergovernmental payments to local governments are offered, split into two categories, those for *general* local government support and those in support of *specific* functions such as education, highways, and welfare. In terms of the amount of revenue, State sharing is important for income taxes, liquor store profits, motor vehicle licenses and registration fees, gasoline taxes, sales taxes, tobacco taxes, and pari-mutuel taxes.

STATE INTERGOVERNMENTAL EXPENDITURES

Intergovernmental expenditure by States on a significant scale is a phenomenon of the 1930's, although a structure had been built up earlier. In 1902, the first year for which the Bureau of the Census supplies figures, this State intergovernmental expenditure was $52 million. It is a mark of the limited scope of State governmental activities that $52 million amounted to 38.8 percent of total State direct general expenditure. (See table 3–8.) Local governments were then relatively much more important, and the $52 million received by them from State governments comprised only 6.1 percent of their general revenue. By 1927, State intergovernmental payments had risen to $596 million—totalling 43.2 percent of total State expenditures and 10.1 percent of local general revenue. The 1930's and the postwar period brought further absolute increases. For some years State intergovernmental expenditure has been more than half of State direct general expenditure and nearly 30 percent of local general revenue.

TABLE 3–8.—*State intergovernmental expenditure, State direct general expenditure, and local general revenue, selected years, 1902–63*

[Money amounts in millions of dollars]

Item	Year				
	1902	1927	1938	1948	1963
State intergovernmental expenditure	$52	$596	$1,516	$3,283	$11,885
State direct general expenditure	$134	$1,380	$2,576	$6,186	$22,491
Local general revenue	$854	$5,903	$6,651	$11,373	$41,218
State intergovernmental expenditure as a percentage of State direct general expenditure	38.8	43.2	58.8	53.1	52.9
State intergovernmental expenditure as a percentage of local general revenue	6.1	10.1	22.8	28.9	28.8

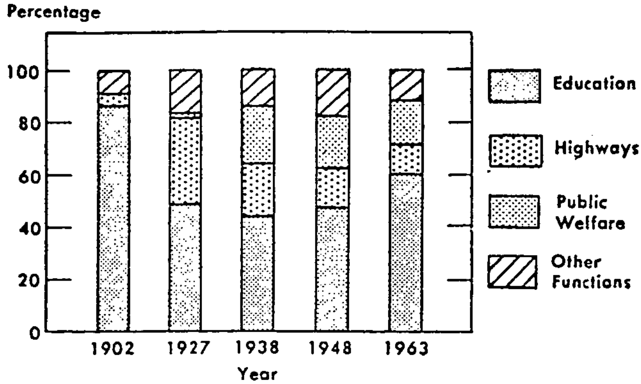
Sources: U.S. Census Bureau, "Historical Statistics of the United States: Colonial Times to 1957" (1960) p. 728; "Governmental Finances in 1963," pp. 22–24.

THE FUNCTIONAL DISTRIBUTION OF STATE AID

Significant changes have taken place, over the decades, in the *functional* distribution to State aid. (See Chart 3–2.) In 1902 education was the major recipient—87 percent of the total; in 1963 it was still the function receiving by far the largest slice—59 percent. But public welfare began to secure important State aid in the 1930's and by 1963 accounted for 16 percent of total State aid.

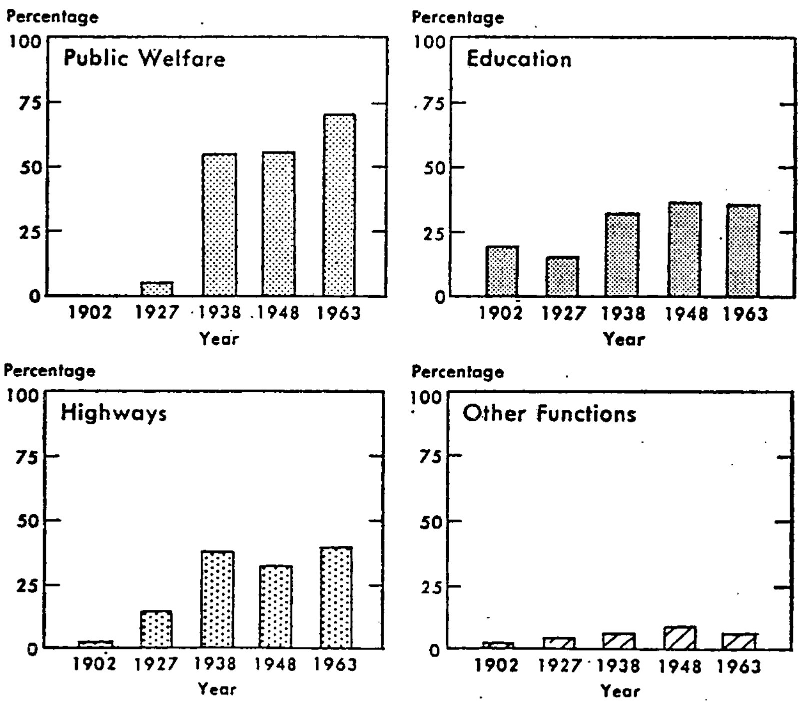
These developments mean, of course, a great increase in State-local collaboration. Chart 3–3 shows that State governments now provide a good slice of the finance of important functions of local government—over two-thirds of public welfare and over one-third of education and highways—and they give a good deal of direction as well. In some States centralization has gone farther, with complete control of a function assumed by the State government.

CHART 3-2. Percentage Distribution of State Intergovernmental Expenditure, by Function, Selected Years, 1902–63



Source: Appendix Table A-15.

CHART 3-3. State Intergovernmental Expenditure as a Percentage of Local Expenditure, by Function, Selected Years, 1902–63



Source: Appendix Table A-16.

THE NEED FOR REFORM

A major fault of State transfers has been that, by accepting the existing government organization, they have sometimes perpetuated the lives of inefficient units and placed barriers in the way of desirable reforms. In many parts of the United States school districts, for example, have been and still are, too weak in resources and too small in area and number of children to provide effective educational units. Their boundaries were drawn in the light of conditions—especially transportation—which no longer exist. Some logical reconstitution of units would reduce inequalities in revenue resources and provide a school population relevant to effective organization. Against such a step local loyalties and all the forces of *status quo* will often be ranged, and, as a result, State legislatures have sometimes preferred to distribute State aid without requiring local governmental reorganization. The effect is to strengthen the power of inefficient units to resist reform. State aid is dissipated without accomplishing the objectives which are its justification.

An alternative to State aid is a reallocation of governmental functions so that provision and administration of education, public assistance, and roads (or some designated portion of them) become a State responsibility. Centralization of this sort has progressed in recent decades, especially with respect to highways and public assistance. An improved reallocation of functions would reduce administrative expenses by reducing overhead and duplication. It is, however, no cure-all centralization at the State level has faults as well as virtues. It runs counter to the idea of "home rule"—that local governments need autonomy in performance of some activities because they are aware of, and responsive to, the variety of local needs. Indeed, the insensitivity of State legislatures to urban needs is so patent that State control over cities should often be weakened rather than strengthened. State aid offers a middle course: it leaves performance of the specific governmental activity in local hands, while providing State financial assistance and a modicum of overall direction.

In postwar years many students have urged that State governments reform their system of intergovernmental transfers. Indeed, usually no *system* exists. Driblets of shared taxes and grants go to local governments for fragmented functions, and by an amazing variety of formulas. Consolidation—pooling of aid and distribution by a simplified formula—would be a clear gain.

The question arises about how much *equalization* is desirable and how it is to be secured. The granting of State aid is moving toward an approach—now only dimly perceived—that first defines the *local need* for different government programs. The second major task is the definition of the *local ability* to finance a foundation program from its own sources. For example, the need for primary and secondary education is often measured in *dollars per pupil in average daily attendance*. Local ability is indicated by what it can raise through taxation at a specified rate on equalized property valuations. Thus, if a minimum program for primary education requires $300 annual expenditure per school child in average daily attendance, and if the local unit could raise $150 per child by levying a property tax at a specified rate (uniform for a type of unit), the indicated grant would be $150 per child. The reader should understand that adequate and objective evidence upon which to base such a quantification of need and ability is not easy to secure. Further, there are objections to expressing the need for some functions, such as education, in money terms.

In any reform of intergovernmental transfers the States should provide some aid as general or unconditional grants—grants without strings and for no specific local function. New York in 1946 moved in this direction by the so-called Moore plan which, among other things, replaced certain volatile shared taxes with a per capita grant for general municipal purposes. The change provided the localities with a stable revenue which they could use for whatever purposes they chose, thereby promoting local autonomy. This promising instance has, however, not been enlarged in New York or imitated elsewhere. State legislatures seem to prefer to provide aid for specific purposes.

INTERGOVERNMENTAL FISCAL RELATIONS*

BY GEORGE F. BREAK

OF the imposing array of fiscal problems facing the United States in recent years, some have been entirely new and some simply intensified versions of old difficulties. While Federal officials have worried alternately about inflation and the drag on the economy imposed by rapidly rising Federal tax revenues, State and local governments have struggled, frequently with only indifferent success, to provide the wide variety of services their citizens are increasingly demanding. All too often in the governmental sector, the money is not where the needs are; or if it is there, the means for mobilizing it are far from obvious. As a result there are many deficiencies, and the costs are heavy, widespread, and often not recognized for what they are.

The price of inadequate education, for example, is paid not only by those who lack the opportunity to develop their talents fully but by the public which loses the important capital resources represented by these talents. Comfortably housed suburbanites, who spend much of their time on congested highways breathing unclean air and worrying about the rising tide of crime and violence, often overlook the fact that their withdrawal to the suburbs has contributed to these problems. By extending the metropolitan area, they have added to the freeways and the smog and also helped to impoverish the central city of whose difficulties they tend to take a chill and distant view. Individuals with more and more leisure time find less and less opportunity to enjoy it because of growing river pollution and crowded public parks—situations intensified by their penuriousness as taxpayers as well as by official timidity and general public shortsightedness.

The failure of local governments to cope adequately with mushrooming communities and, above all, the strange reluctance of the taxpayer to protect his own welfare have resulted in urgent public needs which are only gradually being recognized as their critical points approach. This uncomfortable situation raises serious questions about the continued vitality of federalism in the United States. We live in an age of impatience, and if State and local governments make only halting progress toward the Nation's basic goals, they may find themselves coming increasingly under the influence or control of Washington. The present study focuses on these issues, exploring ways in which current fiscal problems can be solved under a strong and flexible federal system of government.

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*Reprinted from *Intergovernmental Fiscal Relations in the United States*, The Brookings Institution, 1967; chapter I: Introduction.

FISCAL TRENDS IN THE U.S. FEDERAL SYSTEM

There is no need to dwell on the rapidity with which government purchases of goods and services have risen during this century. In 1900, for example, the output of all three levels of government was 6 percent of gross national product; in 1964 it was over 20 percent. During a period of such rapid growth one would expect to observe numerous changes in the structure of American governments. That there have been some major ones will be clear from the discussion in the rest of this section. What is even more impressive, however, is the number of stable relationships that have persisted over fairly long periods of time. The Federal fiscal system, it would appear, has been able to adapt itself to changing economic conditions without losing its basic characteristics. Whether it can continue to do so is the major issue to be considered in later chapters.

Relative Shares of Direct General Expenditures

In any comparison of the roles of the three levels of government as sources of expenditure, it is important that the terms of reference be clearly defined. If all public expenditures (omitting those made to other governments or by insurance trust funds) are considered, the results will show a dramatic shift in the direction of centralization. In 1902 local governments made 58 percent of all direct general expenditures; in 1964 the Federal Government had exactly that share (table I–1).[1] If, on the other hand, defense and war-related expenditures are excluded, the picture is quite different. Then, as table I–1 shows, local governments in 1964 were about twice as important as either of the other two levels. Moreover, these relative Federal-State-local shares of ¼–¼–½ have remained remarkably stable during the postwar period. Compared to 1902 or 1927, however, this new pattern represents a definite shift in civil government expenditures from the local to the Federal and State levels.

TABLE I–1.—*Shares of the 3 levels of government in direct general public expenditures selected years, 1902–64*

[Percentage distribution]

Year	Defense and civil				Civil only			
	Federal	State	Local	Total	Federal	State	Local	Total
1902	34	8	58	100	17	10	73	100
1913	30	9	61	100	18	11	71	100
1922	40	11	49	100	18	15	67	100
1927	31	12	57	100	15	15	70	100
1938	44	16	40	100	36	19	45	100
1948	62	13	25	100	23	26	51	100
1954	67	11	22	100	26	24	50	100
1964	58	15	27	100	23	27	50	100

Source: Frederick C. Mosher and Orville F. Poland, The Costs of American Governments: Facts, Trends Myths (Dodd, Mead & Co., 1964), pp. 44–45, and U.S. Bureau of the Census, Governmental Finances in 1963–64 (1965), p. 25. In this and other tables, the data on governmental finances relate to fiscal years. Most of the economic data, including gross national product figures, are on a calendar year basis.

[1] Inclusion of insurance trust fund expenditures in the totals would accentuate the trend but not by much, the local share being 55 percent in 1902 and the Federal share being 61 percent in 1964.

As would be expected, this shift has not been the same for each major type of spending. In table I–1, 1927 is the most recent year that was relatively unmarked by severe unemployment or the effects of hot and cold wars. Since 1927 education, highway, and public welfare expenditures have been shifted mainly from local to State governments, while spending for health and natural resources has been moved from the local to the Federal level. Table I–2 shows the nature of these changes. It should be stressed that these patterns are based on the expenditures actually made by each level of government whether they were financed by it or by some other level. The next step, therefore, is to consider what has happened to the intergovernmental sharing of program costs during the present century.

TABLE I–2.—*General civil expenditures by the 3 levels of government, 1927 and 1964* [1]

[Percentage shares]

Level of government	Type of expenditure									
	Education		Highways		Public welfare		Health and hospitals		Natural resources	
	1927	1964	1927	1964	1927	1964	1927	1964	1927	1964
Federal	0	4	1	1	6	2	18	31	31	53
State	10	21	28	66	25	48	39	35	26	20
Local	90	75	71	32	69	51	43	35	43	28
Total	100	100	100	100	100	100	100	100	100	100

[1] Federal expenditures for veterans have been allocated to the relevant categories. Local parks and recreation are included in natural resources. Figures are rounded and may not add to totals.

Source: Mosher and Poland, op. cit., pp. 46–47, and Governmental Finances in 1963–64, p. 25.

Intergovernmental Aid

Since 1902 both Federal and State expenditures representing payments to other levels of government have grown more rapidly than GNP, though not in any regular fashion (table I–3). Both expanded rapidly during the "Great Depression," receded during World War II, and then remained stable over much of the postwar period. Federal aid, for example, remained close to 1 percent of GNP between 1948 and 1958, rose to 1.4 percent between 1959 and 1963, and increased again in 1964 to 1.7 percent. Since 1950 State payments to local governments have remained within a range of 1.7 to 2.1 percent of GNP, though they have tended to remain near the top of that range more consistently in recent years than earlier.

TABLE I–3.—*Federal and State intergovernmental expenditures as a percentage of gross national product, selected years, 1902–64*

Year	Federal	State
1902	0.1	1.0
1922	.3	.9
1927	.3	1.3
1934	3.7	5.0
1940	2.1	3.9
1942	1.1	2.2
1948	.9	1.6
1957	.9	1.8
1959	1.4	1.8
1964	1.7	2.1

Source: Mosher and Poland, op. cit., p. 162, and "Governmental Finances in 1963–64," pp. 19, 23.

When the budgetary significance of intergovernmental aid is considered, the proportions are also stable. Local governments have received funds for 25 to 27 percent of their total expenditures from higher levels of government since the mid-1930's; State governments received 15 to 16 percent between 1948 and 1957 and then 21 to 23 percent in the early 1960's (table I-4). Looked at from the point of view of the giver, State aid has shown the greater stability. While Federal payments to State and local governments, as a percentage of Federal expenditures, have receded during wartime and expanded thereafter, State aid has remained close to 35 percent of State general expenditures throughout the postwar period (table III-9).

TABLE I-4.—*Intergovernmental revenue as a percentage of the recipient's expenditures,*[1] *selected years, 1902-64*

Year	State receipts from Federal Government as percentage of State expenditures	Local receipts from Federal and State Governments as percentage of local expenditures
1902	1.6	5.8
1922	7.4	7.1
1932	8.0	12.8
1934	27.5	24.9
1940	14.5	25.4
1942	16.6	25.4
1948	16.2	26.6
1957	16.0	25.0
1958	18.3	24.9
1960	22.7	26.1
1964	21.2	27.0

[1] Insurance trust funds excluded.

Source: Mosher and Poland, op. cit., p. 162, and "Governmental Finances in 1963-64," pp. 22, 23, and 53.

Since the Great Depression, State governments have functioned as grant intermediaries. In 1922 and 1932 only 8 percent of their spending was financed by the Federal Government and 23 to 29 percent represented aid to local governments. By 1934, 27.5 percent of their spending was Federal money, and nearly 40 percent of their budgets was for State aid. Though neither of these levels was reached again, States in the early 1960's were receiving aid equal to 22 percent of their expenditures and granting aid to local governments constituting 35 percent of their total spending.

State and Local Tax Systems

While the flow of financial aid from Washington has been increasing, State and local governments have not been idle in expanding old taxes or in enacting new ones. As a result, State-local tax revenues have more than kept pace with the growth of the economy, rising from 4 percent of GNP in 1902, to 5 percent in 1942 and 1948, and to nearly 8 percent in 1964. As table I-5 shows, however, the increase has not been a steady one, nor did it match the Federal increase up to the end of World War II. Since then Federal tax receipts have little more than kept pace with GNP (except during the Korean war), but

State-local taxes have increased their ratio by over one-half. Also worth noting in table I–5 is the approximate equality of State and local tax collections as a ratio of GNP during the postwar period (in contrast to the one-third to two-thirds share of the two level of government in direct general expenditures shown in table I–1). In addition, the stability of total tax revenues since 1946, near a level of 22 percent of GNP in 4 of the 5 years listed, merits attention.

TABLE I–5.—*General tax revenues*[1] *as a percentage of GNP by level of government, selected years, 1902–64*

Year	Federal	State and local	State	Local	Total
1902	2.4	4.0	0.7	3.3	6.4
1927	3.5	6.4	1.7	4.7	9.8
1932	3.1	10.5	3.2	7.3	13.6
1940	4.8	7.8	3.3	4.5	12.6
1942	7.7	5.4	2.5	2.9	13.1
1946	17.2	4.7	2.3	2.4	22.0
1948	14.6	5.1	2.6	2.5	19.7
1952	17.2	5.5	2.8	2.7	22.8
1958	15.3	6.9	3.4	3.5	22.1
1964	15.0	7.9	4.0	3.9	22.9

[1] As defined by the Census Bureau. Excludes revenues of the insurance trust funds.

Sources: Mosher and Poland, op. cit., p. 165, and "Governmental Finances in 1963-64," p. 22.

It is clear from table I–6 that State governments have been energetic in enacting new taxes. By 1964 these changes, along with numerous rate increases, had produced the highly diversified tax structure shown in table I–7, and they had created many of the tax coordination problems discussed in chapter II. Varied though the State tax systems are, they have been dominated for some time by three main kinds of taxes: motor vehicle fuel and registration taxes, general sales levies, and individual and corporate income taxes.

TABLE I–6.—*Number of States adopting new taxes, by major type—Frequency distributions by decade, 1901–64*

Period	Type of tax								
	Individual income	Corporate income	Death	Gift	General sales	Distilled spirits	Cigarettes	Gasoline	Auto registration
Pre-1901	-------	-------	23	-------	-------	-------	-------	-------	-------
1901 to 1910	1	1	15	-------	-------	-------	-------	-------	33
1911 to 1920	9	8	7	-------	-------	-------	-------	5	16
1921 to 1930	5	8	2	-------	-------	-------	8	43	-------
1931 to 1940	17	15	2	9	24	29	19	1	-------
1941 to 1950	1	2	-------	3	5	2	15	1	-------
1951 to 1960	-------	2	-------	-------	6	1	5	-------	-------
1961 to 1964	3	1	-------	-------	2	-------	1	-------	-------
Total	[1] 36	[2] 37	49	12	37	[3] 32	48	50	49

[1] Includes the partial income taxes of New Hampshire, New Jersey, and Tennessee.
[2] Excludes South Dakota's tax on financial institutions.
[3] Excludes the 17 States that either operate or supervise government liquor stores.

Sources: Advisory Commission on Intergovernmental Relations (ACIR), "Tax Overlapping in the United States, 1964" (July 1964), p. 25, and the Tax Foundation, "Tax Review" (October 1964), p. 38.

TABLE I-7.—*The structure of State tax collections,*[1] *selected years, 1902-64*

Year	Total (millions)	Percentage distribution									
		Individual income	Corporate income	Death and gift	General sales	Motor fuel	Motor vehicle licences	Alcoholic beverages	Tobacco	Property	Other
1902	$156			4.5						52.6	42.9
1927	1,608	4.4	5.7	6.6		16.1	18.7			23.0	25.5
1942	3,903	6.4	6.9	2.8	16.2	24.1	11.0	6.6	3.3	6.8	15.9
1948	6,743	7.4	8.7	2.7	21.9	18.7	8.8	6.3	5.0	4.1	16.5
1958	14,919	10.3	6.8	2.4	23.5	19.6	9.5	3.8	4.1	3.6	16.4
1964	24,243	14.1	7.0	2.7	25.1	16.7	7.9	3.6	4.9	3.0	15.0

[1] Excludes insurance trust fund revenues.

Sources: Tax Overlapping in the United States, 1964, p. 20, and Governmental Finances in 1963-64, p. 22.

In 1963-64, each of the first two produced one-fourth of State tax collections; the income tax produced one-fifth. Excise taxes on tobacco and alcoholic beverages and property taxes yielded 10 percent. A long list of relatively unimportant levies produced the remaining 20 percent.

Local tax systems, in contrast, are much less diversified. Property taxes still dominate, though not nearly to the extent that they did before the Great Depression (table I-8). Reacting to many problems (see ch. V), some of the largest cities have been especially active in the search for new revenue sources. While some utilized taxes similar to those existing at higher levels of government to their great advantage, others have gone their own independent ways, frequently adding to both their own and their taxpayers' costs.

TABLE I-8.—*The structure of local tax collections, selected years, 1927-64*

Year	Total (in millions)	Percentage distribution			
		Property taxes	Sales and gross receipts taxes	Income taxes	Other taxes
1927	$4,479	97.0	1.0		2.0
1942	4,625	92.0	3.0	1.0	4.0
1948	6,599	89.0	6.0	1.0	5.0
1958	15,461	87.0	7.0	1.0	4.0
1964	23,542	87.2	7.7	1.6	3.6

Sources: "1927-58: Tax Overlapping in the United States, 1964," p. 43; "1964: Governmental Finances in 1963-64," p. 5.

FEDERAL-STATE-LOCAL FINANCIAL RELATIONS*

BY C. LOWELL HARRISS

Every session of a State legislature or of Congress, and many meetings of city councils and other local government bodies, deal with problems involving financial relations with other governments. Federal, State, and local officials in their day-to-day activities deal with each other in many ways, most of which have financial significance. Numerous and persuasive changes are taking place in the relations among governments—city and suburb, neighboring towns, State welfare agencies with their Federal and local counterparts—and soon. The change may be large and well publicized; more often it is small and undramatic.

The problems are so complex and their elements so interrelated, the developments are so numerous and widely varied, that no brief account can possibly do the subject justice. The space available here will be used to identify some of the problems and then to discuss what is perhaps the most important financial development, the growth of grants-in-aid.

ISSUES BEARING ON THE STUDY OF INTERGOVERNMENTAL RELATIONS

The analysis of intergovernmental financial relations can draw on a huge literature which deals with a variety of points, not always closely related to each other. The following brief statements summarize material useful for understanding the discussion which follows.

1. The American public believes that some functions can be performed best at the local level rather than the State (or by the State in preference to the National Government). The assignment of responsibilities for performing governmental functions, however, has not always been matched by the grant of effective ability to raise revenue. For decades localities have faced increasing pressure to spend more, but their own effective power to raise the necessary revenue has lagged. Local governments have depended heavily upon the property tax. Though its yield has grown rapidly, especially since World War II, objections to the increasingly intensive use have been strong. Earlier, during the Great Depression, property owners often found themselves unable to pay the tax due, and various protective limits were imposed in many States. More recently, one objection to the heavier use of this tax is a conviction that to do so would lead some taxpayers to flee from, not enter, or not expand in, the community. When businesses are discouraged in this way, it is argued, the source of jobs and income will suffer.

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* Reprinted from: *Handbook of State and Local Government Finance*, Tax Foundation, Inc., New York, 1966.

2. Such mobility, very real among localities, also concerns States, though to smaller extent. The taxes which one government can impose will depend upon what others do. Unless extra tax burdens pay for differential governmental services of (clear) benefit to the persons who are required to pay the costs, tax bills which are much above those of neighboring States and communities will, it is feared, weaken the economic base. A State, of course, has more effective taxing power than the sum of its localities acting individually. Each local unit faces competition from close neighbors. But if the State government imposes a tax to raise equal revenue, mobility is less of a threat. And if the National Government does the job, no one State can attract either businesses or high income taxpayers away from other states by offering to lower the tax in question.

3. The vast majority of local governments cannot possibly administer nonproperty taxes as effectively and efficiently as a State. Similarly, the Federal Government has some advantage over States in administering taxes. In short, the larger units of government are better able than smaller units to collect income, sales, death, and other nonproperty taxes. These, it became clear many years ago, will be called upon to provide some of the money for schools, public assistance, highways, and other functions.

4. States prescribe the obligations of localities to perform functions. States also grant the legal authority of local governments to tax and in other ways influence their power to raise revenue. State governments, therefore, exert commanding influence on local finances.

5. The spending in one community has "spillover" effects outside, nearby and possibly to some extent far across the country. The amount spent for functions, and the quality of performance, in one State, or locality, will not be a matter of indifference in the rest of the country.

6. Overlapping (sometimes called double or multiple) taxation, increases as more and more units at different levels of government utilize consumption, business, and income taxes. One burden piled on others may produce a total result significantly different from anything desired or desirable. The revenue which one government can raise will be affected by the use which others are making of the same tax base. Moreover, costs of administration and complianice of such multiple taxes lead to waste and apparently needless use of resources. Fortunately, evidence of progress exists; many States, as noted earlier, have made their income tax reporting requirements conform to the Federal, easing greatly the taxpayer's job of compliance. Undoubtedly, however, more can be achieved.

7. The use of government to redistribute income by providing some groups with relatively more than others, perhaps in government service or perhaps in transfer payments of money, will create special problems of intergovernmental relations.

8. The exemption of governments from one another's taxes creates conflicts. For example, when the Federal or a State Government acquires real estate, the locality loses part of its property tax base. When a town or city engages in business-type activity, such as the provision of utility services, the State government cannot collect income tax as it could if a private, profitmaking business supplied the service. Deductibility, such as local taxes in computing State or Fed-

eral income tax, will relate the finances of different governments in ways which can be complex; the results will be diffiuclt to appreciate fully.

Coordination and Cooperation [1]

In some respects various States and localities have competing, even antagonistic, interests. Yet these governments also need to cooperate if they are to deal efficiently with problems of mutual concern—water, traffic, or policing in a metropolitan area; preventing evasion of State sales taxes; deciding on the relative State and local use to be made of the same tax base. Arrangements for getting such cooperation are far from adequate, but many developments are taking place.

Interstate compacts, for example, regarding license fees and motor fuel taxes paid by truckers or the development of river areas, are negotiated and approved by Congress. Less formal agreements among States deal with a variety of problems. Governors meet together to discuss their common problems; so do mayors. Interesting procedures to serve mutual interest are developing in urban areas where the problems are varied, complex, and changing. Dozens of separate governments in the same area claim independence, but in fact they depend on each other. In some cases, State governments provide authority or compulsion for neighboring localities to work together. Frequently, localities contract for services to be provided by one government in return for payment. The growth of professionalism among civil servants enlarges informal cooperation; influential results, even though largely unnoticed by the public, are modifying local performance and even policymaking. Local personnel discover many aspects of common interest in the solution of problems of policing, public health, education, and other activities.

How can we improve methods of dealing with the many and overlapping problems. Possibilities have been studied extensively, by legislative bodies, special commissions, professional groups, and scholars. In 1959 President Eisenhower signed a law setting up the Advisory Commission on Intergovernmental Relations. Its 25 members include Congressman, Cabinet members, Governors, mayors, members of State legislatures, county officers, and private citizens. A professional staff aided by expert consultants has produced excellent analyses of problems, some broad and some pinpointed to narrowly specific problems. The Commission has seen some of its recommendations adopted widely. For example, in their 1964–65 sessions 39 State legislatures enacted one or more proposals of the Commission. In 1965 Congress adopted a dozen recommendations. Yet, as of 1966, the Commission's list of unfinished business is long and growing.

Intergovernment Payments: Grants-in-Aid

Payments from governments at one level to those at another are no modern creation. Their rapid growth in recent years, however, has altered their role beyond measure (Table 16). Complex and widely diverse systems have been developed. States frequently *share* with

[1] The coordination which results from grants-in-aid is discussed later.

localities the revenue from one or more taxes. For example, Michigan gives cities and townships one-eighth of sales tax proceeds on the basis of population; Wisconsin shares one-third of personal income tax revenue with counties, cities, and towns. However, a large portion of state payments to local government, and almost all Federal distributions, take the form of *grants-in-aid.*

TABLE 16.—*Intergovernmental revenue as percent of total general revenue, selected years, 1922–65*

[Dollar amounts in millions]

Year	State				Local			
	Amount		Percent of total general revenue		Amount		Percent of total general revenue	
	From Federal Government	From local government	From Federal Government	From local government	From Federal Government	From State government	From Federal Government	From State government
1922	$99	$27	7.9	2.2	$9	$312	(1)	8.1
1927	107	51	5.3	2.5	9	596	(1)	10.1
1936	719	39	19.6	1.1	229	1,417	3.7	22.9
1946	802	63	12.8	1.0	53	2,092	.6	25.4
1954	2,668	215	17.4	1.4	298	5,635	1.5	28.8
1960	6,382	363	23.3	1.3	592	9,522	1.8	28.8
1962	7,108	373	22.8	1.2	763	10,879	2.0	28.4
1964 [2]	9,046	417	24.0	1.1	956	12,873	2.2	29.2
1965 [2]	9,874	447	24.1	1.1	1,155	14,077	2.4	29.4

[1] Less than 0.05 percent.
[2] Fiscal year.

Source: Department of Commerce, Bureau of the Census.

Although Federal grants to aid a few State-local activities go back many decades, the dollar amounts were small before the Great Depression. They then increased to meet serious emergencies. New programs were added, and with a few exceptions, they continued after prosperity returned. Since World War II Federal grants have multiplied, not only in dollar amounts but also in the number of different programs. In 1955 around 90 Federal *grant-in-aid* programs were in effect; the 1965 total was at least 140,[2] and in 1966 the number was increased significantly.

FUNCTIONS FINANCED BY INTERGOVERNMENTAL PAYMENTS

Table 17 shows the major functions which are financed by intergovernmental payments. Education gets much the largest total, with highways and public welfare next and approximately equal. The latter two each received roughly twice or more as much as education in Federal funds. By 1967, however, Federal grants for education will have risen markedly.

[2] Estimates of the number of programs differ because of lack of agreement whether related activities make up a single program or are better considered as two or more. For example, the "school lunch program," which distributes commodities and makes direct payments to participating schools, may not be substantially different from the "school milk program," which makes payments to States to increase milk consumption by school children.

TABLE 17.—*Intergovernmental expenditure by selected function and level of government, selected years, 1953–65*

[Millions]

Source of intergovernmental funds [1]	Functions					
	Education	Highways	Public welfare	Health and hospitals	Natural resources	Social insurance administration
1953:						
Federal	$508	$510	$1,332	$116	$66	$196
State	2,737	803	981	130	11	
Local	14	67	23	39	8	
1957:						
Federal	60	944	1,557	111	122	245
State	4,094	1,071	1,025	253	11	
Local	16	26	25	54	2	
1960:						
Federal	950	2,905	2,070	135	127	325
State	5,300	1,247	1,483	176	20	
Local	(2)	41	31	72	(2)	
1963:						
Federal	1,384	2,981	2,752	184	164	342
State	6,993	1,416	1,919	207	28	
Local	25	29	35	75	3	
1965:						
Federal	1,677	3,997	3,098	292	187	413
State	8,351	1,630	2,436	241	38	
Local	20	32	36	80	1	

[1] Local figures represent payments to State governments only; interlocal transactions excluded.
[2] Minor amounts not included.

Source: Department of Commerce, Bureau of the Census.

REASONS FOR GRANTS [3]

Why have intergovernmental grants grown so much? Some of the reasons are implied in the points made earlier. Local governments have felt pressures to enlarge expenditures more rapidly than the public wished to increase utilization of the property tax; States developed new revenue sources which could help finance payments to localities. Somewhat similarly, the Federal Goverment has been able to raise funds—by borrowing during the 1930's and more recently from a rapidly growing income tax base and progressive rates—with less difficulty than States or localities would have in getting such amounts. Some supporters of Federal aids emphasize the argument that the Federal revenue system utilizes taxes which come nearer to meeting the criteria of a good revenue system than do the taxes of states and localities.[4]

Another reason for the growth of "payments" from higher to lower levels of government has been a desire by various groups to influence both the total and the pattern of government expenditure. For example, how could the counties of a State—or the States of the Nation— be induced to develop a unified highway system? Would it not

[3] For the sake of simplicity, the term "grant" will be used here to include tax sharing. Although this usage is now customary, the two have somewhat different economic and political significance. Grants may carry with them more control over spending of the funds than does tax sharing. When the State and its localities share in the revenue from a tax, each feels the effect of fluctuations in yield; some grants, however, are for fixed amounts in the short run so that one level, usually the State, must absorb all of the results of yield variations.

[4] While the argument seems plausible, a more thorough analysis reveals reasons for doubt. No one can be sure what *changes* in the two revenue systems would result from the heavier use of one to relieve the other.

be desirable to get all school districts to offer standards of education above the level some would provide? How could all States be induced to offer more medical aid to the aged poor? In practice, grants have been responsible for an increase in the total amount of State and local expenditures. Moreover, the allocation among functions has undoubtedly been modified, and so have the methods of actual performance.

The justification advanced for the extension of influence may be a belief that the quality of performance of a function in one community has significance outside. It is argued, for example, that the common responsibility for defense, the constant movement of population, the interdependence of all parts of the economy, and the needs of citizenship—all combine to make health, education, reduction of poverty, urban transit, and so forth more nationwide, and less completely local, matters than Americans once believed. When some areas fail to provide good quality government service, people far removed may suffer at least a little. Perhaps, therefore, all taxpayers should be compelled to help pay for services in other areas. Some spillover effects unquestionably develop. But to what extent? The benefit to people in one area of better performance by localities at the other side of the State or Nation may be trifling. Yet the existence of even a little potential benefit has been cited to support action to compel one group to help pay for services elsewhere without any evidence that on balance there is likely to be net benefit.

Support for the use of grants to influence expenditures also comes from a belief that the larger jurisdiction (State vis-a-vis localities or Nation vis-a-vis States or localities) can and will direct performance to achieve better results than would the smaller ones acting on their own.

The growth of Federal-to-State and State-to-local grants for assistance to the poor rests in part upon a belief that the provision of relief aid is more properly the responsibility of the larger, than of the smaller, units of government. Otherwise some localities (or States) would have much greater burdens per capita than would others. And the sources of distress and causes of poverty, it is argued, lie in forces operating on a broader scale than any locality (or State) can control. Whatever the reasons for economic recession, they are not actions of State or local governments; nor are they forces which States or localities have power to control. Moreover, will not the ability to finance relief aid be least just where the need is largest?

Another type of consideration helps account for the growth of grants—the greater practical capacity of larger units to raise revenue. Localities contain all the taxpayers from whom States and the Federal Government can collect revenue. Why, then, is the ability of localities to raise taxes less than that of States? Inadequate facilities for administering some taxes, fear of suffering in the competition for business, and the greater force of opposition to tax increases when exerted close to home—all these, it is said, limit the actual ability of many localities to pay their own way. States are somewhat freer than localities from interarea competition for business, but it cannot be ignored.

Taxes which apply to the whole State offer less room for competition among communities than when local taxes must raise the same revenue.

National taxes eliminate both interlocality and interstate competition. Federal financing, therefore, seems a way around one obstacle to either local or State financing. And is it not human for local officials to prefer to have States (or Congress) levy taxes for local benefits?

Families and businesses which are free to decide where to locate will presumably take account of governmental services, tending to favor locations where services are relatively attractive. Some of the persons attracted, however, may be unable, or unwilling, to pay the taxes needed to cover the cost of such services. High standards of welfare aid, for example, or housing subsidy or superior public schools may draw into an area some families whose presence may add more to governmental costs than to revenue. Relatively high quality government service which is supplied without a charge on the specific users will to some extent create its own demand for the service. The necessary taxes, however, will be higher than those elsewhere. The extra burdens may tend to drive away some individuals and businesses, perhaps those with relatively high taxpaying capacity but not attracted by the particular services (especially benefits for low income groups).

Some people believe that government finances should be used to redistribute income from the more to the less prosperous. What would happen if some local governments were to attempt to do much more in this direction than at present? Imagine a local tax system designed to finance far more redistribution than in other communities, *e.g.*, provide relatively extensive services for the poor to be paid for by taxes on those at the top of the income scale. In time, many businesses and individuals most burdened would tend to move to areas where they would not be compelled to pay for services bringing them little or no benefit. No single locality, nor even the largest State on down can do much through taxes and tending to alter greatly the distribution of income. The smaller the jurisdiction school district, village, city, or State, the narrower the limits on its power to tax without providing benefits which the major taxpayers believe will be worth the approximate cost to them.[5] Consequently, Americans who hope to use government to force one group to pay for benefits to others can be expected to prefer Federal taxes over reliance on State taxes—or State taxes rather than local—often press for grant method of finance by pointing out the merits of the *function*, what desirable things would result, with little or no mention of how the cost would be met. Finally, among the reasons for the growth of grants, we can note that government officials who are closely associated with particular programs, seeing opportunities for better performance, are likely to urge expansions.

Bases for Distributing Grants

Proposals for grants (or for tax sharing) must consider the question: On what basis shall the money be distributed? Sometimes the goal is to return the dollars to the places from which they come—the point of *origin* determined accurately or asserted arbitrarily. Often, however, plans utilize one of two other systems:

[5] Zoning can serve to exclude low income families by requiring high quality homes, the residents, though prosperous, may then pay less than the average of the area for public services.

(1) Grant distribution may try for an element of *equalization*, perhaps by providing more for relatively poor areas than for the more prosperous.[6] For example, more funds for schools or for relief of the needy may be given to poorer communities than to the more prosperous, that is, more relative to some measure of income or need. Presumably, then, some of the spending in poorer localities is paid for by taxes from higher income areas. Allowance may be made, at least roughly, for the effort a community has exerted in utilizing its own revenue sources. Frequently, the objective is to assure at least a minimum standard of performance everywhere.

(2) Grant funds may be used to offer incentives, to *stimulate* local (or State) governments to make efforts of certain kinds, to do more of something (or in a different way) than otherwise. A State, for example, may "say" to local governments, "For each dollar of your own money that you spend on function A, you can spend a dollar of State money." The prospect of getting $2 worth of a service by spending only $1 of money raised locally can induce localities to spend more than they ordinarily would on the designated activity. They will do so, not only because more dollars become available but also because of the incentive stemming from the nature of the grant. Sometimes, however, such a grant may do relatively less to increase the total outlay on the function than to change the emphasis and manner to comply with directions from the government which gives the funds.

Both equalization and stimulation have merits and weaknesses in theory and in practice. Stimulating grants, for example, can certainly be effective. In such cases, however, they are sometimes properly criticized for inducing "overspending" on the aided functions relative to others. Such a grant also tends to favor the more prosperous communities because they can afford to put up the money needed to take full advantage of the grant offer.[7] Equalization in grant distribution gets support from persons who believe that aiding the poorer localities (or States) also serves the broader public by making possible more and better government services of types which have significance beyond local (or State) boundaries. But who can be sure? The recipient area may keep its own effort to pay for the function below what it would otherwise exert.[8]

The actual distribution of grants will depend upon the balance of political power in State legislatures, in Congress, and in the executive branch of Government. Groups of voters who are overrepresented (in relation to population) in legislative bodies may succeed in getting for themselves relatively generous benefits. Recent reapportionment of both State legislatures and congressional districts has altered the balance of political power. Rural areas have generally lost power to urban areas, and there have been shifts in voting power which will affect

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[6] The grant-in-aid literature uses the term "equalization" with many different shades of meaning. Rarely if ever does it imply getting all persons or areas on exactly the same basis as regards the program being considered.

[7] The State or Federal tax system, of course, will take more tax dollars from people in such areas.

[8] Grants which are relatively generous to areas of below average income may delay movement of population to localities where the fundamental economic outlook offers greater promise. Grants may also discourage other adjustments which in the longer-run would prove beneficial. Evidence as to what extent these possibilities become actualities is incomplete.

city-suburb and intersuburb relations. The effects on distribution of grant funds will develop gradually.

As more Federal grants are made directly to local governments, new problems of State-local relations must be faced. Governors, State legislatures, and State agencies are bypassed. How, then, can effective statewide programs be planned and administered? Yet in the view of some observers, society will benefit from freeing urban areas from the restrictions of State governments, which are, or are said to be, less than adequately concerned with the problems of cities.

Some Features of Grant Programs

Great programs are profoundly influenced American society. But in the absence of knowledge about what would have developed otherwise, judgment of the results must be tentative. The following generalizations do not cover the whole subject and do not pretend to present a coordinated summary.

The programs have become increasingly complicated. Only experts may be able to understand some formulas now used. The few persons who are qualified to evaluate the results are likely to be too specialized (and possibly biased) to have good judgments about the merits compared with those of other public programs or private alternatives.

Details of grants can get out of date, but modernization may be put off year after year because of disagreement about what would be preferable. In one State, for example, grants to induce school consolidation continued for many years after the objective had been essentially achieved.

When one level of government pays part of the cost of programs carried out by others, officials at the level which hands out the money have responsibility for seeing that the funds are used as intended. Frequently, however, the resulting supervision arouses criticism. A weakening of local independence may be alleged, perhaps with good reason. Such control can reduce the opportunity to adapt to differences in circumstances among localities (or States). Red-tape can be worse than a nuisance. It can obstruct innovation and tie the hands of persons who would like to try something that seems better. For a single program the cost in time and money of filling out seemingly endless questionnaires (and maintaining the records required) and of handling the data submitted may not seem unreasonable. But for dozens of grant programs the total burden can weigh heavily.

"Direction from above," however, finds support as a source of positive advantage. Officials who administer grants (or lawmakers who establish programs) may set better standards than would otherwise prevail in some areas. Administrators who are able to draw upon broad experience can use it to induce—or force—improvement in performance. In many communities, for example, little or nothing may be known about the best of developments; some officials if free to do so, will resist constructive change. The central agency distributing grants occasionally helps to arrange cooperation among localities or States.

Federal influence has grown rapidly, along with Federal dollars. State and local lawmakers and administrators feel compelled to accept Federal money when it is offered; their residents would save nothing in Federal taxes (or nothing large enough to be identified) by rejecting a grant. To get the money, however, even when the Federal dollars are a small fraction of the total to be spent on the program, the receiving government may need to modify its operations to meet Federal requirements. Some of the newer programs give Federal officials considerable discretion in allocating funds. Governors, mayors, and other State-local officials are experiencing new problems in trying to get Federal funds when the decision hinges upon the judgments of a few men in Washington rather than upon fixed rules known clearly in advance.

People close to various programs differ in their evaluations of the results of the controls (as distinguished from the money). There is wide agreement, however, that efforts for improvement of controls and coordination devices are increasingly necessary as grants exert wider influence and become more complex.

Despite the large growth of Federal grants already scheduled—proposals for still greater expansion find support. A few States, and more localities, the argument runs, are not expanding and improving services rapidly enough within the limits of what appears potentially possible for the economy as a whole. Expansion of Federal aid seems to offer a way toward improvement.[9] The dollars alone will make a difference; and in addition the control exerted might increase the effectiveness.

Recently there has been discussion of a new type of Federal grant along the lines found in some other countries. The aid would be for general purposes (block grants) rather than tied to specific expenditure programs. Each State—perhaps even each locality—would be free to use the funds for what its residents believe to be of highest priority. No Federal control of particular spending programs would be involved. Although impressive arguments are made in support of such untied aid, the supporters of particular programs seem to exert more total influence. One possibility would be to consolidate the numerous grants for each broad function—welfare, education, health—freeing the States from many of the detailed controls of specific programs.

Concluding Comment

Changes of profound importance are taking place in the system of grants and, more broadly, in all aspects of intergovernmental relations. Ever larger amounts of money are involved. Complexity and interdependence increase each year. Federal influence continues to multiply. In some cases the pattern of controls has become so largely fixed that modification proves very difficult. But for the system as a whole, and, of course, especially for the newer programs, important areas of choice remain open. The quality of American government for the indefinite future will depend significantly upon how the public deals with the many problems of intergovernmental financial relations as they arise at each level of government.

[9] Compared with the necessary Federal taxes they would pay, the people of some States would get more, others less, from almost any expansion of Federal grants. Federal taxes paid by the residents of each State can be estimated and compared with grants-in-aid now received by each State. For 1965 the people of Illinois, Indiana, and New York, for example, paid about \$1.60 in Federal taxes for each dollar of nonhighway aid while for Arkansas, Mississippi, and Oklahoma the figure was around 30 cents. Tax Foundation, *Allocation of the Federal Tax Burden by State* (New York: The Foundation, 1966), p. 3.

FEDERAL AID TO STATE AND LOCAL GOVERNMENTS*

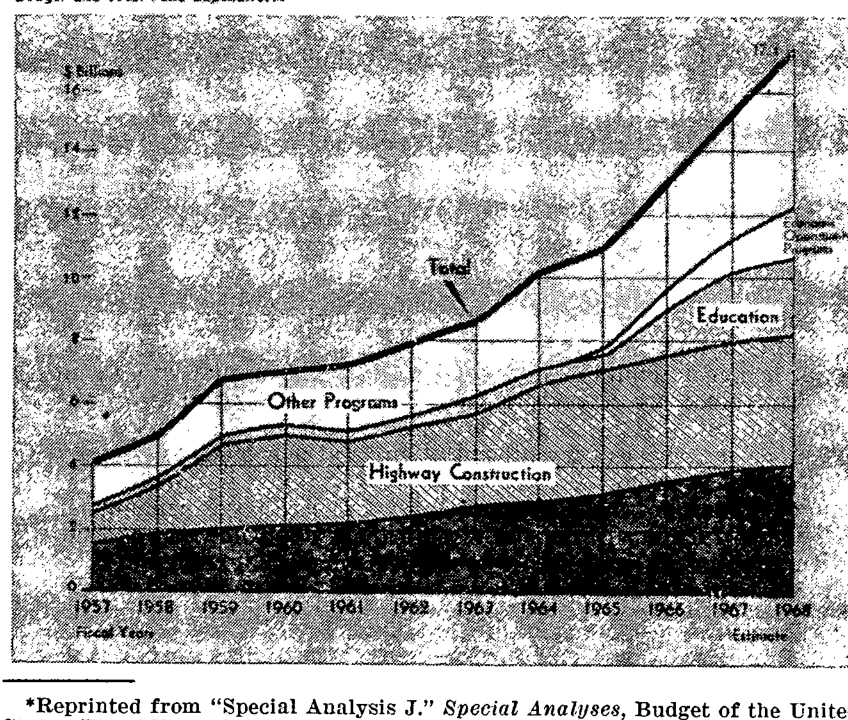
BY U.S. BUREAU OF THE BUDGET

In recent years, there has been a significant growth in the scope of cooperative governmental efforts to solve national problems. By sharing the resources derived from a growing economy, Federal aid enables vital national goals to be pursued in such areas as education, health, welfare, and urban development. At the same time, these jointly administered programs:

- Make it possible to pursue broad national objectives in a way which recognizes the diversity of local conditions and needs;
- Spread creative innovation in public services from one jurisdiction to another; and
- Preserve a fair and equitable total tax system—by relieving some of the pressure on those States and local tax sources which are less closely related to ability to pay than income taxes.

Federal Aid to State and Local Governments

Budget and Trust Fund Expenditures



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*Reprinted from "Special Analysis J." *Special Analyses*, Budget of the United States, Fiscal Year 1968.

HIGHLIGHTS FOR FISCAL YEAR 1968

The emphasis of Federal aid programs has shifted from time to time, in response to the diversity of problems confronted.

The following represent the highlights of the aid program for fiscal year 1968:

(1) *Total Federal aids* to State and local governments are estimated to increase by $2.1 billion over 1967, to $17.4 billion.[1] This represents more than a threefold increase in the short span of only a decade, and is nearly 45 percent greater than the rise in total Federal nondefense expenditures over the same period.

(2) *Public assistance and highways* continue to be the largest programs. Together, they constitute about half of total Federal aid payments.

(3) The *fastest-growing* grants are those to advance the war on poverty and to upgrade the elementary and secondary educational opportunities available to children of low-income families. Between fiscal years 1965 and 1968, grants administered by the Office of Economic Opportunity will increase by $1.3 billion and those for the new elementary and secondary education program will rise by $1.4 billion.

(4) *Total aids to metropolitan or urban areas* have risen from about $3.9 billion in 1961 to an estimated $10.3 billion in fiscal year 1968. Thus, Federal aids benefiting urban areas have grown almost $6½ billion, or nearly 165 percent in less than a decade. (Included in these amounts are grants to States which subsequently benefit urban areas.)

GROWTH AND DEVELOPMENT OF FEDERAL AIDS

The distinguishing features of our present system of Federal grants-in-aid can be traced back more than a century to the enactment of the Morrill Act in 1862. This act established land-grant colleges (so called because assistance for education was provided initially in the form of Federal land), and instituted certain minimum requirements. In rudimentary form, the pattern was established for providing needed resources in exchange for acceptance of certain national standards. (This type of aid has come to be known as categorical grants.)

Federal aid was extended to agricultural programs around the turn of the century. The second decade of the 20th century saw the inauguration of Federal assistance programs for highways, and for vocational education and rehabilitation.

In the depression years of the 1930's, the financial exigencies of the time led the Federal Government to launch a wide range of new welfare and economic security programs. These were designed not only to help individuals but also to alleviate the intense pressures on State and local resources. Other measures were enacted to provide low-rent public housing and improved health services.

The years following World War II were marked by a series of new categorical grants for health care, for education in selected fields and areas, and for renewing the physical environment of the Nation's cities.

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[1] Included in this amount are grants-in-aid and shared revenues from both administrative budget and trust funds. Loans and repayable advances are discussed separately.

More recently, significant steps have been taken to broaden elementary, secondary, and higher educational opportunities; to develop economically depressed areas of the country; to help finance health services and medical care for the indigent; and to launch a concerted attack on poverty. And, in 1966, a comprehensive new program was enacted to transform areas of cities now encumbered by slums and blight into model neighborhoods.

Factors underlying growth in Federal aids.—Increasing population and rapid urbanization have led to greater demands for the services traditionally provided by State and local governments. Programs in education, health, housing, urban renewal, highways, and public transportation have all increased in size and scope. Rapid economic change and rising affluence have stimulated programs for safeguarding the economic security of individuals. While the major burden for providing such public services rests directly upon the more than 90,000 State and local governmental jurisdictions, the Federal Government also plays a vital role: first, by providing financial assistance to State and local governments; and second, through direct operation of various programs. Furthermore, by encouraging a sound and growing economy the Federal Government helps States and localities indirectly by promoting a growing tax base.

Federal-aid program by function.—The factors creating pressures to increase Federal aids, coupled with the changing nature of State and local program needs, have altered substantially the focus of Federal aids at several junctures in the past two decades. These changes can be traced in the accompanying table.

In 1950 and 1955, prior to the advent of the expanded Federal-aid highway program, nearly three-fifths of total grant payments were for health, labor, and welfare programs. Public assistance payments alone accounted for nearly half of the total. Commerce and transportation activities comprised another one-fifth.

The Federal-Aid Highway Act of 1956 significantly modified the pattern of aid to State and local governments. By 1960, with the infusion of more than $2¼ billion in additional funds for highway grants, commerce and transportation programs moved once again to a dominant position in Federal assistance activities.

TABLE J–1.—*Percentage distribution of Federal aids to State and local governments by function* [1]

Function	1950 actual	1955 actual	1960 actual	1965 actual	1968 estimate
Agriculture and agricultural resources	5	7	3	5	3
Natural resources	2	3	3	3	3
Commerce and transportation	21	19	43	40	25
Housing and community development	1	4	4	5	7
Health, labor, and welfare	69	57	41	40	46
Education	2	8	5	6	14
Other	1	2	1	1	1
Total	100	100	100	100	100

[1] Excludes loans and repayable advances.

In more recent years, both the nature and number of aid programs have changed appreciably. In the last 4 years, the Congress enacted several programs which are aimed primarily at broadening the scope of individual opportunity and development. The cumulative effect of these programs has been to place the principal emphasis of Federal aid once again on health, labor, and welfare activities—as well as to give added impetus to education and housing and community development efforts. In 1968, these programs will account for two-thirds of total estimated aid payments.

Federal aid in relation to Federal and State-local outlays.—The rapid increase in Federal aid to State and local governments has become an increasingly important factor in the finances of all levels of government. Federal aid as a proportion of total Federal outlays has nearly doubled in the past decade—rising from 5 percent of total Federal outlays in 1957 to an estimated 10 percent in 1967. In terms of domestic programs, about one-fifth of Federal payments will take the form of grants to State and local governments in 1968. Because of strenuous efforts on their own behalf, the relative increase in the amount of Federal aid has not been quite as marked for the recipient State and local governments as it has for the Federal Government. Federal aid constituted approximately 11 percent of all general revenue available to State and local governments in 1957; the corresponding amount for 1967 will rise to an estimated 16 to 17 percent.

TABLE J–2.—*Federal-aid expenditures in relation to total Federal expenditures and to State-local revenue* [1]

	Total expenditures for aid to State and local governments, budget and trust accounts			
	Amount (millions)	As a percent of total cash payments to the public	As a percent of domestic [2] cash payments to the public	As a percent [3] of State-local revenue
1955	$3,257	4.6	11.9	10.4
1956	3,724	5.1	12.7	10.6
1957	4,039	5.0	12.5	10.5
1958	4,935	5.9	14.2	12.0
1959	6,669	7.0	15.0	14.6
1960	7,040	7.5	15.6	13.8
1961	7,112	7.1	15.0	13.2
1962	7,893	7.3	15.6	13.5
1963	8,634	7.6	16.1	13.7
1964	10,141	8.4	17.5	14.8
1965	10,904	8.9	17.7	14.7
1966	12,960	9.4	18.8	15.6
1967 estimate	15,366	9.6	19.5	16–17
1968 estimate	17,439	10.1	20.4	(4)

[1] Excludes loans and repayable advances.
[2] Excluding payments for national defense, space, and international affairs and finance.
[3] Based on compilations published by Governments Division, Bureau of the Census. Excludes State-local revenue from publicly operated utilities, liquor stores, and insurance trust systems.
[4] Not available.

Division of responsibility among governments.—From the turn of the century until the early 1950's, local government expenditures declined relative to those of the States. However, for the past decade or more, the three levels of government have shown a remarkable stability in the proportionate costs they bear for directly providing civilian services. About two-thirds of total civilian outlays are made by States and localities, with the localities alone providing more than 40 percent.

TABLE J–3.—*Direct spending for general domestic [1] programs—Percentage distribution*

Fiscal year	Federal	State	Local	Total
1965	34	23	43	100
1960	36	22	42	100
1955	38	21	41	100
1950	46	19	35	100
1944	60	12	28	100
1936	49	15	36	100
1902	28	9	62	100

[1] Direct general expenditures, excluding those for defense, space, and international programs. Excludes trust funds and Government-operated enterprises.

Source: Tabulations of the Governments Division, Bureau of the Census.

ADMINISTRATION OF FEDERAL-AID PROGRAMS

The effective administration of Federal-aid programs, while always important, has become a matter of increasing concern. The manner in which funds are distributed and the need to coordinate the growing number of aid programs have attracted particular attention.

Types of grant-in-aid formulas.—With the growth in the number and variety of grants, the methods of allocating the funds have undergone considerable change. A major feature of this change since World War II has been the increased use of fiscal "equalization" provisions, enabling States with relatively meager resources to obtain a proportionately larger share of Federal aid.

Before the 1930's, Federal grants were apportioned among the States either as a flat sum per State or on the basis of State population. More recently, many of the grant programs have taken some account of variations among States in relative fiscal capacity. In fact, several of the new grant programs enacted during the past 4 years use a "fiscal capacity" index.

Most present Federal grant programs have two distinct but coordinate provisions to determine State shares of grant funds. The first is an apportionment formula which specifies the proportion of total Federal grant funds for which each State is eligible. The second provision, a matching formula, specifies to what extent a participating State must share in the costs of the program.

Apportionment formulas vary considerably, but most often incorporate one or more of the criteria embraced by the so-called "PFN" formula: Population, financial ability, and need for the program.

- *Program need* is usually measured by the total population or the relevant population group.
- *Financial ability* is typically measured by relative per capita income. This is the case, for example, in grants for school lunches.

Matching requirements—requiring States to share in program costs—are common elements of most grants. The matching or cost-sharing requirements are of two kinds: variable matching, which takes account of the differing abilities of the States to support their aided functions; and fixed ratio matching under which each State is required to share in the same proportion of program cost.

Growth in number of aid programs.—The number as well as the magnitude of Federal-aid programs has grown in response to the increasing array of problems faced by State and local governments which are also of immediate national concern.

While not strictly comparable to the concept of aid used in this analysis, the Legislative Reference Service of the Library of Congress has tabulated the number of aid programs in effect during the past 3 years. In early 1964, the number of major assistance programs exceeded 115. Two years later, the number of programs had grown to 162. In many cases, a given program has several different grant authorizations. The total number of such authorizations rose from 239 in 1964 to 399 in 1966.

TABLE J-4.—*Number of aid authorizations in effect at specified dates*

Functional category	Apr. 1, 1964	Jan. 4, 1965	Jan. 10, 1966
National defense	11	11	11
Agriculture and agricultural resources	12	12	15
Natural resources	33	41	54
Commerce and transportation	23	25	37
Housing and community development	17	23	32
Health, labor, and welfare	94	114	153
Education	37	42	82
Veterans benefits and services	1	3	3
General government	11	12	12
Total number of authorizations	239	283	399
Total number of major programs	(116)	(135)	(162)

Source: Labovitz, I. M., "Number of Authorizations for Federal Assistance to State and Local Governments Under Laws in Force at Selected Dates During 1964–66" (Library of Congress), July 5, 1966.

On the agency basis, the largest number of programs—more than 45 percent of total authorizations—is administered by the Department of Health, Education, and Welfare.

The Departments of Agriculture, Interior, and Housing and Urban Development, combined, account for an additional 25 percent.

Measures to coordinate Federal-aid programs.—While easing State and local financial problems, the rapid increase in new aid programs has focused attention on the need for coordination and improvement in their administration.

A number of steps are being taken to improve the administration of grant programs and intergovernmental relations:

- High-level liaison with State and local governments is being provided through the Vice President of the United States and the Executive Office of the President.
- Funds will be sought to enable the Bureau of the Budget to intensify its review of intergovernmental relations problems and to strengthen the coordination of Federal programs, particularly in the field.
- Systematic examinations of problems of intergovernmental coordination are being made in selected States.
- Coordination of Federal efforts is being strengthened by the specific assignment of such roles to the Department of Housing and Urban Development for urban areas and the Department of Agriculture in rural areas.
- Simplification of the grant-in-aid system has been undertaken in the area of public health. A number of grants have already been brought together under the new partnership in health pro-

gram. Other areas of Federal aid will be studied to determine whether additional grants can be combined to make them more effective tool of intergovernmental action.

- Improved consultation with elected officials of State and local governments is being sought in the development and execution of Federal programs.
- New aids to multijurisdictional coordination have been provided in such programs as those for metropolitan development, pollution control in river basins, and regional economic development.
- Steps are being taken to coordinate Federal and State actions in establishing development planning districts.

As a further step toward more effective cooperative governmental services, legislation will be proposed to improve the training and mobility of State and local personnel. In addition, the Congress will be asked again to take favorable action on general legislation to improve and strengthen intergovernmental cooperation.

Efforts to refine the grant as an instrument of cooperative intergovernmental action are clearly worthwhile. Grants have served us well in the past and offer equal promise for the future. These joint Government programs have proven *effective*—by combining available resources, by specifying certain minimum standards of performance, and by decentralizing their actual administration. They are also *efficient*, since Federal funds are focused on those national goals and governmental units which need them most.

Special Aspects of the 1968 Aid Program

This section focuses only on the 1968 aid program, and some of its significant features. Major changes from the preceding year, and Federal aid by agency and type are the principal topics treated.

Major program changes for 1968.—In 1968, total expenditures under existing and proposed programs for financial assistance to other levels of government will increase substantially. The total is estimated to be $2.1 billion more than for 1967 and $4.5 billion more than the actual total for 1966.

The major increases in grants for 1968 over the 1967 estimates are as follows:

Health, labor, and welfare grants will rise an estimated $1 billion, as antipoverty efforts gain further momentum and cooperative health programs increase in scope.

Grants for housing and community development are up by an estimated $446 million (54 percent over 1967), as programs to assist in solving urban slum, growth, and transit problems are intensified.

Educational assistance programs are estimated to rise by $260 million to a total of $2.5 billion, largely reflecting legislation enacted in the past 4 years for elementary, secondary, vocational, and higher education.

Decreases in expenditures in 1967 are expected to occur in: (1) accelerated public works (almost $36 million), as most projects are now completed; and (2) Federal-aid-highways (nearly $125 million).

Federal-aid programs by agency.—In 1968, the Department of Health, Education, and Welfare will spend approximately $8 billion through its grants-in-aid programs—about 46 percent of total Federal aid. Another 23 percent, or $4.1 billion, will be accounted for by the Department of Transportation. The Office of Economic Opportunity, and the Departments of Agriculture and Housing and Urban Development will finance an additional 22 percent of Federal-aid programs. The detailed table at the end of this analysis lists the various programs of Federal aid to State and local governments by function, type of aid, agency, and major program group.

TABLE J-5.—*Federal aids by agency*[1]

[In millions of dollars]

Agency	1966 actual	1967 estimate	1968 estimate
Executive Office of the President	0.9	0.7	0.2
Funds appropriated to the President:			
Economic opportunity programs	639.3	1,103.4	1,410.0
Other (primarily public works acceleration and disaster relief)	221.8	120.1	34.5
Department of Agriculture	849.3	1,101.5	1,221.4
Department of Commerce	17.7	96.6	220.0
Department of Defense—Military	24.3	26.2	32.7
Department of Defense—Civil	20.0	16.8	35.7
Department of Health, Education, and Welfare	5,676.8	7,051.6	7,963.3
Department of Housing and Urban Development	582.0	765.0	1,203.7
Department of the Interior	237.1	288.6	413.3
Department of Justice	.6	10.4	31.9
Department of Labor	491.3	547.5	591.6
Department of State	6.3	6.4	6.4
Department of Transportation	4,055.4	4,063.1	4,093.2
Treasury Department	71.4	80.1	76.7
General Services Administration	.7		
Veterans' Administration	8.6	11.4	15.0
Other independent agencies	12.4	16.8	18.9
District of Columbia[2]	44.2	60.0	70.6
Total, budget and trust fund expenditure for Federal aid	12,960.1	15,366.1	17,439.0

[1] Excludes loans and repayable advances.
[2] Represents Federal payments to the District of Columbia.

Types of Federal aid.—Federal financial assistance to State and local governments primarily takes the form of grants-in-aid and shared revenue. In 1968, it is estimated that $17.2 billion or 98.7 percent of total expenditures for aid will take the form of grants-in-aid. Shared revenue will account for $223 million, or 1.3 percent. Apart from these types of Federal aid, many other Federal expenditures which are not included in this analysis affect the finances of State and local governments, such as contractual payments or grants to public institutions for research and training in specialized fields.

TABLE J-6.—*Types of Federal aid by function, 1968*

[In millions of dollars]

Function	Grants-in-aid	Shared revenues	Total aids
National defense	32.9		32.9
International affairs and finance	6.0		6.0
Agriculture and agricultural resources	559.0		559.0
Natural resources	405.3	136.0	541.3
Commerce and transportation	4,313.8		4,313.8
Housing and community development	1,274.3		1,274.3
Health, labor, and welfare	8,042.0		8,042.0
Education	2,497.9		2,497.9
Veterans benefits and services	15.0		15.0
General government	70.1	86.7	156.8
Total	17,216.3	222.7	17,439.0

Formerly, certain transactions of a strictly financial nature were also classified as aids to State and local governments. *Loans and repayable advances* were included in the aid totals on a net basis (disbursements less repayments or sales). Since the amounts were small (an average of less than 3 percent of the total), and essentially different in kind from the outright grants and shared revenues, they are shown separately this year. Moreover, to measure the total activity generated by these loans and advances, they are shown on a gross, as well as net, disbursements basis. Net loans and repayable advances have been removed from the historical series on Federal aids to make the data consistent over time.

TABLE J-7.—*Loans and repayable advances*

[Budget and trust accounts in millions of dollars]

Agency and program	Gross disbursements			Net expenditures		
	1966 actual	1967 estimate	1968 estimate	1966 actual	1967 estimate	1968 estimate
Agriculture and agricultural resources	0.9	1.0	0.8	0.9	1.6	1.4
Natural resources:						
Department of Agriculture: Watershed protection and flood prevention	4.8	6.8	6.2	4.3	6.2	4.8
Department of the Interior: Irrigation projects	18.0	14.4	15.5	17.8	14.2	15.4
Total, natural resources	22.8	21.2	21.7	22.1	20.4	20.2
Commerce and transportation: Economic development	3.7	21.5	38.6	3.7	21.5	21.4
Housing and community development:						
Department of Housing and Urban Development:						
Liquidating programs: Community facilities loans	-------	-------	2.6	-.4	-.4	2.2
Low-rent public housing program	199.3	218.8	246.5	-2.1	-.2	-.2
Public facilities	33.4	54.1	56.2	28.9	-30.6	-27.5
Public works planning	16.1	20.5	19.1	8.8	12.0	10.0
Urban renewal fund	284.9	625.0	371.3	30.3	36.7	22.5
Urban transit fund	3.1	-------	-------	2.9	-.2	-.2
District of Columbia: Capital outlays and operations	71.2	90.2	52.7	24.1	55.1	52.7
Total, housing and community development	608.0	1,008.6	748.4	92.5	72.4	59.5
Education:						
Department of Health, Education, and Welfare:						
Student loan fund	-------	17.5	-------	-------	17.5	-------
Higher education facilities	25.4	127.7	99.5	25.4	-27.7	-.5
Department of Housing and Urban Development: College housing	179.0	195.0	171.6	167.2	-87.8	-555.3
Total, education	204.4	340.2	271.1	192.6	-98.0	-555.8
General government:						
Department of Defense—Civil: Corps of Engineers: Construction of power systems, Ryukyu Islands	.4	4.4	4.0	.4	4.4	4.0
Department of the Interior: Administration of territories	5.4	5.4	5.0	5.4	5.4	4.4
Total, general government	5.8	9.8	9.0	5.8	9.8	8.4
Total, loans and repayable advances	845.6	1,402.3	1,089.6	317.6	27.7	-444.9

AIDS TO URBAN AREAS AND REGIONS

Increasing attention has been focused recently on two cross-cutting issues concerning Federal aids:

(1) The amount of these aids which assist metropolitan or urban areas in meeting their pressing needs; and

(2) The geographical distribution of Federal aids.

Counties are the smallest geographical unit for which information on Federal aids is generally available. Therefore, Standard Metropolitan Statistical Areas (SMSA's) were chosen as the definition of "urban" for purposes of the figures in the following analysis—since SMSA's are generally combinations of entire counties. These areas cover the bulk of the urban population and display the urban phenomena which place heavy pressure on public service requirements; high population density and rapid population growth. Nevertheless, the amounts shown still only represent *approximations*, based on the best information readily available.

Aids to urban areas.—Approximately $10.3 billion of the $17.4 billion of total Federal aids will be spent in SMSA's to help fill the growing gap between their needs and resources. This represents an increase of almost $6½ billion or 165 percent over the amount of aid provided to such urban areas in 1961. The amount will have increased almost $3 billion in the short span of only 2 years.

The table below shows the major sources of urban aid, by function and program, for selected years.

TABLE J–8.—*Federal-aid payments in urban areas (budget and trust accounts)*

[In millions of dollars]

Function and program	1961 actual	1966 actual	1968 estimate
National defense (civil defense and National Guard centers)	10	20	26
Agriculture and agricultural resources	155	149	235
Natural resources	54	105	200
Commerce and transportation:			
Highways	1,398	2,138	2,176
Economic development		2	36
Airports	36	30	33
Other	1	52	6
Housing and community development:			
Public housing	105	169	208
Water and sewer facilities			61
Urban renewal	106	235	336
Model cities			132
Urban transportation		14	98
District of Columbia	25	44	71
Other	2	23	100
Health, labor, and welfare:			
Office of Economic Opportunity		449	1,010
School lunch, special milk, food stamp	131	196	290
Hospital construction	48	75	95
Community health	33	127	450
Public assistance (including medical care)	1,170	1,905	2,243
Vocational rehabilitation	37	108	211
Employment security and manpower training	303	417	501
Other	21	47	101
Education:			
Elementary and secondary	222	895	1,292
Higher education	5	37	172
Vocational education	28	90	160
Other	3	27	80
Other functions		(2)	6
Total aids to urban areas	3,893	7,354	10,329

2 Less than $50,000.

The major increases in Federal grants for urban areas occur in housing and community development, education, and programs to improve the welfare of our disadvantaged citizens.

In addition to the grants and shared revenue which will be provided to State and local governments in 1968, approximately $498 million in loans and repayable advances will also be made available. This represents approximately 70 percent of total disbursements for such financial assistance, and an increase of $322 million from the amount so provided in 1961.

Federal housing loans and loan insurance encourage additional public and private funds to be provided to meet urban housing needs. Mortgage funds totaling $10.6 billion in 1968 will be covered by these programs, up $3.3 billion from 1961.

The emphasis in this analysis has been on those programs which provide financial assistance to urban communities to help them meet their public service needs. It includes grants made to States which are subsequently spent to benefit metropolitan areas. No attempt has been made to add up all the various forms of funds to reach an overall total. However, the Department of Housing and Urban Development (HUD) estimates that the total Federal financial commitment for urban social and community development aids could exceed $33 billion in 1968—nearly double the level in 1961.

While the tabulations are not fully comparable, the estimates of the Department of Housing and Urban Development do serve to put in perspective the more direct urban aid expenditures covered by this analysis. The Department's figures indicate the magnitude of financial involvement in communities of 2,500 population or over, as measured by obligations or commitments. (Obligations or commitments indicate the current level of program activity rather than the current disbursement of funds.) The HUD data also include the cost of some construction undertaken and services provided directly by the Federal Government in urban areas.

Regional distribution of Federal aids.—The regional distribution and relative importance of Federal aids to State and local governments can be seen in the following table:

TABLE J–9.—*Regional distribution of Federal aid, fiscal year 1965* [1]

Region	Total (in millions)	Per capita	Percent of State and local government general revenue
New England	$619.7	$55.67	14.5
Mideast	1,796.2	43.60	10.6
Great Lakes	1,614.0	42.31	11.7
Plains	973.6	61.31	16.0
Southeast	2,637.7	62.52	20.4
Southwest	998.2	63.69	18.2
Rocky Mountain	481.6	102.53	22.9
Far West	1,658.7	66.61	13.3
United States	[2] 10,903.9	56.26	14.7

[1] Excludes loans and repayable advances.
[2] Includes $124,100,000 for Puerto Rico, the Virgin Islands, and other.

Sources: Annual Report of the Secretary of the Treasury and "Governmental Finances in 1964–65," Bureau of the Census.

The distribution of Federal aids on a regional basis ranges from a high of more than $2.6 billion in the Southeast to a low of $482 million in the Rocky Mountain area. However, when account is taken of population differences, the Rocky Mountain area ranks highest with grant payments per capita reaching $102.53, while the Great Lakes and Mideast regions are lowest with $42.31 and $43.60 per capita respectively. Population density and per capita income are the two major factors which account for this wide variation.

Population density is inversely related to the level of per capita aids. The population density of the Rocky Mountain area is the lowest of the regions, while per capita aids are highest. At the other end of the scale, per capita aids are lowest in the Great Lakes and Mideast where population density is the greatest. This inverse relationship stems primarily from aids for highway construction. The cost of building a highway which crosses a State is little affected by the number of people living in the State.

Per capita aid is also inversely related to per capita income. There are two reasons for this relationship. First, some grant programs, such as hospital construction and water pollution control, require lower matching by the relatively poorer States. Second, certain grant programs, such as those for public assistance and elementary and secondary education, are designed as aids to the disadvantaged and, hence, tend to flow to States with lower incomes.

The forthcoming Annual Report of the Secretary of the Treasury for 1966 (table 84) provides more detailed information concerning the State distribution of grants-in-aid and shared revenues for fiscal year 1966.

TABLE J-10.—*Federal aid to State and local governments*

[In millions of dollars]

Agency and program	1966 actual	1967 estimate	1968 estimate
BUDGET AND TRUST ACCOUNTS [1]			
GRANTS-IN-AID AND SHARED REVENUE [2]			
National defense:			
Executive Office of the President: Office of Emergency Planning—Federal contributions to State and local planning	0.9	0.7	0.2
Department of Defense—Military:			
Civil defense shelters and financial assistance	21.2	25.5	30.0
Construction of Army National Guard centers	3.0	.7	2.7
Total, national defense	25.2	26.9	32.9
International affairs and finance: Department of State: East-West Cultural and Technical Interchange Center	6.3	6.2	6.0
Agriculture and agricultural resources:			
Department of Agriculture:			
Commodity Credit Corporation and Consumer and Marketing Service: Removal of surplus agricultural commodities and value of commodities donated	226.9	324.5	361.2
Rural water and waste disposal facilities	.1	40.9	30.0
Rural housing for domestic farm labor		6.0	4.0
Resource conservation and development	.3	1.2	2.3
Agricultural Research service: Grants for basic scientific research	1.0	1.0	1.0
Agricultural experiment stations	50.9	57.0	64.1
Cooperative agricultural extension service	86.7	89.5	93.6
Payments to States, territories, and possessions, Consumer and Marketing Service	1.8	1.8	1.8
Commodity Credit Corporation: Grants for research	1.1	3.3	1.2
Total, agriculture and agricultural resources	368.7	525.1	559.0

See footnotes at end of table, p. 170.

[In millions of dollars]

Agency and program	1966 actual	1967 estimat	1968 estimate
BUDGET AND TRUST ACCOUNTS [1]—Continued			
GRANTS-IN-AID AND SHARED REVENUE [2]—continued			
Natural resources:			
Department of Agriculture;:			
Watershed protection and flood prevention	69.1	68.2	71.4
Grants for forest protection, utilization, and basic scientific research	18.7	19.2	19.8
National forest and grassland funds; payments to States and counties (shared revenue)	35.9	42.9	43.6
Department of Defense—Civil: Corps of Engineers:			
Payment to California, flood control	18.1	14.4	33.7
Payments to States, Flood Control Act of 1954 (shared revenue)	2.0	2.4	1.9
Department of the Interior:			
Water pollution control	88.5	92.0	171.0
Payments to States and counties from grazing receipts, grasslands, and sales of public lands (shared revenue)	.9	1.0	1.1
Bureau of Indian Affairs: Resources management	.9	.9	.9
Bureau of Reclamation:			
Grants	.1	.1	-----------
Payments to Klamath area, Arizona and Nevada (shared revenue)	.6	.7	.7
Office of Water Resources Research	5.4	5.6	.80
Office of Saline Water	-----------	-----------	3.5
Payments from grant lands: Oregon, California, and Coos and Douglas Counties (shared revenue)	20.2	21.4	24.3
Mineral Leasing Act payments (shared revenue)	46.9	48.2	49.2
Bureau of Mines:			
Mine drainage and solid waste disposal	.3	.5	1.1
Appalachian mining area restoration	.4	2.3	11.0
Aid for commercial fisheries	.4	3.2	4.4
Payment to Alaska from Pribilof Island fund (shared revenue)	-----------	.3	.4
Fish and wildlife restoration and management	21.8	24.7	25.1
Wildlife refuge fund and grasslands payments (shared revenue)	.4	1.6	1.5
Land and water conservation grants	3.1	28.8	51.0
Preservation of historic properties	-----------	-----------	1.8
Department of State: Pacific Halibut Commission	-----------	.2	.4
Federal Power Commission: Payments to States (shared revenue)	.1	.1	.1
Tennessee Valley Authority: Payments in lieu of taxes (shared revenue)	10.4	11.9	13.1
Water Resources Council	-----------	1.4	2.1
Total, natural resources	344.5	391.7	541.3
Grants-in aid	(226.9)	(261.3)	(405.3)
Shared revenue	(117.5)	(130.4)	(136.0)
Commerce and transportation:			
Funds appropriated to the President: Public works acceleration	84.7	35.7	-----------
Department of Commerce:			
State marine schools	.4	.4	.4
Improvement of weights, measures, and technology	.1	-----------	-----------
Office of State Technical Services	1.3	3.5	7.1
Economic development assistance	7.0	50.6	131.8
Appalachian development highways	8.9	42.1	80.7
Department of Transportation:			
Chamizal Memorial Highway	-----------	-----------	4.0
Forest and public lands highways	40.0	39.4	(3)
Highway safety and beautification	2.5	42.8	(4)
Highway Beauty-Safety (trust fund)	-----------	-----------	227.5
Federal-aid highways (trust fund)	3,958.9	3,926.8	3,802.7
Federal Aviation Administration: Federal-aid airport program	54.0	54.0	59.0
Appalachian Regional Commission	.9	.9	.6
Total, commerce and transportation	4,158.7	4,196.3	4,313.8
Grants-in-aid, administrative budget	(199.8)	(269.4)	(283.6)
Grants-in-aid, trust fund	(3,958.9)	(3,926.8)	(4,030.2)

See footnotes at end of table, p. 170.

[In millions of dollars]

Agency and program	1966 actual	1967 estimate	1968 estimate
BUDGET AND TRUST ACCOUNTS[1]—Continued			
GRANTS-IN-AID AND SHARED REVENUE[2]—continued			
Housing and community development:			
Funds appropriated to the President: Alaska mortgage indemnity grants		3.3	
Department of Housing and Urban Development:			
Alaska housing			.1
Low-rent public housing program	225.5	249.1	277.7
Urban planning grants	20.1	22.0	30.0
Open space land and urban beautification	7.9	28.5	57.8
Grants for basic water and sewer facilities		40.0	110.0
Grants for neighborhood facilities		3.0	15.0
Model city grants		5.2	147.0
Urban renewal	312.8	361.3	447.5
Urban transportation assistance	15.8	55.9	108.7
Metropolitan development incentive grants			7.0
Other aids for urban renewal and community facilities			3.0
District of Columbia: Federal payment	44.3	60.0	70.6
Total, housing and community development	626.2	828.2	1,274.3
Health, labor, and welfare:			
Funds appropriated to the President:			
Disaster relief	131.7	81.1	34.5
Office of Economic Opportunity:			
Community action programs:			
Headstart	75.7	250.0	360.0
Other	215.0	318.0	436.0
Neighborhood Youth Corps	239.3	291.0	300.8
Work experience	74.4	124.8	97.0
Adult basic education	21.1	13.9	
Adult work training and special impact		75.0	185.0
Other	13.8	30.7	31.2
Department of Agriculture:			
Special milk and school lunch	291.5	315.7	343.6
Food stamp	65.4	131.4	184.0
Department of Health, Education, and Welfare:			
Hospital construction	196.1	219.9	230.5
(Portion to private, nonprofit institutions)	(104.5)	(114.4)	(116.3)
Health manpower	6.7	47.5	138.3
Comprehensive health planning and services		4.0	105.7
Medical services: Hospitals and medical care, Hawaii; and Indian health facilities	.8	1.2	1.5
National Institutes of Health	.1		
Mental health	92.4	112.4	216.1
Health services	20.4	33.2	55.7
Disease prevention and environmental health	43.6	72.8	49.6
Maternal and child welfare	114.4	154.6	207.3
Medical assistance	769.5	1,038.2	1,182.8
Public assistance (exclusive of medical assistance)	2,758.0	2,887.6	2,970.2
Vocational rehabilitation	158.8	256.8	309.7
Administration on Aging	1.3	4.6	10.3
Department of Labor:			
Manpower development and training activities	22.0	30.0	40.0
Grants to States for administration of employment security programs (trust fund)	469.3	517.5	551.6
Equal Opportunity Commission		.7	.7
Total, health, labor, and welfare	5,781.3	7,012.4	8,042.0
Grants-in-aid, administrative budget	(5,312.0)	(6,494.9)	(7,490.4)
Grants-in-aid, trust fund	(469.3)	(517.5)	(551.6)
Education:			
Department of Health, Education, and Welfare:			
Assistance to schools in federally affected areas	378.2	391.0	390.0
Elementary and secondary educational activities	900.0	1,324.2	1,456.1
Higher education activities (including land-grant colleges)	53.2	170.3	345.3
Vocational education	128.5	220.7	228.0
Arts and humanities educational activities	.1	.5	.5
Grants for library services and construction	44.8	89.9	107.3
Training teachers of the handicapped	2.6	6.0	13.0
Community services and National Teachers Corps		3.0	8.5
Civil rights educational activities	2.0	3.5	15.9
Teaching of the blind and deaf	.9	1.1	1.6
Educational television facilities	4.4	7.8	19.7
Department of the Interior: Bureau of Indian Affairs: Education and welfare services	10.0	9.5	10.0
National Foundation on the Arts and Humanities		1.0	2.2
Total, education	1,524.7	2,228.5	2,497.9

See footnotes at end of table, p. 170.

[In millions of dollars]

Agency and program	1966 actual	1967 estimate	1968 estimate
BUDGET AND TRUST ACCOUNTS[1]—Continued			
GRANTS-IN-AID AND SHARES REVENUE[2]—continued			
Veterans' benefits and services: Veterans' Administration:			
Aid to State homes	8.6	9.0	9.3
Grants for construction of State nursing homes		1.0	4.2
Administrative expenses	.3	1.5	1.5
Total, veterans' benefits and services	8.9	11.4	15.0
General government:			
Funds appropriated to the President: Transitional grants to Alaska	5.4	(5)	
Department of the Interior:			
Grants to territories	26.5	36.8	38.2
Internal revenue collections, Virgin Islands (shared revenue)	10.4	11.1	10.0
Department of Justice:			
Law enforcement assistance:			
Education and training	.6	4.2	6.2
Other		6.3	6.3
Crime prevention and control			19.5
Treasury Department:			
Tax collections for Puerto Rico (shared revenue)	51.8	52.0	52.0
Bureau of Customs: Refunds, transfers, and expenses of operation, Puerto Rico and the Virgin Islands (trust fund shared revenue)	19.6	28.1	24.7
General Services Administration: Hospital facilities in the District of Columbia	.7		
President's Crime Commissions	.6	.9	
Total, general government	115.6	139.3	156.8
Grants-in-aid, administrative budget	(33.8)	(48.1)	(70.1)
Shared revenue, administrative budget	(62.2)	(63.1)	(62.0)
Shared revenue, trust fund	(19.6)	(28.1)	(24.7)
Total grants-in aid and shared revenue	12,960.1	15,366.1	17,439.0
Total grants in aid, administrative budget	(8,332.6)	(10,700.1)	(12,634.6)
Total grants in aid, trust funds	(4,428.1)	(4,444.4)	(4,581.8)
Total shared revenue, administrative budget	(179.7)	(193.5)	(198.0)
Total shared revenue, trust funds	(19.6)	(28.1)	(24.7)

[1] Budget accounts unless otherwise specified. Many expenditures listed here are parts of larger appropriation accounts or trust accounts.
[2] Grants in aid unless otherwise specified.
[3] Reflects proposed transfer of forest and public lands highways in the highway trust fund.
[4] Reflects proposed establishment of a new beauty-safety trust fund.
[5] Less than $50,000.

EMERGING PATTERNS OF FEDERALISM*

BY SELMA J. MUSHKIN and ROBERT F. ADAMS**

The Federal system of government, as practiced in the United States, is a working equilibrium continuously adapting to altered circumstances. In the last decade, the adaptation in the scope and responsibilities of the more than 90,000 governments that comprise the Nation's public sector has been characterized by growth-oriented public programs designed to break the log-jam of need for increasingly essential public services within the burgeoning economy. These have included services that give support to the growing private sector, make viable the urbanized situs of the population, enhance the equity of allocation of goods and services, and facilitate further expansion of the economy. Such change in the activities of the Nation, the States, and the local communities is descriptive of viable democratic government within a Federal system.

In this paper, we attempt to describe the patterns that are emerging, illustrate quantitatively the interdependence of the governments, and set forth preliminary criteria for evaluating the resulting structure.

THE STRUCTURE EMERGING

National economic planning, once a sharply debated issue, is now a generally accepted part of our national economic life. Neighborhood and community development metropolitan-area planning, State economic programing, and regional economic development are becoming part of the fabric of the public sector as the Nation moves toward more orderly and rational government decisionmaking. How this multilevel planning and programing will intermesh with national policies and, at the same time, complement those policies has yet to be determined. This section of the paper describes the present design of the fabric as we see it. The threads have been spun. Numerious variations, as the threads are woven, can be expected, but if the process already begun continues, we believe the design will emerge somewhat as described below.

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*Reprinted from *National Tax Journal*, vol. XIX, No. 3, September 1966.

**Dr. Mushkin is director of the State-Local Finances Project of The George Washington University; Professor Adams is assistant professor of economics, University of Maryland.

The authors are indebted to Gabrielle Lupo of The George Washington University; Ralph Currie of State of California Department of Finance and Carl Shoup and William Vickrey of Columbia University for their review of an earlier draft of this article. This paper is part of a program of research and education supported by a grant from the Ford Foundation to The George Washington University.

THE CITY'S LARGE TASK OF ADMINISTRATION AND ENGINEERING

Local governments have faced a growing task in meeting public service requirements for an increasingly urbanized society. Central cities, particularly in the older sections of the Nation, continue to wrestle with the necessity for rebuilding structures and relocating people. The problems of the central city have been neatly characterized as "urban blight." But the problems that the term describes—slum congestion and high rates of delinquency, death, and crime are sprawling problems that produce needs, greater than proportionate to population, for housing, medical care, social services, and transportation. As more and more people are added to the spreading suburbs of a metropolitan area, the traffic problem of the central city becomes even more acute and contamination of the air an even greater health hazard. To serve the spreading area, water systems must be extended and new sources of water supply eventually must be found; new sewers and sewage disposal systems must be constructed.

The overall components listed below as making up the package of public services required for metropolitan living were originally determined, not from some preconceived concept, but from an analysis of actual expenditure experience.[1] Accordingly, we included a function in this package if per capita expenditures for that function are substantially higher in metropolitan areas than in other localities. The effect of urbanization on expenditure growth was grouped in the following four categories of outlays.

1. *Household-supporting services.*—The realities of urban congestion—whether in slum or nonslum sections, compel official collective provision for such services as water, sanitation, sewerage, and fire and police protection—services that may be performed, in the most isolated rural communities, by individual households or neighborhoods and, in small or moderate-sized towns by an inexpensive combination of volunteer and official services. Local governments of standard metropolitan areas spent $46 per capita for such services in 1962; in all smaller localities, the amount spent was less than half that sum.

2. *Supports to disadvantaged families.*—Of the total public expenditure for needy families, the largest proportion goes into cash assistance. However, the extent of need among the aged, disabled, blind, and children for assistance, for example, varies little between urban and rural places, and statewide standards for the categorical assistances, coupled with the support of those standards through grants from the national government, make for considerable uniformity. We therefore excluded such federally aided cash payments from our metropolitan public service package, but included public housing and public medical care for which approximately 43 cents per capita is spent by smaller localities for each $1 by metropolitan areas. Similarly, general assistance payments were almost three times as large in standard metropolitan areas as in other local areas.

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[1] See Selma J. Mushkin and Robert Harris, "The 1970 Outlook for Public Services in the States," in *Proceedings of the Fifty-Seventh Annual Conference on Taxation sponsored by the National Tax Association, 1964.*

3. *Supports for industrial development.*—Included in this category are those facilities and services undertaken by local governments to encourage private investment in commercial, industrial, and residential development. Altogether such expenditures—for example, for airports, water transport, parking facilities, urban renewal, and vocational training and retraining—amounted to about $10 per capita in standard metropolitan areas and about $2.50 per capita in smaller localities.

4. *Supports for the better life.*—Wide varieties of services are supplied by local governments to provide a better environment for their citizens. These may include museums, art galleries, playgrounds, ball fields, swimming pools, bathing beaches, parks, auditoriums, and libraries. In 1962, expenditures for such amenities amounted to more than $8 per capita in standard metropolitan areas, and $3 per capita in smaller places.

The combined package so defined accounted in fiscal year 1962 for almost 30 cents of each $1 laid out by the standard metropolitan areas. In the years ahead we can expect considerable growth in this type of spending by local governments:

—Water supplies, sewerage, and sanitation will require vastly higher expenditures to accommodate the continuing growth in urban population, to bring within central water and sewerage systems suburban communities now relying on private wells and septic tanks, and to clean up polluted streams through additional waste-treatment works, storm sewer installations, and so on.

—The antipoverty program has focused attention on public service requirements for disadvantaged groups in the population. Provisions for education and training, legal services, health care, welfare services, and referral services will undoubtedly be expanded to prevent the continuing intergeneration transmission of poverty. Extended programs of public housing for low-income families can also be anticipated.

—Increasingly, resources will be allocated to improve mass transportation facilities in cities, to deal with congestion in the air and on the ground, to renew industrial and residential neighborhoods, and to expand harbor and terminal facilities.

—Public amenities, so clearly under-supported in an affluent nation, call for vastly enlarged outlays to support the fine arts, music, and the performing arts, and to make available more outdoor recreational areas and activities.

Of the total 1964 outlays of States and localities combined, those of the local governments accounted for almost two-thirds. That from 1902 to 1964 local expenditures declined as a percentage of the total is far overshadowed by the sharp recent increases of their dollar growth (table I). In 1946 the localities spent $7.9 billion; in 1964 they spent $37.1 billion more. Over the period 1962–64 local expenditures rose $2.6 billion per year, and almost the same amount per year over the period 1956–64. If local spending continues to rise only by this amount each year, it would reach almost $62 billion by 1970.

TABLE I.—*Local share of direct general expenditures, selected fiscal years 1902–64*

[Dollar amounts in millions]

Fiscal year	State and local expenditures	State expenditures	Local expenditures	Local as a percent of State and local expenditures
1964	$69,302	$24,275	$45,027	65.0
1962	60,206	20,375	39,831	66.2
1956	36,711	12,319	24,392	66.4
1946	11,028	3,153	7,875	71.4
1940	9,229	2,730	6,499	70.4
1927	7,210	1,380	5,830	80.9
1902	1,013	134	879	86.8

Source: U.S. Bureau of the Census, Governments Division, "Governmental Finances in 1963–64"; Census of Governments, 1962, "Historical Statistics on Governmental Finances and Employment," vol. VI (Topical Studies), No. 4.

THE STATES AS REGIONAL GOVERNMENTS

The urbanization of population and the rapidity of structural changes in the economy, as well as mounting State and local budgets, have contributed to the States' concern with economic growth and with improved standards of living for their residents.

In the past, we, as a nation, have paid little heed to economic development at the State level. The main emphasis of national economic policies has been on increasing aggregate consumer demand—enlarging markets to gain general prosperity in all regions. Economic growth, however, tends to result in uneven geographical gains in job opportunities, industrial output, population, and family welfare. Hypothetically, uniform income elasticities of demand for each product would distribute the incremental gain in gross national product evenly among the States. But since States diverge widely in their industrial patterns, the actual history of the past several decades has been one of dissimilarities in their rates of income and population growth.[2]

Despite this uneven impact, there is little doubt that the state of the Union affects the well-being of the people in each State; we have yet to learn the full dimensions of the effect of the economic policies of each State on the state of the Union.[3] A number of States have established councils of economic advisers—or similar offices—to report on internal economic prospects and thereby provide a basis for decision-making.

Recent national grant programs (outlined in a subsequent section) have encouraged State planning activities. But the present urgency of State action was actually triggered by (1) the concentrations of population in large metropolitan areas with their multiplicity of political and taxing jurisdictions, and (2) the complex interdependency of contiguous States in shouldering responsibility for transportation facilities, water supplies, effective land-use, and industrial development.

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[2] Edward F. Denison, *Sources of Economic Growth in the United States* (New York, Committee for Economic Development Supplementary, Paper No. 13, January 1962). See also Harvey S. Perloff, "Relative Regional Economic Growth: An Approach to Regional Accounts" in *Design of Regional Accounts*, Werner Hochwald, ed. (Baltimore: Johns Hopkins Press for Resources for the Future, 1961).

[3] Selma J. Mushkin, *State Programming and Economic Development* (Chicago: Council of State Governments, 1965).

Each of the Nation's largest metropolitan areas has its own multiplicity of local governments—jurisdictions that often number in the hundreds, with varied public service responsibilities, taxing powers, and borrowing authorizations.[4] Many of these large centers straddle parts of two or more States. The efforts so far directed at unraveling the "metropolitan problem" have been concentrated on such matters as annexation, extraterritorial powers, interlocal contracting, councils of governments, urban counties, control of special districts, and city-local consolidations.

Each local government is a creation of its State, in that, it derives its authority from, and is dependent on, the State for taxing, borrowing, and spending powers. Increasingly, the State government is expected to provide planning leadership to meet the multijurisdictional problems which define "the metropolitan problem." More States direction and assistance is indicated as a way to gain coordination of public services in urban areas to assure, for example: efficient public facilities for transporting people and things by air, water, rail, and motor vehicles; adequate water to supply the requirements of industry and households; and viable community patterns of residential, industrial, and commercial installations, along with parks, playgrounds, and other recreational facilities.

During much of the latter part of the 1950's and early 1960's State financial support for local governments increased, but in proportion to local general revenues, it remained almost stable.[5] In fiscal year 1964, however, State grants to localities were $12.9 billion—a rise of $6.3 billion above the 1956 figure and representing some breakthrough in enlarging their ratio to local "own" general revenues (table II).

TABLE II.—*State aid to local governments, selected fiscal years 1902–64*

[Dollar amounts in millions]

Fiscal year	General from local sources revenue	State aid	State aid as a percent of general revenue from own sources
1964	$30,256	$12,873	42.5
1962	26,705	10,879	40.7
1956	16,238	6,590	40.6
1946	6,082	2,092	34.4
1940	5,007	1,654	33.0
1927	5,298	596	11.2
1902	798	52	6.5

Sources: U.S. Bureau of the Census, Governments Division, "Governmental Finances in 1963–64"; Census of Governments, 1962. "State Payments to Local Governments," vol. VI (Topical Studies), No. 2.

SMSA (1960 populations):	*Revenue from State as percent of all general revenue*
1,000,000 or more	23.5
500,000 to 999,999	25.3
300,000 to 499,999	26.7
200,000 to 399,999	29.9
100,000 to 199,999	27.5
50,000 to 99,999	21.6

[4] Robert C. Wood, *1400 Governments* (Cambridge: Harvard University Press, 1961); Seymour Sachs and William F. Hellmuth, Jr., *Financing Government in a Metropolitan Area* (New York: Free Press, 1960).

[5] U.S. Bureau of the Census, Government Division, *State Payments to Local Governments, 1962.*

In accord with conventional State aid formulas, a more than proportionate to population share of the aid has tended to go to nonurban areas. In fiscal year 1962 State government grants accounted for 28.2 percent of all general revenues of both urban and nonurban local governments, and for 24.7 percent of general revenues of standard metropolitan statistical areas (SMSA). The comparable figure by size of population (1960) of these areas were: [6]

Reapportionment of State legislatures, coupled with a national spotlighting of needs for State action on public-service deficiencies in metropolitan areas, point to further increases in State aids, particularly for those areas.[7]

A State's role as a regional government has increasingly included the additional responsibility of joining its neighbors in interstate contracts and agreements to formulate and carry out public programs. A variety of methods have been used to achieve efficient operation. In some cases, a complete administrative organization has been developed to carry out the interstate agreement—such as the Port of New York Authority compact, the Ohio River Valley Sanitation compact, and the Upper Colorado River Basin compact.

Transportation and water development are recognized today as essentially interstate problems that call for interstate action. Thus, States, rather than the National Government, have taken the initiative for developing varioust compact agencies. Increasingly, such arrangements are also being made to deal with problems of crime control, civil defense, highway safety, higher education, mental health and other aspects of institutional care, and conservation and development of such resources as oil, gas, fisheries, and forests. Most recently, the States have joined together to develop a nationwide policy for elementary and secondary education.

Interstate compacts concerned with higher education furnish a useful illustration of the purposes of such arrangements. As of 1965–66, three interstate regional education boards existed—in the New England area, the South, and the West. Patently, not every State can provide adequate training over the whole range of professional and technical skills. Some of the less populous States often concentrated on special training facilities in those fields for which a large student demand existed and for which natural materials and resources were available. Thus, outstanding schools of mining and petroleum engineering have been established in States that have vast mineral and oil resources. Programs of archeology have burgeoned in southwestern areas, and oceanic studies on both eastern and western seaboards. Moreover, as the demand for educational opportunities mounted following World War II, the number of colleges and universities relative to the dimension of student demand became more limited. As a consequence, many State-supported schools faced the problem of restricting the admission of out-of- State students.

The recent interstate agreements providing reciprocal privileges have kept educational opportunities for non-State residents open. States that participate in the agreements share the cost of educating their students in out-of-State institutions. The institutions selected as

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[6] U.S. Bureau of the Census, Census of Governments, 1962, *Local Government in Metropolitan Areas*, p. 10.

[7] For example, *Guidelines for Improving Maryland's Fiscal Structure, January 1965* (Interim Report of the Commission on State and County Finance, State of Maryland).

regional training facilities are strengthened financially by the arrangement, and at the same time, taxpayers in the participating States are saved money. Most important, the compacts provide specialized training for students who could not obtain it in their own States but lack the money for matriculating fees formerly charged out-of-State applicants.

THE "NATION" IN THE STATES

The Employment Act of 1946 clarified, to some degree, the National Government's economic policies. Since then, more sensitive policies toward the States and local communities have gradually emerged, but the sensitivity has yet to gain full implementation. Shortly after the end of World War II, steps were taken to direct national procurement into labor surplus areas, and to give special consideration to those areas in other programs such as grants-in-aid. Only in the last few years however, have those early steps been broadened into expressed policies—such as the charge-off of an allocable share of the costs of generalized long-range management to defense-aerospace contracts; or the sort of community planning that would produce more diversification of industrial development; or encouragement of procurement agencies to adopt policies that are more favorable to communities, including the use of government-owned/contractor-leased facilities for commercial work. The new emphasis on assessing the geographic impacts of national procurement activities gives the force of documentation to the uneven geographic distribution of such activities as defense spending. The Ackley Committee report, "The Economic Impact of Defense and Disarmament," thus marks a new direction for the National Government.[8]

The regional economic development program adopted in 1965, together with the Appalachian regional program, represents a new step in national encouragement of intergovernmental action for such purposes. An earlier community-area development program sought, through community-wide action, to meet problems of unemployment originating in structural changes in the economy.[9] The evident inadequacies of the community as the focal point for economic programming pointed to a broadening of the area for economic progress and the designation of a "region" encompassing a development area with a potential for expansion. Equally important, the 1965 programs broke new ground with the creation of a regional commission composed of the Governor of each participating State (or his representative) and a Federal appointee.

In adopting these programs, the Congress explicitly recognized the interdependence of the national economy and the economic vitality of local and regional sectors. It sought to establish a flexible framework within which National, State, and local planning efforts could meet the varied problems of economic development; expand the opportunities for employment; provide the basic community facilities necessary for the growth of industrial, commercial, recreational, and cultural activities; and achieve lasting economic improvement for the local communities, the States, and the Nation.

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[8] *Report of the Committee on The Economic Impact of Defense and Disarmament*, July 1965. Washington, D.C., 1965.

[9] Area Redevelopment Act, Public Law 87–27, 1962.

New national programs adopted to meet gaps in public services include, for example, hospital insurance for the aged; a "job corps" to increase the employability of young men and women, 16 through 21 years of age; and a rent subsidy schedule. But the main thrust of the national action was to (1) forge new instruments of intergovernmental cooperation, (2) enlarge the national financial participation in intergovernmental programs, (3) give added impetus to planning for coordinated program performance, and (4) stimulate innovative action in the States and local governments.

The newly enacted grants-in-aid and technical assistance measures augmented the intergovernmental-relations tool kit of the National Government by providing some amount of national direction or assistance over the broad range of civilian public services administered by State or localities. The major addition was, perhaps, the new aid to elementary and secondary education. During the three decades or so of public debates on general federal aid to education piecemeal, special assistance was authorized for construction and operation of schools in federally affected areas, for an extended vocational education program, and for science and language instruction in the schools, but not until 1965 was a broad program of elementary and secondary school assistance adopted.

Other 1964–65 Federal grants authorized medical assistance to medically indigent children and other federally aided assistance recipients; new programs to train and retrain persons in the work force; construction and equipment of mass transportation facilities; new attempts to prevent juvenile delinquency; establishment of community mental health centers; and hospital modernization. Measures to control air and water pollution were strengthened, and new steps were taken to improve solid-waste disposal systems. Training of new or additional public-service personnel—such as police and social workers—for local communities was provided for, as was additional support for research directed at improving public services. A concentrated "economic opportunity" program was launched to combat poverty, which included such innovations as the now-famous "Headstart" project to prepare disadvantaged 3- to 5-year-olds for elementary school and the locality-based Community Action Program.

The brief enumeration above is illustrative only, for the additions or extensions are many. The steps that have been taken may be summarized somewhat as follows:

1. At least $6 billion annually has been added on a fully operational basis as the commitment in Federal assistance to the States and localities.
2. Over the broad range of State and local governmental activities, some amount of Federal support is available for personnel training, research on new methods of operation, conduct of public services, or construction of public facilities in support of such services.
3. Relatively few of the programs, however, call for national expenditures in excess of $100 million, or the equivalent of $2 million per State. Two sets of grants (the latter of which continues to be the largest single grant)—public assistance and interstate highway aids—accounted for $7 billion of the almost $11 billion total for fiscal year 1965.[10] By fiscal year 1967, two other

[10] Including shared revenues but excluding Federal contract payments for research.

sets of grants—elementary and secondary school assistance and the economic opportunity program—will each have added over $1 billion to the total. Nevertheless, the largest four sets of aids will account for only $3.25 of each $5 of grants-in-aid. The programs that call for expenditures of $100 million or more, in either fiscal year 1965 or 1967, are shown in table III.

TABLE III.—*Largest Federal grants to States and localities, actual fiscal year 1965 and proposed fiscal year 1967* [1]

[In millions]

	Fiscal year 1965	Fiscal year 1967
Total, all grants	$10,903.9	$14,752.5
Total, largest 19 grants	9,187.8	12,299.6
Public works acceleration	288.4	8.1
Federal aid highway program	3,979.5	4,027.7
Appalachian development highway system	(2)	101.1
Low rent public housing program	206.3	253.6
Urban renewal	280.6	373.5
Special milk and school lunch	263.0	202.3
Food stamp	31.8	126.5
Headstart	5.0	255.0
Other community action	41.1	389.1
Neighborhood Youth Corps	44.3	247.9
Work experience	20.2	138.7
Medical care for the aged (public assistance)	272.2	288.8
Vocational rehabilitation	101.5	259.8
Public assistance (exclusive of medical care for the aged)	2,787.2	3,306.2
Administration of employment security programs	393.3	500.6
Assistance to schools in federally affected areas	340.6	252.0
Elementary and secondary educational activities		1,200.0
Higher education facilities construction	1.3	164.6
Vocational education	131.5	204.1

1 Grants calling for expenditures of $100,000,000 or over.
2 Less than $50,000.

Source: Bureau of the Budget, "Federal Aid to State and Local Governments," "Special Analyses, Budget of the United States, 1967" (Washington, D.C., 1966).

The vanishing dollar-for-dollar grant.—Many of the new enactments leave behind the traditional 50–50 matching provisions in favor of an enlarged Federal share. Essentially, title I of the new Elementary and Secondary Education Act provides unmatched grants to the local communities for promoting educational services for the culturally disadvantaged child. Grants for economic development may cover up to 80 percent of the cost of projects in areas of greatest need. Ninety percent of manpower training funds can come from the Federal Government. Under the Economic Opportunity Act of 1964, localities were asked to furnish only 10 percent of the cost of a Community Action Program during the first 2 years of the act's authorization; the 1965 amendments extended that percentage for another year, and in both cases, no local contribution was required from a community too poor to pay it.

The largest grant program—the interstate highway aid first enacted in 1956—was the original jar to the 50–50 matching provisions with its 90 percent Federal offering (90.5 percent where the State also participates in the control of outdoor advertising). Since 1956, the Federal share of numerous grant programs has been increasingly set above 50 percent and varied matching requirements have been used to encourage more effective provision of public services. In an even newer departure, some recent programs—e.g., the Economic Opportunity Act and the regional economic development programs—provide Federal moneys almost exclusively to the poorest jurisdictions or neighborhoods for a range of local programs.

The matching shares for the largest grants-in-aid are summarized below (table IV).

TABLE IV.—*Matching on largest Federal grants to States and localities, proposed fiscal year 1967* [1]

[Dollar amounts in millions]

	Federal share (percent)	Amount
Unmatched grants, total		$1,922.4
Assistance to schools in federally affected areas		252.0
Elementary and secondary education (title I)		1,100.0
Administration of employment security programs		500.6
Vocational rehabilitation:		
Research and demonstration		60.3
Expansion		9.5
Uniform matching, total		6,610.0
Highway program by activities		4,030.0
Grants for construction:		
Interstate System	90	2,912.7
Primary system	50	436.0
Secondary system	50	292.0
Urban highways	50	242.0
Emergency relief	50	30.0
Grants for planning and research and administration and research	[2] 78	7.3
Economic opportunity program:		
Work-study	90	134.6
Adult education	90	35.5
Headstart	90	310.0
Neighborhood Youth Corps	90	300.0
Work-experience	[3] 100	160.0
Higher education facilities construction:		
Title I:		
Public junior colleges and technical institutes	40	100.8
4-year colleges and others	33⅓	357.2
Title II—Graduate education centers	33⅓	60.0
Vocational education:		
Work-study (vocational)	[3] 100	10.0
Other	50	240.8
Vocational rehabilitation:		
Training and innovation	90	8.0
Basic grants	75	236.0
Low-rent public housing program	66⅔	253.6
Urban renewal program	66⅔	373.5

	Federal share (percent)		Amount
	Minimum	Maximum	
Variable matching, total			$3,419.6
Vocational rehabilitation (facilities)	50	70.0	4.5
School lunch	25	83.8	202.3
Public assistance:			
Old-age assistance	50+	83.8	1,351.1
Aid to families of dependent children	50+	83.8	1,110.5
Aid to blind	50+	83.8	49.0
Aid to permanently and totally disabled	50+	83.8	381.1
Medical assistance	50	80.0	220.0
Appalachian development highway program		(4)	101.1

[1] Some of the amounts in this table differ from those in table III in that they have been adjusted to correspond to amounts actually requested from Congress in subsequent legislation.
[2] Average.
[3] The current appropriations bill calls for no matching funds for fiscal year 1967. The authorization for the program calls for 90–10 matching.
[4] Up to 70 percent.

Source: Amounts in Bureau of the Budget, Budget of the United States, 1967 (Washington, D.C., 1966).

Planning and program coordination.—Surveys, subsequent planning in terms of the survey findings, and eventual programming in relation to planning have increasingly become preconditions to receipt of Federal aid. Under the 1946 Hill-Burton program for hospital construction, for example, grant support was provided for projects which conformed to a statewide hospital plan. As additional health facilities were added to the list of eligible projects, the survey and planning provisions were also broadened. Provisions for highway aids, as of 1965, required the development of a comprehensive transportation planning process in urban areas. And mental health grants are being conditioned on community-wide assessment of mental health needs.

Another developing type of planning machinery looks at community facilities as a coordinated whole. Comprehensive community planning for urban development is being fostered by grant programs under the new U.S. Department of Housing and Urban Development (HUD). An even wider area of planning efforts is being encouraged by the Appalachian and other regional economic development programs. From the outset, as from the first stages of the earlier area redevelopment program, these programs have been tied to an overall economic development plan (OEDP). And the Community Action Program under the Economic Opportunity Act as established, as one of its conditions for granting Federal support to local efforts, that a coordinated program must be outlined in a community's application proposal.

Grants are also provided to encourage the most effective structuring of administrative arrangements, and as incentives for metropolitan area cooperative planning and cooperation, with technical assistance being offered to help with the planning work.

Innovations and experimentation.—A large and growing number of national grant programs have as their objective innovations in public services or facilities. The use of grants-in-aid as a device to stimulate States and communities to meet specifically demonstrated public needs are, of course, familiar. The effectiveness of such categorical aid is implicit in some of the criticisms of the grants, especially when they pressure the State or local government to act on programs for which the aid is available, sometimes at the expense of nonaided programs. In recent years, however, we have had a multiplication of small grant sums authorized as "seed moneys" to focus attention on a needed public service through a demonstration of new techniques.

Innovation and experiment as primary devices for improving the efficiency of public services are gaining increased attention. New ideas, new methods, and new arrangements are being encouraged, through grants which the National Government makes available to public or private agencies to carry out acceptable and approved demonstration and research projects. Almost all major Federal grant programs now contain some provision for such funding.

Trying to count the total aids to States and localities is a complex numbers problem, because the count depends heavily on what is being defined as a separate and distinct program. However, the major characteristics of the many present Federal aids are (1) the number of them that are designed to stimulate improvement in State and local services by pinpointing specific experimental and demonstration objectives, and (2) the support given to planning and program coordination in the States and localities.

THE STATE OF THE UNION'S FISCS

State and their local governments have, over the decades since the early 1900's, been responsible for the largest share of all expenditures for civilian public services. Table V shows the amounts per capita and the distribution of direct expenditures (other than defense and defense-connected) of the National Government and the States and localities for selected years since 1902.

Table V focuses on some strategic factors in intergovernmental relations:

1. The rapid growth in State and local expenditures since the end of World War II—from $78 per capita in 1946 to an amount more than 4.5 times that level in 1964.
2. The lack of movement in State and local expenditures during World War II—a stability that occurred despite the growth in gross national product from $100 billion in 1940 to well over $200 billion by 1946 and that accounted for some of the pressure, following the end of World War II, on the States and local governments to repair past neglect of public facilities and to restore salary levels of public employees to a competitive level.
3. The predominance of the States and localities in the provision of civilian public services, with the national government enlarging its responsibilities during the Great Depression until, by 1940, it reached a direct outlay for civilian public service expenditures of almost two-thirds the amount spent by States and localities.
4. The growth in aids from the National Government to States and localities from less than 10 cents per capita in 1902, to over $50 per capita by 1964.

TABLE V.—*Per capita national civilian services and State and local general expenditures, selected years 1902–64*

Year	National civilian services			State and local general expenditures	Ratio of National to State and local	
	Combined	Direct [1]	Intergovernmental		Combined	Direct
1964	$193.77	$141.01	$52.77	$362.20	.53	.39
1962	173.14	131.51	41.63	324.00	.53	.41
1956	105.81	85.81	20.00	219.42	.48	.39
1946	60.74	54.42	6.32	78.00	.78	.70
1940	51.40	44.71	6.69	69.85	.74	.64
1927	12.97	11.94	1.03	60.57	.21	.20
1902	3.00	2.91	.09	12.80	.23	.22

[1] National direct expenditures are found by subtracting from direct general expenditures, expenditures for (1) national defense and international relations, (2) veterans services not elsewhere classified, and (3) interest on the Federal debt.

Sources: U.S. Bureau of the Census, Governments Division, "Governmental Finances in 1963-64"; Census of Governments, 1962, "Historical Statistics on Governmental, Finances and Employment," vol. VI (Topical Studies), No. 4.

FISCAL INTERDEPENDENCE

Consideration of these trends alone would ignore the interlocking aspect of our Federal system. One cannot assume that the expenditure trends reflect the actions of autonomous levels of government, independent of each other. To gain some perspective on the changes in the pattern of fiscal federalism, we must consider the possible changes in the degree of financial interdependence. Table VI illustrates that degree by measuring the ratios of State and local revenues from "own sources" to intergovernmental grants.

TABLE VI.—*Ratios of State and local revenue from own sources to intergovernmental grants, selected years 1946–64 and 1970 (projected)*

Year	State [1] / Federal	Local [2] / State	Local [3] / Federal	State and local [3] / Federal
1970				[4] 4.0
1964	3.1	2.4	31.6	5.8
1962	3.3	2.5	35.0	6.4
1958	3.8	2.4	47.9	7.5
1954	4.7	2.4	45.7	7.4
1950	3.9	2.3	45.4	8.8
1946	6.8	2.9	114.8	13.5

[1] Own sources include general revenue only, exclude revenues from liquor stores and insurance trusts.
[2] Own sources include general revenue only, exclude revenues from utilities, liquor stores and insurance trusts.
[3] Own sources include general revenue only.
[4] Projected.

Source: U.S. Bureau of the Census, Governments Division, "Governmental Finances in 1963–64," Census of Governments. 1962, "Historical Statistics on Governmental Finances and Employment," vol. VI (Topical Studies.) No. 4; and 1970 estimates State and local finances project of the George Washington University.

At the State level we find an increase in Federal moneys relative to State revenues from own sources. In 1946, $1 came from the National Government for each $6.8 raised from the States' own sources. By 1964 the relationship had fallen to the point where $3 of State money was used for every $1 of funds from the National Government. At the local level, the change is even more spectacular, moving from approximately $115 to $32 of local own revenue per $1 of Federal funds. Combining State and local funds, this index of financial interdependence changes from 13.5 in 1946, to 5.8 in 1964, and to a projected 4.0 in 1970. Thus, as the business of all levels of government has grown, State and local governments have become much more closely entwined with the National Government. It is important to observe that the major part of this change has already taken place.

STATE-LOCAL FISCAL OUTLOOK, 1970

As indicated earlier, by the close of the 1965 congressional session a large number of new categorical aids had been enacted and the potential Federal payment to States and localities had been raised considerably. "Project '70," a recent study of State-local finances, attempted a quantification of these aid supports and arrived at a calendar-year 1970 total of over $20 billion in Federal grants and shared revenues, and an additional $1.7 billion in Federal payments in the form of contract and research grants to State and local agencies, principally public colleges and universities.[11]

[11] Individual studies within "Project '70" include: Selma J. Mushkin and Eugene P. McLoone, *Public Spending for Higher Education in 1970*, Council of State Governments, Research Memorandum 374; Mushkin and Robert Harris, *Transportation Outlays of States and Cities: 1970 Projections*, RM 375; Mushkin, *State Programing and Economic Development*, RM 379; Mushkin and Harris, *Financing Public Welfare: 1970 Projections*, RM 380; Mushkin, *Property Taxes: The 1970 Outlook*, RM 381; Mushkin and McLoone, *Local School Expenditures: 1970 Projections*, RM 382; Harris, *Income and Sales Taxes: The 1970 Outlook for States and Localities*, RM 384; Mushkin, *Financing Public Hospitals and Health Services: 1970 Projections*, in manuscript; Robert Rafuse, *Water, Sewerage, and Other Sanitation Expenditures of State and Local Governments: Projections to 1970*, in manuscript.

The aggregate, some $22 billion, assumed that (1) existing Federal aids would not be cut back, (2) authorization for grants due to expire before 1970 would be renewed, and (3) grants recently adopted by Congress would be increased, since grant enlargements were almost implicit in the program operations. Also included were some minor additions in grants based on new programs whose directions were already fairly clear: for example, additional grants for community mental health, child health programs, and mass transportation facilities.

These 1970 Federal aids, when added to "own" State and local revenue sources and new debt issues, are projected to be sufficient over the Nation as a whole to finance a general expenditure load of over $108 billion (as shown in table VII.)[12]

TABLE VII.—*Fund requirements of State and local governments, fiscal year 1964 and (projected) calendar year 1970*

[In billions]

	Calendar year 1964	Fiscal year 1970
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	−0.6	−0.5
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

Source: Unpublished estimates of the State-local finances project, the George Washington University.

Within the framework of the economic model, the fairly optimistic portrayal of State-local finances is almost entirely attributable to the Federal-aid package projected. To illustrate the effect on State and local finances of a lesser amount of Federal aid, the total derived by costing out aided programs and "matching" requirements and by reference to appropriation authorizations was more or less arbitrarily scaled down to $18.5 billion. Federal payments to States and localities at the $18.5 billion figure, coupled with an assumed slippage in property tax

[12] The projections of the 1970 outlook shown in table VII for State and local governments are based on a series of economic and demographic assumptions and an assumed continuation of world tensions as they prevailed in 1963, the year Project '70 was started. The national model to which the findings are linked was one of several preliminary models of the national economy developed by the Federal Interagency Study of Economic Growth in the United States. The model assumed a high employment economy, with a gross national product of $864 billion in current dollars for 1970, continued increases in productivity, shorter hours of work, and price increases of 1.5 percent per annum.

assessment ratios (a slippage in line with 1956–61 experience), would require new sources of revenue for States and localities—new State and local taxes, higher tax rates, or additional Federal support.

In the decade past, highways and education were the major growth elements in State and local spending. Highway projects were stimulated by new Federal grants; education was financed largely without Federal aid. In the period ahead, new program developments are likely to be supported by at least some categorical aid and prospects for additional grant support are good, if the international commitments of the National Government permit.

The path for Federal support for such new programs as regional economic development, the attack on poverty, manpower training, better education and health care for the culturally disadvantaged has been cleared. The budget for fiscal 1967, as submitted by the President, sets Federal aid payments to States and localities at $14.8 billion, a figure which, when adjusted to differences in definition between the Census of Governments and the budget, corresponds to total Federal payments of approximately $15.5 billion, or more than 50 percent above the 1964 level. Several of the new programs—for instance, the new medical assistance program—are likely to begin operation only during fiscal year 1967; accordingly, a full year's operation is not reflected.

Table VIII shows that grant-in-aid amounts for the "growth points" in State and local activities. Fiscal year 1963 budget expenditures for these programs totaled under $1 billion; 1967 budget estimates for them call for almost $5 billion, or $4 billion additional, and the calendar year 1970 projection places them at $6 billion more, with over one-half of the added amount going to education and manpower training.

TABLE VIII.—*Grants-in-aid for the "growth points" in State and local activities, actual fiscal year 1963, budget fiscal year 1967, and calendar year 1970 (projected)*

[In millions]

	Actual, 1963	Budget, 1967	Projected, 1970
Total	$921	$4,926	$11,034
Education:			
Manpower training and vocational education	42	262	803
Higher education	15	199	700
Preprimary education		310	601
Education of the culturally disadvantaged		1,200	3,000
Vocational rehabilitation	73	260	223
Health:			
Community health activities	124	215	388
Community mental health	(1)	72	(1)
Environmental health	6	11	(1)
Regional medical programs		35	(1)
Child and maternal health	73	146	243
Medical assistance for children, aged, and others	157	289	1,012
Urban development:			
Urban renewal	199	373	750
Water, sewers, and neighborhood facilities	52	170	325
Urban transportation		65	300
Low-rent public housing	170	254	400
Open space and beautification		29	150
Library services and arts and humanities	7	52	100
Economic development, including Appalachia	3	204	689
Other poverty-attack programs		780	1,350

[1] Included in "Community health activities."

Sources: Bureau of the Budget, "Federal Aid to State and Local Governments," Special Analysis, Budget of the United States, 1966. and "Federal Aid to State and Local Governments," Special Analysis, Budget of the United States, 1967; and 1970 Estimates, State and Local Finances of the George Washington University.

On the basis of present statutory provisions, many of the new aid programs would go directly from the National Government to localities, changing the distribution of the Federal aids markedly, as illustrated below:

Federal aid to local governments

[In billions]

Calendar year 1970 (projected) [13]	Fiscal years			
	1964	1962	1956	1940
$5.5	$1.0	$0.8	$0.3	$0.1

[13] Approximate amount, computed by adding to the 1964 total, as reported by the U.S. Bureau of the Census, Governments Division, the projected amount for both title I of the Elementary and Secondary School Act and the Economic Opportunity Act.

When the projections of total 1970 Federal payments are considered State by State, interdependence between National and State and local governments is seen to be growing more uniform. States such as New York, with a relatively high ratio of their own revenues to Federal payments, are estimated to receive large additional grant support, with a consequent drop in the ratio of own revenues to revenues from the Federal Government (table IX).

TABLE IX.—*Ratios of State and local own funds to Federal payments, selected years, 1942–62 and 1970 (projected)*

States	1942	1957	1962	1970	States	1942	1957	1962	1970
Alabama	7.7	4.0	3.2	2.1	Montana	7.0	4.6	3.8	2.7
Alaska	(1)	3.1	2.0	1.6	Nebraska	7.5	7.3	5.7	3.5
Arizona	5.6	6.8	5.0	3.7	Nevada	2.9	4.7	4.5	3.6
Arkansas	7.8	4.3	3.1	2.0	New Hampshire	9.8	9.8	4.6	3.[illegible]
California	11.2	8.3	6.1	4.4	New Jersey	22.8	20.7	10.5	5.5
Colorado	5.9	5.8	5.2	3.6	New Mexico	6.5	3.4	3.5	2.3
Connecticut	15.1	17.5	8.3	4.6	New York	25.3	17.2	13.1	6.3
Delaware	8.4	10.0	9.2	5.0	North Carolina	11.3	5.1	5.6	3.1
District of Columbia	5.5	4.6	2.7	2.1	North Dakota	10.2	7.1	5.1	2.9
Florida	11.2	9.0	8.1	5.6	Ohio	11.2	11.5	6.9	4.4
Georgia	8.9	6.0	4.1	2.9	Oklahoma	5.9	4.7	3.7	2.4
Hawaii	(1)	5.8	4.2	3.7	Oregon	7.5	6.2	4.3	3.0
Idaho	5.8	5.3	3.7	3.3	Pennsylvania	11.0	14.6	8.1	3.7
Illinois	13.5	13.5	7.9	4.8	Rhode Island	14.4	7.2	6.4	2.9
Indiana	10.0	13.7	8.3	5.0	South Carolina	5.6	6.5	4.7	2.8
Iowa	12.0	9.2	7.1	3.9	South Dakota	7.8	5.0	3.2	2.6
Kansas	8.3	7.5	6.7	4.2	Tennessee	8.5	6.0	3.9	2.3
Kentucky	8.1	5.9	3.9	2.2	Texas	9.3	6.8	6.2	3.4
Louisiana	9.8	5.8	4.1	2.8	Utah	4.8	5.8	4.0	2.7
Maine	9.4	7.3	5.4	3.6	Vermont	8.3	6.6	2.5	2.3
Maryland	13.9	10.9	7.2	4.3	Virginia	10.5	9.8	5.2	2.9
Massachusetts	13.3	12.9	8.1	4.9	Washington	5.9	7.9	6.0	3.8
Michigan	13.1	11.7	7.9	5.0	West Virginia	7.8	6.9	4.2	1.6
Minnesota	10.0	9.2	7.2	4.7	Wisconsin	13.5	13.1	7.9	5.7
Mississippi	6.8	4.9	3.8	2.3	Wyoming	5.0	3.0	2.3	1.9
Missouri	7.3	5.1	4.6	3.3					

[1] Not available.

Sources: Bureau of the Census, Census of Governments, 1962, "Historical Statistics on Governmental Finances and Employment," vol. VI (Topical Studies), No. 4; and 1970 estimates, State and local finances project of the George Washington University.

While most of the populous States (population 5 million and over) are projected to continue to raise a larger than national average share of revenues from own sources—i.e. more than $4 from own sources for each $1 of aid—the variations in ratios among States are projected to continue to narrow. In 1957, for example, New Jersey raised almost seven times as much of its own revenue per $1 of Federal aid as Wyoming did. In 1962, New Jersey's ratio had dropped to about five times that of Wyoming; for 1970 it is projected to decline to 2.5.

A Framework for Analysis

"Spillovers" and Intergovernmental Aids

Externalities that prevent the private market from operating effectively have increasingly absorbed the attention of the economist who is attempting to formulate guidelines for public decisionmaking. Although the theoretical work done so far on externalities has barely scratched the surface of the wide range of closely intermeshed public and private activities, as well as the complementarities among public services, the basic notions of external benefits that point to some governmental intervention are nevertheless in a rudimentary way now being applied in the development of a theory of intergovernmental relations.[14]

Starting with the notion that there is a traditional State responsibility for civilian public services—education, highways, hospitals and other health facilities, water supplies, and so forth—the economist has reassessed the externalities of public services among jurisdictions as a barrier to the appropriate allocation of resources to public services by the State. A variety of benefits received by persons outside a State flow from services provided inside. In those instances where metropolitan areas cross State lines, additional benefits accrue to out-of-State residents in the course of the daily traffic flows on the highways or in mass transit facilities and through the periodic movement of people across State lines to use such facilities as public libraries, art museums, and so on.[15]

Collectively, taxpayers in a State evaluate the benefits that accrue to them from the public services provided. According to the running argument on this subject, where there are large geographic spillovers, the taxpayers rationally decide in favor of lower expenditures. Thus spillovers of benefits have an effect on the decision process and bring about an underallocation of resources for those services that are characterized by large interstate externalities.

More particularly, the movement of people among the States has been posed as one of the causes of inadequate allocation of funds to education. The idea that the benefits of public education are not realized solely by those within the specific community that provides the education is not new, but the quantification of the spillovers of benefits has only recently attracted the attentioin of economists. Burton Weisbrod, for example, has attempted to measure such external geographic benefits and to determine whether their existence has af-

[14] Julius Margolis, ed., *The Public Economy of Urban Communities,* The Johns Hopkins Press for Resources for the Future, Inc. (Baltimore, 1965).

[15] Selma J. Mushkin, "Intergovernmental Aspects of Local Expenditure Decisions" in Howard G. Schaller, *Public Expenditure Decisions in the Urban Community,* The Johns Hopkins Press for Resources for the Future, Inc. (Baltimore, 1963).

fected the level of local financial support.[16] His accumulated evidence suggests that benefit spillovers accompanying outmigration tend to depress aggregate expenditures on education. The type of analysis he has made would be applicable for any public service which involves long-range investments in people and in those services, like highways, that are the means of interstate movement.

The work that has been done on geographic spillovers of benefits leads to the conclusion that the National Government has the responsibility for compensating the States for the benefit spillovers so that the marginal cost of the public services can be equated with the marginal social utilities created. The essential implication, as Jesse Burkhead has noted, is that we need a regional social external economies board with authority to measure the spillover gains in welfare among States and to order the amount of compensatory funds, so that a rational allocation of resources can be made.[17]

In this scheme of things, States would provide the public services, and the National Government would make compensatory grants to the States to assure efficiency in the allocation of resources to public services. Further, because of the differential spillovers of different classes of services, the scheme would have to identify the amounts of Federal compensatory funds with each of the classes of public services and their benefits. This would yield a configuration of special categorical aids related specifically to overcoming a misallocation of resources when benefits from a specific service accrue to outsiders.

SPILLOVERS PLUS

There is another way of assessing intergovernmental fiscal relations that starts with an altogether different assumption with respect to the activities of governments within a federal system. This second formulation discards the idea of rigid responsibilities among the governmental units within a Federal structure. Instead, the consumer-voter, in making his decision with respect to preferences for public services is seen as deciding as well about the "mix of governments" in the provision of these services. He turns, not exclusively to the State, but to the National Government, States, and localities—as needed—to provide the public services he seeks. He does this within our political structure through identification with others (e.g., vested interest groups) to gain the services he desires—clean water, school lunches, maternal and child health facilities, and so forth.

This second formulation broadens the framework of analysis to take cognizance of the differing positions on two continua: (1) *efficiency* in (*a*) use of scarce innovational and governmental skills, (*b*) administration due to economices of scale, and (*c*) operation due to economies of scale; and (2) *flexibility* of government as characterized by (*a*) ease in voter-consumer influence on government action, (*b*) speed in voter-consumer influence on government action, (*c*) differentiation of government services to tailor them to the demands of

[16] Burton Weisbrod, *External Benefits of Public Education,* Princeton University Industrial Relations Section (Princeton, 1964).
[17] Jesse Burkhead, "Comment" in *Design of Regional Accounts,* Werner Hochwald, ed., The Johns Hopkins Press for Resources for the Future, Inc. (Baltimore, 1961).

specific groups, and (*d*) extent of the access to power by the govmental units.

This preference of the consumer-voter is an important aspect of our Federal structure that is often overlooked. It means that when individuals are not satisfied with the levels of services they are receiving, they may change the "mix" of jurisdictions. For the individual, this is often a more suitable answer than moving to another community.[18]

In this scheme, there is no "natural" dividing line between the responsibilities of the Nation, the States, or the local communities, based solely upon the spatial distribution of externalities. The responsibilities shift as the consumer-voter alters his judgment about which mix of governments can best provide him with the public service he seeks. The issues involved may be clarified by the three following illustrations.

1. *Responsiveness of governments.*—Suppose that considerable interest in urban vocational training programs exists within a State, but any attempt to provide such a service has been thwarted because the State legislature is dominated by rural representatives who block the passage of an authorizing bill. Thus the public demand for a service is not effectively reflected within the jurisdiction that is the proper one in terms of the area of benefits. To overcome this problem, interested parties may (1) reapportion the legislature, (2) turn to local jurisdictions, or (3) appeal for national action. If they chose to appeal to the National Government, the solution could be either a direct national program, or a categorical aid program.

2. *Economies of scale.*—Suppose that an old-age insurance benefit plan had been designed optimally as a State plan in terms of the area of benefits (i.e., where the aged live), but the design would lead to high administrative costs per capita of those served. If substantial economies of scale are apparent through a consolidated national system to achieve the benefits, individuals may well prefer that to the State plan.

3. *Tailoring of services to consumer demand.*—Suppose that the application of externalities criteria alone in a certain situation points to Federal aid. But if the Federal grant imposes a "standard" at variance with the desires of the citizens in a State—that is, if the standard does not give them the benefits sought for their residents—the Federal moneys with its "strings" attached will be rejected. (This was the actual case with aid for the needy blind in Pennsylvania.)

A proper allocation of resources in accord with any single criterion—externalities, for example—is deficient. Moreover, there is a great comparability between an argument for a monopoly structure in the private market—because of economies of scale and innovation—and an argument for Federal intervention where no externalities are present, but economies of scale and innovational abilities can be gained. The question "What mix of enterprise?" differs little whether asked in the public or the private sector. We must evaluate the performance of governmental structures and industrial structures with equal care.

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[18] James A. Buchanan, *The Public Finances*, revised edition, Irwin (Homewood, Ill., 1965). See also Charles M. Tiebout, "An Economic Theory of Fiscal Decentralization" in *Public Finances: Needs, Sources and Utilization*, National Bureau of Economic Research, Princeton University Press (Princeton, N.J., 1961).

In the private sector, entrepreneurship has served to seek out new commodities and new ways of producing goods more efficiently. How are innovation and experimentation achieved in the public sector? One answer has been provided by the Federal aids that encourage demonstration programs and experimentation. Recent grants have authorized, for example, demonstrations of ways to reduce urban transportation needs or to improve services; saline water research; demonstration programs of vocational education; experiments with improved methods of providing housing; research on methods of managing financing, and operating small businesses; experiments on methods to reduce public dependency and coordinate public and private agency activities in the welfare field; testing of new types of hospital construction and applications of experimental hospital equipment; development of improved nursing care of the sick at home and in nursing homes; and new highway research and practice.

For over 20 years the National Government has been encouraging research in universities and industries. Only in very recent years has an important beginning been made on research into the affairs of government itself. Chracteristically, such undertakings require considerable leadership and high quality personnel. Scarcity of innovational and experimental skills has contributed to dependence on staffs of national agencies for innovations in government and for the technical guidance that can lead to innovations by other governmental units. Not only are grants provided for experimentation but also recommendations made in 1965 by the Ackley Committee recharging to defense contracts a share of the costs of generalized long-range community planning have encouraged application of new techniques of systems analysis and operations research to State and local problems.[19]

The political scientist characterizes the mix of governments in the provision of public services as a "marble cake" and distinguishes between this combination and a rigid demarcation of roles of governments in a federal system illustrated by the "layer cake." [20] The search for a clear role, respectively, of the National Government, of State governments, and of local governments has long since been abandoned by the political scientist. In its place has come an emphasis on a federal system partnership of governments within which there are changing mixes of National, State, and local action with respect to any specific function or activity. To build a theory of Federal fiscal relations at this stage on the notion of a clearly defined "Role of the States" sets a framework for analysis and for public policy recommendations which would be at variance with the system that has recently emerged, and that gives promise of adapting government to changing economic circumstances.

The strong preference for local administration is indicated by the fact that most civilian public services *are* (as noted earlier) locally administered. The consumer-voter has chosen to keep the allocation of such services as close to home as possible, so that the levels of service could be tailored in the light of his preferences. He has also chosen national programs when administrative economies or efficiencies

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[19] *Report of the Committee on the Economic Impact of Defense and Disarmament*, July 1965, Washington, D.C., 1965.

[20] See, for example, Joseph E. McLean, *Politics Is What You Make It* (Public Affairs Pamphlet No. 181, 1952), p. 5.

pointed to national action—for example, in the case of the social insurance system. He has turned to national leadership for innovation and experimentation when scarce professional skills at both State and local levels indicated national stimulation through demonstration grants.

Lack of responsiveness of the States has frequently been cited as a cause of the expansion of Federal aids. Repeatedly noted also has been the need for improved representation in the States, so that the voter and the interest groups which represent him would have a better chance of being heard close to home. The "mix" of governments the voter chooses is clearly influenced by the responsiveness of the several levels of governments that are potential suppliers of public services. While the weaknesses of State and local governments certainly reinforce the pressures for national action, responsiveness is only one of a series of flexibility criteria applied by the voter-consumer in making his choice. For example, reapportionment in State legislatures to improve the representation of urban groups may reduce the pressures for grants-in-aid to alleviate and remedy specific social problems but will not eliminate the opting for some national involvement where economies of scale in administration or use of scarce manpower skills dictate such involvement.

COST SPILLOVERS

Social costs resulting from the provision, or lack of provision, of a public service have their own spillover. For example, the public-service provision of a massive superhighway in jurisdiction A may cause a sizable traffic problem in jurisdiction B. On the other hand, when jurisdiction C dumps untreated sewage into a river, there are significant spillover costs to the downstream communities, as a result of C's failure to provide a public service. Cost spillovers can also range widely from cause to effect, due to population movements. A welfare cost in Chicago may originate from low levels of education in the South, or a heavy public hospital load in New York City may be the result of inadequate health services in Puerto Rico.

The question of "mix of government" arises in such cases of social cost spillovers, just as it does in the benefits cases considered above. This is demonstrated easily in the problem of inadequate waste treatment by up-river communities. At least five corrective options are possible: voluntary (but probably unlikely) action on the part of the up-river communities; local government confederation; creation of a river basin authority with independent taxing authority; State regulation; and Federal action. The last option, Federal action, may take three forms: direct action on the part of the U.S. Corps of Engineers, or some similar agency; intergovernmental grants to encourage up-river communities to mend their ways; or Federal regulation of interstate flows.

An individual consumer-voter may prefer an option that depends on one of the government levels or on a "mix," according to his estimate of the cost, the quickness of response, and various criteria. This type of evaluation may explain why the Corps of Engineers sometimes participates in projects even though no relevant externalities appear to be involved. It may also explain why the Corps is an expert consultant on many projects that are "purely a local matter."

ANALYSIS AND PRESCRIPTIONS

Differences in the formulation of our Federal structure lead to differences in policy prescriptions. In summary, the first formulation points to a reassessment of the present Federal aid structure to:

Determine which of the aided programs have "benefit spillovers" and which do not, so that grants may be made available where the spillovers are large, and may be eliminated where these spillovers are negligible, for example, Federal aids for old-age assistance.

Assess the amounts of the spillovers so as to provide a yardstick for determining the size of the grant, with concomitant increase in some grants and reduction in others.

Develop some supplementary device to compensate jurisdictions for the costs arising from insufficient investment in public services when investment requirements are viewed from the perspective of the state of immigration rather than the state of outmigration.

The criterion of benefit spillovers as a basis for Federal aid is not easily applied. George Break, in his recent formulation of intergovernmental fiscal patterns based on the notion of spillovers, argues (1) that the categorical programs for which aid is given must be designed to leave the determination of levels of services in the hands of the States, and (2) that the open-ended grant would achieve this purpose.[21]

Such proposals for open-ended grants emanate from the conceptual emphasis on the State as the primary decisionmaker for an efficient allocation of resources. Clearly, the single criterion creates difficulties. A State's decision on the level of expenditure, such as expenditure per child in average daily school attendance or assistance payments per needy child, will not necessarily yield a nationally acceptable standard of program performance. Mississippi's judgment of the proper levels of educational expenditures, for example, is made within the framework of the type of education necessary for independent economic functioning in Mississippi, but education that is designed for an agricultural type of community is not suitable for the economic life in such complex metropolitan areas as Chicago, New York, and Oakland, Calif. Mississippi cannot make rational choices among classes of public services, even assuming compensatory financing to offset benefit spillouts that will meet the public service underpinnings for human capabilities outside of the State.[22] This reformation points to some national standards for public services.

Cost spillovers require separate solutions. Even a national *minimum standard* of education would be inadequate for the complexities of living in large metropolitan areas. And the past neglect of public service needs in States of population outmigration leads often to expenditures for classes of public services different from the neglected one, for example, inadequate educational investment may require higher outlays for public welfare, public housing, crime, etc. where the costs of the past neglect spill-in.

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[21] George Break, unpublished manuscript on intergovernmental fiscal relations, The Brookings Institution (Washington, D.C.) 1965.

[22] A followthrough on this normative concept of State responsibility for expenditure-level decisions to the prescription of open-ended categorical grants also means abandonment (1) of the notion of equalizing categorical grants that seek to assure minimum national program standards and (2) of matching requirements.

The second approach requires a total reevaluation of our present fiscal structure, not just a partial estimation of benefit spillovers and an assigned "Role of the States." Such a reevaluation should be focused upon the range of economic and flexibility criteria, including:

1. The area of benefits of the service.
2. Economics of scale in administration, operation, and in use of scarce innovational and governmental skills.
3. Voter-consumer preferences for differentiated governmental services.
4. Responsiveness of "governments" to the demands of specific groups within the community.

Obviously, these criteria are not all mutually compatible. For example, the level of operation which gives the lowest cost per unit of service may not be consistent with the area of benefits. Hence, the most important aspect of the second formulation is the recognition of a multiplicity of objectives or goals which cannot all be met simultaneously. This recognition of a number of objectives must take the form of alternative plans of fiscal federalism, out of which appropriate combinations must be chosen.

To clarify what such a total reevaluation entails, let us consider crime prevention—one of the main problems of our central cities. Frank appraisal of the organization of our efforts to prevent crime in the central city must include far more than a mere analysis of spillovers. Obviously, we need to contemplate reorganizing the whole present structure, and we must concern ourselves with the potential economies of scale in this function.

We must consider the ability of the present structure to capitalize on the latest crime-prevention managerial innovations. We must estimate the effectiveness of our present approach in preventing criminal behavior and apprehending lawbreakers. We must begin to understand the preference of the consumer-voter as to the degree of centralization of the law enforcement function, and other noneconomic factors. We must consider the ability of various levels and sizes of jurisdictions to gauge effectively the demands for such services and to implement an appropriate program. Such an appraisal will lead us to a restructuring of our present efforts—a restructuring that may include more intergovernmental aids, but is more likely to lead to a restructuring of expenditures. In any case, periodic reexamination of intergovernmental aids is indicated—to test the consumer-voter preferences on the public service package and on the "mix" of governments currently required to meet the consumer-voter demands.

FISCAL STRUCTURE OF THE GOVERNMENTS

This paper has omitted reference to the range of taxation issues that affect intergovernmental relations. National taxation policy in a federal system cannot neglect the combined effect of National, State, and local taxation on growth objectives, or on objectives of income redistribution and equity. The fiscal capacity of States and localities is limited both by the types of tax sources available to them and by the current income flows out of which these taxes are paid. Interjurisdictional mobility of people, of industry, and of commodities limits the taxing capacity of the States and, to an even greater extent, the taxing capability of local governments. Tax inducements, when used by States or localities as an instrument to attract industry, reinforce these limits and make more urgent a national policy on State and local taxation that can help reduce tax impacts on industrial location and create greater interstate uniformity in taxation of business.

Equity of tax burdens and the effect of alternative taxation forms on consumer demand and investment point also to more national concern about sources of State and local taxation, the documented relative regressivity of State and local taxation, and tax impediments to carry out such national program policies as urban renewal. Doctrines of local taxation for local benefits need to be reassessed when division between those who benefit and those who pay creates (1) lack of concensus that weights the scales in favor of local inaction, and (2) a preference for State or National Government financing. This preference is reinforced by the high gross product elasticity of the national tax structure in which originates the Federal tax "dividend."

Section C: EVALUATION BY FEDERAL, STATE, AND LOCAL COMMISSIONS AND OFFICIALS

RECOMMENDATIONS OF THE ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS AND EARLIER GOVERNMENT COMMISSIONS

BY RICHARD F. KAUFMAN*

The impact of Federal aid on Federal-State-local fiscal relations and the Federal system has been of paramount concern to officials at all levels of government for the past quarter of a century. Earlier interest in these problems, beginning with the Great Depression, is reflected in the work of the Council of State Governments, particularly its Committee on Conflicting Taxation and that committee's 1935 report, *Conflicting Taxation*, and in the Tax Policy League symposia, beginning in 1937.

DEPARTMENT OF THE TREASURY

1. THE GROVES, GULICK, NEWCOMER COMMITTEE

The Department of the Treasury's Special Committee on Intergovernmental Fiscal Relations (known as the Groves, Gulick, Newcomer Committee), published its report entitled *Federal, State, and Local Government Fiscal Relations* in 1943. The Special Committee had been established by the Secretary of the Treasury in 1941 and was financed in part by special funds provided for this purpose by Congress. The report is significant, in terms of current trends of thought, for its advocacy of the "middle ground" between "the strong centralizers, who feel that State and local fiscal independence has served its usefulness and is no longer compatible with modern economic facts" on the one hand, and "those who are satisfied with what we have" on the other.[1] The general position taken is that

> While much weight needs to be given to the values associated with autonomous local government, these have to be balanced against the advantages, such as reduced confusion and wider perspective, which attend central control. A priori generalizations concerning centralizing are of little use. Each specific problem has to be considered on its own merits. In some cases federalization of a function may (by a balance of the interests) be warranted; in others, retention of the function by States and municipalities may be called for; and most often joint participation, in one way or another, may be the best solution. Decentralization within the sphere of Federal activities may also have a place in the future.[2]

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*Staff economist, Joint Economic Committee. The views expressed are those of the author and do not necessarily represent the views of the Joint Committee or individual members thereof.

[1] Intergovernmental Fiscal Relations, S. Doc. No. 69, 78th Cong., first sess. (Washington, 1943). The committee consisted of Harold M. Groves, Luther Gulick and Mabel Newcomer; special advisers and staff included L. Laszlo Ecker-Racz, Carl Shoup, and Walter W. Heller, and others.

[2] *Ibid.*, p. 5.

a summary of the Committee's recommendations which it termed an action program for each level of government follows:[3]

I. Federal Government

A. For immediate action:

1. Negotiate with State representatives and pass legislation to create a Federal-State Fiscal Authority.
2. Amend the income tax law to make State income taxes deductible on an accrual basis even though other expenses are reported on a cash basis.
3. Revise, modernize, and broaden the death-tax credit.
4. Give the Federal estate tax a thorough overhauling, integrating death and gift taxes, substantially reducing exemptions and coordinating the Federal and State taxes.
5. Eliminate tax-exempt securities in a manner to secure States and municipalities against loss arising from the taxability of their securities.
6. Defeat discrimination resulting from State community-property laws by providing that they shall not apply in the operation of Federal tax laws.
7. Provide a clearing house and "board of appeals" (Federal-State Fiscal Authority) for more careful and consistent treatment of payments in lieu of property taxes on Federally owned property. Such payments should be generous, espectially during the war.
8. Provide a special joint committee of Congress to consider legislative proposals for payments in lieu of taxes; provide facilities for maintaining a permanent inventory of Government property.
9. Allow State sales-tax application to contractors working on Government orders.
10. Modify and improve the coordination and efficiency in unemployment compensation by increasing the Federal credit from 90 to 100 percent and requiring the States to furnish part of the cost of administration.
11. Disallow sales taxes as a deduction in Federal income-tax practice; if the deduction is retained, make it general and not conditioned upon certain technicalities in the tax law.
12. Pay more heed to cost of compliance in framing tax laws.
13. Extend the civil-service coverage to include all personnel engaged in Federal tax administration.
14. Consider the provision of a suitable bond instrumentality for the investment of State and local surplus funds during the war. This might take the form of a nonnegotiable bond redeemable after the emergency or upon a showing of war-created need, and to be matched by the Federal Government if used for approved public works.[4]
15. Continue and enhance cooperative efforts to improve State and local accounting and reporting; provide annual compilation of cost of government and total taxes.
16. Expend more effort on Federal-State collaboration in the administration of overlapping taxes.
17. Repeal the automobile-use tax, or, if it is retained, require receipt as a condition for obtaining a State license.
18. Further promote better uniform governmental accounting and reporting.
19. Assume the responsibility of annual calculation and publication of the overall cost of government and other fundamental fiscal data.
20. Cultivate an attitude which regards States and localities as partners in a joint enterprise.

B. For immediate or future action:

21. Develop in consultation with the States, standard rules for income- and death-tax jurisdiction; develop suitable rewards for State compliance with these rules and other suitable procedures so that the Federal Government may serve as an umpire in multiple-taxation disputes.
22. Develop in consultation with the States rules of uniform income-tax procedure; promote the adoption of such rules looking toward single administration of a relatively uniform State and Federal income tax.

[3] *Ibid.*, pp. 41–45.
[4] Written before recent developments which cover, to some extent, the needs of the States.

23. Adopt a Federal-collection-State-sharing program for the tobacco tax.
24. Enact legislation providing for Federal incorporation of corporations doing an interstate business.
25. Provide distribution of welfare grants to the States through a graduated bracket system as suggested in the Connally amendment.

C. For future action:

26. Abandon motor vehicle taxes to the States reserving the right to tax motor fuel used in aviation.
27. Inaugurate a thorough study of the cost of tax compliance and the burden of multiple taxation on interstate companies; reserve action on centralization of business taxes until this evidence is available.
28. Use a public investment technique (if necessary) to cope with post-war deflation and unemployment; dual budget; creative public works (health, housing, nutrition, and regional development); full liquidation of outlays.
29. Reduce repressiveness of the tax system by deemphasizing business taxes and by equalizing burden upon equity-financed companies compared with those financed by means of indebtedness (through a partial credit to the corporation for dividends paid out).
30. Broaden Federal aid to include relief and elementary education.
31. Broaden the Social Security program to include uncovered groups under old-age insurance and unemployment compensation. This would not only provide more equitable coverage but would also make possible some simplification of payroll taxes.
32. Recognize a national minimum status for elementary education by provision of a differential (equalization) grant.
33. Provide controls which will insure improvement in the division of educational revenues, local districting, and the quality of the educational product, at the same time insuring against coercive interference with local autonomy and minority views concerning education.
34. Provide for Federal scholarships to insure the adequate development of talent through higher education.
35. In the interest of simplification, repeal Federal liquor license fees retaining licenses where needed for administration.

D. Contingent action:

36. If a Federal retail sales tax is enacted, provide legislative implementation and administrative action to insure the fullest cooperative use of State personnel and machinery.

II. State Governments

1. Negotiate with Federal representatives and collaborate in the development of a Federal–State Fiscal Authority.
2. Negotiate with Federal officials and Congress to inaugurate a program for the elimination of tax-exempt securities in such manner as not to embarrass States and municipalities fiscally.
3. Tighten property exemption provisions; relax ceiling and uniformity requirements as to local property tax levies; develop more adequate supervision of property-tax administration.
4. In collaboration with municipalities, refrain from demanding unreasonable wartime aid from the Federal Government, thus recognizing the importance of local independence.
5. Apply surplus revenues, where possible, to the elimination of debt and the development of a reserve against wartime loss of revenue and post-war need for public works.
6. When revenues will permit, allow Federal income taxes as a deduction in calculating State income taxes.
7. Redouble attack on trade barriers, multiple taxation, and special inducements for the location of industry; use of education, reciprocal agreements, and interstate compacts toward these ends: pass legislation allowing credit to new residents for automobile license taxes paid in the same year to other States.
8. Collaborate with the Federal Government looking toward Federal arbitration of jurisdictional disputes and joint determination and promotion of uniform practices in income and business taxation especially with regard to questions of jurisdiction.

9. Further collaborate with the Federal Government in the joint administration of overlapping taxes.
10. Adopt legislation on their own initiative that would make payment of Federal automobile use tax a condition for the receipt of a State license.
11. Mitigate the "rotten-borough" system by providing more adequate representation for cities in State legislatures.
12. Give more consideration to cities in the distribution of shared taxes, particularly motor-vehicle taxes.
13. Adopt enabling legislation that would permit cities to supplement the general property tax with a rental tax on occupiers.
14. Adopt enabling legislation that would facilitate surplus financing during wartime.
15. Adopt legislation requiring more adequate and more uniform governmental accounting and reporting.
16. Cultivate an attitude that regards all governments as partners in a joint enterprise.
17. Collaborate with the Federal Government on a broader and more generous program of Federal aids, accepting controls, but insisting that they be cooperatively applied rather than dictated.

III. Municipal Governments

1. Negotiate with Federal representatives and collaborate in the development of a Federal-State Fiscal Authority.
2. Negotiate with Federal officials and Congress to inaugurate a program for the elimination of tax-exempt securities that will not fiscally embarrass States and municipalities.
3. In collaboration with States, refrain from demanding unreasonable wartime aid from the Federal Government, thus recognizing the importance of local independence.
4. Apply surplus revenues, where possible, to the elimination of debt and the development of a reserve against wartime loss of revenue and post-war need for public works.
5. Broaden the property tax program by supplementing the property tax with a rental tax on occupiers.
6. Strictly interpret property tax exemptions.
7. Inaugurate a thoroughgoing study of possible new sources of independent local revenue.
8. Study successful procedures for safeguarding reserve funds, and enact legislation needed for this purpose.
9. Develop more metropolitan cooperation and the use of large metropolitan districts for financing functions of common interest.
10. Emphasize raw material producing districts' claim upon aids and shared taxes because their tax base does not represent their contribution to the national product.
11. Demand more equitable representation in State legislatures.
12. Demand more equitable distribution of shared revenues, particularly motor-vehicle taxes.
13. Provide for more adequate governmental accounting and reporting.
14. Cultivate an attitude which regards all governments as partners in a joint enterprise.
15. Prepare for collaboration with the Federal Government in a post-war public investment program.
16. Collaborate with the Federal Government on a broader and more generous program of Federal aids, accepting controls, but insisting that they be cooperatively applied rather than dictated.

It is interesting to note the Groves, Gulick, Newcomer committee's consideration of the revenue-sharing concept. After taking cognizance of the time-honored precedent for sharing by the States and their municipalities (57 percent of State-collected taxes were distributed to local units in this way in 1935), the report says that "Sharing involves more centralization than any other coordination device except reallocation of functions. It involves centralization both as to the levy of taxes and as to their administration, leaving local discretion only as to expenditure." The report also points out that the two foreign experiences with revenue sharing, in Argentina in 1934 and in Germany in 1919, were not happy ones. In neither case were the systems readily adjusted to State needs nor did they foster responsibility: "The shared taxes led to State and local extravagance in the few years of prosperity in which they were being distributed, and in time of depression they brought maldistribution of funds, since the neediest districts in general received the least." In view of these and other difficulties, the committee recommended Federal-State revenue sharing only with respect to the tobacco tax, on an experimental basis.[5]

2. Joint Conference on Federal-State Tax Relations

The Joint Conference on Federal-State Tax Relations, created by the Council of State Governments, met in 1947 and 1948. This conference was attended by the Governors of 15 States, 10 Members of the House of Representatives, and six U.S. Senators. The House Members represented the House Committees on Ways and Means and Expenditures in the Executive Departments, and the Senators represented the Senate Committees on Finance and Expenditures in the Executive Departments.

In 1947 the conference issued a joint statement of general principles and immediate objectives urging among other things the reduction of Federal excise taxes, Federal-State sharing of revenues from inheritance and estate taxes, Federal relinquishment to the States of the Federal tax on employers relating to State employment security programs and assumption by the States of the administration of these programs. The recommendations follow:[6]

1. That the Federal Government should reduce Federal excise taxes as soon as practicable;
2. That the Federal Government should amend inheritance and estate taxes to provide more equitable division of this revenue between the Federal Government and the States;
3. That the Federal Government should relinquish to the States the Federal tax on employers levied to cover the administrative expenses of the State employment security programs, and the States will assume the responsibility for the administration of the unemployment compensation and employment service programs;
4. That the Congress take the earliest possible action to correct by Federal law the income tax inequities existing between the community-property and the non-community-property States; and
5. That the States should avoid encroachment upon tax fields which are peculiarly adaptable to Federal uses.

Also in 1947, the Governor's Conference met and reaffirmed its belief that the States needed to assume their own responsibilities, urged the elimination of tax competition between the Federal and State Governments, and "recommended that future Federal aid legislation require Federal administrative agencies to confer with and secure approval from the Executive Committee of the Governor's Conference in

[5] *Ibid*, pp. 155–158.
[6] Council of State Governments, *Federal-State Tax and Fiscal Program* (Chicago 1948), also printed as S. Doc. No. 4, 81st Cong., first sess. (Washington, 1949), pp. 33–34.

the preparation of rules and regulations governing the administration of grants to States."[7]

The Subcommittee To Study Intergovernmental Relations of the Senate Committee on Expenditures in the Executive Department, was designated by the Joint Conference to prepare a report conforming to the objectives of the conference. The subcommittee's report was submitted to Congress in 1948.[8] It set forth the following specifications as a basis for seeking solutions to the problems of intergovernmental relations:[9]

> 1. They must strengthen the ability of all units of government, whether Federal, State, or local, to finance their various functions and services on a scale commensurate with the relative importance of each function or service to the people as a whole.
> 2. They must improve the equity and administrative efficiency of the country's overall tax structure.
> 3. They must promote the country's economic strength.
> 4. They must be conducive to economy and efficiency in the spending of public funds.
> 5. They must be consistent with the principles of our Federal system and must preserve the vitality of our State and local governments.

This report had been approved by the Federal-State Tax Relations Committee of the Governor's Conference.

The Joint Conference of representatives of Congress and the Governor's Conference again met in 1948 and adopted the following recommendations:[10]

> 1. That grants-in-aid from the Federal Government to the States for continuing activities be reduced by not less than 20% for the fiscal year 1950 and that the Federal Government withdraw from or reduce rates in connection with certain tax fields that can best be used by State and local Governments. Grants-in-aid from the Federal Government to the States for continuing activities have increased in the past four years from approximately $950,000,000 annually to $1,950,000,000; and States and localities, because of demands upon them, are strenuously searching for additional sources of revenue.
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> 2. That the technical staffs of the appropriate committees of the two Houses of the Congress and of the Governor's Conference be directed to develop a concrete plan in accordance with this over-all policy, such a plan to be submitted to the appropriate committees of the two Houses of the Congress and to the Governor's Conference.
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> 3. It is further proposed that very soon after the convening of the 81st Congress, the appropriate committees of the two Houses arrange a joint meeting with the tax committee of the Governor's Conference to discuss the general policy and the proposed plan.

3. First Hoover Commission

The Commission on Organization of the Executive Branch of the Government (the first Hoover Commission) was created by Congress in 1947.[11] In referring to the work of the Hoover Commission in the area of Federal-State relations it is necessary to cite two of its publications because of the difference in outlook each represents. The Commis-

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[7] W. Brooke Graves, *American Intergovernmental Relations* (New York, 1964), pp. 458–459.

[8] *S. Rept. 1054*, 80th Cong., second sess.

[9] *S. Doc. No. 4*, 81st Cong., first sess. (Washington, 1949), p. 34.

[10] *Ibid*, pp. 34–35.

[11] *Public Law 162*, 80th Cong.

sion's task force report[12] was prepared by the Council of State Governments under contract to the Commission. The Commission's formal recommendations are contained in its report on *Overseas Administration, Federal-State Relations, and Federal Research.*[13]

The task force report emphasizes the interrelatedness of the Federal and State levels of government: "There is no past in which these governments were completely separate entities. There is no future in which completely separated, strong governments may exist."[14] While each level of government possesses functions over which it has, if not sole, at least primary powers, even in some of these fields there is interaction and a sharing of functions, according to the report.

The task force warmly endorses Federal grants as a means for extending governmental services throughout the country which the States alone would have not been able to supply, and lists as factors that have strengthened the system the provision of a redistribution of resources from some of the richer States to others, bringing about a more cooperative Federal system which has added to the resources and services of the States, and bringing about a "division of responsibilities, the National Government giving financial aid and establishing broad standards, the State governments sharing the fiscal burden and maintaining primary responsibility for administration."[15] At the same time certain deficiencies are recognized: "The existing aggregation of grant programs, however, has never been coordinated sufficiently for the device to serve its full purpose in intergovernmental fiscal relations."[16] Other "weakening factors" cited by the report are the removal of large areas of discretionary and administrative powers from the hands of State officials, and the burdens imposed on State budgets by Federal concentration on some activities while neglecting others.[17] And the report warns against the dangers of centralization: "With grants goes control. With control goes power. With power goes centralization—and in too much centralization lies danger to our entire Federal system of government."[18]

To achieve more effective intergovernmental fiscal relations, the task force report recommended modification of future grants in accordance with the following criteria:[19]

1. National grants should be provided on a broad functional basis rather than on a piecemeal basis—thus giving the States discretion in adapting them to their own needs. This criterion does not eliminate the possibility of concentrating on selected program goals; in fact, it may permit establishing and expressing such goals in terms of performance rather than of expenditures.

2. National grants should help support a Nation-wide level of governmental services which will be acceptable as a national

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[12] *Federal-State Relations*, S. Doc. No. 81, 81st Cong., first sess. (Washington, 1949). Frank Bane was Executive Director of the Council of State Governments at the time the report was prepared.

[13] Commission on Organization of the Executive Branch of the Government, *Overseas Administration, Federal-State Relations and Federal Research* (Washington, 1949), Dean Acheson, Vice Chairman of the Commission, and James Forrestal, Commissioner, dissented from the Federal-State section of the report on the grounds that the Commission had exceeded its jurisdiction by going into the realm of legislative policy, p. 25.

[14] *Federal-State Relations, op. cit.*, p. 128.

[15] *Ibid*, p. 128.

[16] *Ibid*, p. 81.

[17] *Ibid*, pp. 127–128.

[18] *Ibid*, p. 129.

[19] *Ibid*, p. 81.

standard. To this end, the grants should be apportioned to relate as closely as possible to (a) the need for the service within the individual States and (b) the capacity of the individual States to finance the service without disproportionate tax burdens.

3. The cooperation between levels of government which is required for the successful operation of a grant system necessarily restricts to some extent, the control which any one government can exercise over grant expenditures. Nevertheless, national grants and the programs which they support should be subjected to budget review in both the National Government and the State governments.

4. National grants should be conditioned upon effective State administration of the aided programs. The assumption of national responsibility for financing the aided programs should not be used to justify the erection, either by statute or by administrative interpretation, of obstacles to the efforts of State governments to adopt the broad national policies to their local needs and customs.

The task force rejected the block grant or revenue sharing device. After discussing proposals for unrestricted grants, it concluded that:[20] "Assigning complete administration of functions to the States and financing those functions either through unrestricted block grants or through the return of national tax yields to the States also present substantial difficulties. Block grants, for example, would have the advantage of supplying unrestricted funds to the States; but they would have the disadvantages of making the States more dependent upon the National Government for general revenues and possibly increasing the supervision of the National Government over the States' general governmental functions." However, its recommendation for "broad functional grants" is viewed as an intermediate arrangement between the block grant and the narrowly, restricted grants. The broad functional grants "would be restricted to general governmental purposes, but not to particularized programs. If the national interest were deemed to extend to certain specific facets of a function (e.g. tuberculosis, venereal disease, and epidemic diseases in the general field of public health), it might be feasible to specify that certain levels of performance be achieved for each of these narrower fields as a condition for continuance of the whole broad grant but without limiting expenditure of the grant money to the specified objectives."[21]

In its formal report and recommendations the Commission expresses a more disapproving attitude toward grants-in-aid generally, although it is resigned to the fact that they are "a part of the warp and woof of present day government."[22] It lists as assets on the one hand and liabilities on the other a set of considerations similar in some respects identical to the "weakening" and "strengthening" factors listed by the task force. But it adds, significantly, in its list a broad, general condemnation:[23] "Federal grants-in-aid retard and repress the initiatives of the States in financing the growing needs of State and local government, because such grants frequently result in rewarding those States which avoid their responsibility and in penalizing those which accept it."

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[20] *Ibid*, p. 130.
[21] *Ibid*, pp. 78–79.
[22] *Ibid*, p. 29.
[23] *Ibid*, p. 32.

The Commission then states that the effects upon the executive branch of the Federal Government of grants-in-aid have been to enlarge it by requiring great expansion in many departments and the establishment of new administrative agencies, to increase national taxes, and to help account for the development and extension of the "fourth area of Government" serviced by Federal regional offices.[24]

Its formal recommendations are as follows:

1. That the functions and activities of government be appraised to determine which can be most advantageously operated by the various levels of government, and which require joint policymaking, financing, and administration.
2. That our tax systems—National, State, and local—be generally revised and that, in this revision, every possible effort be made to leave to the localities and the States adequate resources from which to raise revenue to meet the duties and responsibilities of local and State governments.
3. That all grants-in-aid which are given to State governments directly be budgeted and administered on the Federal and State levels as are other Federal and State funds.
4. That the grant-in-aid plan and program be clarified and systematized.
5. That a continuing agency on Federal-State relations be created with primary responsibility for study, information, and guidance in the field of Federal-State relations.

Recommendation No. 4 is interesting because of the explanation the Commission gave for it. In explaining this recommendation the Commission stated that a system of grants should be established, "based upon broad categories—such as highways, education, public assistance, and public health—as contrasted with the present system of extensive fragmentation."[25] In other words, the Commission carried forward into its formal recommendations the position of the task force favoring broad functional grants as opposed to block grants or narrowly, restricted grants.

Recommendation No. 5 resembles the recommendation of the Groves, Gulick, Newcomer Committee for a Federal-State Fiscal Authority.

4. Kestnbaum Commission

The Commission on Intergovernmental Relations, known as the Kestnbaum Commission after its Chairman, Meyer Kestnbaum, was established as a temporary body by Congress in 1953,[26] and at the time was considered the culmination of the work of the Hoover Commission and earlier reappraisals of the Federal system.[27] Section 1 of the act establishing the Commission declared that:

> it is necesary to study the proper role of the Federal Government in relation to the States and their political subdivisions . . . to the end that these relations may be clearly defined and the functions concerned may be allocated to their proper jurisdiction. It is further necessary that intergovernmental fiscal relations be so adjusted that each level of government discharges the functions which belong with its jurisdiction on a sound and effective manner.

[24] *Ibid*, p. 33.
[25] *Ibid*. p. 36.
[26] Public Law 109, 83d Cong.
[27] *Report of the Commission on Intergovernmental Relations* (1955), hereinafter referred to as the *Kestnbaum Report*, p. 5.

Section 3(b) of the act stated:

(b) The Commission shall study and investigate all of the present activities in which Federal aid is extended to State and local governments, the interrelationships of the financing of this aid, and the sources of the financing of governmental programs. The Commission shall determine and report whether there is justification for Federal aid in the various fields in which Federal aid is extended; whether there are other fields in which Federal aid should be extended; whether Federal control with respect to these activities should be limited, and, if so, to what extent; whether Federal aid should be limited to cases of need; and all other matters incident to such Federal aid, including the ability of the Federal Government and States to finance activities of this nature.

The Commission was composed of 25 members, including State Governors, mayors, and Members of the U.S. House and Senate. The findings of the Kestnbaum Report may be summarized as follows:

1. The Federal system as a whole is in a healthy condition. It has preserved local autonomy for the States which make their own constitutions and laws. Most States in turn have established a division of powers and responsibilities between themselves, their counties and cities, keeping in local hands control of the schools, police, the provision of most municipal services, the machinery of elections and the control of the party system. And it makes possible a large degree of popular participation and consent. The Federal system has met the test of civil war, accommodated vast territorial expansion while extending to new States constitutional equality with the old, helped bring about great economic growth and social advances, shouldered an increased degree of responsibility for social security and welfare, and enabled the mustering of resources for waging two World Wars and developing atomic energy.[28]

2. There is a danger of overcentralization and a weakening of the Federal nature of our system as the National Government expands its activities. Whether the reason for this expansion has been unreadiness of the States and localities to act on social and economic problems or overzealousness on the part of the National Government, the fact remains that the proper balance of powers between the levels of government have been endangered.[29]

3. The strengthening of State and local governments is essentially a task for the States themselves,[30] and must be carried through to the lowest levels of government.[31] Most States need to review their constitutions and remove obstacles to more vigorous and effective government, improve their systems of representation, improve the efficiency of their legislative and administrative machinery, provide their governors with more authority, develop better techniques of interstate cooperation, provide more home rule, fewer and stronger local units, better utilization of the counties, and develop solutions to the crucial problems of metropolitan areas.[32]

4. The National Government needs to pay greater attention to intergovernmental relations, and to facilitate cooperative or independent State action. Provision should be made for a permanent agency,

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[28] *Ibid*, p. 34.
[29] *Ibid*, pp. 4–6, 34–36.
[30] *Ibid*, p. 37.
[31] *Ibid*, p. 47.
[32] *Ibid*, pp. 56–57.

located in the executive branch of the National Government, to carry out these objectives.[33]

5. Fiscal imbalances among levels of government must be reduced. The problem arises because of unequal distributions of tax resources between the National Government and the States, among the States, and within the States, and because the States and local governments are not fully utilizing their revenue capacity. A sustained attack by all levels of government is required.[34]

6. The grant-in-aid has become a fully matured device of cooperative government. Where deemed necessary, conditional grants represent a basically sound technique, despite their piecemeal development and hodgepodge appearance. Substantial improvement, however, is desirable in determining both how and when to use them. This can be accomplished by developing more searching tests of the need for national participation, better understanding the possibilities and limitations of the grant, and more conscious and skillfull adaptation of legislative provisions and administrative supervision to grant-in-aid objectives.[35]

The Report, in its chapters on fiscal relations and grants-in-aid, discusses the use of a "comprehensive subsidy program" as an alternative to conditional grants to reduce fiscal disparities and for general governmental purposes. It rejects this proposal stating: [36]

> It would doubtless relieve the States of pressing financial obligations, but it would also relieve them of fiscal autonomy. The Commission believes that, whenever possible, decisions to spend and decisions to tax should be made at the same governmental level, thus encouraging financial responsibility.

The Commission reasons that such grants would have to be safeguarded by prescribed standards to insure efficient performance and equitable distribution of funds, which could entail a high degree of conformity and uniformity by the States. In addition, the more the States participated, the higher would be the necessary taxes and the more each State would insist on its share of the funds: "The spiral would lead to ever-increasing centralization." Other objections to unconditional grants cited by the Commission are: that subsidies would not materially relieve pressures for National action for specific objectives, resulting in a piling of conditional grants on top of subsidies, or enlargement of the field of direct National provision of services, or both, and the tendency would be for States and localities to rely more and more on the National Government to levy taxes.[37] [38]

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[33] *Ibid*, pp. 86–88.
[34] *Ibid.*, pp. 90, 92, 99–100, 102–103, 117.
[35] *Ibid.*, pp. 120, 122–124.
[36] *Ibid.*, p. 115.
[37] *Ibid.*, pp. 115, 121–122.
[38] Senator Wayne Morse, a member of the Commission, filed a separate statement dissenting from the Report. In his dissent, he stated: "I do not accept the point of view of those State-Righters who still cling to the notion that the sovereignty of the State is superior to the sovereignty of the Federal Government, even if in the exercise of State sovereignty the general welfare of the people of the Nation as a whole is denied." Basing his views on the general welfare clause of the Constitution, Senator Morse said that the report should have given greater emphasis to the requirement for a coordinated approach on the part of the State and Federal Governments on all issues that involve the National interest. He added, "I think the report gives undeserved aid and comfort to the ultra-conservative point of view in respect to the general subject of Federal and State sovereignty." *Ibid.*, pp. 278–279.

5. Joint Federal-State Action Committee

In 1956, the former Chairman of the Commission, Meyer Kestnbaum was appointed by President Eisenhower to the staff of the Executive Office of the President to follow through on the recommendations of the Commission. In 1957 President Eisenhower asked the Governor's Conference to join him in creating a task force for action with responsibilities for designating functions which the States could assume from the Federal Government, to recommend the Federal and State revenue adjustments required to enable such assumptions, and to identify functions likely to require future Federal or State attention and recommend the level of governmental effort needed.[39]

The result was the creation of the Joint Federal-State Action Committee whose membership included nine Governors, and seven high-level Federal officials. The Committee issued progress reports in 1957 and 1958, and a final report in 1960.

The major recommendations of the Joint Action Committee were: [40]

1. The States should take full responsibility for the vocational education grant programs and the local waste treatment facilities construction program in return for the transfer of 40 percent of the revenues from the Federal telephone tax.
2. The State and local governments should increase their financial responsibility for natural disaster relief and should assume a greater share of the responsibility for the promotion and regulation of peaceful uses of atomic energy and for handling problems of urban development, housing, and metropolitan planning.
3. The Federal estate tax should be reviewed so that the Federal credit for State taxes may be increased and the Federal and State taxes may be standardized. (The idea that a Federal income tax credit should be created for income tax payments to the States was discussed but not acted upon.)
4. A number of categorical public health grants (Venereal Disease Control, Tuberculosis Control, General Health Assistance, Mental Health Activities, Cancer Control, and Heart Disease Control) should be consolidated into a comprehensive grant.

In light of the establishment of the Advisory Commision on Intergovernmental Relations, the Joint Action Committee recommended dissolution for itself and it went out of existence in 1960. Before discussing the ACIR the work of two congressional committees in the late 1950's should be noted.

6. The House Subcommittee on Intergovernmental Relations

Under the Legislative Reorganization Act of 1946, the Committee on Government Operations was given the duty of studying intergovernmental relationships. In the House of Representatives this duty was delegated to the House Subcommittee on Intergovernmental Relations. In 1955 the report of the Kestnbaum Commission came before it and studies and hearings began to be conducted in order to study Federal-State-local relations, with particular emphasis on grant-in-aid

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[39] Address by President Eisenhower reprinted as Appendix I, *Final Report of the Joint Federal-State Action Committee* (Washington, 1960), p. 44.
[40] *Ibid.*, pp. 2, 13, 82.

programs, and to evaluate the recommendations of the Kestnbaum Commission.[41]

The subcommittee, in its *Report on Federal-State-local Relations*, concluded that categorical grants represent a useful device for harnessing cooperative governmental effort in the accomplishment of a national purpose and recommended that in future legislation Congress systematize categorical grants, and that a permanent Advisory Commission on Intergovernmental Relations be established. The subcommittee also raised the issue of the basis of distribution of Federal grants for purposes of equalization including the question of what would be an equitable measure of State-local fiscal effort.[42]

7. The Joint Economic Committee

In 1957 the Subcommittee on Fiscal Policy of the Joint Economic Committee undertook a study of Federal expenditure programs in terms of their impact on the level of economic activity and the standards for public expenditures to promote overall economic growth in the long run. Ninety-seven experts from universities, business, research groups, and government were invited to prepare papers on a wide range of topics dealing with major issues affecting Federal spending programs. A number of the papers, representing a wide range of viewpoints, dealt with the "Level at Which Public Functions Are Performed" and other aspects of Federal-State-local fiscal relations and the impact of Federal grants. The papers were printed in a compendium and were followed with hearings during which the experts responded to questions by members of the committee. The subcommittee then issued a report which was printed early in 1958.[43]

The subcommittee, in conducting its inquiry, was concerned primarily with the impact of Government activity on attainment of the Nation's basic economic policy objective: "A high rate of growth productive capacity with minimum fluctuations in the rate of resource use and

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[41] Publications during the late 1950's of the subcommittee, known as the Fountain Subcommittee after its Chairman, Representative L. H. Fountain, include the following:

Recommendations and Major Statement of the Commission on Intergovernmental Relations, Annotated to Show Method of Implementation and Federal Agency and Program Affected (August 1956).

Staff Report on Replies From Federal Agencies to Questionnaire on Intergovernmental Relations (August 1956).

Intergovernmental Relations in the U.S., a Selected Bibliography (November 1956).

Replies from State and Local Governments to Questionnaire on Intergovernmental Relations, Sixth Report by the Committee on Government Operation (June 1957).

Federal-State-Local Relations. Hearings (July 29, 30, 31, 1957).

Federal-State-Local Relations, State and Local Officials. Hearings (September–December 1957).

Federal-State-Local Relations, Dade County (Fla.) Metropolitan Government. Hearings (November 21, 22, 1957).

Federal-State-Local Relations, Joint Federal-State Action Committee. Hearings (February, 1958).

Federal-State-Local Relations, Nongovernmental Organizations and Individuals. Hearings (Feb. 24, 25, 1958).

Federal-State-Local Relations, Federal Departments and Agencies. Hearings (March–June 1958).

[42] For a fuller discussion of the Fountain Subcommittee's recommendations, see J. A. Maxwell, "Recent Developments in Federal-State Financial Relations," *National Tax Journal*, vol. XIII, (December 1960), pp. 310–319.

[43] Representative Wilbur D. Mills was chairman of the subcommittee. The following publications resulted from the study:

Federal Expenditure Policy for Economic Growth and Stability: Papers Submitted by Panelists Appearing Before the Subcommittee on Fiscal Policy (Nov. 5, 1957).

Federal Expenditure Policy for Economic Growth and Stability: Hearings. (Nov. 18–27, 1957).

Federal Expenditure Policies for Economic Growth and Stability. Report (Jan. 23, 1958).

in the general price level."[44] At the outset of the hearings subcommittee Chairman Wilbur D. Mills stated that while recognizing that many other considerations enter into the determination of the scope and character of Federal Government activity, which in many instances must be ruling:

> Nevertheless, we cannot ignore the economic consequences of any Government spending program if we are to be assured that Government will most greatly enhance or least interfere with the conditions requisite to economic progress.

The report of the subcommittee set forth "broad principles to assist in the formulation of Federal expenditure policies in the light of the Employment Act objectives."[45] The "broad principles" set forth in the report dealing directly with fiscal federalism are as follows:

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14. The scope and character of Federal spending programs should reflect, wherever possible, the comparative economic advantages of the Federal, State, and local governments and of private enterprise in achieving program objectives

The dynamic qualities in the Nation's political and economic development have resulted in frequent changes in the relationships among the Federal, State, and local governments, and between the public and private sectors of the economy. No clearly established division of responsibility for satisfying changing demands has emerged in this development. This flexibility, while possibly posing the danger of undue concentration of power at the Federal level, also may be a major source of strength in the economy, since it affords assurance that changing demands for services in response to changes in conditions required for economic growth need not be frustrated by institutional barriers.

The nature of the problems and objectives giving rise to many Federal programs precludes substantial and effective non-Federal participation. On the other hand, many types of activities performed by the Federal Government also can be and are performed by State and local governments and in the private sectors of the economy. Apart from the generally recognized social and political virtues in minimizing Federal responsibility for such functions and activities, considerations of the economy's growth potential also require Federal programs to be so formulated as to give non-Federal organizations every opportunity to determine whether they can efficiently participate in achieving the desired objectives.

15. Failure of State and local governments and private enterprise to recognize and to respond quickly to new demands must be expected to result in public pressure for the Federal Government to expand its activities

The historical record shows that the public has turned readily to the Federal Government when other agencies failed to meet new or expanded demands, and that the Federal Government has not been able to defer very long taking the action demanded of it. Revision and expansion of educational programs and of basic research efforts are the most important cases in point at the present time. The significance of these programs for the Nation's defense preparation and for economic growth has suggested to many the occasion for Federal Government action. The prospect for such pressures was stressed by the Subcommittee on Economic Stabilization of the Joint Economic Committee in its 1955 study of automation and technological change. The subcommittee pointed out, however, that first responsibility for meeting the demands for technical and scientific skills should fall upon local communities and upon the individuals and businesses interested in such competence.

These and similar programs are those in which a major role of the Federal Government, in the past, has been to stimulate activity in the non-Federal sectors of the economy. Whether that role now is to be substantially expanded well may depend on the speed with which agencies other than those of the Federal Government respond to the new and rapidly increasing demands.

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[44] *Federal Expenditure Policies for Economic Growth and Stability.* Report (Jan. 23, 1958), p. 2.
[45] *Ibid*, p. 1.

16. Federal participation in activities shared by State and local governments and private enterprise should be aimed primarily at improving the effectiveness of these activities and should avoid merely transferring responsibility for them to the Federal Government.

In the field of education, for example, the basic objective is to improve the quality of curriculum and instruction at all grade levels as well as to increase the number of teachers, classrooms, and enrollments in advanced institutions.

Achieving this objective will require reappraisal and revision of the basic substance of educational programs at the elementary, secondary, and advanced levels. Although these revisions will not be achieved merely by increasing expenditures, they should be expected to result in rising costs. since they will require relatively more and better resources than now are available. In view of this prospect, efforts to improve education programs should seek every possible opportunity to exploit technological advances. The use of television as a means of supplementing present instrumental techniques, for example, suggests numerous other low-cost, high-return capital outlays which might well be made, particularly at the secondary and advanced levels of education. More intensive use of existing school plant and equipment may also serve to reduce the real costs of expansion and improvement of the Nation's education programs.

There is no evidence that the extent of the increase in these costs depends significantly on whether responsibility for improving educational programs is assigned to the Federal, State, or local governments or to the private sector of the economy. The role of the Federal Government in this effort, therefore, should be determined on other grounds.

Some of the participants in the subcommittee's study urged greater Federal responsibility for educational programs on the basis that the extra demands on resources in education arise from national rather than local requirements. Whether the national interest in education is greater than, or even different from, that of the States and localities cannot be objectively determined. In any case, since the real costs of the desired improvements will not be materially affected by shifting responsibility, greater financial participation by the Federal Government, if deemed necessary, should avoid obscuring these costs lest States and localities be encouraged to divert their resources to programs of lower social priority, with a consequent loss to the economy as a whole.

Statutory and constitutional provisions limiting their financial resources may inhibit States and localities from promptly assuming increasing responsibility for public functions. Such limitations cannot be realistically ignored in the formulation of Federal expenditure policies. Where these are the principal constraints faced by State or local governments, however, the efforts of the Federal Government should be directed primarily toward the development of an expanded fiscal capacity at the State and local level.

Very much the same considerations are involved in the case of improving and expanding research activities. The subcommittee's hearings brought out the fact that a major obstacle to more effective research programs is the difficulty in establishing criteria for the allocation of highly limited and specialized research skills and equipment. It is agreed generally that a significant expansion of research efforts is required. Success in this respect, however, depends at the outset on improving the organization of research resources and their allocation into more productive lines of inquiry. Merely providing substantial increases in Federal outlays for these programs may serve only to transfer available research skills and facilities from the private sectors of the economy to the Federal Government, without materially improved results. Such competition may, in fact, disrupt current research efforts in which the Federal Government has a major interest.

The subcommittee's study brought out clearly the importance of expanding activity in pure research as the basis for continued technological advance and, therefore, economic growth. The study also revealed the limitations on present knowledge concerning the conditions and incentives necessary for long-run expansion of pure research efforts. It seems clear that over much of the period of this Nation's industrial development, the complex of patent laws, the tax system, and other institutional arrangements provided a setting highly conducive to rapid exploitation of applied research and developmental activity. Further study and analysis is required to determine the adequacy of these arrangements under today's conditions, and more particularly, to determine whether these arrangements are consistent with the growing requirements for pure research.

A number of the participants in the subcommittee's study maintained that, in view of the highly uncertain results, it is unlikely that private enterprise can be expected to undertake of its own initiative a major part of these pure research activities. However significant this limitation may be, it does not necessarily follow that merely enlarging research establishments within the Federal Government will achieve the desired objective. A necessary first step is determining the present availability and use of research talent and facilities in business, the universities, private research organizations, and at all levels of government. Federal research programs should seek closer integration and better organization of research activities. Such improvements are fundamental in assuring the greatest possible productivity from any increase in Federal research outlays.

8. The Advisory Commission on Intergovernmental Relations

The Advisory Commission on Intergovernmental Relations was created by Congress in 1959.[46] The statute requires that it be composed of representatives from the three levels of government: three Federal executives, three U.S. Senators, three Congressmen, four Governors, three State legislators, three county officials, four mayors, and three private citizens.[47] In addition to providing a forum for the discussion of problems common to Federal, State, and local governments and that are likely to require intergovernmental cooperation and to making available technical assistance to the Federal Government in determining the overall impact of proposed legislation on the Federal system, the ACIR is specifically authorized to—

1. Give critical attention to the conditions and controls involved in the administration of Federal grant programs.
2. Recommend within the framework of the Constitution, the most desirable allocation of governmental functions, responsibilities, and revenues among the several levels of government.
3. Recommend methods of coordinating and simplifying tax laws and administrative practices to achieve a more orderly and less competitive fiscal relationship between the levels of government and to reduce the burden of compliance for taxpayers.

The work of the ACIR is reflected in its policy reports, which contain formal recommendations, and its staff studies and information reports. The recommendations are directed to various levels of government for legislative or administrative action. Since its inception the Commission has adopted 29 policy reports involving close to 300 recommendations. The recommendations affect a wide range of matters from grants-in-aid to local fiscal relations, from coordination of Federal agencies to metropolitan planning, central city and suburban social and economic disparities, building codes, and Federal-State coordination of personal income taxes.

ACIR recommendations may be divided into three general categories: taxation and finance, governmental structure and functions, and

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[46] Public Law 380, 80th Cong.

[47] The Chairman of the Commission from 1959 to 1966 was Frank Bane who was Executive Director of the Council of State Governments at the time that the Task Force Study on Federal-State Relations for the First Hoover Commission was conducted. The present Chairman is Gov. Farris Bryant. L. L. Ecker-Racz who was a member of the staff of the Groves, Gulick, Newcomer Committee at the time of its report on Federal, State and Local Government Fiscal Relations was prepared, was Assistant Director of ACIR until he retired in 1967.

metropolitan areas.[48] Of primary interest to this discussion are the ones dealing with taxation and finance, which include the subject of grants-in-aid. A list of the recommendations to date in this category follows:

1. Estate and gift taxes (January 1961)

Amendment of the Internal Revenue Code to increase the credit against the Federal estate tax for inheritance and estate taxes paid to the States, such amendment to be effective with respect to any given State only after (*a*) State legislative action to shift the State tax from an "inheritance base" to an "estate base" and (*b*) legislative action adjusting State tax rates to assure that the effect of the increased credit would redound to the benefit of the State treasury rather than to individual Federal taxpayers.

2. Investment of idle cash balances (January 1961)

Where such authority does not now exist, enactment by States of legislation authorizing State and local governments to invest their idle funds in interest-bearing deposits with insured institutions and in obligations of the State or the Federal Government. (Mayor Celebrezze did not concur in this recommendation.)

Technical assistance by financial officers of the State government to smaller local units of government with respect to the desirability of, and opportunities for the investment of idle funds.

Cooperative action by the U.S. Treasury Department and State and local finance officers designed to provide full and current information regarding the investment opportunities in short-term Treasury obligations, including exploring the desirability of special Treasury issues particularly designed to meet the needs of State and local government.

3. Public Health grants (January 1961)

Amending the Public Health Service Act of 1944 to grant authority to States to transfer funds up to 33⅓ percent among specific health categories of Federal grants-in-aid for tuberculosis, venereal disease, heart disease, and cancer control and general health services;

Amending the Public Health Service Act of 1944 to place Federal grants-in-aid for the aforementioned categories under a single apportionment and matching formula instead of the different formulas now existing. (HEW Secretary Flemming did not concur in these recommendations.)

4. Reassessment of Federal grants-in-aid (June 1961)

The enactment by the Congress of a general statute, applicable to any new grants which may be enacted in the future, to provide that each new grant would be reenacted, terminated, or redirected at the end of 5 years, depending upon the results of a thorough reexamination of the grant by the cognizant legislative committee of the Congress. (Senator Leslie Cutler did not concur in this recommendation.)

Periodic review by congressional committees and executive agencies of the status of Federal grants-in-aid now in existence.

5. Legislative and tax jurisdiction over private property on Federal areas (June 1961)

(*a*) Favorable congressional action on pending legislation to authorize and direct Federal agencies to retrocede legislative jurisdiction to the States over U.S. Government properties as rapidly and extensively as consistent with their essential needs.

(*b*) That the States enact legislation, if required, to enable them to accept jurisdiction.

(*c*) That the President and Governors support implementation of the legislation.

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[48] These are the categories employed by ACIR itself in its report on the 5 years of its activities and its future role. Joint Hearings Before the Subcommittees on Intergovernmental Relations, 89th Cong., first sess. (May 25, 26, and 27, 1965).

6. *Cooperative tax administration* (*June 1961*)

(*a*) The enactment by the States of legislation authorizing the exchange of tax records and information among States and with the Federal Internal Revenue Service.

(*b*) Joint action by the Treasury Department, the Council of State Governments, and the Commission's staff to identify those State and local records and types of information that are potentially useful for the administration of Federal income and other taxes.

(*c*) Development by the States for submission to the Treasury Department and the Congress of a proposal for the admission of State and local tax enforcement personnel to training programs conducted by the Internal Revenue Service (authorized by Public Law 87–870).

(*d*) Favorable consideration by the Congress of pending legislation to authorize the Internal Revenue Service to perform statistical and related services for State tax agencies on a reimbursement basis (enacted, Public Law 87–870).

7. *Local nonproperty taxes* (*September 1961*)

(*a*) Providing cities and adjoining jurisdictions in large metropolitan areas with uniform taxing powers and authority for cooperative tax enforcement.

(*b*) Authorizing the addition of local tax supplements to State sales and income taxes where these taxes are used both by the State and a large number of local governments.

(*c*) Permitting pooled administration of similar local taxes levied by numerous local governments.

(*d*) Limiting local governments to the more productive taxes and discouraging the smaller jurisdictions from excessive tax diversity.

(*e*) Providing State technical assistance to local tax authorities including tax information, training facilities for local personnel, access to State tax records and where appropriate, using sanctions against State taxpayers who fail to comply with local tax requirements.

8. *Local government debt* (*September 1961*)

(*a*) Maximum flexibility for local government borrowing with any governing State provisions being as comprehensive and uniform in character as possible.

(*b*) Vestment of authority to incur debt with the governing bodies of local governments, subject only to a permissive referendum if petitioned by the voters and resolved generally by a simple majority vote.

(*c*) Repeal of constitutional and statutory provisions limiting local government debt by reference to the local property tax base (Mr. Michaelian and Mr. Burton did not concur in this recommendation).

(*d*) Provision by the States of technical assistance to local governments regarding debt issuance and State prescription of the minimum content of public announcements of local bond offerings.

(*e*) Consideration by the States of a substitute basis for the regulation of long-term local debt; namely, by reference to the net interest cost of prospective bond issues in relation to the prevailing yield of high-quality municipal securities (Mayor Clinton, Senator Cutler, and Mr. Burton did not concur in this recommendation).

9. *State constitutional and statutory limitations on local taxing powers* (*October 1962*)

(*a*) Statutory provisions are preferred to constitutional provisions.

(*b*) Use of full market value of taxable property as the basis is preferred to fractional assessed value.

(*c*) Limitations on local functions n general are preferred to singling out individual functions.

(*d*) Capital financing and debt service needs should be excluded.

(*e*) Provision should be made to enable local governing bodies to obtain relief from tax limitations either by reference to the electorate or administratively by a State agency.

(*f*) The electorate should always have power to initiate referendums on proposed rate increases.

(*g*) If governing bodies and citizens are provided with the avenues of relief specified in (*c*) and (*f*), then tax limits embracing all overlapping local taxing jurisdictions are preferred to single jurisdiction limits.

(*h*) Home rule charter counties and cities should be excluded from tax rate limitations.

10. The role of the States in strengthening the property tax (June 1963)

(*a*) Each State should take a hard, critical look at its property tax law and rid it of all features which cannot be administered as written, encourage taxpayers' dishonesty, force administrators to condone evasion and which, if enforced, would impose an intolerable tax burden. Each State should exclude from its property tax base any component it is unwilling or unable to administer completely.

(*b*) To give legislatures and Governors flexibility and responsibility for producing and maintaining equitable, productive, administrable property tax systems, constitutions should be divested of all details that obstruct sound utilization and administration of the property tax.

(*c*) No new changes in the property tax system, whether by exemption or classification, should be undertaken without weighing the effect on facility of administration. Where administration has been needlessly complicated by such changes in the past, the defects should be eliminated wherever feasible.

(*d*) In any State where the laws governing assessment administration have not been carefully reviewed and recodified in recent years and where ambiguities, inconsistencies, and other weaknesses have developed, the laws should receive a thorough reexamination, overhauling, and recodification.

(*e*) In the instance of any class of self-assessed personal property, unless the local assessor is given adequate means to audit the declarations of the taxpayers, the property should be assessed by the State or the tax on such property abolished.

(*f*) Both the legislative and executive branches of the State governments should study the property tax as consistently as the other major sources of State-local revenue and treat it as an integral part of overall State and local financial planning. Adequate provision should be made for continuing study and analysis in the research divisions of State tax commissions and tax departments and by the interim tax study committees, legislative councils, and legislative reference bureaus of State legislature, with workable liaison arrangements.

Eliminating Underassessment

(*a*) The States should eliminate all requirements for fixed levels of assessment except for specifying the minimum assessment ratio (in relation to market value) below which assessments may not drop, and use for equalization and measurement purposes the annual assessment ratio studies conducted by their State supervisory agencies, as follows:

(1) The determined average level of assessments in each of a State's assessment districts would provide the basis for tax equalization in taxing districts located in more than one assessment district and for equalizing State grants for schools and similar purposes.

(2) The determined figures for the market value of taxable property in each taxing district would be the base for all regulatory and partial tax exemption provisions now related to assessed valuations or valuations equalized at fractional levels.

(*b*) In conjunction with adoption of the foregoing course of action, a State should conduct a thorough reevulation of all regulatory and partial tax exemption provisions that have been related to assessed valuation, consider the desirability of their continuance from the point of view of sound policy, and, for any that may be continued, make such adjustments as are called for by new market value relationships.

(*c*) Because there is a tendency for nonuniformity of assessment to increase when property is assessed at low fractions of full value, it is important to use as high a floor as is feasible in setting minimum assessment levels.

Tax Exemption

(*a*) In order that the taxpayers may be kept informed, each State should require the regular assessment of all tax exempt property, compilation of the totals for each type of exemption by taxing districts, computation of the percentages of the assessed valuation thus exempt in each taxing district, and publication of the findings, including the function, scope, and nature of activities so exempted.

(*b*) Outright grants, supported by appropriations, ordinarily are more in keeping with sound public policy and financial management, more economical, and more equitable than tax exemptions and should be used in preference to the latter, with allowance for such exceptions as are clearly indicated by the public interest. No tax exemption for secular purposes should be initiated or continued which would not be justifiable as a continuing State budget appropriation.

(*c*) In the instance of mandatory tax exemptions extended to individuals for such purposes as personal welfare aid (the aged) and expressions of public esteem (the veterans), the States should reimburse the local communities for the amounts of the tax "loss."

Centralization of Assessment and Assessment Supervision

(*a*) Centralized assessment administration with more inclusive centralization when dictated by efficiency should be considered for immediate adoption by some States and for ultimate adoption by most States because it offers an uncomplicated and effective means of obtaining uniformly high-standard assessing throughout a State by the use of an integrated professional staff following standard methods and procedures under central direction.

(*b*) The geographical organization of each State's primary local assessment districts should be reconstituted, to the extent required, to give each district the size and resources it needs to become an efficient assessing unit and to produce a well-ordered overall structure that makes successful State supervision feasible.

(*c*) No assessment district should be less than countywide and when, as in very many instances, counties are too small to comprise efficient districts, multicounty districts should be created.

(*d*) All overlapping assessment districts should be abolished to eliminate wasteful duplication.

(*e*) The State's share in joint State-local assessment administration should be vested in a single agency, professionally organized and equipped for the job, and headed by a career administrator of recognized professional ability and knowledge of the property tax and its administration.

(*f*) In States in which tax administration is coordinated in a central tax department, the agency should be a major division of that department; in States where organization for tax administration is diffused the agency should be given due prominence as a separate department or bureau. Under the latter condition, particularly when strong central executive control is lacking, it may be desirable to have the career administrator serve under a multimember commission appointed for overlapping terms.

(*g*) The State supervisory agency should be responsible for assessment supervision and equalization, assessment of all State-assessed property, and valuation research, with adequate powers clearly defined by law.

(*h*) The State supervisory agency should be empowered to establish the professional qualifications of assessors and appraisers and certify candidates as to their fitness for employment on the basis of examinations given by it or of examinations satisfactory to it given by a State or local personnel agency, and to revoke such certification for good and sufficient cause. No person should be permitted to hold the office of assessor or to appraise property for taxation who is not thus certified.

(*i*) Assessors should be appointed to office, with no requirement of prior district residence, by the chief executives or executive boards of local governments when assessment districts are coextensive with such governments and by the legally constituted governing agencies of multicounty districts; they should be appointed for indefinite, rather than fixed, terms; and should be subject to removal for good cause, including incompetence, by the appointing authorities.

(*j*) To avoid obstruction to local recruitment and retention of competent professional presonnel, State legislatures should not prescribe or limit the salaries paid certified local assessors and appraisers.

(*k*) State legislatures should prescribe, or authorize the State supervisory agency to prescribe, and in either case authorize the agency to enforce minimum professional staffing requirements in all local assessment districts. Legislatures should authorize the supervisory agency and any local districts to enter into agreements under which the agency will provide the district with specified technical services.

(*l*) Each State should (*a*) evaluate the structure, powers, facilities, and competence of its present agency or agencies for the supervision of assessment administration; (*b*) in continuing the existing setup or in creating one more suitable, determine and establish clearly its proper and necessary functions, services and powers and equip it with adequate and appropriate personnel and facilities for meeting its responsibilities; and (*c*) provide for continuing systematic evaluation, by the legislative as well as the executive branch, of the usefulness of the agency and the means of improving its utility.

(*m*) In any State establishing professional qualifications for assessors and appraisers, the State supervisory agency should cooperate with educational institutions in planning and conducting preentry courses of study, and should conduct or arrange for regular internship training programs.

(*n*) To guard against weak spots among local assessing districts and to assure that assessing throughout the State meets at least acceptable minimum standards, each State should determine by thorough research the minimum level of acceptable assessment performance and require the State supervisory agency to provide for appropriate assessment administration, at district expense, in those local districts that fail to meet the minimum standards. (Senator Muskie did not concur in this recommendation.)

State-Assessed Property

(*a*) State assessment should be extended to all property types (*a*) which customarily lie in more than one district and do not lend themselves to piecemeal local assessment, (*b*) which require appraisal specialists beyond the economical scope of most local district staffs, and (*c*) which can be more readily discovered and valued by a central agency.

(*b*) The division of assessment jurisdiction between State and local agencies should be clear both to taxpayers and assessors.

Studies and Reports

(*a*) The State agency responsible for supervision of property tax administration should be empowered to require assessors and other local officers to report data on assessed valuations and other features of the property tax, for such periods and in such form and content as it prescribes, in adequate detail to serve its needs for supervision and study. The agency should be required to publish meaningful digests of such data annually or biennially.

(*b*) The State supervisory agency should be required to conduct, annually comprehensive assessment ratio studies, in accordance with sound statistical procedures, of the average level of assessment and degree of uniformity of assessment over all and for each major class of property, in all assessment districts of the State. The agency should be required to publish the findings of each study, both as to the quality and average level of assessment, in clear, readily understandable form.

(*c*) States should take all feasible steps to facilitate the compilation of comparable interstate property tax information by the Bureau of the Census, particularly by improving and standardizing their own collection, compilation, and analysis of essential data.

Taxpayer Appeals

(*a*) The present administrative-judicial heirarchy of agencies for assessment review and appear in most States should be objectively evaluated and reconstituted, as necessary, to provide the remedies to which taxpayers are entitled, but do not now receive under the uniformity provisions of State laws and the equal protection clause of the 14th amendment.

(*b*) The review machinery should have a two-level organization, with both the local and State agencies serving only an appellate function and being professionally well staffed for that purpose; the State agency—either an administrative board or a tax court—should be separate from any State agency for property tax administration, should be an appellate body to hear appeals from decisions of local review agencies and from central assessments by the State supervisory agency, and should include a small claims division with a simple, inexpensive procedure; appeals from the State agency, but on questions of law only, should be to the supreme court of the State.

(*c*) To aid the taxpayer in proving inequitability in his assessment (*a*) the State supervisory agency should be required, following sound statistical procedures, to make and publish the findings of annual assessment ratio studies which, in addition to serving the purposes of supervision and equalization, will inform the taxpayer of the average level of assessment in his district; and (*b*) the legislative should provide that the assessment ratios thus established may be introduced by the taxpayer as evidence in appeals to the review agencies on the issue of whether his assessment is inequitable.

12. Industrial development bond financing (*June 1963*)

(*a*) The Commission recommends that the States restrict and regulate by law the precise conditions under which local governments may engage in this activity, as follows:

(1) Subject all bond issues to approval by a State supervisory agency;

(2) Restrict authority to issue such bonds to counties and municipalities; deny the authority to special districts;

(3) Give priority to communities with surplus labor, outside the area of the effective operation of conventional credit and property leasing facilities;

(4) Limit the total amount of such bonds which may be outstanding at any one time in the State; and

(5) Prohibit such financing for the "pirating" of industrial plants by one community from another.

(*b*) The Commission recommends that local industrial development bond financing be confined to rural areas. States desiring to stimulate employment in urban and industrial areas, can accomplish this best by a program of second mortgage loans to supplement local civic and conventional financing or by State guarantees of conventional loans.

(*c*) The Commission finds the industrial development bond device particularly offensive when it is used to finance plants for strong national firms which themselves have access to adequate financing through conventional channels. The abuse is especially glaring when the firm itself acquires the tax-exempt bonds issued to finance the plant it occupies, thus becoming also the beneficiary of tax exempt income. Therefore the Commission recommends that the Congress amend the Internal Revenue Code so that the firms which buy the tax-exempt bonds themselves cannot deduct as a business cost the rents paid for the use of industrial plants built with these bonds.

13. The role of equalization in Federal grants (*January 1964*)

(*a*) The national policy considerations which require Federal grant programs require also that, with important qualifications, the distribution of Federal grants among the States take account of the relative inequalities in the fiscal capacities of the States (together with their local governments) in such a way as to facilitate the achievement of a more uniform level of minimum program standards in all States.

(*b*) The equalizing aim of Federal grant distributions should be limited to the functions and services specifically related to and involved in national objectives and only to the minimum service levels consistent with these national objectives.

(*c*) Explicit equalization provisions are inappropriate to several categories of grants, including (*a*) planning and demonstration grants, (*b*) stimulation grants, (*c*) grants to meet localized emergencies, and (*d*) grants which cover tax exempt income. Therefore the Comission recommends that the Congress substantially all of the program costs. Apart from these exceptions, Federal grant distributions should reflect differences in the States' relative fiscal capacities to support the particular program or services at the required minimum level. This conclusion is subject to the overriding qualification that where program need is proportionate to relative State fiscal capacity, the objectives of an equailzation grant can be met without use of an explicit equalizing provision.

(*d*) To the extent practicable, equalization provisions, introduced through both allocation and matching requirements, should aim for a reasonable uniform level of minimum program performance in every State; that uniformity in the mechanics of the equalization provisions is preferred over variety; and that statutory specification is preferable to administrative discretion.

(*e*) Departments and agencies charged with the administration of Federal grant programs should be required by the President to review periodically (*a*) the adequacy of the need indexes employed in their respective grant programs, and (*b*) the appropriateness of their equalization provisions and that this review be coordinated by the Bureau of the Budget. This requirement may be coordinated with the periodic congressional review of grants-in-aid recommended in an earlier report of this Commission and embodied in legislation pending before the present Congress.

(*f*) The President, through his Executive Office, should provide for the development of plans and procedures to assemble the data required for improving measures of State relative fiscal capacity and a tax effort for use, to the extent practicable, on a Governmentwide basis and to collect and tabulate such necessary data on a continuing basis.

14. State-Federal overlapping in cigarette taxes (September 1964)

(*a*) That the Governnors direct their tax policy officials to explore with representatives of the tobacco industry the procedures that would be required to place the cigarette tax on a return basis at the manufacturing level in such a way that the burden on the industry would be minimized.

(*b*) That the Treasury Department, Internal Revenue Service, participate in this exploration, which should include the potential scope of Federal-State administrative cooperation.

15. The intergovernmental aspects of documentary taxes (September 1964)

(*a*) Congress should amend chapter 34 of the Internal Revenue Code to repeal the stamp tax on conveyances, such repeal to be effective 3 years after its enactment.

(*b*) When the Federal tax on real estate transfers is repealed, those States without such a tax should consider it for use at either the State or local level.

16. Federal-State coordination of personal income taxes (October 1965)

(*a*) The proper role of the personal income tax in a State's tax system must be determined by the State, for itself, on the basis of its revenue needs, resources, and its people's preference among types of taxes. However, in formulating their tax policies, States without the personal income tax should give early and careful consideration to incorporating it into their tax system and States presently employing a relatively ineffective income tax should strengthen it.

(*b*) Extensive use of the Federal personal income tax since 1940 has retarded the State personal income tax movement and this deterrent should be neutralized in order to enable the States to help themselves before Congress is asked to consider other general forms of Federal financial aid. Congress should amend the Internal Revenue Code on a prospective basis to give Federal income taxpayers an option to either (*a*) continue itemizing their income tax payments to State and local governments or (*b*) claim a substantial percentage of such payments as a credit against their Federal income tax liability.

(*c*) The States should bring their income tax laws into harmony with the Federal definition of adjusted gross income, modified to allow the deduction of individuals' income earnings expenses and for such additions to the tax base as considerations of base-broadening and equity make feasible.

(*d*) To encourage experimentation with Federal collection of State income taxes, Congress should authorize the Internal Revenue Service, and State legislatures should authorize their governors, to enter into mutually acceptable agreements for Federal collection of State income taxes.

(*e*) The States should continue to allow credits to their residents for personal income taxes they pay to other States and those States that now allow a nonresident credit should repeal such nonresident provision.

(*f*) The States should adopt the following definition of "residence":

"A resident individual means an individual (*a*) who is domiciled in this State, unless he maintains no permanent place of abode in this State, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than 30 days of the taxable year in this State; or (*b*) who is not domiciled in this State but maintains a permanent place of abode in this State and spends in the aggregate more than 183 days of the taxable year in this State."

The State tax agency should be authorized to enter into reciprocal agreements to eliminate potential double taxation that might result from conflict in interpretation of the residence rule.

(*g*) Taxation of personal income should be done at the State rather than the local level, but if local income taxes are also levied, they should be authorized only in the form of a supplement ("piggy-back") to be administered with the State tax. States electing to relinquish the personal income tax to their local governments are urged (*a*) to limit them to as large taxing areas as possible, ideally coinciding with the boundaries of trading and economic areas, (*b*) to prescribe rules governing taxpayers, tax base rates, etc., uniformly applicable to all local taxing jurisdictions, and (*c*) to provide technical assistance in the administering and enforcement of local income taxes.

17. Grant consolidation (April 1967)

The enactment of a statute by Congress authorizing the President to prepare grant consolidation plans, to become law at the end of 90 days after transmittal to Congress unless vetoed by either the House of Representatives or the Senate.

18. State and local tax concessions and industrial location (April 1967)

(a) Early identification of significant shifts in the industrial base of central cities, suburban communities, and nonmetropolitan areas would facilitate more effective intergovernmental planning. Therefore, the Commission recommends that the President direct the appropriate Federal agencies to give early and favorable consideration to assembling on a continuing basis more timely and detailed geographical information on industrial location trends, including a breakdown among central city, suburban, and rural portions of Standard Metropolitan Statistical Areas.

(b) The States, by statutory enactment or administrative regulation, should set forth enforceable physical presence rules to govern the jurisdictional reach of their income and sales tax administrators; the States, through collective action, should strive to make such physical presence rules as uniform as possible.

(c) Retention or repeal of the tax on business personal property is a policy issue the State alone can resolve in full awareness of its own local circumstances. However, in framing their business tax policies, States should give a high priority to eliminating or perfecting the locally administered tax on business personal property because it discriminates erratically among business firms. The States should eliminate the tax on business inventories and either move the administration of the tax on other classes of business personalty (notably machinery and equipment) to the State level or provide strong State supervision over the administration of the tax to insure uniformity, and should reimburse local governments for the attendant loss in revenue by making more intensive use of State imposed business taxes.

(d) The practice of making special tax concessions to new industry can have baneful effects on our Federal system by setting in motion a self-defeating cycle of competitive tax undercutting and irrational discriminations among business firms. The states should avoid policies calculated to provide special tax advantages or concessions to selected groups of business firms, and frame their business tax policies along general rather than special benefit lines.

(e) Recognizing that interlocal competition for economic development is a natural and healthy manifestation of local home rule and that any States intervention designed to prevent this competition should be handled with care, the practice of negotiating the aassessment of new industrial property solely at the local level may produce a discriminatory tax system that is open to abuse. Therefore, the State should provide adequate technical assistance and supervision in local property tax assessments to insure uniformity of treatment.

On the subject of the Federal grants, the Commission's overall attitude may perhaps best be summarized with the following quotation from the ACIR report on *The Role of Equalization in Federal Grants* (1964):

> The Federal grant-in-aid has developed into an important instrument for carrying out the essential partnership of the States and the National Government in a Federal system. It reconciles State and local administration of public services with Federal financial support in programs of National concern. In the century in which it has been used, the Federal grant has been forged into a tool capable of doing many types of jobs both small and big. Its strength has been its flexibility and adaptability.

The Commission advocates rationalization of grants-in-aid through better coordination on all levels of government, consolidation of the more fragmented programs, as in the field of health, and periodic review by the Federal Government so that those which may have become outmoded or unnecessary can be revised or eliminated. In one of its most recently adopted recommendations, the Commission moved beyond its earlier position on grant consolidation by proposing that the President be authorized to initiate consolidation plans to Congress through use of a procedure similar to administrative reorganization proposals. The grant consolidation plan would become effective 90 days after transmittal unless either the House or Senate passed a resolution unfavorable to the plan.[49] In an ACIR press release announcing adoption of the recommendation it was stated that: [50]

> The Commission's recommendation was in response to the major problems of coordination, comprehension, and manageability created by the rapid multiplication of Federal aid programs now totaling more than 400 separate authorizations. According to one count, Federal grant programs are administered by 21 Federal departments and agencies, at least 150 Federal bureaus and divisions, and involve all 50 States, and a sizable proportion of the 92,000 units of local government. This proliferation of grant programs has tended to confuse objectives, recipients, and administrators.

ACIR endorses the equalization role of Federal grants, with some qualifications as to certain programs. As stated in one of its recommendations, 13(c), "Federal grant distributions should reflect differences in the States' relative fiscal capacities to support the particular program or services at the required minimum level."

A high level of Federal economic activity, particularly in an affluent society, obviously stimulates and creates demand for more local government spending.[51] An affluent population demands and expects better education, recreational facilities, police protection, and other public services. But because local governments' revenues depend on property tax revenues, which only keep pace with National growth, while local governments' expenditures grow almost twice as fast as the National economy, the local revenue deficiency grows progressively worse. For this reason, local taxes tend to increase as does the need for grants from the States and the National Government.

Still, it is desirable to relate the taxing responsibility to the spending responsibility on the local level, so that those who do the spending will face the problem of taxing: "The American system does provide, to be sure, for interlevel financial aid, but we want the role of grants kept to a minimum in deference to our dislike for centralization and our affinity for home rule." But "as National economic growth continues, America will need to reconcile itself to more and more Federal financial aid, and [the] State will need to assume financial responsibility for increasing shares of local needs." [52] If the extent of Federal and State aid is to be kept down, local governments must accomplish fiscal reform. The following selection from ACIR's report on *The Role of Equalization in Federal Grants* (pp. 19–24) briefly describes the impact of Federal grants on State and local finances through 1962.

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[49] The consolidation plan recommendation was adopted at the Apr. 14, 1967 meeting of the ACIR.

[50] ACIR press release dated Apr. 24, 1967.

[51] The statement on local fiscal policy is based in part on an address by L. L. Ecker-Racz before the 59th Annual Conference of the Municipal Finance Officers Association of the U.S. and Canada, June 8, 1965.

[52] *Ibid.*

Impact on State and Local Finances

Federal assistance has assumed an increasingly important role in financing State and local governments since the turn of the century. State and local governments' receipts in the form of Federal aid amounted to 9 cents per capita in 1902, less than one percent of their general revenues. The relative importance of Federal aid reached a peak at the height of the Depression, fell somewhat during the war years, and rose again in the postwar years (table 1).

TABLE 1.—*Trends in Federal aid relative to general revenue of State and local governments and to Federal general expenditures, 1902–62*

[Dollar amounts, except per capitas, in millions]

Fiscal year	State and local general revenue				Federal general expenditure		Federal aid as a percent of—			Federal aid as percent of GNP
	Amount		Per capita				State and local general revenue	Federal general expenditure		
	Total	Federal aid [1]	Total	Federal aid [1]	Total	For civil functions [2]		Total	For civil functions	
1962	$58,214	$7,857	$313.28	$42.28	$96,689	$29,871	14	8	26	1.4
1960	50,505	6,974	280.61	38.75	83,719	23,562	14	8	30	1.4
1958	41,219	4,865	237.80	28.07	75.689	19,066	12	6	26	1.1
1956	34,667	3,335	207.26	19.94	68,792	16,854	10	5	20	.8
1954	29,012	2,966	178.63	18.26	72,631	14,598	10	4	20	.8
1952	25,181	2,566	160.36	16.34	67,778	12,001	10	4	21	.7
1950	20,911	2,486	137.86	16.39	40,285	13,890	12	6	18	.9
1948	17,250	1,861	117.34	12.39	34,175	9,839	11	5	19	.7
1946	12,356	855	87.39	6.05	65,448	8,340	7	1	10	.4
1944	10,908	954	78.87	6.89	100,032	11,749	9	1	8	.5
1942	10,418	858	77.25	6.36	35,180	7,035	8	2	12	.5
1940	9,609	945	72.73	7.15	9,780	6,704	10	10	14	.9
1938	9,228	800	71.08	6.16	8,278	5,732	9	10	14	.9
1936	8,395	948	65.56	7.40	9,099	5,686	11	10	17	1.1
1934	7,678	1,016	60.76	8.04	5,881	4,029	13	17	25	1.6
1932	7,267	232	58.21	1.86	4,215	1,878	3	6	12	.4
1922	4,781	108	43.44	.98	3,754	1,378	2	3	8	(3)
1913	1,912	12	19.66	.12	970	508	1	1	2	(3)
1902	986	7	12.46	.09	572	226	1	1	3	(3)

[1] Includes amounts received from the Federal Government for contractual services and shared revenues, as well as Federal grants-in-aid.
[2] Excluding national defense, international affairs and finance, space technology, veterans' benefits and services (except education), and interest on debt.
[3] Not available.

Source: U.S. Bureau of the Census, *Historical Summary of Governmental Finances in the United States*, 1957 Census of Governments, Vol. IV, No. 3; and *Governmental Finances in 1962*, October 1963.

In 1962 State and local governments collected $58.2 billion from taxes, charges for current services, and other general revenue. Of that total, $7.9 billion, or 13.5 percent, came from the Federal Government, mainly in the form of grants-in-aid, but including also shared revenues and contractual payments for scientific research and other public services. The proportion of State and local government revenue represented by Federal grants and other Federal payments has been increasing since 1946 when it was only 6.9 percent.

There is considerable interstate variation in the Federal contribution to State and local revenues. In 1962 it ranged in individual States from less than 10 percent of State and local general revenue in three Eastern industrial States to more than 25 percent in two Western and one New England State (table 2). In general, the States with the lowest per capita incomes also have the largest proportion of revenue from the Federal Government relative to their total general revenues. Thus, Federal aid averaged 17.4 percent of general revenue in the South.

TABLE 2.—*Federal aid in relation to total general revenue of State and local governments, by State, 1962*

State and region	Amount (millions)		Per capita		Revenue from Federal Government as percent of total general revenue
	Total general revenue	Revenue from Federal Government	Total general revenue	Revenue from Federal Government	
United States	$58,214	$7,857	$313	$42	13.5
New England and Mideast	16,825	1,647	334	33	9.8
Maine	277	41	284	42	14.7
New Hampshire	178	32	287	51	17.8
Vermont	144	42	372	109	29.4
Massachusetts	1,798	200	346	39	11.1
Rhode Island	247	34	281	38	13.6
Connecticut	881	95	336	36	10.7
New York	6,837	484	391	28	7.1
New Jersey	1,922	168	302	26	8.7
Pennsylvania	3,116	340	274	30	10.9
Delaware	157	15	337	33	9.8
Maryland	977	118	302	36	12.0
District of Columbia	291	78	369	99	26.8
Midwest	16,085	2,013	307	38	12.5
Michigan	2,604	289	324	36	11.1
Ohio	2,818	359	281	36	12.7
Indiana	1,314	142	282	30	10.8
Illinois	3,189	357	316	35	11.2
Wisconsin	1,300	146	324	36	11.2
Minnesota	1,222	149	353	43	12.2
Iowa	882	108	318	39	12.3
Missouri	1,163	210	269	49	18.0
North Dakota	232	37	367	58	15.8
South Dakota	244	59	339	81	24.0
Nebraska	400	62	277	43	15.4
Kansas	716	94	323	42	13.1
South	14,143	2,464	256	45	17.4
Virginia	944	154	222	36	16.3
West Virginia	454	87	253	48	19.1
Kentucky	730	148	237	48	20.2
Tennessee	810	164	222	45	20.3
North Carolina	1,071	162	228	35	15.2
South Carolina	511	90	209	37	17.5
Georgia	1,003	196	246	48	19.5
Florida	1,541	166	284	31	10.8
Alabama	753	181	227	55	24.1
Mississippi	510	105	226	47	20.7
Louisiana	1,065	213	316	63	20.0
Arkansas	421	101	229	55	24.0
Oklahoma	752	162	307	66	21.6
Texas	2,734	375	270	37	13.7
New Mexico	345	77	346	78	22.4
Arizona	498	82	335	55	16.4
West	11,160	1,739	403	63	15.6
Montana	253	53	363	76	20.9
Idaho	214	47	306	67	21.8
Wyoming	160	50	483	151	31.1
Colorado	716	114	378	60	15.9
Utah	306	61	320	64	20.0
Washington	1,157	163	384	54	14.1
Oregon	654	124	362	69	18.9
Nevada	152	28	435	81	18.5
California	7,142	1,000	419	59	14.0
Alaska	135	46	557	190	34.0
Hawaii	271	52	391	76	19.4

Source: U.S. Bureau of the Census, *Governmental Finances in 1962*, October 1963.

It is estimated that State and local governments provided $3 billion to match the $7 billion Federal grants-in-aid distributed in 1962. In the aggregate, this was 7.6 percent of all State and local tax collections. The 12 lowest per capita income States provided from 9.7 to 17.9 percent of their tax collections to match Federal grant funds. By contrast, the percentage in nine of the 12 highest income States was less than 7.6 percent. It was only 4.3 percent in New Jersey and 5.1 percent in New York (table 3).

TABLE 3.—*Required State and local matching of Federal grants-in-aid in relation to State and local tax revenue and general expenditure from own sources for selected functions—12 highest and 12 lowest income States, 1962*

States (ranked from highest to lowest 1962 per capita income)	Required matching as percent of tax revenue	Required matching as percent of general expenditure from own sources [1]				
		Total	Education	Highways	Public welfare	Health and hospitals
U.S. average	7.6	6.1	1.9	12.8	48.0	2.6
12 highest per capita income States:						
Nevada	7.2	5.1	1.6	6.8	52.9	8.0
Delaware	5.9	4.7	1.8	3.6	25.0	16.5
Connecticut	5.3	4.1	1.3	7.4	29.3	1.2
New York	5.1	4.3	1.4	8.1	42.5	.9
New Jersey	4.3	3.7	1.4	9.1	33.7	1.8
California	5.6	4.6	1.1	8.3	44.0	2.0
Illinois	6.6	5.7	1.7	14.0	34.9	2.2
Massachusetts	7.5	6.7	2.0	13.3	44.6	1.1
Maryland	5.6	4.4	1.7	9.5	48.7	1.5
Alaska	10.0	5.9	2.7	4.1	37.9	6.7
Washington	7.9	6.0	1.5	13.6	48.2	3.0
Michigan	6.7	5.1	1.6	10.5	41.9	2.0
12 lowest per capita income States:						
Oklahoma	16.0	12.9	2.6	20.3	69.4	5.0
West Virginia	11.0	9.3	3.2	9.9	86.4	5.4
New Mexico	11.2	8.4	2.1	16.5	68.0	7.9
Louisiana	13.2	9.5	2.4	14.1	79.9	4.0
Georgia	12.9	9.4	3.4	18.0	(2)	4.3
North Carolina	9.7	7.9	3.1	14.8	90.0	5.1
Kentucky	12.1	7.4	2.6	12.1	74.4	6.8
Tennessee	11.5	8.6	3.4	14.2	69.1	4.3
Alabama	16.7	11.6	3.0	23.3	96.3	5.1
Arkansas	17.9	15.1	5.3	29.9	96.3	7.7
South Carolina	10.9	8.9	3.5	25.9	72.1	6.5
Mississippi	13.5	9.4	3.1	17.6	54.6	6.5

[1] The expenditure categories are as defined by the Bureau of the Census and include substantial amounts for activities for which there are no Federal grant programs. "General expenditure from own sources" is defined as total general expenditure less amounts received from the Federal Government.
[2] Approximately 100 percent.

The required State and local matching under existing grant programs generally takes a larger fraction of fiscal resources in the poorer States than in those with relatively high per capita income. For example, Delaware devotes $4.54 per $1,000 of its personal income to match Federal grant offerings while Mississippi devoted more than three times as much, or $14.78 per $1,000 of personal income (table 4). It is for this reason that the highest proportion of their spending for the major federally aided functions—highways, public welfare, health and hospitals, and education—goes in the low income States to meet matching requirements (table 3).

TABLE 4.—*Required matching under existing Federal grant programs per $1,000 of personal income, by State, 1962*

States ranked in order of per capita personal income (high to low)	Required matching	States ranked in order of per capita personal income (high to low)	Required matching
Delaware	$4.54	Kansas	$9.53
Nevada	6.29	Iowa	8.70
Connecticut	4.74	Arizona	6.07
New York	5.45	Montana	12.71
California	5.88	Florida	5.66
Alaska	7.92	Texas	7.67
New Jersey	3.57	Utah	7.23
Illinois	5.61	Vermont	16.66
Massachusetts	7.37	Virginia	6.47
Maryland	4.70	Oklahoma	15.68
Washington	8.05	Maine	8.95
Ohio	6.36	New Mexico	11.20
Michigan	6.55	Idaho	11.04
Hawaii	8.60	South Dakota	11.61
Wyoming	12.91	West Virginia	10.53
Colorado	10.50	North Dakota	13.18
Pennsylvania	5.78	Louisiana	15.21
Oregon	7.97	Georgia	11.09
Missouri	9.27	North Carolina	8.79
Rhode Island	7.65	Kentucky	10.64
Indiana	5.82	Tennessee	9.80
Wisconsin	6.51	Alabama	13.89
Nebraska	9.22	South Carolina	9.62
New Hampshire	8.11	Arkansas	16.84
Minnesota	8.33	Mississippi	14.78

Since 1916, when the first highway aid program was enacted, and the Depression years, when the social security programs were initiated, highways and public welfare have dominated the Federal aid picture. Federal intergovernmental expenditure for highways and public welfare has not fallen below 50 percent of the total since 1922 and in some years reached four-fifths of total Federal intergovernmental expenditure. In 1962 about two-thirds of all Federal intergovernmental expenditure was for highways and public welfare—$2.7 billion, or 35.5 percent for the former and $2.4 billion, or 31.6 percent for the latter (table 5). Because highway aid is dominated by the Interstate Program, which is largely Federally financed, more matching funds are provided by the States and localities for public welfare than for highways. Thus, it is estimated that the $2.4 billion of public welfare grants called for $1.3 billion of State and local matching funds. Most low-income States spend little more for public welfare than from their own resources than can be matched by Federal grants under matching requirements, while high income States spend for this purpose considerably more from their own resources than is matched by the Federal Government (table 3).

TABLE 5.—*Federal intergovernmental expenditure, by function, selected years, 1913–62 (includes Federal payments to States other than grants)*

Year	Amount (millions)					Percent distribution			
	Total	Education	Highways	Public welfare	Other	Education	Highways	Public welfare	Other
1962	$7,735	$1,169	$2,748	$2,448	$1,370	15.1	35.5	31.6	17.7
1957	3,873	604	944	1,557	768	15.6	24.4	40.2	19.8
1952	2,585	436	415	1,181	551	16.9	16.1	45.7	21.3
1946	894	149	79	429	242	16.7	8.8	47.4	27.1
1944	1,072	193	147	420	312	18.0	13.7	39.2	29.1
1942	887	76	164	383	264	8.6	18.5	43.2	29.8
1940	884	154	195	278	257	17.4	22.1	31.4	29.1
1938	762	112	264	218	168	14.7	34.6	28.6	22.0
1936	908	147	285	290	186	16.2	31.4	31.9	20.5
1934	976	61	279	495	141	6.3	28.6	50.7	14.4
1932	232	12	191	1	28	5.2	82.3	.4	12.1
1922	118	7	92	1	18	5.9	78.0	.8	15.3
1913	12	3		2	7	25.0		16.7	58.3

Source: U.S. Bureau of the Census, *Historical Summary of Governmental Finances in the United States*, 1957 Census of Governments, 1959, Vol. IV, No. 3; *Governmental Finances in 1962*, October 1963.

ACIR's position is that local fiscal reform depends on local governments making more effective use of their own taxing powers and moneys already available to them. This goal has been the subject of a great amount of ACIR's efforts.[53] The Commission has made recommendations to eliminate or ease State restrictions on local taxing and borrowing powers,[54] to improve property tax administration,[55] and to authorize local governments to utilize nonproperty taxes, for example taxsharing, with the States.[56]

On the question of Federal actions to improve the fiscal strength of State and local government, ACIR has come out strongly for a partial Federal tax credit for State income tax payments. This position is based on the Commission's analysis of the fiscal plight of the States, on the superiority of the personal income tax as a revenue instrument in terms of revenue elasticity and tax fairness, on the finding that the Federal Government has more or less monopolized the personal income tax and thereby deterred its expanded use by the States, and on the conclusion that the tax credit device would reinforce the independence of the States by placing them in a better position to solve their fiscal problems out of their own resources. The following selections from ACIR Report, *Federal-State Coordination of Personal Income Taxes* (A–27, October 1965, chapters 2 and 6) explain this reasoning in more detail:

Chapter 2. THE FISCAL PROBLEM OF THE STATES

The fiscal problem of State (including local) governments is the failure of their revenue systems to generate yields that grow—without rate increases or new taxes—as rapidly as expenditure requirements. In this chapter we examine the dimensions of this problem; first expenditures, then revenues. Since the focus of our analysis is the State personal income tax, the primary emphasis is on State government.

EXPENDITURES

State and local governments today are responsible for slightly more than half (52 percent) of all government spending for civilian-domestic purposes. Exclusive of trust fund and business enterprise activities, the States and local governments account for over three-fourths of civilian general expenditures. In fiscal year 1964, the latest year for which State-local data are available, the Federal Government spent about $23 billion for nonmilitary general expenditure purposes. State and local governments' direct general expenditures were $69 billion. The States' share of this total was $24 billion, or approximately 26 percent of all civilian-domestic general government expenditures (table 1).

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[53] See ACIR's Study, *Unshackling Local Government*, published as H. Rept. No. 1643, 89th Cong., second sess. (Washington, 1966) for a survey of the proposals made by the Commission.

[54] ACIR, *State Constitutional and Statutory Restrictions on Local Taxing Powers* (Rept. A–14, October 1962), and *State Constitutional and Statutory Restrictions on Local Government Debt* (Rept. A–10, September 1961).

[55] ACIR, *The Role of the States in Strengthening the Property Tax* (Rept. A–17, June 1963).

[56] ACIR, *State Constitutional and Statutory Restrictions on Local Taxing Powers* (Rept. A–14, October 1962).

TABLE 1.—*Civilian-domestic direct general expenditures by governments, 1948, 1954, and 1964*

[Dollar amounts in millions]

Government	Civilian-domestic direct general expenditures					
	1948		1954		1964	
	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total
Federal [1]	$8,713	33.0	$12,792	29.4	$22,838	24.8
State and local	17,684	67.0	30,701	70.6	69,302	75.2
All governments	26,397	100.0	43,493	100.0	92,140	100.0
State only	6,186	23.4	10,109	23.2	24,275	26.3

[1] Total direct general expenditures less expenditures for defense and international relations, space research and technology, interest on general debt, and veterans' services.

Sources; U.S. Bureau of the Census, Census of Governments: 1962, Vol. VI, No. 4, *Historical Statistics on Governmental Finances and Employment*, 1964, pp. 36, 39, 42; *Governmental Finances in 1963–64*, 1965, pp. 19, 25.

During the past decade the gross national product rose at an average annual rate of 5.5 percent. (This figure slightly overstates the true growth rate of the economy because 1954 was a recession year, and 1964 a year of prosperity.) The same period saw State and local direct general expenditures rise steadily by 8.5 percent per year. The States' expenditures rose even more rapidly at 9.2 percent every year, while Federal spending increased at a rate—6 percent—that barely exceeded the rate of GNP rise.

The accomplishments of the years since World War II notwitstanding, the pressures for growing expenditures are not likely to abate in the near future. Most of the factors responsible for expenditure growth in the immediate past will continue to be operative: the total population, the relative importance of the dependent age groups and of those living in the relatively costlier urban areas, will continue to rise; growing economic affluence will continue to generate demand for improving community amenities.

Some of the factors operating to raise State and local expenditure needs are less widely appreciated. As the business community's methods become more sophisticated, its management insists on a better educated labor force, on improved public facilities (water, sewage, roads, airports), and on better environmental conditions for its employees. The National Government's aspirations for a Great Society and its economic growth and foreign policy objectives, as well as rapidly changing technology and increased population mobility, operate in the same direction, both directly and by stimulating the social consciousness of the people. The impact of national policies on State and local budgets is inescapable because the public services and facilities prerequisite for the environment in which the Federal policies can be realized by the individual, the business firm, and the community are largely local and State responsibilities.

It needs to be recognized, too, that while the postwar expenditure increases have improved the quality of governmental services, the improvement has been very uneven. Some States and some communities within most of the States have been bypassed. Regrettably, expenditure levels tend to be least adequate in the very areas where needs are greatest—where the economically underprivileged predominate. Even among States, disparities in spending levels remain wide. In 1964 public school expenditures per pupil ranged from $241 in Mississippi to $705 in New York. Average monthly old-age assistance payments ranged from less than $40 in Mississippi to $108 in California; general assistance payments per recipient from less than $4 in Arkansas to $64 in Maryland. Average monthly earnings of full-time municipal employees ranged from $255 in Mississippi to $607 in California. Since these are State averages, the needs in many places within particular States are even more acute.

We make no attempt here to develop firm, quantitative projections of future State and local spending levels. The economic, technological, and social transformation in process is too rapid to warrant confidence in the continued validity of past trends. Ten, possibly even 5 years ago, few would have anticipated a 1965 State-local expenditure level of nearly $90 billion, and understandably so. Services known only to residents of a few pioneering communities in one decade become commonplace in the next. Consider, for example, the implications for State and local budgets of a national undertaking to rectify the educational and health deficiencies or the employment handicaps of the economically and socially disadvantaged. Man's aspirations for goods and services always lead current availabilities. These considerations suggest that the rate of State and local expenditure growth experienced in the immediate past will continue for the near future.[1] However, the growth need not continue at the 8.5 percent annual rate of the last decade to produce spending levels in excess of $100 billion by 1970. In the absence of untoward international and defense developments, State and local expenditures can readily outdistance total Federal spending within a decade.

REVENUES

The expenditure growth examined in the preceding section has been financed from three general sources: State and local taxes, fees, and user charges; Federal grants-in-aid; and State and local borrowing (table 2). General revenues raised by State and local governments from their own sources increased 124 percent during a decade in which the GNP rose only 71 percent; those raised by State governments along increased 126 percent. Even these spectacular rates of growth were modest in comparison with the increase in Federal aid. It more than tripled in the 10-year period and, with $9 out of every $10 going to the States, accounted for nearly 30 percent of the rise in total State general revenue. Moreover, about 45 percent of the aid was earmarked for highways and another 25 percent for public welfare (primarily public assistance payments to the aged, dependent children, the blind, and the disabled).

TABLE 2.—*Sources of State and local general revenue in 1954 and 1964*

[Dollar amounts in millions]

Source	Amount		Percent increase, 1954–64	Amount of increase, 1954–64	Percent of total increase, 1954–64
	1954	1964			
Total State-local general revenue	$29,012	$68,443	135.9	$39,431	100.0
Federal grants	2,966	10,002	237.2	7,036	17.8
Revenue from State-local sources	26,046	58,440	124.4	32,394	82.2
Total State general revenue	15,299	37,648	146.1	22,349	100.0
Federal grants	2,668	9,046	239.1	6,378	28.5
Revenue from State sources [1]	12,631	28,602	126.4	15,971	71.5

[1] Including a small amount of revenue from local governments.

Sources: U.S. Bureau of the Census, Census of Governments: 1962, Vol VI, No. 4, *Historical Statistics on Government Finances and Employment*, 1964, pp. 39, 42; *Governmental Finances in 1963–64*, 1965. p. 22.

Of the $28 billion in general revenue collected by the States from their own sources in 1964, 86 percent—$24 billion—came from taxes. State tax systems are dominated by consumer taxes (table 3), in contrast to the Federal system, which relies primarily upon income taxes, and to local systems, which obtain most of their revenue from property taxes. The most important single source of State revenue in 1965 was the general sales tax. Individual income taxes came in a poor third after motor fuel levies. It should be noted, however, that, while the relative contribution of consumer taxes to total State tax yield has been virtually constant since World War II, the role of income and general sales taxes has increased significantly, largely at the expense of selective sales and miscellaneous license and privilege taxes.

[1] It obviously cannot continue indefinitely at a rate faster than the growth in the GNP.

TABLE 3.—*State tax collections, by major source, selected years, 1902–65*

[Dollar amount in millions]

Year	Total, excluding employment taxes	Individual income	Corporation income	Sales and gross receipts				All other
				Total	General	Motor fuel	Other	
1902	$156	----------	----------	$28	----------	----------	$28	$128
1913	301	----------	----------	55	----------	----------	55	246
1922	947	$43	$58	134	----------	$13	121	712
1927	1,608	70	92	445	----------	259	186	1,001
1932	1,890	74	79	726	$7	527	192	1,011
1934	1,979	80	49	978	173	565	240	872
1936	2,618	153	113	1,394	364	687	343	958
1938	3,132	218	165	1,674	447	777	450	1,075
1940	3,313	206	155	1,852	499	839	514	1,100
1942	3,903	249	269	2,218	632	940	645	1,167
1944	4,071	316	446	2,153	720	684	749	1,157
1946	4,937	389	442	2,803	899	886	1,019	1,304
1948	6,743	499	585	4,042	1,478	1,259	1,304	1,616
1950	7,930	724	586	4,670	1,670	1,544	1,455	1,950
1952	9,857	913	838	5,730	2,229	1,870	1,631	2,376
1953	10,552	969	810	6,209	2,433	2,019	1,757	2,564
1954	11,089	1,004	772	6,573	2,540	2,218	1,816	2,740
1955	11,597	1,094	737	6,864	2,637	2,353	1,874	2,902
1956	13,375	1,374	890	7,801	3,036	2,687	2,078	3,310
1957	14,531	1,563	984	8,436	3,373	2,828	2,234	3,548
1958	14,919	1,544	1,018	8,750	3,507	2,919	2,324	3,606
1959	15,848	1,764	1,001	9,287	3,697	3,058	2,531	3,798
1960	18,036	2,209	1,180	10,510	4,302	3,335	2,873	4,137
1961	19,057	2,355	1,266	11,031	4,510	3,431	3,090	4,405
1962	20,561	2,728	1,308	12,038	5,111	3,665	3,263	4,487
1963	22,117	2,956	1,505	12,873	5,539	3,851	3,482	4,783
1964	24,243	3,415	1,695	13,957	6,084	4,059	3,814	5,176
1965	26,104	3,642	1,931	15,052	6,710	4,295	4,047	5,479
	PERCENTAGE DISTRIBUTION							
1902	100	----------	----------	17.9	----------	----------	17.9	82.1
1913	100	----------	----------	18.3	----------	----------	18.3	81.7
1922	100	4.5	6.1	14.1	----------	1.4	12.8	75.2
1927	100	4.4	5.7	27.7	----------	16.1	11.6	62.3
1932	100	3.9	4.2	38.4	0.4	27.9	10.2	53.5
1934	100	4.0	2.5	49.4	8.7	28.5	12.1	44.1
1936	100	5.8	4.3	53.2	13.9	26.2	13.1	36.6
1938	100	7.0	5.3	53.4	14.3	24.8	14.4	34.3
1940	100	6.2	4.7	55.9	15.1	25.3	15.5	33.2
1942	100	6.4	6.9	56.8	16.2	24.1	16.5	29.9
1944	100	7.8	11.0	52.9	17.7	16.8	18.4	28.4
1946	100	7.9	9.0	56.8	18.2	17.9	20.6	26.4
1948	100	7.4	8.7	59.9	21.9	18.7	19.3	24.0
1950	100	9.1	7.4	58.9	21.1	19.5	18.3	24.6
1952	100	9.3	8.5	58.1	22.6	19.0	16.5	24.1
1953	100	9.2	7.7	58.8	23.1	19.1	16.7	24.3
1954	100	9.1	7.0	59.3	22.9	20.0	16.4	24.7
1955	100	9.4	6.4	59.2	22.7	20.3	16.2	25.0
1956	100	10.3	6.7	58.3	22.7	20.1	15.5	24.7
1957	100	10.8	6.8	58.1	23.2	19.5	15.4	24.4
1958	100	10.3	6.8	58.7	23.5	19.6	15.6	24.2
1959	100	11.1	6.3	58.6	23.3	19.3	16.0	24.0
1960	100	12.2	6.5	58.3	23.9	18.5	15.9	22.9
1961	100	12.4	6.6	57.9	23.7	18.0	16.2	23.1
1962	100	13.3	6.4	58.5	24.9	17.8	15.9	21.8
1963	100	13.4	6.8	58.2	25.0	17.4	15.7	21.6
1964	100	14.1	7.0	57.6	25.1	16.7	15.7	21.4
1965	100	14.0	7.4	57.7	25.7	16.5	15.5	21.0

NOTE.—Detail may not add to total because of rounding.

Sources: U.S. Bureau of the Census, Census of Governments: 1962, Vol. VI, No. 4, *Historical Statistics on Governmental Finances and Employment*, 1964; *Compendium of State Government Finances in 1964*, 1965; *State Tax Collections in 1965*.

State and local debt outstanding increased from $39 billion in 1954 to $92 billion in 1964, a rise of 137 percent. State debt grew even more dramatically—161 percent—during a period in which the debt of the Federal Government rose only 15 percent.

Our discussion of State general revenue must be pursued in substantially greater depth before the true dimensions of the States' fiscal problem are clearly established. The points made in the following discussion apply equally to fees, charges, and other general revenue, but to simplify the terminology we refer only to taxes. The important issues will be easier to handle if we establish a simple conceptual distinction. On the one hand, the most obvious fact about State revenue systems is that in any particular fiscal year different taxes yield different amounts of revenue. Thus our discussion begins with the factors that determine the absolute amounts of tax yields. Only slightly less obvious, on the other hand, is the fact that the yields of different taxes grow at widely varying rates, and that these rates appear to brear no relationship to the relative importance of the taxes in total revenues. Our discussion of the factors that account for different rates of growth will take us directly to the heart of the States' fiscal problem.

The amount of revenue yielded by a given tax in a particular fiscal year depends directly upon two basic factors: the size of the tax base and the average effective tax rate. A general sales tax that excludes food from its definition of taxable sales (the tax "base") for example, will yield less revenue than the same tax rate applied to a base that includes food.[2] The quality of tax administration is an important enough variable to deserve mention as a third determinant of total yield. The introduction of income tax withholding, for example, has brought forth very substantial increases in yields without rate increases or "base-broadening."

Increases in tax collections from one year to the next involve an additional set of considerations. Other things being equal, of course, the yield of a given tax will be higher next year than in the present fiscal year if the legislature increases the average rate, or if it broadens the definition of the base, or if it appropriates more money for tax enforcement. Similarly, the yield of a State's revenue system as a whole will increase if entirely new taxes or fees are adopted. We will see that a very large proportion of the actual increases in State general revenues since World War II have resulted from these types of "structural" changes in State systems. It is by no means true, however, that the tax with the broadest base and/or the highest average rate will have the most rapidly growing yield.

Income Elasticity

The discussion of the next few pages focuses on an aspect of the growth of State general revenue; that is from the point of view of defining the dimensions of the States' fiscal problem, more important than any other—the portion of changes in receipts that may be called automatic.

Tax collections rise automatically whenever the gross national product increases, and when the GNP declines during a recession the yield of almost every tax suffers. This relationship exists because individuals' incomes and consumption expenditures, which are the sources of nearly all tax revenues, move in the same direction as the GNP. Apart from the influence of tax enforcement, the amount of tax collections, of course, depends upon the size of the base (consumer expenditures or income) and the tax rate: rate times base equals yield.

The yield of each tax responds differently to changes in the GNP, and the concept that measures the degree of automatic responsiveness is called income elasticity. If an increase of 10 percent in the GNP is accompanied by a 10 percent rise in the proceeds of a particular tax (with no change in rate), the tax is said to have an income elasticity of one. If the percentage change in yield is less than the percentage change in the GNP, the tax is inelastic (the ratio of the percentage changes has a value of less than one). If the reverse is true the tax is elastic (income elasticity is greater than one).

The income elasticity of every tax is determined primarily by the responsiveness of its base to changes in the gross national product. During 1964, for example, the GNP increased 6.6 percent, gasoline sales increased approximately

[2] The exclusion of food from the base can result in the loss of a quarter or more of the potential yield.

4 percent, and consumer spending for goods and services rose 6.5 percent.[3] On the basis of this information we would expect the income elasticity of a gasoline tax to be considerably less than that of a general sales tax, and this is, in fact, the case.[4] When the behavior of its tax base has been defined, the income elasticity of a consumption tax is explained.

The elasticity of an income tax is a considerably more complicated matter, and a detailed consideration of the question appears in chapter 5. Suffice it to say here that the elasticity of an income tax is primarily a function of the responsiveness of its base—taxable income—to changes in the GNP, so the above discussion of the elasticity of consumption taxes should be sufficient for the purposes of this discussion.

A number of studies of State finances have come up with estimates of the GNP elasticities of the major categories of State general revenues. Table 4 is based on the results of several of these studies. Note that three elasticity estimates are provided for each category. It is necessary to be somewhat less than specific about the elasticities for two basic reasons. First, there is no consensus among economists regarding the proper average elasticities. Secondly, the evidence suggests that the elasticities of all, or nearly all, categories of receipts vary over time. The best we can do, then, is to specify the ranges within which we may reasonably expect the elasticities to fall during any particular period. For these reasons, references in this report to receipts elasticities generally will be to ranges rather than to precise figures.

TABLE 4.—*Gross national product elasticities of the major categories of State general revenue*

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 beverages	.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

Sources: Benjamin Bridges, Jr., "The Elasticity of the Property Tax Base: Some Cross Section Estimates," *Land Economics*, Vol. 40, November 1964, pp. 449–51; Jesse Burkhead, *State and Local Taxes for Public Education*, The Economics and Politics of Public Education Series, No. 7 (Syracuse University Press, Syracuse: 1963), p. 67; David George Davies, "The Sensitivity of Consumption Taxes to Fluctuations in Income," *National Tax Journal*, Vol. 15, September 1962, pp. 281–90; James S. Duesenberry, Otto Eckstein, and Gary Fromm, "A Simulation of the United States Economy in Recession," *Econometrica*, Vol. 28, October 1960, pp. 749–809; Harold M. Groves and C. Harry Kahn, "The Stability of State and Local Tax Yields," *American Economic Review*, Vol. 42, March 1952, pp. 87–102; Robert Harris and Selma Mushkin, "The Revenue Outlook in 1970: A Further Report on Project '70," unpublished paper prepared for the National Association of Tax Administrators' 1964 Conference on Revenue Estimating, October 1964, p. 16, Ernest Kurnow, "On the Elasticity of the Real Property Tax," *Journal of Finance*, Vol. 18, March 1963; pp. 56–8; Eugene P. McLoone, "Effects of Tax Elasticities on the Financial Support of Education," unpublished Ph.D. dissertation (College of Education, University of Illinois, Urbana: 1961); Dick Netzer, "Financial Needs and Resources Over the Next Decade: State and Local Governments," in *Public Finances: Needs, Sources, and Utilization*, a Report of the National Bureau of Economic Research (Princeton University Press, Princeton: 1961), pp. 23–65; Robert W. Rafuse, Jr., "The Cyclical Behavior of State-Local Finances," in Richard A. Musgrave, Editor, *Essays in Multi-Level Finance*. Studies of Government Finance, The Brookings Institution, Washington, D.C., 1965; Lee Soltow, "The Historic Rise in the Number of Taxpayers in a State with a Constant Tax Law," *National Tax Journal*, Vol. 8, December 1955, pp. 379–81.

[3] U.S. Department of Commerce, *Survey of Current Business*, February 1965, p. 16. Gasoline sales estimated by the American Petroleum Institute, reported in Federation of Tax Administrators *Tax Administrators News*, January 1965, p. 6.

[4] Studies have determined that the GNP elasticity of the typical gasoline tax is approximately 0.5 while the elasticity of general sales taxes approaches 1.0.

These crude estimates of the GNP elasticities of the major categories of State government suggest a number of interesting conclusions. Estimates of the GNP elasticity of total State general revenues at any particular point in time are given by weighted averages of the elasticities of the several revenue sources, using actual collections in the year in question as the weights.[5] Thus, it is possible to say that the GNP elasticity of total State general revenue in fiscal year 1964 was approximately 0.92—the result yielded by using the medium elasticity hypotheses. The low and high estimates for 1964 are 0.82 and 1.01, as shown in the following table:

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

As time passes and economic growth results in an increasing GNP, the yields of the receipts categories with higher elasticities automatically grow more rapidly, by definition, than collections from categories with lower elasticities. Thus, unless rate increases and new adoptions are relatively more frequent in the cases of the low elasticity receipts categories, the overall elasticity of State general revenue will increase every year that the GNP increases. By 1970, if the GNP increases according to the estimates of the Interagency Study of Economic Growth, that is, by approximately 60 percent above 1964, and if there are no increases in tax rates or adoptions of new sources,[6] this process will automatically raise the elasticity of general revenues to 0.89, or 0.99, or 1.09 (low, medium, and high elasticity hypotheses, respectively). The elasticity of State general revenues has in fact been rising gradually since the end of World War II. Using actual yields in 1947 and 1954 as weights, the medium elasticity estimate for 1947 is 0.83. By 1954 the elasticity (medium estimate) had increased slightly to 0.85. Clearly, the process of elasticity-rise has proceeded somewhat more rapidly since 1954.

The set of elasticity estimates for the major categories of State general revenue also provide the necessary raw material for determining the approximate relative importance of rate increases and adoptions of new taxes—changes that may be

[5] The average elasticities discussed here are for total State general revenue. Since the importance of a particular category of receipts will vary from State to State—yielding averages that will vary depending on the State—these estimates of system elasticities should not be interpreted as applying to any particular State.

[6] Or if there are such increases or adoptions, we assume only that they are evenly distributed among the categories.

referred to as "structural," to distinguish them from the automatic changes that are handled by the elasticity concept—in raising State general revenues in the postwar period. Accordingly, we have prepared estimates of the percentages of the actual increase in State revenues that was accounted for by structural changes in State revenue systems (rate increases and new sources) during the periods 1947–64 and 1954–64.[7]

Between 1947 and 1964 the medium elasticities imply that 58 percent of the total increase in State general revenues is attributable to taxes and rate increases enacted since 1947.[8] For the period since 1954 our calculations indicate that roughly 55 percent of the rise in State receipts is attributable to structural changes,[9] and only 45 percent to the automatic responsiveness of collections to the growing GNP. These findings suggest that state legislative activity in the revenue field was only slightly less vigorous between 1954 and 1964 than it had been during the earlier years of the postwar period.

If these estimates of the revenue increases attributable to structural changes in State systems seem high, a moment's reflection on the record of new adoptions and rate increases during the past 17 or 18 years should prove convincing. In 1946, 23 State revenue systems included a general sales tax. By the end of 1965, 15 more States (not including Hawaii) had adopted the tax, 19 of the original 23 States had raised their rates, and still others had broadened their tax bases. At the beginning of the postwar period 30 States taxed personal incomes, and by 1964 three more States had been added to the list.[10] Seventeen States increased their income tax rates between 1950 and 1964. Five States have adopted corporation income taxes since 1947. Thirty-eight States raised their gasoline tax rates between 1950 and 1964. Fifteen States enacted cigarette taxes between 1947 and 1964, and by 1964, 42 had increased their rates. The experience of the past 2 years is excellent evidence of the States' quest for new revenues through structural changes in their tax systems (table 5).

[7] Each of the sets (low, medium, and high) of elasticity hypotheses is used to estimate the automatic increase in the yield of each revenue category that would have accompanied the increase in the GNP for the period in question. Presumably, then, the differences between the predicted automatic increases and the increases that actually occurred represent the revenue impact of new taxes and rate changes.

[8] The corresponding low and high elasticity estimates are, respectively, 63 percent and 53 percent.

[9] The low and high elasticities yield estimates of 60 and 50 percent, respectively.

[10] These figures do not include New Hampshire and Tennessee, which have taxed income from intangibles since before World War II; New Jersey, which enacted its "commuters'" (personal income) tax in 1961; and Nebraska, which adopted a personal and corporation income tax in 1965 that will go into effect on January 1, 1967, if it is not voted down in referendum.

TABLE 5.—*State tax increases, 1964 and 1965*

General sales		Personal income		Corporation income		Cigarette		Alcoholic beverages		Gasoline	
1964	1965	1964	1965	1964	1965	1964	1965	1964	1965	1964	1965
NEW TAX											
----------	Idaho New York	--------	Nebraska [1]	----------	Nebraska [1]	Colorado	Oregon [2]	----------	----------	----------	----------
RATE INCREASED											
Mississippi Rhode Island	Colorado Hawaii Kansas Rhode Island South Dakota Washington West Virginia Wyoming	--------	Arizona Hawaii Iowa Kansas Minnesota Montana Utah Wisconsin	Georgia	Arizona Connecticut Hawaii Iowa Kansas Montana Utah	Georgia Kansas Massachusetts Mississippi Rhode Island	Alabama Arizona Arkansas Colorado Connecticut Delaware Hawaii Illinois Indiana Iowa Kansas Maine Nebraska New Hampshire New York North Dakota Oklahoma South Dakota Texas Vermont Washington Wisconsin	Georgia Kansas Virginia	Hawaii Kansas Nebraska New Hampshire Utah Washington	Maryland	Arizona Arkansas California [3] Colorado [4] Connecticut [5] Delaware Iowa Massachusetts Nebraska

[1] Effective Jan. 1, 1967 (subject to referendum).
[2] Subject to referendum.
[3] Temporary increase (Apr. 1–Aug. 31, 1965) to finance the repair of roads and bridges damaged by recent floods.
[4] Temporary 1 cent additional tax (Aug. 1, 1965–Aug. 31, 1966).
[5] Effective July 1, 1967.

REVIEW OF THE OVERALL SITUATION

Since reserves accumulated during World War II disappeared about the time the Korean war began, many States have been confronted by continuous fiscal crisis. They have been able to struggle through the past 15 years only by resorting to one expedient after another. They have doubled and redoubled cigarette taxes, they have pushed sales tax rates as high as 5 percent, they have asked for and received massive aid from the Federal Government, they have experimented with an ingenious arsenal of budgetary legerdemain, and they have even resorted to the operation of lotteries. And still yields fall short of needs. Things will be no better 5 years from now unless States make progress toward a solution of their basic fiscal problem, the inability of most of their revenue systems to generate yields that grow—without rate increases or new taxes—as rapidly as expenditure requirements. In technical terms, as discussed in the preceding pages, the income elasticity of State revenue systems is too low.

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 percent 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.[11] 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. At the Federal level the situation is entirely different. The GNP elasticity of Federal expenditures appears to be considerably less than that of State expenditures. The elasticity of Federal receipts by all indications appears to be in the same neighborhood as the elasticity of expenditures—1.1 or 1.2. Indeed, recent discussions of the Federal budgetary outlook have centered on the remarkable prospect that the automatic growth of Federal receipts in the next few years may actually outdistance foreseeable expenditure increases, thus creating the phenomenon referred to as "fiscal drag." This line of thinking is responsible for the attention that has been given recently to proposals for further tax cuts and unrestricted grants to the States.

In the past the gap between the high elasticity of expenditures and the low elasticity of receipts has been closed by legislation that, in nearly every State, contributed very little to a real solution to the underlying problem. In any particular fiscal year the gap between revenues and expenditures can be bridged, of course, by the yield of a doubled cigarette tax, or the yield of an increase in gasoline tax rates, to cite two examples. But such measures are no more than palliatives. They contribute nothing to a solution of the real problem; indeed, increases in the rates of cigarette and gasoline taxes will only aggravate the longrun situation, since they will tend to depress the GNP elasticity of the State's

[11] Technically, the concept of elasticity relates only *automatic* changes in receipts to changes in the GNP. As we have seen, the behavior of government receipts cannot really be understood without distinguishing between automatic and structurally induced changes in revenue yields. On the expenditure side, however, there are very few cases of *automatic* changes that result from the ebb and flow of the GNP. Unemployment compensation payments are perhaps the only pure example of a counterpart on the expenditure side to automatic receipts behavior. Such payments, of course, move contrary to cyclical changes in the GNP—increasing during recession and declining during boom—and their GNP elasticity, for this reason, is negative. This is by no means to suggest that economic growth and decline have no effects on spending levels. It is to say that the relationships are indirect rather than direct. Since significant changes in expenditure levels tend to require legislative action, they are more analogous to structural revisions of a revenue system than they are to the automatic changes in receipts that invariably accompany swings in the level of economic activity.

tax system. In the following fiscal year spending will again rise faster than the GNP, revenue will again rise at approximately the same rate as the GNP, and the gap will reappear to haunt the unhappy political leadership. That this treadmill can be negotiated for an extended period of time is one of the most surprising lessons of the postwar period. That it is not without its pitfalls is testified to by a long list of ex-Governors, who have been toppled from power by the political hazards inherent in a policy that requires a new round of tax increases every few years.

Even with the imposition of rigorous expenditure controls, the only real solution to the States' fiscal problem lies in the adoption of measures that raise the GNP elasticity of State revenue systems. In essence, this approach amounts to nothing more than increasing the emphasis on high elasticity sources and deemphasizing sources that have low elasticities. More specifically, this means increasing reliance on income and general sales taxes.

Chapter 6. THE FEDERAL ROLE IN THE STATE INCOME TAX MOVEMENT

Since the Federal Government's personal income tax collections are approximately 11 times larger than those of State and local governments, its income tax policies are critically important to any assessment of the future of income taxes below the Federal level.

The historical evidence marshaled in chapter 3 supports the finding that heavy Federal use of the personal income tax, especially since 1940, has been the single most important deterrent to its expanded use by the States. It has enabled the opponents of State income taxation to gain a sympathetic hearing with the argument that the Federal Government has effectively "preempted" this tax; that, therefore, State and local governments must necessarily depend primarily on consumer and property taxes.

It is significant that not a single State adopted a personal income tax between 1937 and 1960, a period during which 12 States adopted general sales taxes.[12] Although three new State income taxes have been enacted since 1960, approximately 95 percent of current collections from this source go to States that enacted such taxes before 1938—over a quarter century ago. In contrast, only 68 percent of general sales tax revenue is collected by States that adopted this tax prior to 1938.

In the light of this record and our conclusion that the national interest would be served by expanded State use of the personal income tax, the next question is whether it would be appropriate to urge the Federal Government to neutralize the deterrent effect of its heavy income tax on the States' use of this revenue source.

With respect to this issue three general policy alternatives appear to be available to the Federal Government:

1. *A strong inducement policy*—according State income tax payments such Federal income tax preference over other tax payments that no State could afford to forego a personal income tax.
2. *A status quo position*—continuing the present Federal tax treatment (deduction) of State tax payments in general and of State income tax payments in particular, that is, according no preferential treatment to State income taxes.
3. *A compensatory policy*—according State income tax payments a *limited* degree of preferential tax treatment calculated to be just enough to offset the deterrent effect of the massive Federal income tax; every State would not necessarily be encouraged to adopt an income tax.

STRONG INDUCEMENT POLICY

The Federal Government could obviously bring every State into income taxation by providing financial inducements so attractive that no State could resist them. The Congress followed this kind of inducement strategy in 1935 when it provided a 90 percent credit against its unemployment compensation tax for taxes paid to States to insure that every State would adopt an unemployment insurance system. The 80 percent estate tax credit for death taxes paid to States, enacted in 1926 to halt competitive State tax reductions, is another example.

[12] Alaska adopted an individual income tax in 1949, when it was a territory.

Federal inducement to State income taxation could be provided forcefully also through an appropriately devised grant program.

An inducement policy carrying this degree of compulsion would be difficult to justify in the case of State income taxation. If the case for State taxation of personal income is as strong in its own right as we here develop it (ch. 1, 2 and 5), it should be unnecessary to employ highly coercive inducements in order to bring about expanded State use of these taxes.

Moreover, a strong Federal inducement policy, as exemplified by a full credit of State income taxes (not to exceed, say, 20 percent of Federal tax liability) could be extremely costly. While the initial cost to the U.S. Treasury would approximate $3 billion, this cost would increase rapidly as States moved to take full advantage of the credit. Quite apart from these cost considerations, however, State legislatures ought to be left free to shape their own tax policies in the absence of compelling national interest requirements.

STATUS QUO POLICY

Federal income taxpayers may now claim a standard deduction equal to 10 percent of adjusted gross income or $1,000 (whichever is smaller),[13] or they may deduct specifically itemized State and local income, property, sales, and gasoline tax payments (among authorized deductions).

These Federal provisions can be viewed as being neutral with respect to the State and local taxes that are eligible for itemization. A continuation of this policy of neutrality—the rejection of all types of inducements, be they mild or strong—has several considerations to recommend it.

The Case for Status Quo—No Preferential Treatment

Preferential Federal tax treatment for State personal income tax payments might be viewed as both imprudent and unnecessary: imprudent because it would violate the traditional concept of neutrality as the general public understands it and unnecessary because the growing fiscal crisis at the State level is likely eventually to force most States to make greater use of the personal income tax—their last major source of untapped revenue—without overt Federal encouragement.

Because preferential tax treatment for State income tax payments would be very expensive for the Federal Treasury—the initial cost would range from several hundred million to several billion dollars, depending upon the kind of inducement utilized—it can also be argued that no such program should be adopted without a comprehensive study of the whole State and local fiscal system and the various alternatives available to the Federal Government for relieving the financial burdens of State and local governments.

It must also be emphasized that special treatment for State personal income tax payments could discriminate in favor of Federal taxpayers residing in the two-thirds of the States with income taxes and against those in States that rely on other sources of revenue. The property taxes paid by the homeowner in New Jersey and the sales taxes paid by the consumer in Illinois come out of personal income and should be entitled to the same Federal treatment as the income tax payments of the residents of other States. This kind of discrimination would quickly trigger a demand that Congress provide comparable treatment for sales and property taxes. If Congress heeded these demands, the goal of the incentive plan—greater State use of the personal income tax—would be nullified.

It is also necessary to point out that it is impossible to devise a "moderate" inducement or compensatory policy just adequate to compensate for the deterrent effect of the heavy Federal income tax. Because of the diverse political and economic circumstances in each State, a limited preferential treatment policy implemented through a fractional tax credit would overcompensate for the Federal income tax in some States and undercompensate for it in others. Moreover, it can also be contended that if the case for State taxation of personal income is a strong one in its own right, it should not require buttressing by preferential Federal treatment.

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[13] The Revenue Act of 1964 provides the following minimum standard deductions: $300 for a single individual; $400 for a married couple, and an additional $100 for each dependent up to a ceiling of $1,000.

The Probable Effects of a Status Quo Policy

Given the gradual rise in effective rates over the last 15 years, it is probably safe to assume that many of the 25 States that now levy both a broad-based income tax and a general sales tax will gradually increase their personal income tax yields by either raising rates or broadening the tax base, or by making both base and rate adjustments. Some of the nine income tax States that now have no general sales tax can be expected to broaden and diversify their revenue structures through the adoption of general sales taxes within the next decade in response to the public's demand for property tax or income tax relief or both. When Wisconsin adopted its sales tax in 1961 most of the sales tax revenue was earmarked for property tax relief, while the adoption of a sales tax in Idaho in 1965 was accompanied by some income tax reduction.

The two States that have neither a broad-based income tax nor a general retail sales tax—New Jersey and New Hampshire—could go either way. It is also conceivable that either or both of these States might compromise by enacting an Indiana-type, broad-based, flat-rate income tax coupled with a general sales tax, with part of the revenue perhaps earmarked for property tax relief.

The 14 nonincome tax States currently levying a sales tax pose the most difficult forecasting problem. Some of them will almost certainly be forced to broaden and diversify their tax systems through the adoption of a personal income tax within the next decade.

Several considerations suggest that the State income tax movement may be regaining its forward momentum. We have already stressed the States' pressing need for additional revenue and the remarkable revenue performance of the personal income tax in response to economic growth during the last few years. These two facts, coupled with growing public confidence in the ability of national economic policies to sustain economic growth and to prevent the recurrence of serious economic recessions, is both increasing State interest in the revenue potential of the income tax and reducing State concern with the instability of this revenue source. State receptivity to income taxes will increase also as general sales tax rates reach or approach the 4 or 5 percent level—a kind of psychological ceiling—and as property tax loads continue to mount.

There appears to be an increasing awareness that a broad-based income tax, integrated with a general sales tax through a system of income tax credits (and refunds to non-income taxpayers) to safeguard the low income groups, can help bypass or overcome the traditional political stalemate between personal income tax and sales tax supporters. Indiana's, Colorado's, and Hawaii's recent decisions to integrate their income and sales tax systems through the tax credit device have already been noted.

Finally, as a result of the major Federal income tax reduction of 1964, the Federal income tax may have lost some of its "preemptive" character for legislators in the nonincome tax States.

A COMPENSATORY POLICY

The central aim of a compensatory policy would be to provide a *limited* degree of preferential Federal tax treatment for State income tax payments to offset the deterrent effect of the heavy Federal income tax. A compensatory policy rests on the expectation that once the State income tax movement is liberated from the restraining influence of the Federal income tax, State legislators would look with favor on this revenue source because (a) it represents the last major untapped State revenue source, (b) it has unique revenue growth potential, and (c) it enjoys certain unique advantages from the standpoint of tax fairness.

Modification of Present Deductibility System

Because a compensatory policy is based on the premise that the Federal Government's present treatment of State and local tax payments does not adequately compensate for the heavy Federal income tax, it logically raises the question of the means the Federal Government might employ to neutralize most effectively the deterrent effect of its own income tax for State tax policy purposes. Three lines of preferential action are possible and the justification for taking any one of them is to be found in the fact that such action recognizes that personal income, unlike consumer expenditures and property, is heavily taxed by the Federal Government.

1. The Federal Government could restrict the itemization privilege to State and local income tax payments by disallowing property, gasoline, and sales tax deductions—*the constriction approach.*

2. It could broaden the itemization privilege for State and local income tax payments only by permitting persons using the standard deduction to itemize, in addition, income tax payments—*the liberalization approach.*

3. It could modify the present deductibility system by permitting all Federal income taxpayers a choice between (a) continuing to itemize income tax payments made to State and local governments, or (b) claiming such payments as a partial credit against their Federal tax liability—*the optional partial tax credit approach.*

Constriction approach.—While disallowance of property, gasoline, and sales tax deductions probably would be sufficient to neutralize the deterrent effect of high Federal income taxes, such a proposal can be expected to encounter bitter political opposition. Homeowners, who have long been accustomed to deducting their residential property tax payments in computing their taxable income for Federal tax purposes, would be especially aroused. Moreover, such "corrective" or neutralizing action could also be expected to trigger stout opposition from State and local governmental officials, who view the present deductibility system as a form of intergovernmental comity—with the Federal Government underwriting a system of general tax relief for State and local taxpayers.

Liberalization approach.—The second possible modification of the deductibility system—permitting persons using the standard deduction to take, in addition, State income tax payments as an itemized deduction—would undoubtedly enjoy greater political acceptability becaue it would give standard deduction filers (generally those with smaller incomes) visible relief for the State income tax payments. Persons using the standard deduction would be in a position to "write off" their State income payments against their Federal liability at the average rate of about 17 cents on the dollar.

This proposition, however, is not without major defects. First, it would conflict with the Federal objective to simplify the tax liability formula in order to facilitate automated tax computation and ease the compliance burdens of low-income taxpayers. Second, and far more important, this alternative would provide only token compensation for the presence of heavy Federal income tax rates, because approximately 60 percent of all State income tax payers already itemize their Federal deductions and would receive no benefit from it, while the other 40 percent—standard deduction filers—tend to fall in the lowest Federal tax rate brackets, and on the average would enjoy only a 17 percent write off.

The token character of this alternative is indicated by the fact that if it had been in effect in 1964, it would have cost the Federal Government less than $150 million in tax revenue. Thus, while it would tend to move in the right direction—leveling the tax policy scales—it would probably fall far short of truly neutralizing the presence of the Federal income tax.

Optional partial credit approach.—A partial or fractional tax credit stands out as a more promising method for providing compensatory Federal treatment of State income tax payments. For example, Congress could give Federal income taxpayers a choice between continuing to itemize their State income tax payments *or* to claim instead a specified percentage of such payments as a credit against their Federal tax liability. The standard deduction provision would not be modified.

Because of its high visibility, even a partial credit has great political and psychological value. Under the present system, the State income tax payment appears as one component of the State and local tax deductions (alongside property, sales, and gasoline tax payments). A tax credit, available to *all* taxpayers whether or not they itemize, would be identified as a separate item to be subtracted by all from the amount of tax otherwise payable. This would make State tax policymakers mindful of its special Federal tax-reduction value. If the credit were set at 40 percent, virtually all taxpayers below the $50,000 adjusted gross income class would find it to their advantage to use the credit option.

Because the Federal Government now sustains a heavy revenue loss under the present deductibility system—approximately 24 cents on each dollar collected by State income tax officials—the *initial* cost of an optional credit plan would not be nearly as large as might be expected. In terms of Federal revenue foregone, it is estimated that the present system of itemizing State income tax payments cost the Federal Government approximately $700 million in fiscal year 1964, as compared with a potential revenue cost of $1.2 billion for an optional 40 percent credit for the same year (table 26). As the following tabulation shows, the additional 1964 cost attributable to the credit would have been about $500 million: [14]

Federal tax treatment	Federal revenue forgone	
	Present law	Optional 40-percent credit
	Millions	*Millions*
State income taxes claimed as itemized deductions	$720	$245
40-percent credit for State income taxes paid		975
Total cost	720	1,220
Additional cost of optional credit proposal		500
	Cents	*Cents*
Federal revenue cost of each $1 of State income tax collections	0.24	41

[14] These revenue cost estimates exclude local income tax payments because the distribution of these tax payments by income classes was not readily available. It is estimated that identical Federal tax credit treatment for local income tax payments would increase the Federal revenue loss by approximately 15 percent.

TABLE 26.—*Approximate Federal revenue cost in fiscal year 1964 of the present treatment of State income tax payments (deductibility) compared with the initial cost of an optional credit against Federal tax of 40 percent of the taxpayer's State individual income tax payment—Calendar year 1963 income levels, fiscal year 1963 State income tax collections, and 1965 Federal tax rates*

Adjusted gross income classes	State income taxes claimed as personal deductions on Federal returns				Average of cols. 3 and 5 (percentages)	Estimated personal deductions for State income taxes 1963 Federal returns [1] (millions)	Estimated cost, fiscal year 1964 (Federal revenue forgone) (millions)	
	1960		1962					
	Amount (thousands)	Percentage of total State collections	Amount (thousands)	Percentage of total State collections			Present law (deduction only for itemizers)	Optional credit (40 percent of State tax liability for all Federal taxpayers)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Under $3,000	$14,121	0.6	$15,037	0.6	0.6	$18	[2]	$7
$3,000 to $5,000	83,802	3.8	78,702	2.9	3.3	99	$15	40
$5,000 to $10,000	478,557	21.7	542,519	19.9	20.8	614	105	246
$10,000 to $20,000	448,918	20.3	608,413	22.3	21.3	630	155	252
$20,000 to $50,000	451,651	20.4	543,257	19.9	20.2	597	200	239
Over $50,000	360,232	16.3	415,844	15.2	15.8	466	245	[3] 245
Nontaxable returns	38,118	1.7	50,526	1.9	1.8	53	0	0
Nonitemizers' returns	0	0	0	0	0	0	0	192
Total	[4] 1,875,399	84.9	[4] 2,254,298	82.6	83.8	[4] 2,476	720	1,221

[1] Total actual 1963 State income tax collections distributed on basis of col. 6.

[2] Less than $2,500,000.

[3] Revenue loss from a deduction rather than a credit (same as entry in col. 8). Marginal rates applicable to taxpayers in this AGI bracket are likely to exceed 40 percent, so tax liabilities would be minimized by deducting State income taxes rather than by claiming the credit.

[4] Total actual collections (which include taxes paid by Federal taxpayers who use the standard deduction—nonitemizers) were as follows: 1960, $2,209,294,000; 1962, $2,727,-984,000; 1963, $2,955,996,000.

Table 27 projects these costs through 1968. In the fiscal year 1967, for example, the additional cost to the Federal Government of an optional 40 percent credit is estimated at about $730 million. It is estimated that the additional cost of a 33 percent credit proposal would be about $500 million, if it were to go into effect in fiscal year 1967.

TABLE 27.—*Approximate Federal revenue cost of the present treatment of State income tax payments (deductibility) compared with the initial cost an optional credit against Federal tax of 40 percent of the taxpayer's State individual income tax liability, fiscal years 1964 through 1966* [1]

[In millions]

	Fiscal year 1964 [2]		Fiscal year 1965 [2]		Fiscal year 1966 [2]		Fiscal year 1967 [2]		Fiscal year 1968 [2]	
	Present law	Optional credit	Present law	Optional credit	Present law	Optional credit	Present law	Optional credit	Present law	Optional credit
Estimated Federal income tax revenue cost of—										
State income taxes claimed as personal deductions	$720	$245	$834	$284	$890	$302	$1,063	$361	$1,173	$399
40 percent credit for State income taxes paid		975		1,126		1,201		1,435		1,582
Total cost	720	1,220	834	1,410	890	1,503	1,063	1,796	1,173	1,981
Additional cost of the optional credit proposal		500		576		613		733		808

[1] These estimates are derived in the same way as those in cols. 8, and 9 of table 26. State individual income tax collections for the relevant fiscal years are: 1963, $2,956,000,000 actual; 1964, $3,415,000,000 actual; 1965, $3,642,000,000 preliminary; 1966, $4,350,000,000 estimate; and 1967, $4,800,000,000 estimate.

[2] Estimates are based on the assumption that this is the first year the proposal is in effect.

On the very extreme assumption that a 40 percent credit would immediately encourage every State to enact an individual income tax with a yield equivalent to 3½ percent of the adjusted gross income reported on Federal income tax returns less personal exemptions (a most unlikely assumption), the additional cost in Federal revenue foregone would approximate $4.2 billion in fiscal year 1968. To produce this result the States would have to be collecting approximately $13 billion of personal income taxes by 1968—in contrast to an estimated $4.8 billion if present Federal policy is continued unchanged. In other words, the estimated additional Federal revenue cost would be offset by a gain in State revenues in the ratio of 2 : 1.

The case for a compensatory policy.—The case for a compensatory policy implemented by an optional partial tax credit rests on the following general arguments. First, special Federal tax treatment for State and local income tax payments is necessary because the present system makes inadequate compensation for the heavy Federal income tax and, therefore, tends to divert State and local policymakers away from income taxes to consumer and property taxes. Thus, the Federal Government's present policy of "neutrality" is far more apparent than real. As has already been explained, the present deduction treatment, originally adopted in 1913, lost its neutral character when the National Government embarked on the policy of placing primary reliance on the individual income tax during World War II.

If it is appropriate to exhort the States to make fuller use of the personal income tax in the national interest, it is equally appropriate to exhort the Federal Government to abandon its present policy, which works against heavier State reliance on the income tax, and, as a *minimum*, to pursue a policy of true neutrality by providing State income tax payments the special consideration necessary to achieve that neutrality. While it is not possible to define the precise amount of special consideration that would just compensate for the deterrent effect of the Federal income tax, reasonable inferences can be drawn from historical experience. We know, for example, that a 90 to 100 percent credit would tip the scales decisively in favor of State income taxation. We know also that the present deductibility system, which is equivalent to an average credit of about 24 percent, does not compensate for the high Federal rates, and that, as a consequence, Federal tax policy tips the scales in favor of State and local consumption and property taxes. This suggests that a credit in the 30 to 50 percent range might be an appropriate compromise between undercompensation (status quo) and overcompensation (the 100 percent or full credit).

It can also be argued that it is necessary to hurry history along because letting nature take its course, albeit convenient, is too costly. The point must be emphasized that any decision to impose a new general tax on the public must be viewed as a last resort type of political decision, and policymakers in the non-income-tax States can be expected to exploit less controversial revenue sources before adopting a personal income tax, particularly in view of the fact that the massive presence of the Federal income tax tips the scales in favor of consumer taxes at the State level. Thus, in the absence of some type of compensatory Federal action, many if not most of the non-income-tax States will continue to be hobbled by their relatively inelastic tax structures.

No comprehensive study of all possible ways of aiding State and local governments can overrun the hard logic that States should be encouraged to tap their tax potential to the fullest extent before Congress is urged to consider any large-scale revenue sharing plan. Thus, while a compensatory policy might be viewed as Federal intervention in State tax policy matters, it is more logical to regard it as a measure to reinforce the independence of the States by placing them in a better position to solve their fiscal problems out of their own resources.

A Federal income tax reduction in the form of a substantial credit for State income tax payments could be expected to have a far greater expansionary effect on State income tax yields than the conventional type of Federal income tax reduction. While each dollar of conventional Federal income tax reduction is likely, through its expansionary effect on State and local tax bases, to increase collections on the order of 10 to 20 cents, each dollar of a Federal tax reduction in the form of, say, a 40 percent credit would produce approximately a $2.50 increase in State revenue yield, to the extent that it prompted the States to step up to their income tax performance. Of course, to the extent that taxpayers chose to take a tax credit rather than the present deduction for State income taxes already in force, the loss of Federal revenue attributable to State income taxes would not be offset by increased State revenues.

In this connection, it should be noted that, while preferential tax treatment for State income tax payments would have the *initial* effect of discriminating in favor of Federal taxpayers residing in income tax States, this transitional cost is necessary if the policy is to have the desired influence. To the extent the policy is effective the discrimination would be short lived. State legislators in non-income-tax States would have ample opportunity and incentive to prevent the horizontal inequity from continuing for long.

Moreover, by making the partial credit provision effective some (say 2 or 4) years after the date of enactment, Congress would be giving the legislators in the non-income-tax States an opportunity to enact a personal income tax and thereby prevent discriminatory Federal tax treatment for their constituents. It should also be emphasized that this prospective approach would alert the legislators in the income tax States in sufficient time to permit them to raise their State income tax rates to offset the Federal tax reduction. Because many of the income tax States make rather inadequate use of this revenue source, it is reasonable to assume that they would tend to take immediate advantage of the impending Federal income tax reduction via the partial tax credit route and raise their State income tax rates. Thus, adoption of this prospective approach could conceivably produce results somewhat similar to a revenue maintenance provision but without its coercive aspects.

SUMMARY

Although in theory there are three basic policy positions that the Federal Government can take on the State income tax issue—a strong inducement strategy, a compensatory or mild inducement policy, or a status quo position—in actual fact there are only two practical alternatives. The strong inducement approach exemplified by the 90 percent unemployment tax credit for taxes paid to States appears to be neither necessary nor available, at least at this time, for the purpose of encouraging the State personal income tax movement.

The issue thus reduces itself to the relative merits of a status quo position, which rejects any type of preferential Federal tax treatment for State income tax payments, and a compensatory or mild inducement policy, which would use a partial credit to "neutralize" the deterrent effect of the heavy Federal income tax.

The status quo supporters can be expected to take a bleak view of the political effect of any proposal for granting preferential Federal tax treatment, no matter how limited, for State and local income tax payments on the grounds that it would violate the accepted or traditional concept of neutrality and would be interpreted as Federal intervention in State tax policy matters. The status quo advocates, on the other hand, can be expected to take a rather optimistic view of the future of the State income tax movement. They can point to recent State income tax enactments and to the States' compelling need for additional revenue in support of their view that the fiscal winds have shifted and are now propelling rather than retarding the personal income tax movement.

The case for a moderate inducement policy rests on the claim that the present deductibility system fails to compensate adequately for the heavy Federal income tax, and that Federal tax policy, therefore, tips the scales away from income taxes in favor of consumption and property taxation at the State and local levels. Thus, if it is in the national interest to exhort the States to make fuller use of the personal income tax, it is equally appropriate to exhort the Federal Government to abandon its present policy, which works against fuller use of income taxes by the States, and to urge that, as a *minimum*, it pursue a policy of "true" neutrality by providing special consideration for State income tax payments. In essence, this argument rests on the assumption that this case requires the Federal Government to discriminate in order to be fair.

The belief that present Federal policy is non-neutral rests on the fact that the heavy Federal reliance on the personal income tax since the late 1930's stands out as the single most important deterrent to expanded State use of this revenue source.

Supporters of a mild inducement or compensatory policy also challenge the sanguine view that the winds are now behind the State income tax movement. They emphasize that the decision to impose a new general tax on the public must be viewed as a last resort type of political decision on the part of Governors and legislators. Thus, policymakers in the non-income-tax States can be expected to exploit less controversial revenue sources before adopting a personal income tax, particularly in view of the fact that the massive presence of the Federal income tax tips the scales in favor of consumption taxes at the State level. In the absence of some type of compensatory Federal action, many of the non-income-tax States will continue to be hobbled by their relatively inelastic tax structures.

As indicated earlier, we do not here consider alternative ways by which the Federal Government could share its revenue with the States or provide them with other forms of financial assistance. Our purpose is limited: to consider the amount of financial inducement that would be required to offset the deterrent effect of the heavy Federal income tax on the State personal income tax movement. It is for this reason that we do not advance a precise percentage for such partial income tax credit, recognizing that the measurement of the amount required to achieve the limited, neutralizing purpose sought is essentially a political judgment that can best be assessed in the legislative arena.

Finally, it needs to be recorded that we have considered various techniques for encouraging more effective State use of income taxes. Our present discussion is limited, however, to only some of these, those found to have particular relevance as instruments for neutralizing the deterrent effect of the Federal income tax.

It should be noted that the ACIR does not view its tax credit proposal as excluding other types of general Federal aid; namely, revenue sharing or unconditional grants, but as a necessary political prerequisite to such other forms of Federal aid. But as John Shannon, senior analyst for ACIR, stated in an address to the National Association Conference in 1966:

The political case for Federal revenue sharing would be far more persuasive if most of the States were making a respectable income tax effort. Such is not the case at the present time.

The tabular summary facing this page of six different ways of distributing a Federal surplus was prepared by John Shannon and distributed by ACIR in 1964.

CONCLUSIONS

Looking back over 25 years of recommendations by government commissions we can see these trends of thought in connection with Federal grants to the States and localities generally and alternatives to the grant device:

First, if we distinguish the official recommendations of the various government commissions from the individual views of those who have worked on task force studies for the commissions, we note a gradual shift in attitude from deep resentment to a more friendly view toward Federal grants. The government commissions were at first rather strongly opposed to Federal grants and their proliferation on the grounds that they tended to usurp the autonomy of the States and local governments and that they represented a danger of overcentralization of government. The recommendations of the Groves, Gulick, Newcomer Committee represent somewhat of an exception to the historical trend inasmuch as the Committee well-recognized the utility of the grant mechanism, employed judiciously, and of the joint participation that is necessary to the success of federalism. In this sense the more recent commissions have finally caught up with the 1943 *Report on Federal, State, and Local Government Fiscal Relations*. The

ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS: A STAFF ANALYSIS OF SIX ALTERNATIVE WAYS OF DISTRIBUTING A FEDERAL SURPLUS

December 8, 1964

SIX ALTERNATIVES	FEDERAL TAX EFFECT	INTERSTATE EQUALIZATION EFFECT	OVERALL TAX BURDEN EFFECT	EFFECTIVENESS OF PLAN FROM A STATE AND LOCAL STANDPOINT	FEDERAL INVOLVEMENT IN STATE & LOCAL EXPENDITURE DECISIONS	INTERGOVERNMENTAL RELATIONS EFFECT	TECHNICAL EVALUATION	POLITICAL EVALUATION
COMPENSATORY FISCAL APPROACH--cut Federal income tax or reduce the national debt or both depending on economic conditions.	Federal income taxpayers could expect further reductions in tax liability.	No significant effect.	The overall Federal-State-local tax system would be less progressive because the Nation would be required to place increasing reliance on proportional and regressive State and local taxes to finance rising domestic needs.	Least efficient because direct benefits accrue to individual Federal income taxpayers--indirect benefit to the extent that a compensatory fiscal policy promotes greater economic activity and expands the State and local tax base. Can affect willingness to raise State and local taxes either way.	None	Federal role somewhat diminished by the relinquishment of effective control of part of its fiscal resources and State and local government roles commensurately enhanced.	The most efficient plan if the objective is to reduce (1) Federal income tax burden, (2) Federal role in relation to State and local governments and (3) the progressiveness of the total Federal-State-local tax system. From a State and local aid standpoint, quite inefficient.	Probably the first choice of most political conservatives and the most objectionable course of action from a liberal point of view.
TAX CREDIT OPTION APPROACH--provide Federal income taxpayers a more generous write-off of their State and local taxes with an option plan permitting them either to itemize their State and local tax payments (as they can do now) or receive a tax credit for State and local tax payments in excess of __% of their net taxable income.	Persons in the low and middle tax brackets carrying above average State and local tax loads would receive the most benefit. Persons in the high tax brackets now enjoy a liberal write-off privilege through itemization.	No significant effect. 1/	The overall effect slightly more progressive because (a) low and middle income tax bracket taxpayers receive larger write-offs, and (b) State and local governments would be encouraged to place more reliance on income taxes in order to maximize tax credit possibilities.	More efficient than outright tax cut only to extent that tax credits overcome resistance to higher State and local tax rates. Much less efficient than sharing or grant approaches because direct aid is to taxpayers rather than to governments.	None	Federal role somewhat diminished--State and local governments somewhat enhanced because a more liberal write-off of State and local taxes could help to overcome resistance to higher State and local taxes.	The most efficient approach if the objective is to cut the Federal income tax while increasing the progressiveness of the tax system and maximizing indirect benefits of Federal tax reduction to State and local governments. However, it provides no benefit for persons at lowest income level with no Federal tax and renters could write-off State and local sales and income taxes but not the property tax. It has no significant equalization effect. 1/	Probable appeal for many political conservatives and moderates (a) as compromise position between straight Federal tax cut and plans calling for greater Federal aid to State and local governments and (b) as a tax reform measure placing all Federal income taxpayers in a better position to write-off "excessive" State and local tax payments. Despite its progressivity feature, this approach would probably be opposed by most liberals as inefficient when contrasted to direct forms of Federal aid to State and local governments.
TAX SHARING APPROACH--distribute to the States a designated percentage of the Federal tax revenue on the basis of collection.	None	High income States with high tax payments would receive the largest shares.	No marked change in the tax incidence picture unless Federal dollars actually replace State and local revenue sources. In that case, there is a slight progressive effect.	An efficient aid mechanism because States are left free to allocate the funds among competing needs. Local governments' benefit dependent on how they share in the funds.	None	Federal role diminished; States' role enhanced because these governments determine how funds would be spent.	The most efficient aid plan if the objective is to shift a part of the rising costs of State and local services to a nationwide income tax without reducing the States' established responsibility for allocating public funds among competing needs. The tax sharing approach ignores the equalization issue.	This approach would probably be opposed by most liberals because it tends to aggravate the fiscal disparity as between wealthy and poor States. Some difficulty may be encountered in proving that State and local fiscal needs warrant general purpose Federal support. Probably the third choice of most conservatives.
UNCONDITIONAL GRANT APPROACH--through a permanent Trust Fund, distribute among the States for general government purposes, on a per capita basis, an amount equal to 1% or 2% of the Federal income tax base (proposal of President's Task Force on Intergovernmental Fiscal Cooperation).	None	Moderately equalizing.	No marked change in the tax incidence picture unless Federal dollars actually replace State and local revenue sources. In that case, there is a slight progressive effect.	An efficient aid mechanism because States are left free to allocate the funds among competing needs. Local governments' benefit dependent on how they share in the funds.	None	Federal role diminished; States' role enhanced because these governments determine how funds would be spent.	The most efficient aid plan if the objective is to shift a part of the rising costs of State and local services to a nationwide income tax without reducing the States' established responsibility for allocating public funds among competing needs. The unconditional grant approach provides for a moderate degree of interstate equalization.	Because of its middle-of-the road position, it could pick up support from the left and the right as a compromise measure despite the novel character of this aid plan. Some difficulty may be encountered in proving that State and local fiscal needs warrant general purpose Federal support.
CONDITIONAL GRANT APPROACH--expand present type of conditional grant-in-aid programs to finance specific functions.	None	A mild to considerable effect depending on function aided and the factors cranked into equalization formula.	No marked change in the tax incidence picture unless need for State and local matching funds requires increases in regressive type taxes.	A fairly efficient aid mechanism. Both State and local governments are directly benefited but because of their specific expenditure focus, conditional grants tend to distort allocation of funds among programs.	Considerable	Federal role definitely enhanced in relation to State and local governments.	The most efficient aid plan if the objective is to help State and local governments to finance specific programs. While this approach has equalization possibilities, it tends to distort allocation of funds among programs.	Due to its Federal control and equalization possibilities this approach receives considerable political support from most liberals. Because of its time-tested character, it also enjoys a certain measure of general political acceptance not accorded to tax credit and unconditional grant proposals. Political conservatives can be expected to resist this approach since it would increase Federal involvement in State and local affairs and might preclude a Federal income tax cut.
DIRECT FEDERAL EXPENDITURE APPROACH--step up direct Federal expenditure for such programs as river and harbor construction projects; or launch new programs to deal with domestic problems of an interstate character, such as air pollution and mass transportation.	None	Mild to considerable effect depending on type of beneficiary and locus of expenditure.	No marked change in the tax incidence picture. Distribution of benefits for construction type projects likely to be less favorable to low income groups than expenditures on social purposes.	An indirect aid to the extent that direct Federal activity relieves State and local governments of the responsibility for financing the program. Far less effective than tax sharing or grant approaches.	Little or none	Federal role definitely enhanced in relation to State and local governments.	The most efficient approach if the objective is to bring direct Federal action to bear on the solution of a national domestic problem. From a State and local aid standpoint, quite inefficient.	Strong political appeal for liberals particularly if direct Federal expenditures fall in the social welfare category. Conservatives can be expected to oppose since it would increase Federal control on the domestic front and might preclude a Federal income tax cut.

1/ These shortcomings could be remedied and a significant degree of inter-area equalization could be effected by a system of negative tax credits (cash rebates) and allowances for imputed property taxes paid by renters.

prevailing view has come to accept the categorical or conditional grant as one important means of providing needed public services within the existing framework of cooperative federalism. For whereas the Joint Conference on Federal-State Tax Relations, the Hoover Commission, and the Joint Federal-State Action Committee by and large wanted to sharply limit or curtail Federal grants, and even undo some of the existing Federal, State, and local governmental interrelationships, the Kestnbaum Commission, the Fountain subcommittee, the Joint Economic Committee, and the Advisory Commission on Intergovernmental Relations have looked with favor upon the Federal grant device, with important suggestions as to how to improve them as, for example, through consolidation, and have adopted a more pragmatic and dynamic view toward the Federal system.[57]

Secondly, there are two interesting tendencies with respect to the fiscal plight of the States and local governments and alternatives to conditional grants. There is a growing awareness beginning with the Kestnbaum Commission that to achieve a balanced federalism and to offset the dangers of overcentralization the States and local governments must themselves take steps to strengthen their roles and must assume certain responsibilities. Toward this end, as the ACIR recommends, State and local fiscal reform and improvement in the State constitutions, local laws and administrative procedures are necessary. In other words, the States and localities should put their own houses in order.

Furthermore, in considering ways and means to achieve local fiscal reform and strengthen the States several of the government commissions have considered and rejected the revenue sharing solution. As we stated earlier, the Hoover Commission task force opposed block grants or revenue sharing on the grounds that utilizing national tax yields or block grants to finance local functions would tend to make the State more dependent upon the National Government for general revenues. It would, according to the Kestnbaum Commission relieve the States of fiscal autonomy. It will also be recalled that the Groves, Gulick, Newcomer Committee had arrived at similar conclusions. The reasoning of these commissions may serve to explain, at least in part, the recommendations of the Groves, Gulick, Newcomer Committee, the Joint Federal-State Action Committee, and ACIR to expand the estate tax credit concept,[58] and of ACIR for income tax credits, as well as ACIR's reluctance, so far, to propose revenue sharing or unconditional grants. However, it should again be noted that ACIR has been careful not to exclude by the income tax credit device additional ways by which the Federal Government could share its revenue or otherwise provide financial assistance to the States.

[57] See Daniel J. Elazar, 'The Continuing Study of the Partnership—The Publications of the Advisory Commission on Intergovernmental Relations," *Public Administration Review*, March 1966.

[58] The Groves, Gulick, Newcomer Committee discussed but did not specifically recommend the income tax credit. *Report on Federal, State, and Local Government Fiscal Relations*, pp. 448–451.

QUALITY OF AMERICAN GOVERNMENT*

A Message to Congress by President LYNDON B. JOHNSON

THE FEDERAL SYSTEM

Shaped by our Founding Fathers, the Federal system has withstood a test of time and experience they could never have foreseen.

It has been adapted to a complexity of government functions unknown and unanticipated in the simpler times of its creation.

Today the Federal system rests on an interlocking network of new relationships and new partnerships among all levels of government.

That structure is elaborate. It consists of 50 States, over 3,000 counties, 18,000 municipalities, more than 17,000 townships, and almost 25,000 school districts, all of which employ more than 7 million people with a monthly payroll of nearly $5 billion.

Every American is served through these units of government.

In shaping programs to meet the needs of modern-day America, several factors have emerged which have important consequences for our Federal system:

First, many of the problems we are dealing with are national in scope, requiring national strategies to attack them. But these problems exist in communities and neighborhoods, so their solutions must be tailored to specific local needs.

Because broad national strategy must be fused with local knowledge and administration, the Executive Branch and Congress have chosen to operate through the mechanism of the grant-in-aid. The 1968 budget provides $17 billion in Federal grants-in-aid to States and local governments. These range from old age assistance to infant care, from housing development to highway construction.

During the past 3 years, we have returned to State and local governments about $40 billion in grants-in-aid. This year alone, some 70 percent of our Federal expenditures for domestic social programs will be distributed through the State and local governments. With Federal assistance, State and local governments by 1970 will be spending close to $110 billion annually. As I said in my 1967 State of the Union Message, "these enormous sums must be used wisely, honestly, and effectively."

Second, attacking the major ills of our society—poverty, crime, pollution, and decay—requires the interaction of many agencies working together at different levels of government. Coordinating and marshaling their efforts is a demanding challenge.

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*Reprinted from H. Doc. No. 90, 90th Cong., first sess., **Quality of American Government**, message from the President of the United States, Mar. 20, 1967 (excerpts).

Third, many of the problems transcend established boundaries. Air and water pollution, for example, respect no State or municipal lines. Neither does mass transit—with commuters moving in and out of central cities and across different borders. Many of our programs, therefore, have resulted in new groupings and councils of old jurisdictions working together for the first time.

Careful study of these key factors reveals the need to strengthen the Federal system through greater communication, consolidation, consistency, and coordination.

1. Better Lines of Communication

This does not require an act of Congress. It simply requires an "open-door" policy—a willingness by all who participate in the adventure of cooperative government to sit together to discuss their common problems.

All levels of government must be able to communicate with each other more frequently and freely than they ever have before.

The door of discussion will always be open in the Federal Government to the mayor of every city and the Governor of every State.

I have invited and met with the Governors or substantial groups of them on at least seven separate occasions.

I have repeatedly assured each Governor that top officials of the Executive Branch stand ready to brief him and to visit his State Capital to discuss matters of mutual concern.

Over the past several weeks, a team of Government officials headed by Gov. Farris Bryant, Director of the Office of Emergency Planning, has accepted the invitations extended by 16 Governors and visited their State Capitals, where full and frank discussions with the Governors on the problems of Federal-State relationships have been carried on. Additional visits are planned in the weeks ahead.

I have extended invitations to the Governors of every State to come to the Nation's Capital this Saturday to meet with me and members of my Cabinet for discussions and briefings, and to exchange ideas on how the ties between the Federal Government and State and local governments can be strengthened.

In addition, *I have directed the heads of all departments and agencies to consult on a frequent and systematic basis with Governors, and mayors, and other local officials in development and administration of Federal programs.*

I have requested the Vice President and Gov. Farris Bryant, Director of the Office of Emergency Planning, to confer with State and local officials whenever problems of intergovernmental relati s arise.

2. Consolidation of Grant-in-Aid Programs

There are today a very large number of individual grant-in-aid programs, each with its own set of special requirements, separate authorizations and appropriations, cost-sharing ratios, allocation formulas, administrative arrangements, and financial procedures. This proliferation increases red-tape and causes delay. It places extra burdens on State and local officials. It hinders their comprehensive planning. It diffuses the channels through which federal assistance to State and local governments can flow.

There are several steps we should take to help remedy this situation.

The first step is to simplify procedures for grant application, administration and financial accounting.

A local health program, for example, may draw upon separate Federal grants-in-aid for child health, training of health personnel and mental health. Similarly a governor often wishes to focus several related Federal grant programs upon a single complex problem.

At the present time it is usually necessary for the Governor or mayor to submit separate applictaions and follow separate financial and administrative procedures for each such Federal grant.

Initially, we should make it possible, through general legislation, for Federal agencies to combine related grants into a single financial package thus simplifying the financial and administrative procedures—without disturbing, however, the separate authorizations, appropritaions, and substantitve requirements for each grant-in-aid program.

The development of a workable plan for grant simplification will demand careful preparation. The statutes involved are varied and complex.

I have instructed the Director of the Bureau of the Budget, in cooperation with the Federal agencies concerned and representatives of the States and local governments to form a joint Task Force to develop such a plan. The Task Force will report to me within one month. I will then submit to the Congress the necessary legislation to simplify our grant-in-aid procedures.

Beyond administrative and financial consolidation, and even more fundamental restructuring of our grant-in-aid programs is essential.

Last year's "Partnership for Health" Act pointed the way. With that measure Congress combined into a single package a number of health grants. It established for these activities a single set of requirements, a single authorization and a single appropriation.

I have requested the Director of the Bureau of Budget to review the range of Federal grant-in-aid programs to determine other areas in which a basic consolidation of grant-in-aid authorizations, appropriations, and statutory requirements should be carried out.

As that review is completed, I will seek the necessary legislation to combine and modernize the grant-in-aid system, area by area.

3. Consistency and Coordination

Each major Federal department and agency works through a series of regional or field offices. These offices are the vital links between Washington and people in States, cities and townships across America. Whether our programs are effective often depends on the quality of administration in these field offices.

Yet, for all their importance, there has been only infrequent critical analysis of their roles and performance.

The cause of intergovernmental cooperation is poorly served when these offices are out of touch with local needs, or when their geographic boundaries overlap or are inconsistent.

I have asked the Director of the Bureau of the Budget to undertake a comprehensive review of the Federal field office structure and to develop a plan to assure the most effective use and location of these offices.

I have asked him to recommend a plan for the restructuring of these offices, and I hope to incorporate the first steps of this plan in my next budget message.

STATE AND LOCAL ACTION

Our Federal system is strong. It is the best instrument we have—or any nation has ever had—for joint action.

If we observe strains in the workings of that system, they are natural consequences of the great stirring of governmental action at all levels to cope with acute problems. When governments do nothing, when they are oblivious to the needs of the times, there is an illusion of order. It is an illusion both costly and disastrous.

But to survive and serve the ends of a free society, our Federal system must be strengthened—and not alone at the national level.

Some State and many local jurisdictions maintain planning, budgetary and statistical systems unchanged since the 19th century. Obsolete and arbitrary fiscal restraints increase pressures for Federal action in areas where State and local communities themselves should assume responsibility.

I particularly urge Governors and mayors to take advantage of the channels of communication which I mentioned previously. I urge the Governors to utilize that provision of the Model Cities Act which encourages, and helps to finance, the establishment of State centers for information and technical assistance to medium-sized and smaller communities.

Two years ago, discussing the challenges which the improvement of our society poses, I said, "The solution to these problems does not rest on a massive program in Washington . . ." I repeat those words today, with an emphasis even stronger.

No nation so great as ours can develop the society its people need if the Federal Government evades its responsibility. This Government has not and will not. But neither can such a nation hope to succeed on the strength of Federal action alone.

We began as a nation of localities. And however changed in character those localities become, however urbanized we grow and however high we build, our destiny as a nation will be determined there.

Just as the effectiveness of every law must be gauged by its administration, many programs must succeed—or fail—in the local health department or school board or urban renewal office or community action agency which turns it from plan to performance.

VIEWS OF FEDERAL OFFICIALS: FEDERAL AID AND FEDERALISM

BY RICHARD F. KAUFMAN*

1

The views of Federal officials on the Cabinet and subcabinet level have been remarkably consistent regarding the basic assumptions of the Federal system, its present strengths and weaknesses, and the implications of Federal aid programs to the States and local governments.[1]

There is general agreement, for example, on the desirability of preserving the division of authority within government, on maintaining our pluralistic system of democracy, and on the dangers of overcentralization.

Secretary of Labor Willard Wirtz believes that our structure of government was "devised deliberately to distribute and divide up public authority, partly to avoid the dangers which attend its concentration"[2] and that, indeed, "it was a very good thing to divide up authority in a good many ways within the Federal Government and also between the Federal and State Governments, and within the States for, among other things, the deliberate purpose of being sure that it wasn't so efficient that it would corrupt the power which was involved."[3]

Secretary of Health, Education, and Welfare John W. Gardner holds that our system is "characterized by dispersed power and initiative."[4] But, he adds, "If we want pluralism in the system—and I assume we do—we are going to have to build it in consciously and systematically. The logic of modern organization does not necessarily move us toward pluralism—in some cases, it may move us away from it."[5] Charles L. Schultze, Director of the Bureau of the Budget, carries this thought further by saying, "To be effective we must decentralize."[6]

There is also a consensus among Federal officials on the executive level that recent patterns of Federal expenditures in States and localities have given rise to certain administrative and intergovernmental problems—problems which are perhaps inevitable in a system as

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*Staff economist, Joint Economic Committee. The views expressed are those of the author and do not necessarily represent the views of the Joint Economic Committee or individual members thereof.

[1] Senate Subcommittee on Intergovernmental Relations, Committee on Government Operations, hearings on *Creative Federalism*, U.S. Senate, 89th Cong., second sess., 1966.
[2] *Ibid.*, p. 243.
[3] *Ibid.*, p. 235.
[4] *Ibid.*, p. 268.
[5] *Ibid.*, p. 268.
[6] *Ibid.*, p. 389.

complex as ours. The major problem areas identified include the following:[7]

(1) There is some lack of coordination in the administration of aid programs between departments and agencies on the Federal level.

(2) The numerous, narrow categorical Federal grant and loan programs have led to complexity and fragmentation.

(3) There is a need for improved communication among Federal, State, and local levels of government, and for greater information at the State and local level about what the Federal Government is doing.

(4) The States and local governments must act to coordinate Federal efforts with its own resources and needs.

(5) There is a serious shortage of trained manpower in State and local governments.

These problems, however, are not viewed as either insoluble or having placed an undue strain on the Federal system. Several recent steps and innovations are cited as evidence of reasonable adjustment on the Federal level to the growing complexity of Federal aid programs. Secretary of Housing and Urban Development Robert C. Weaver states that the Federal Government is evolving a "new strategy" to control the fragmenting and disorganizing forces: "The heart of this strategy is to achieve coordination and cooperation at the first stage of planning and mobilization of effort, to diagnose and fashion solutions to the problems." And, "The model or demonstration cities program is at the center of this new strategy to bring wide ranging Federal response to a city's needs to remove physical blight and to provide an array of social welfare efforts."[8] Secretary Weaver points out that under the Model Cities program, a number of existing grants-in-aid are brought together and supplemented by additional grants "to help communities plan and carry out comprehensive demonstrations covering entire neighborhoods."[9] The creation of HUD itself is cited as an action by the Federal Government to improve coordination of aid programs on the national and the intergovernmental levels.[10] Other examples of recent efforts toward better coordination of Federal urban programs at the national level include promulgation of the "Convener Order" signed by the President in 1966, requiring the Secretary of HUD to "exercise leadership at the direction of the President in coordinating Federal activities affecting housing and urban development."[11], and the establishment within HUD of the Office of Intergovernmental Relations and Urban Program coordination. The 701 planning and assistance programs illustrate the impetus that has been provided by HUD toward intergovernmental coordination in the States and metropolitan areas.[12]

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[7] *Ibid.*, pp. 88, 93 (Secretary Weaver), 131 (Under Secretary Wood), 143 (Deputy Director Harding), 260 (Secretary Wirtz), 272–273 (Secretary Gardner), 320–322 (Secretary Udall), 354 (Secretary Connor), 390–393 (Schultze).

[8] *Ibid.*, p. 88.

[9] *Ibid.*, p. 88.

[10] *Ibid.*, p. 92.

[11] *Ibid.*, p. 106. See also, Executive Order 11297, Aug. 11, 1966. In a statement made upon signing the order, President Johnson said: "This order will help the Secretary of Housing and Urban Development insure better coordination of Federal programs for our urban areas. It authorizes the Secretary to take the initiative by convening special meetings and special working groups within the Government—in Washington and in the field—to cope with problems as they arise."

[12] *Ibid.*, pp. 99–103.

Both the Department of Labor and the Department of Health, Education, and Welfare have taken steps to improve departmental coordination and interdepartmental cooperation in the carrying out of major grant programs. Secretary Wirtz states that the establishment in 1966 of the Assistant Secretary for Manpower position provides overall executive direction and leadership with the Department of Labor for the many manpower programs it is responsible for.[13] One of the major manpower programs, under the Manpower Development and Training Act, is operated jointly by Labor, which determines worker needs, selects persons for training, pays training and subsistence, and places trained workers in jobs, and HEW, which provides occupational training.[14] The President's Committee on Manpower [15] facilitates interdepartmental cooperation among the Departments of Labor, HEW, Defense, Interior, Agriculture, the Office of Economic Opportunity, and others, in appraising national manpower requirements and resources and in developing new programs.[16] However, Secretary Wirtz concedes that the committee has not yet succeeded in effectively coordinating all Federal manpower programs.[17]

In HEW a number of categorical grant programs in the field of health have been consolidated under the Comprehensive Health Services Act of 1966. HEW Secretary John W. Gardner [18] and Bureau of the Budget Director Charles L. Schultze [19] consider this to be a major step forward. Secretary Gardner states that the best example of cooperation at the Federal level is the way the Public Health Service has worked with the Social Security Administration on Medicare.[20] Interdepartmental cooperation is also achieved with HUD through a joint task force and with Labor and OEO through regular meetings between Secretary Gardner, Secretary Wirtz, and Mr. Shriver. Because of the ineffectualness of the interdepartmental committee device, informal day-to-day contact is preferred, according to Secretary Gardner.[21] On the State and local level, the Division of State Merit Systems whereby States have been encouraged to upgrade their public personnel practices and the new program of grants to universities for the training of State and local personnel are considered highly successful.[22]

Stewart L. Udall, Secretary of the Interior, emphasizes the soundness of the "old-line", mature grant-in-aid arrangements such as Federal aid for highways and the mapping work done by the Geological Survey, and states that it is common and normal to find difficulties in the administration of any grant-in-aid program in its early years of operation.[23] These problems, which may result from rivalries between agencies or overlaps of jurisdiction, are capable of being solved "only by hard, patient and persistent effort." [24] A successful example of interdepartmental cooperation recently worked out may be found in

[13] *Ibid.*, p. 246.
[14] *Ibid.*, p. 247.
[15] Established by Executive Order 11152, Apr. 15, 1964.
[16] *Creative Federalism, op. cit.*, p. 239.
[17] *Ibid.*, p. 258.
[18] *Ibid.*, p. 284.
[19] *Ibid.*, p. 395.
[20] *Ibid.*, p. 278.
[21] *Ibid.*, p. 274.
[22] *Ibid.*, pp. 269, 274.
[23] *Ibid.*, pp. 319–320, 340.
[24] *Ibid.*, p. 341.

the Open Space program of HUD and the Land and Water Conservation Fund of the Department of the Interior. After some struggle, a coordination mechanism was devised for the operation of these two recreation programs.[25] While the five existing water pollution programs present a more serious problem, it too can be resolved only by a high degree of coordination, not by any simple reorganization, Secretary Udall states.[26]

Former Secretary of Commerce John T. Connor and BOB Director Schultze similarly stress the importance of interdepartmental cooperation and improved planning to meet the management challenge in administering Federal aid programs.[27] Mr. Schultze also points out that while Federal aid programs were originally grouped according to major purpose within a limited number of executive departments to achieve coordination by the department head, the recognition that some needs cannot be met by uniform national programs has prompted the development of a multijurisdictional method. Thus, a number of functional programs may be deployed to solve the problems of poverty, the ghetto, economic development, and rebuilding the Nation's cities, in addition to major reorganizations such as the creation of HUD and the Department of Transportation.[28] Further, a more systematic approach to Federal budgeting and decisionmaking has been introduced to all departments and agencies; namely, the planning, programing, and budgeting system (PPBS).[29]

Mr. Connor and Mr. Schultze have also singled out the need for State and local reform in order for Federal programs to have their greatest beneficial impact. Mr. Schultze has stated: "There are major problems which stem from deficiencies in the capabilities of State and local governments to manage federally aided programs." [30] The need for changes in State and local laws and governmental structures, and for better coordination at the State and local level, have been emphasized by Secretary Weaver [31] and HUD Under Secretary Robert Wood,[32] OEO Deputy Director Bertrand M. Harding,[33] Secretary Wirtz,[34] Secretary Gardner,[35] and Secretary Udall.[36]

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It may be seen that Federal officials at the highest level take, for the most part, an optimistic view of the future of federalism. While most do not address themselves to fiscal federalism as such, the implications of what they have to say about grant programs and the Federal system has obvious fiscal significance. In their view, both the Federal role *and* the State and local role will continue to grow. A balance between these levels of government needs to be maintained for the preserva-

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[25] *Ibid.*, pp. 320–321, 340.
[26] *Ibid.*, p. 338. The five water and sewer loan and grant programs are contained in the following acts: (1) the Federal Water Pollution Control Act, administered by the Department of the Interior, (2) the Appalachian Regional Development Act, administered by the Appalachian Regional Commission, (3) the Public Works and Economic Development Act, administered by the Department of Commerce, (4) the Consolidated Farmers Home Administration Act, administered by the Department of Agriculture, (5) the Housing and Urban Development Act, administered by HUD.
[27] *Ibid.*, pp. 354, 395–399.
[28] *Ibid.*, p. 394.
[29] *Ibid.*, pp. 354, 396, Secretary Gardner also stressed this, p. 273.
[30] *Ibid.*, p. 393.
[31] *Ibid.*, pp. 87–88.
[32] *Ibid.*, p. 131.
[33] *Ibid.*, p. 218.
[34] *Ibid.*, p. 240.
[35] *Ibid.*, p. 273.
[36] *Ibid.*, pp. 342–344.

tion of our pluralistic and democratic system, and for the attainment of national objectives and the satisfaction of local needs. All would probably agree with Secretary Connor's statement that: "There is a basic problem within the Federal Government structure of reconciling the broad objectives of Government—economic growth, maximum employment, higher standards of living—with the more specific objectives of individual programs in meeting the needs of States and local communities." [37] There is, too, recognition of present difficulties as a result of the impact of Federal expenditures in States and local communities, some of which are inherent in the nature and sheer complexity of the Federal system. Admittedly, there is "overlapping and duplication and lack of coordination." [38] This is considered, however, one of the tradeoffs for federalism, and "not too high a price to pay for the finest system of government in the world." [39]

Overcentralization is thought to be a greater problem and a greater danger. In recent decades the American people have strengthened the Federal Government in order to achieve their national objectives. But, as Secretary Gardner has said: "They have never intended (and do not now intend) that their Federal Government should become all powerful." [40] Most Federal officials would probably agree with that statement as well as with Secretary Gardner's analysis of the choices that lie ahead with respect to the future of federalism. He sees three possibilities: (1) the complete subordination of State and local governments, making them mere branch offices of one all-dominating National Government; (2) the creation by the Federal Government of its own network of local instrumentalities, outside the structure of State and local governments, by establishing separate federally financed programs or agencies, making State and local governments vestigial; (3) strengthening State and local government so that it may enter into a healthy partnership with the Federal Government.[41] The third choice is Secretary Gardner's conception of "creative Federalism" and his and undoubtedly most other Federal officials' preference.

The incremental or piecemeal approach to "creative Federalism", as opposed to radical reorganization and reform, is the most widely acceptable. Thus, Secretary Udall prefers "hard, patient and persistant effort" over "simple reorganization", Secretary Gardner sees the old system giving way while a "newer system is invented piecemeal", [42] and both Harding and Schultze view the problem primarily as one in which gaps need to be filled as they appear.[43] Mr. Schultze views the Federal structure as having evolved from an earlier model in which there were two main types of Federal activities, (1) nationwide direct Federal programs such as national defense, agricultural price supports, and veterans' benefits, and (2) formula grants to States for such purposes as highways and public assistance, to the present model which includes the earlier forms of activities plus the new programs whereby the Federal Government (1) directly participates in specific projects in States and communities, (2) acts as a coequal partner with

[37] *Ibid.*, p. 354.
[38] *Ibid.*, p. 243 (Secretary Wirtz).
[39] *Ibid.*, p. 218 (Deputy Director Harding).
[40] *Ibid.*, p. 272.
[41] *Ibid.*, p. 271.
[42] *Ibid.*, p. 272.
[43] *Ibid.*, pp. 217, 389.

the States and local governments in carrying out those projects, and (3) may work with a number of local governments organized into special groups.[44] Model Cities, the Community Action Program, and the Appalachian program characterize the more recent types of Federal activities.

To achieve "creative Federalism" Federal officials would urge more of the corrective action already underway, in addition to the newer kinds of activities—that is, improvement and consolidation of grants-in-aid, departmental reorganization and better coordination and interdepartmental cooperation on the Federal level, improved budgeting and decisionmaking capacity, more effective intergovernmental communication, a more adequate Federal field structure, better coordination of planning jurisdictions and boundaries, improvement in the collection of statistics, elimination of delays in processing and funding applications for Federal assistance; and on the State and local level, better interagency cooperation, changes in State constitutions, laws and local ordinances, and correction of the manpower deficiencies.

On the specific issue of revenue sharing and other alternatives, only a few Federal officials in the executive branch have expressed themselves publicly. Budget Director Schultze has indicated his opposition to unconditional block grants to the States on the grounds that while overcategorization of grants-in-aid should be avoided, there is some value in the impetus provided by the specific requirements attached to Federal grants, and that a solution to the problem might lie somewhere between "just shoveling the money out in buckets, on the one hand, or shoveling it out in teaspoonfuls on the other." [45] This view is most likely representative of other Federal officials. Vice President Humphrey stated a similar one in a speech in 1966 in which he cautioned against oversimplifying the revenue-sharing concept, said that any such program would have to include proper standards and safeguards, and that the Federal Government could not just ladle out money to prop up weak, obsolete and ineffective State and local governments.[46] In an interview in 1964 the then Secretary of Commerce, Luther Hodges, strongly opposed revenue-sharing, stating "It would be very silly to give money to the States on any unconditional basis." [47] Secretary of the Treasury Henry H. Fowler has taken a more neutral position. Secretary Fowler, a member of the Advisory Commission on Intergovernmental Relations, expressed the following reservation at the time that the Commission formally recommended a partial tax credit for State income tax payments:

> I have not voted on this recommendation. At the present time I am clear I cannot vote in favor of it. But since important issues are involved, I do not desire to vote against it. I would prefer that that matter be given wider study and discussion. It represents in effect a method of providing Federal financial assistance to State and local governments. Alternative methods to this end have been suggested by others. All of these alternatives involve a very substantial commitment of Federal funds and for that reason require careful public discussion.[48]

[44] *Ibid.*, p. 388.
[45] *Ibid.*, pp. 410–411.
[46] *New York Times*, Nov. 20, 1966.
[47] *Washington Post*, Dec. 10, 1964.
[48] *Federal-State Coordination of Personal Income Taxes* (Report A–17, October 1965), p. 19.

Orville L. Freeman, the Secretary of Agriculture, and Robert Weaver, then Administrator of the Housing and Home Finance Agency, also members of the ACIR in 1965, did not dissent or otherwise indicate disagreement with the Commission's recommendations on tax credits and presumably approve of them.

FEDERAL EXPENDITURES TO STATES AND REGIONS: A STUDY OF THEIR DISTRIBUTION AND IMPACT*

BY SENATE COMMITTEE ON GOVERNMENT OPERATIONS

(1) FOREWORD

*   *   *   *   *   *   *

During the past three decades, concern for the hard-pressed financial position of the States and their localities has resulted in the adoption of a wide variety of Federal financial aids. This assistance has largely taken the form of categorical grants whose distribution is limited by criteria which fail generally to consider their total economic impact on States or regions affected.

A growing body of research, including this report, indicates that the impact of Federal spending on the economies of the several States or regions cannot be assessed merely by examining separate grant-in-aid programs or the total of Federal-aid payments. Other categories of Federal Government expenditure may have greater economic impacts. The geographic distribution of expenditures under Defense and NASA programs tends to increase economic inequalities among States. On the other hand, distribution of other types of Federal spending, such as aid for highways, education, public assistance, and the like tends to reduce inequalities.

All these regional effects are more or less fortuitous. They result, in large measure, from defense and defense-related procurement policies on a "least cost" basis, and from specific program-oriented criteria contained in individual grant legislation. Little attention has been paid to the possibilities for coordinating these broad sectors of Federal spending as a policy objective. And little information is available concerning ways of reallocating Federal expenditures to achieve a more rational distribution, should major adjustments in defense needs occur or should national policymakers attempt to achieve a great equalization of the regional impact of overall Federal spending.

Reliable estimates of the effects of Federal spending on State or regional bases, however, are difficult to obtain. Many agencies do not report or account for expenditures on a geographic basis; few report such distribution in a timely, comprehensive, and uniform manner. In the case of defense expenditures, primary contract awards are reported on a geographic basis, but adjustments are not made for

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*Reprinted from *Federal Expenditures to States and Regions: A Study of Their Distribution and Impact*, Subcommittee on Intergovernmental Relations, Committee on Government Operations, U.S. Senate, 89th Cong., second sess., June 29, 1966. This study was directed and prepared by Dr. Arnold H. Raphaelson. The selections are from (1) the Foreword of Senator Edward S. Muskie, Chairman of the Subcommittee, (2) the concluding chapter of the study, and (3) the individual views of Senator Jacob K. Javits.

subcontracting or the outside purchase of components and materials. Moreover, no continuous system exists for coordinating what information there is on geographic allocations.

The Secretary of the Treasury does provide an annual report on payments to States and local governments and some types of payments to individuals. The Office of Business Economics of the Department of Commerce estimates, on a calendar year basis, payments of wages and salaries to Federal Government personnel residing in each State. But no system combines these reported data. Consequently, while the estimates in this study may be compared with those of other impact studies, there are no clear standards against which their validity can be checked.

This study's tentative findings no doubt will be considered in the light of growing concern with the fiscal problems of State and local governments. They should be assessed in light of demands for a more equitable distribution of Federal spending. They should be examined in conjunction with revenue sharing, block grants, and tax credit proposals. Finally, these findings suggest a number of steps which should be taken preparatory to the development of national economic policies that would give proper emphasis to the regional impact of Federal expenditures.

> First, new procedures should be introduced for the systematic collection of data on geographic distribution of all Federal expenditures;
>
> Second, computerized models should be developed for using these data and for identifying those factors that actually influence the composition and growth of State and regional economies;
>
> Third, debate on such measures as shared tax revenues and block grants should not focus merely on Federal grant outlays but should assess the whole broad range of Federal expenditures in States and local areas;
>
> Fourth, national economic planners should carefully reexamine the failure of more than half of the existing grant-in-aid programs to include explicit fiscal equalization provisions (the distribution of their moneys and the proportionate Federal-State sharing of program costs being governed, to some extent, by a recognition of the States' relative fiscal capabilities to support these programs). This reassessment is necessary in light of the fact that high per capita income States enjoy a proportionately higher advantage under DOD, NASA, and related defense disbursements;
>
> And finally, changes in the overall composition of defense needs—as well as technological changes in defense requirements—can, without proper forewarning and appropriate adjustment measures, produce severe dislocation in the economies of areas where such expenditures exert a significant impact. The 1965 Report of the Committee on the Economic Impact of Defense and Disarmament underscored the need for adequate planning in this area.

For these and other reasons continued study of the impact of Federal expenditures on regional and State economies appears to be of paramount significance.

*   *   *   *   *   *   *

(2) CONCLUSIONS

National economic policy today, in effect, represents a group of decisions designed to implement a wide range of national goals. These decisions are not part of an integrated national planning process; differing forces shape them in our pluralistic and political system. Yet, insofar as these decisions may be thought to constitute a national economic policy, Federal spending so generated has a substantial influence on the Nation's economy.

In the years examined in this study, Federal expenditures in the national income accounts were in excess of one-sixth of the gross national product. While this proportion may vary in the future with the rate of growth in the national economy and with the scope of Federal activity, it seems likely that Federal fiscal policy will continue to exert a considerable influence on State and regional economies. Moreover, the advent of new Federal responsibilities has increased the importance of Federal expenditures and grants to the States.[1]

The total impact of Federal fiscal policy is not, however, evenly diffused over the Nation. The analysis described in chapter II shows clearly that different categories of Federal spending vary in their growth patterns and in their impact upon the different States and regions. Total allocated expenditures rose from $56.3 billion in 1957 to $88.6 billion in 1963, an increase of 57.4 percent; this increase included a rise of 29.2 percent for civilian and military wages and salaries (from $18.5 to $23.9 billion) and a rise of 112.8 percent for aid to States and localities (from $3.9 to $8.3 billion). These differences in rates of increase for the categories of Federal expenditures reflect shifts in the relative importance of some functions. Transfer payments and aid to States, for example, grew faster than the total; defense procurement increased at about the same rate as the total. Federal wage and salary payments and aid to individuals, on the other hand, grew at much slower rates.

Partly as a result of these changes in the proportions of various categories, Federal expenditures grew more for some States and regions than for others. For example, in New England the growth in total allocated expenditures from 1957 to 1963 with 60.3 percent, well above the national average. This largely reflected the sharp increase in aid to individuals (146.6 percent) and aid to States and localities, and occurred despite below-average increases in every other category except transfer payments. But in Maine, the rise was 30.6 percent (little more than half the regional growth rate); increases in direct Federal payments to individuals other than for wages and salaries, and in aid to States and localities, were in part offset by declines in defense procurement and military reserves and civial works.

Changes in the growth of expenditure categories and shifts of emphasis within categories produced a varied impact of Federal spending over the Nation. California, with 12.7 percent of total allocated expenditures in 1957, had 14 percent in 1963, while New York's share (the next largest in both years) declined from 8.9 to 8.4 percent.

[1] Morris A. Copeland, "Trends in Government Financing," a study by the National Bureau of Economic Research (Princeton: Princeton University Press, 1961), pp. 102, 103.

Alaska's share declined from 0.5 to 0.4 percent over this period, while Utah's rose from 0.5 to 0.8 percent. These disparities, then affected both large and small States as well as those with obviously different types of economies. There were substantial variations in the amounts of expenditure in each State and region in these years, and there were also substantial differences in the changes in total allocated expenditures and spending in each category over this period.

The analysis of the distribution of Federal expenditures in chapter II was not designed to demonstrate that the allocation of national spending among the States is appropriate or inappropriate. To determine the desirability of a particular distribution, it is necessary to examine the relevant decisions affecting Federal spending in different regions. A basic decision, such as a budgetary ceiling, might not be relevant to the geographic distribution unless such a ceiling limits programs of special regional importance. Secondary decisions on uses of Federal spending involve more direct factors in the determination of geographic patterns.

Certain legitimate kinds of Federal spending can exert a strong influence on the pattern of expenditures. An example is the purchase of natural resources, such as coal, iron, or oil; obviously only States and regions endowed with them can meet the demand for these resources. States without these resources feel the impact of such spending indirectly, if at all.

Equally important, the scope of certain Federal programs—as a practical matter—is limited to particular States or areas. Agricultural subsidies, for example, will go only to States where certain surplus crops are raised. More public assistance will go to States with greater numbers of the poor (even if average income is higher).

Certain functions of Federal spending, then, affect some areas more than others. Still, other choices among programs leave room for alternative decisions that affect the geographic distribution of funds. For example, once program allocations are made, subsequent market or Government decisions concerning where such goods and services will be produced frequently are required. Many of these decisions are based largely on competitive bidding. Others are determined on the current ability to produce the desired goods and services, and contracts are negotiated on that basis. Location of Federal facilities may be involved. Most of these decisions result in production in existing facilities, so that a change in program requirements causes a geographic reallocation of expenditures. Finally, many intergovernmental expenditures involve local initiative and other local factors in determining the distribution of Federal outlays.

Thus, many decisions, affecting the distribution of the economic impact of Federal expenditures, are determined by diverse criteria that result in an uneven distribution of funds. Except in the equalizing grant formulas, the subsidy programs, new regional aid programs, and the selection of public works construction, the desire to minimize costs dominates procurement patterns, wage and salary payments, and other Government expenditures.

The treatment of the geographic allocation in chapter II serves as a reasonable estimate of the impact of these expenditures upon the States and regions. Comparisons with the results of other studies in appendix B corresponds with those reported by others, even when different methods were used. Future Government accounting practices may well refine these allocation methods, and yield more information than currently reported data on prime contracts.

A more meaningful consideration of the impact of these expenditures requires its assessment in terms of the economic differences among regions. The most reliable data on interstate and interregional differences involve population and personal income. These factors, along with per capita income, were related in chapter III to the allocation of Federal expenditures.

Total personal income in a State or region is an indicator of the dimensions of the local economy. Between 1957 and 1963, personal income rose in all States and regions. Comparison of the 1957 distribution of personal income with that in 1963 revealed few significant changes in State and regional shares of the national total. But the changes that did occur highlight substantial differences in the economic development of these areas. Arizona's share, for example, rose from 0.6 to 0.7 percent of the national total between 1957 and 1963; this resulted from an increase in total personal income of 70.4 percent, more than twice the national average increase of 33.9 percent. In contrast, Rhode Island's share fell from 0.5 to 0.4 percent, despite an increase of 18.6 percent in personal income. Relatively minor shifts in shares of regional income, then, reflect major differences in rates of economic growth.

The distribution of population growth also exhibited wide variations. While Nevada's population rose by 51.4 percent, West Virginia's fell by 3.8 percent. Many States, notably those in the Plains region, were relatively static.

Differences in distributions of population and personal income are reflected in the levels of per capita personal income. The national average in 1957 was $1,967, as compared with $977 for Mississippi and $2,685 for Connecticut. The rise in Mississippi over this period was 35.9 percent, one of the highest in State increases in per capita income in the Nation and nearly three times that for Connecticut. But in 1963, average per capita personal income in Mississippi, at $1,328, was still less than half that of $3,041 for Connecticut. Despite some narrowing of differentials, then, there were still significant variations in the average economic well-being of the States.

There were also wide disparities among the States in the levels of per capita allocated Federal expenditures. Alaska and the District of Columbia were both very high—more than three times the national average. In 1957, the range for the other States was from $189 for Wisconsin to $595 for Maryland and $641 for Hawaii. But by 1963, Mississippi had the lowest level of per capita allocated expenditures ($324), despite a growth of 53.6 percent, while Maryland, with $761, had risen by only 27.9 percent.

The final measure examined in chapter III was Federal expenditures in the national income accounts as a percentage of personal income. This extrapolation of State and regional shares of Federal expenditures was related to personal income for each State and region. Again, significant disparities appeared, even when Hawaii, Alaska, and the District of Columbia were excluded. High percentages for Maryland and Virginia reflected the importance of the National Capital. Contrasts appeared among other States; Michigan's percentage was less than half that for the State of Washington in each of the sample years.

In examining the relationship between per capita personal income and the percentage of personal income to Federal expenditures, no apparent connection was found; nor was there any apparent trend in changes over the sample years. Instead, the percentage rose in some States and declined in others. However, different statistical techniques developed by other researchers, described in chapter IV, established some clear associations.

The purpose of this study was to provide an analysis of Federal expenditures that would permit estimates of the impact of these expenditures on State and regional economies. This impact was gauged by population and income measures for recent years. Empirical research in chapters II and III provided the basis for the findings described in chapter IV and suggest the following tentative findings:

(1) A strong, direct relationship appears between Federal expenditures and population—States with more people tend to receive more Federal expenditures.

(2) Overall, a strong, direct relationship exists between personal income and Federal expenditures—States with more personal income tend to receive more Federal expenditures.

(3) Direct associations appear between per capita personal income and total Federal expenditures, as well as between per capita income and spending in the categories for Defense and NASA procurement, civilian and military wages and salaries, and transfer payments. However, after allowing for the impact of other Federal expenditures, an inverse relation was found between per capita personal income and per capita expenditures for military reserves and civil works, for direct Federal payments to individuals other than wages and salaries, and for grants to States and localities.

(4) Although richer States tended to receive more Federal expenditures in general—and Defense expenditures in particular—poorer States tended to receive more per person in direct Federal payments to individuals other than wages and salaries, in grants to States and localities, and in spending for military reserves and civil works.

(5) These relationships for the categories of Federal expenditure existed in each of the years examined, and tended to change very little over the 6-year period.

(6) No drastic change was evident in the pattern of the geographic distribution of population, personal income or Federal expenditures. State and regional shares also changed little, but small changes in these shares reflected major shifts in the nature of economic activity in these jurisdictions.

Some of these findings serve largely to reinforce those of other studies. For example, the close association between the distribution of population and personal income described in chapter IV simply corroborates a similar conclusion reached by Robert E. Graham, Jr. He found that since 1948 differences in regional population growth have been the major force in the changing geographic distribution of total income.[2]

[2] Robert E. Graham, Jr., "Factors Underlying Changes in the Geographic Distribution of Income," *Survey of Current Business*, vol. 44, No. 4 (April 1964), p. 30.

This persistence in differences between poor and rich States, however, was not caused wholly by shifts in population. In some areas, per capita income seemed less related to population than to the industrial mix or to changes in the regional share of the national total in each of the region's industries.[3] Thus, a region with only an average population growth may experience greater-than-average increases in per capita income if the region shows any industrial growth.

The responsiveness of regional levels of per capita income to economic factors has obvious meaning for Federal expenditures policy. Federal civilan and military wages and salaries constitute an important growth element in the industrial mix of every State and region. Yet the distribution of regional shares of these expenditures was associated with more rapid growth in some regions, such as the Southwest, and below average growth in others, such as the Great Lakes region. Regional shares of direct Government activity, then, have a measurable impact on regional income. Other Government expenditures (especially the purchase of goods) have an influence on the industrial mix, which in turn affects economic growth.[4] Within the shifting patterns of defense procurement, resulting from changes in weapon systems, this has had the most important single influence on the industrial growth in certain areas affected by the shift from conventional hard goods (such as vehicles and weapons) to missiles and electronics.[5]

Government expenditure policies, then, can affect both the industrial mix of an area and the area's regional share of national economic activity. But other factors are involved.

First, some of the direct activities of Government involve a range of choices and political as well as administrative discretion. On the one hand, expenditures for postal service salaries must be related to population and other determinants of the amounts of business done in each area; here there is little discretion. On the other hand, location must be a factor in program decisions on public works; and it may be involved in decisions concerning military activities, veterans' hospitals, and urban renewal. Such location decisions directly involve the regional shares of total Government activity. They may also affect the industrial mix in some areas, particularly where Government activity is a substantial proportion of the sources of employment and income.

Second, new or modified types of Federal spending condition the national industrial mix. As noted above, the change in Defense weapons systems had this effect. Without any change in regional shares in the industries affected, such shifts alter the patterns of regional income distribution, since initial locations of the industries and their rates of growth are affected.

These two factors must be considered if one of the goals fo Government policy is to achieve a greater equalization of regional levels of per capita income.[6] Such a goal would compensate in part for differ-

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[3] *Ibid.*, p. 32.
[4] *Ibid.*, pp. 27 and 29.
[5] *Ibid.*, p. 23.
[6] Progressive taxation of income is geared to this objective as well as to the equalization of disposable income within the States and regions.

ences among the States with respect to the need for public goods and services or for transfer payments, as well as for the need for additional sources of income. The need for public goods and services roughly approximates population—with the differences in the composition and density of population in States accounting for some variations. Equalization, then, seeks to provide equal access to public services and economic opportunities.

Federal expenditures for equalization purposes must be related to other public and private expenditures. In this context, then, Federal spending has a twofold purpose: (1) to influence private expenditures by purchasing an area's goods and services, and (2) to supplement State and local government expenditures in providing public goods and services and transfer payments. Therefore, greater equalization can be achieved through a more informed and conscious distribution of Federal expenditures and payments.

A full-fledged Federal equalization policy would involve a definite shift in emphasis among the categories of Federal expenditures. Such a policy would result in the expansion of three categories—aid to individuals, grants to States and localities, and spending for military reserves and civil works—since these were shown to offer more expenditures per person to the poorer States.

In addition, a broad-gage equalization effort would have to take account of shifts in expenditures within the other categories affecting low-income regions. Such recognition might require the application of substitute sources of income to adjust income levels of the area. Such substitution could be achieved by expanding the three equalizing categories. Further, within the grant-in-aid categories, more specific recognition (in either the apportionment or matching formulas, or both) of the equalization factor should be provided in the many Federal grants that now rely primarily on population to achieve this effect. Finally, the mechanism for direct activity or procurement might include criteria to favor low income regions. For example, an area in which income from military salaries declines because of the closing of a base might be given some compensatory preference.

A national economic policy geared to achieving greater income equalization obviously would be premised on the maintenance of high levels of national employment as a primary goal, and require the optimal use of the resources of each State and region. When the national economy is at or near full employment, a policy of promoting more rapid growth for poorer States and regions need not imply adverse rates of growth for the richer areas. To some extent, migration from poorer areas may decline if alternative economic opportunities are present. When employment is high, such a policy would permit the poor areas to share in national prosperity. During periods of unemployment, however, the effort to improve the welfare of the poor areas might conflict with the needs of the richer States and regions. This conflict would involve income levels as well as growth rates.

While periods of unemployment make formulation of expenditures policies to equalize income very difficult, the absence of such policies would continue or aggravate differences between the poorer and the richer States and regions.

(3) INDIVIDUAL VIEWS OF SENATOR JACOB K. JAVITS

This report on the distribution and impact of Federal expenditures on the various States and regions is an important contribution to a field which I believe has been much too long neglected by the Congress. I have sought to remedy this lack in part by investigating the impact on my own State of New York, of a number of Federal grants-in-aid to State and local governments. I therefore recognize the complexity and difficulty, as well as the importance, of the issues involved in this study, which covers not only grants-in-aid but also other types of Federal expenditure, including defense and space procurement and Federal salaries, civilian and military.

While the chairman's foreword makes it clear that no member of the subcommittee is in any way bound by the findings, opinions, or recommendations in this study, I believe the results of my own study are directly relevant to the study which is being published here as a committee print. I am therefore incorporating my own study as a part of these individual views.

My study concluded that there are a number of arbitrary and discriminatory features affecting distribution of urban-related Federal grant-in-aid programs—particularly the per capita income factor in so-called equalization formulas—so that in effect urbanized States are being penalized under these programs in comparison to their disproportionately large needs for Federal aid. The subcommittee's study appears to concede this point to some extent but seeks to answer it by concluding that, taking all Federal expenditures together, grants-in-aid plus others, the more populous States, with higher personal income, are receiving a larger total share proportionately than their less populous sister States.

At this point I could not attempt to deal in depth with this thesis. However, I believe on its face it does not constitute an answer to the discrimination I have found in grant-in-aid programs.

For a basic conclusion of my own—and of many others, I might add—is that the highly urbanized centers in our Nation are increasingly unable, despite herculean taxing efforts, to meet their ever-growing problems, problems which are aggravated in an exponential way by the sheer facts of density of population and spiraling costs of public services. And this disability of the urban centers is increasing at an alarming rate despite, and assuming, the disproportions in favor of the populous regions which the subcommittee study finds in the distribution of Federal procurement and salary funds. These other Federal expenditures, after all, form a part of the tax base for State and local governments. Yet the urbanized areas have exhausted their tax base and are still not catching up with their needs for governmental services in areas such as education, housing, and transportation. Only if the grant-in-aid programs which are intended to meet those needs, accurately reflect those needs—both in total amount and in relative distribution, can the urban areas begin to catch up, I believe, and no discussion of the total distribution of Federal funds can mask that very urgent conclusion.

CONCLUSIONS

This is the age of the cities. The Nation and the Congress are recognizing this fact and all that it implies. With similar realizations of national movements, our public and private institutions have responded magnificently. When the decline of the farm population loomed as a danger to our ability to feed our people, we reacted with multibillion-dollar rural aid programs which have boosted our agricultural production so vastly that it is now the wonder of, and a major source of supply for, the world. When the roads of our Nation were found to be grossly inadequate to the great rush into the automotive age, we reacted with a multibillion-dollar interstate highway construction program which is planned to end in 1972.

Now the city must be the focus of our attention, for the huge concentrations of population in major urban centers have created conditions entirely beyond the proportions ever experienced before. These are conditions which threaten the basic livability of the dwelling place of almost 75 percent of our Nation's people. And they are conditions which the cities and the States in which they are located are incapable of handling with their available resources. Only the Federal Government can help to do this job; without the Federal Government the cities are strangling.

This is not because the cities and urban States have not been trying. Between 1946 and 1964 local debt rose from $13.6 to $68.4 billion while Federal debt increased from $269 to $312 billion. On a per capita basis, local debt in that period rose from $97 to $357 while the Federal debt per capita actually decreased by about $300. At the same time the sources of revenue for the cities have been drying up. In 1932 the municipalities were collecting 52 percent of all taxes, more than the Federal and State Governments combined. By 1962 the cities' share of revenues had dropped to 7.3 percent.

What this means is that the Federal commitment to aid the cities needs to be greatly increased and intensified. It is almost unthinkable that as recently as 1963 Federal aid to cities for housing and community development was only $400 million compared to $7.7 billion spent by the Department of Agriculture and $1.9 billion for interstate highways. It has been estimated that, even with the war on poverty, total expenditures for urban aid are less than 1 percent of the entire Federal budget.

Clearly there needs to be a massive reevaluation of our Federal Government's expenditures, other than those for defense, international affairs, space, veterans, and interest costs. These civilian expenditures account for between 20 and 26 percent of the total budget. A major question is whether there should not be some reallocation of our civilian expenditures as between urban and nonurban purposes. A second major question is whether there should not be massive new programs designed specifically for aid to the cities, for example, in housing, schools, recreation, parks, policing, social services. A third major question is whether out of its expected increase in tax revenues the Federal Government should not share some percentage of its revenues with the States, as I have proposed in S. 2619.

Finally, as this report documents, there is much that could and should be done to make many of the urban-related programs already in operation more equitably geared to the needs of the urban centers:

(1) Allocation formulas should be amended to eliminate the per capita income feature, which distorts the shares received by the urban States, and in the absence of a more equitable and sensitive measure, population alone or the density of population should be the basis for allocation.

(2) Maximum and minimum limitations on amounts for each State, which also distort the allocations, should be repealed.

(3) Matching requirements which vary according to per capita income should be amended, and matching requirements should be reevaluated to determine their adequacy, particularly in relation to each other as competing demands for available State and local funds.

(4) Legislators from urban States should seek alternative methods to determine the need in urban States, such as, for example, measures which effectively incorporate differences in the cost of providing governmental services in the most densely populated urban centers.

Clearly the highest priorities should go to amending those allocation formulas and matching requirements which not only use a per capita income factor but intensify that factor by squaring it, such as those in the Hill-Burton hospital and medical facilities and the vocational rehabilitation programs, and those, such as the urban renewal, low-income housing, urban mass transportation, and Neighborhood Youth Corps programs, which impose maximum limitations on each State's share. But as the analyses show, there are many other programs which do not have such obvious distorting factors on their face but which nonetheless result in disproportionately low amounts for the urban centers, and priorities among these should also be established.

(5) We should also support early enactment of S. 561, pending before the House Government Operations Committee, which calls for periodic congressional review of further grant-in-aid programs, so that allocation features are not endlessly perpetuated without any conscious reevaluation from time to time as conditions change.

In short, it is high time that the legislators from urban States became as sensitive to the significance of allocation patterns for Federal funds as those from nonurban States obviously have been for many years.

FEDERAL AID: PROSPECTS AND PROBLEMS IN ILLINOIS* **

BY ILLINOIS LEGISLATIVE COUNCIL

SUMMARY

Federal aid grew from $116 million in 1927 to more than $11 billion in 1966. Fiscal 1967 grants are estimated at totaling $14.6 billion. Federal grants now account for more than a quarter of Illinois State revenue. Illinois received approximately $840 million for 1963–65. It is estimated Illinois will receive $1,089 million for 1965–67.

This growth has caused much concern over the future of the States in the Federal system. Some fear the States are becoming mere administrative units of the Federal Government and thus several new concepts have emerged in recent years for strengthening the role of the States:

—Walter Heller, while Chairman of the Council of Economic Advisors, proposed in 1964 that unconditional block grants be given to the States.

—Illinois State Senator Paul W. Broyles introduced a resolution in 1965 calling for a convention to amend the U.S. Constitution to refund to each State 10 percent of all Federal revenues collected therein.

—Two U.S. Senators in 1965 introduced legislation which would have distributed 1 percent of the personal income tax base to the States.

—Others have proposed a tax credit on the Federal income tax for some portion of State income tax paid, to stimulate the States to adopt the personal income tax as a source of additional revenue.

—Still others have proposed more indirect measures, such as the "Negative Income Tax," giving cash grants to the poor to eliminate the Federal public assistance programs.

* * *

Budgeting for Federal aid can be a very difficult task for State officials. The Department of Health, Education, and Welfare (HEW) alone has over 190 grant-in-aid programs, some involving two or more types of grants. It can be a problem for State officials to keep abreast of them. It can also prove a problem for Governors in keeping control over the programs partially administered by Washington.

Illinois' officials report difficulties primarily because the Federal Government operates on an annual budget and Illinois does not. Sometimes Congress launches new programs or changes Federal matching

*Reprinted from *Legislative Council Publication 140, Federal Aid: Prospects and Problems in Illinois*, November 1966.

**Prepared pursuant to Proposals 619 and 632 sponsored by Representatives Marjorie Pebworth and John C. Parkhurst, and Senator Egbert B. Groen.

formulas in the middle of the Illinois biennium, causing budgetary problems.

Four alternatives for improving budgeting for Federal aid might be:

(1) Establish a central clearing house for Federal grants.

(2) Open a Washington office concerned exclusively with Federal aid problems and contacts.

(3) Require approval at a high level, i.e., by the Governor or by a legislative agency, before agency participation in new grant programs.

(4) Inaugurate a system of annual rather than biennial budgets.

* * *

A case study of public aid in Illinois affords examples of conflict between State and Federal agencies. The Illinois Department of Public Aid reports that basic disagreements result with HEW because of the latter's failure to differentiate between States like Illinois with advanced and comprehensive public aid programs and States which have only minimal programs, conditioned almost entirely upon the availability of Federal financing.

Conflicts have arisen over the "Maintenance of State effort" formula which Illinois officials say penalizes this State with respect to Federal aid, over the question of "cash payments" to public aid recipients (as opposed to deductions for food stamp purchases, for example), and over Federal requirements as to reporting and quality control standards.

FEDERAL FUND BUDGETING IN ILLINOIS

Federal grants now account for more than a quarter of Illinois State revenues as reported by the Department of Finance,[1] with figures for the last biennium (actual) and the current biennium (estimated) as follows:

[Dollar amounts in millions]

	1963-65	1965-67
Total resources	$3,342.5	$4,392.8
Federal aid	$839.7	$1,088.7
Aid as percent of total	25.1	24.8

Many State officials and students of public finance believe Federal grant programs have a distorting effect on State budgets because, they contend, Federal matching formulas stimulate States to channel large sums to the aided programs at the expense of other needed but unaided programs. Phillip Monypenny, who wrote about the impact of Federal aid in Illinois 8 years ago, considered that a wealthy State such as Illinois had the potential revenue resources both to participate in the Federal aid programs and to finance other needed programs; the marked expansion of aided programs in recent years may weaken this argument.

[1] In some cases, e.g., the State universities and colleges, funds from the Federal Government, including revenues from contractual research as well as grants-in-aid, are not shown in the records of the Department of Finance.

Anticipation of Federal grants can present for an agency a serious problem in budget preparation, particularly in view of the biennial budget in Illinois as opposed to the yearly Federal budget. From the viewpoint of State officials who are desirous of taking full advantage of Federal grants, failure to anticipate such grants and provide possible matching funds in the State budget may cause loss of aid. This may be an especially serious problem if the formula is changed by Congress and the State required to contribute a larger matching amount than in the past; here a program could be underway but face difficulties in being continued because of the lack of appropriated State funds for the State's share.

Four possibilities for improved budgeting for Federal aid have been suggested: (1) establish a central clearinghouse for Federal grants within the Governor's office, the Department of Finance, or some other central agency; (2) open an office in Washington for the primary purpose of channeling and coordinating Federal aid to Illinois (now done by the Department of Business and Economic Development which is concerned, however, with Federal aid among several other duties); (3) enact legislation requiring approval by the Governor, or by the Budgetary Commission, or by legislative leaders, etc., before any State agency is permitted to accept Federal grants; and (4) shift from the present pattern of biennial budgets to annual budgeting with annual sessions.

(NOTE.—This report does not discuss particular federally aided programs because of the considerable attention given such programs in an earlier Legislative Council study, Publication 138, "Federal Grant-in-Aid Programs in Illinois," issued in August 1964. Ch. II of the 1964 report discussed the rate of Federal aid expenditures in Illinois and the program emphasis; two appendixes furnished detail as to matching funds required for particular programs and showed for each major Federal aid program the program purpose, how allocations were made by the Federal Government among the States, the State-local matching required, the grant conditions to be met by the State, and recent [up to fiscal 1963] obligations and expenditures.)

POSSIBLE DISTORTIONS RESULTING FROM FEDERAL AID

In support of the view that Federal grants-in-aid earmarked for particular programs or functional areas have a distorting effect on State budgets, the following criticisms have been advanced:

—Overall coordination of grant programs is lacking at the Federal level, and consequently an unbalanced program is passed along to the States.

—Because officials of State agencies receiving Federal grants tend to deal directly with their Federal counterparts, the Governor and his budget staff are bypassed and tend to lose effective control of large sectors of the State administration.

—Where a State begins participation in an aided program by administrative decision, pressures are strong for continuance and the legislature is, in effect, committed to support an activity that it might not have favored otherwise.

—The substantial amounts of State funds required as the State's matching shares for Federal aid leave insufficient funds for unaided programs, and these are neglected.

The first Hoover Commission in 1949 reported that grant programs are often unrelated, uncoordinated, and may have developed in a haphazard manner without any single agency in the Federal Government or in individual State governments being concerned with the overall impact of such programs.[1] The Commission on Intergovernmental Relations (Kestnbaum Commission) in 1955 similarly found that little attention had been given by the States themselves to the overall impact of Federal aid on the structure and functioning of State and local government.[2] It is contended by the Federal Bureau of the Budget, however, that "Special efforts are being made to coordinate and further improve the various Federal aid programs in 1967. The proposed Intergovernmental Cooperation Act, already before the Congress, would improve the administration and facilitate congressional review of Federal grants-in-aid." [3] The bill (S. 561) did not pass, however.

As concerns the role of a Governor and his budget staff with respect to Federal aid, certainly much depends on the controls that the Governor is able to exercise in this area, and this is as much a result of State policy as it is a consequence of Federal aid. Nevertheless, close relations necessarily tend to develop between the officials of a State agency administering an aided program and the Federal agency controlling the grants, and unless provisions are made for coordination by the Governor's office, the principle of executive budgeting can be seriously weakened. In this connection, a study by the Tax Foundation in 1965 noted that Illinois was one of 18 States in which an agency desiring to participate in a Federal aid program was not required to obtain the Governor's approval; [4] at least, the Governor's role was not spelled out by statute in these States.[5] Moreover, it should also be mentioned—as noted by Phillip Monypenny in his 1958 study on the impact of Federal aid in Illinois—that Illinois' central system of budgeting and accounting controls is virtually inapplicable to the independent elected officers in the executive branch.[6] In this connection it should be noted that Federal aids to education are channeled through an independent elected officer, the Superintendent of Public Instruction, and Federal grants to libraries are channeled through the Secretary of State; the question can be raised in such instances as to the effectiveness of the Governor in influencing initial decisions to participate in the aided programs.

Participation in a federally aided program virtually commits a State to continued support of that program or, at least, to costs resulting from the program. A 1964 Joint Legislative Committee on State-Federal Relations in New York State was concerned because it felt that grant-in-aid programs are often such that ultimately the State must

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[1] "The Hoover Commission Report." 1949 (New York: McGraw-Hill Book Co., Inc.) p. 494.

[2] The Commission on Intergovernmental Relations, "A Report to the President for Transmittal to the Congress" (June 1955) pp. 130–131.

[3] Senate bill 561, introduced Jan. 15, 1965, first sess. of the 89th Cong.

[4] The other 17 States in this group were: Arizona, Delaware, Georgia, Idaho, Indiana, Iowa, Kansas, Louisiana, Missouri, Montana, New Mexico, North Dakota, Ohio, Oklahoma, Pennsylvania, South Dakota, and Vermont.

[5] Tax Foundation Inc., "State Expenditure Controls: An Evaluation" (October 1965) p. 59.

[6] Phillip Monypenny, "The Impact of Federal Grants in Illinois," 1958 (Urbana: Institute of Government and Public Affairs) p. 101.

more and more shoulder the burden of the program.[7] Currently cited as examples of this kind in Illinois are the ultimate expense of maintenance of the Interstate highway system being built with 9 to 1 Federal matching and the $70 million that Illinois received in 1966 from the Federal Elementary and Secondary Education Act—an amount not in the State budget for the current biennium and for which State administrative funds will be sought of the 1967 General Assembly.

Whether functions of State government that do not benefit from Federal aid are "neglected" must largely be a manner of individual judgment. Without quarrelling with the benefits derived from Federal support in such fields as highways, health, education, and welfare, however, one might point to such functions as police protection and correctional institutions as examples of possible areas that the States and local governments are not supporting as extensively as they might. At the same time, however, it could equally be argued that a function now "neglected" in favor of aided functions would be even more subject to neglect in the absence of Federal aid—because the State would be compelled to pour larger amounts of State funds into the functions now federally aided.

The Tax Foundation in 1965 sent out questionnaires to State officials asking whether in their opinion Federal grants lead to *serious* misallocations of State funds. The majority view indicated that either serious distortion does not take place or that it is not of major significance (Illinois' response was not reported). Of course, the word "serious" is a key word in the questionnaire; some might consider that it biased the results.

Mark A. Haskell, an economist, questions the charge that Federal aid for some functions leads to neglect of others; on the contrary, he suggests that "nonaided activities may be indirectly aided when Federal funds are substituted for those of the States and localities in the financing of subsidized functions." [8]

Monypenny is another who does not go along with the argument that Federal support of some functions necessarily results in the neglect of others—at least, not in the case of Illinois. Monypenny's view in 1958 was that a wealthy State such as Illinois, after maximum amounts have been set aside to take full advantage of Federal grants, still has adequate prospective income to distribute among other purposes.[9]

PRESENT PRACTICE IN BUDGETING FOR FEDERAL GRANTS

The Kestnbaum Commission reported in 1955 that "States prepare budgets without being sure how much money they will get from most grant-in-aid programs. They are sometimes embarrassed when Congress fails to vote the anticipated amounts." [10] The lack of precise knowledge as to how much Federal aid may be expected is a factor in Illinois budgeting. Complicating it still further is the biennial pattern of regular legislative sessions and biennial budgets in contrast with

[7] Joint Legislative Committee on State-Federal Relations, "Federal Subsidies—An Unguided Force," 1964 Report to the New York State Legislature (January 1964), pp. 59–60.

[8] Mark A. Haskell, "Federal Grants and Budgeting Distortion," The Quarterly Review of Economics and Business, vol. 2 (May 1962), p. 87.

[9] Same as note 5, p. 99.

[10] Same as note 2, p. 130.

the pattern of annual sessions of Congress and annual Federal budgets. That is, it is possible that Federal grants may be changed in the second year of an Illinois biennium, so that the State could either fall short in providing funds necessary to operate a program (after Federal aid had been reduced) or the State might not be in a position to take full advantage of Federal funds. (The Federal Government cannot be blamed, of course, for Illinois' continued pattern of biennial budgets.)

Illinois department heads and budget officials necesarily have to "second guess" Federal appropriations. Typically, they assume that the Federal Government will allocate the same amount of funds currently being received, and then apparently some use a fairly liberal figure for inclusion in their recommendations in the belief that it is better to have the appropriation approved for a higher amount than required than to face the problem of being offered Federal funds for which no matching funds have been appropriated.

State moneys in Illinois are, of course, constitutionally subject to expenditure only by virtue of legislative appropriations. Federal funds are not State moneys, but as a matter of practice, the usual custom is for the legislature to include Federal aid in appropriation bills, and Federal grants must necessarily be appropriated if they are mingled with State moneys in the same fund.[11] Nevertheless, as noted in the budget document for the current (1965–67) biennium "Numerous funds with smaller transactions financed by Federal aid are not appropriated. Some of these are of a temporary nature. Federal aid for new programs is frequently recorded by the Auditor [of Public Accounts] in a special account pending establishment of a treasury fund."[12]

To illustrate specific problems in budgeting, some of the State agencies that receive a large amount in Federal grants were contacted. The results of these interviews are summarized below for the Department of Public Aid, Department of Public Health, Division of Highways, and Office of Superintendent of Public Instruction.

Department of Public Aid

For the current (1965–67) biennium, it is estimated that Federal aid will account for 50 percent of the $661.4 milion; that is, in effect, appropriated to the Department of Public Aid.

Officials of this department report they find budgeting for Federal aid complicated because of the many different types of public assistance programs that receive Federal aid and the complex formulas.

Basically the formation of budget estimates is reached in this manner: the Division of Research and Statistics anticipates the number of caseloads per year, and then the average payment per recipient per month for the many different types of programs, such as the anticipated average payment which will occur under the Aid for Dependent Children program. The Division of Accounting and Data Processing then computes these averages for the many programs with the present Federal matching formulas. Federal funds for total medical costs and for administration must also be estimated. Grant

[11] Illinois State Budget, 74th biennium, p. 5A.
[12] Same as note 10, p. 7A.

money is also received from the U.S. Department of Agriculture for the "food stamp" program.

A primary factor mentioned, and perhaps the most important factor, is the current and future economic picture of the United States and Illinois. If employment is up and recipients of various kinds of public assistance find and qualify for employment, then it can have a great effect on the number of caseloads. Programs such as Aid for the Blind do not vary much with economic conditions, however.

The Department of Public Aid's relationship with the U.S. Department of Health, Education, and Welfare is the subject of chapter III of this report and other budegtary factors that come into the discussion there will not be mentioned here.

Department of Public Health

For the current (1965–67) biennium, Federal aid accounts for 57.3 percent of appropriations to the Department of Public Health; the book, "Appropriations," issued by the Department of Finance, shows that appropriations to the department total $58.5 million including $33.5 million in Federal aid.

The department is advised by the Federal Department of Health, Education, and Welfare (HEW) as to the anticipated allotment for each year based on the Federal budget. The Illinois department reports continuing problems trying to match Federal funds whose availability had not been anticipated in the State budget. In an attempt to obtain matching money for a grant of a half million dollars for a chronic illness program, the department sought funds from local health agencies that would share in the program and also from voluntary agencies, but HEW held that money from voluntary agencies is not valid matching since it is not raised by taxes.

Friction with Federal officials has also occurred with respect to qualified personnel. HEW has reportedly encouraged the State to get programs started in fields where there are shortages of qualified personnel; the State has done its best only to be criticized in HEW audits for unsatisfactory personnel practices.

On the other side of the picture, legislation (S. 3008) was passed this past session of Congress that would lump together grants now given to fight a number of specific diseases. Passage of this legislation will not only simplify administration of these programs but will give the individual States leeway in applying funds to fight diseases that are problems in particular States.

Division of Highways

For the current (1965–67) biennium, Federal aid accounts for 59.2 percent of appropriations to the Division of Highways, Department of Public Works and Buildings; the book, "Appropriations," issued by the Department of Finance, shows that appropriations to the division total $1,048.4 million with Federal aid of $620.3 million anticipated.

The comments of State highway officials suggest that they are in much better shape in anticipating Federal aid than are the officials of other State agencies. The Federal Interstate highway program appears to be much more systematized than other grant programs; this reflects to a considerable degree the nature of the work, since highway construction requires advance planning and schedules that can be adhered to. In contrast, caseloads in the field of public aid are to a considerable extent, as noted above, subject to economic conditions.

The division is informed as to the total of Federal moneys that will be allotted to it; reimbursement then is subject to having plans approved and the work carried through according to approved plans and specifications. On the Interstate program, reimbursement is at the rate of $9 in Federal aid for $1 in State money; since the State is reimbursed (rather than being advanced the Federal aid) a major problem is having enough money in the Road Fund, a State fund, to finance construction until Federal reimbursement is received.

Superintendent of Public Instruction

For the current (1965–67) biennium, Federal aid accounts for only a small portion, 3.4 percent, of appropriations to the Office of the Superintendent of Public Instruction; the book, "Appropriations," issued by the Department of Finance, shows that appropriations to this office total $684.4 million with $23.4 million in Federal aid anticipated. However, as mentioned above, Illinois received through this office an unbudgeted $70 million in early 1966.

Budget officials of the office met with Federal officials in October 1966 to learn the amount of Federal aid they can expect for fiscal 1967. Many of the Federal programs for education provide 100 percent Federal aid without required matching. In the case of the $70 million, however, State funds will need to be sought from the legislature for administrative costs. Also, if the programs that have not called for State matching are eventually modified to require State participation, budgetary problems will occur in this area.

ALTERNATIVES FOR STRENGTHENING FEDERAL AID BUDGETING

Four possibilities for improved budgeting of Federal aid are discussed below: (1) establish a central clearinghouse for Federal grants; (2) open a Washington office concerned exclusively with Federal aid problems and contacts; (3) require approval at a high level, i.e., by the Governor or by a legislative agency, before participation in new grant programs; and (4) inaugurate a system of annual rather than biennial budgets.

Central Clearinghouse

The existence of a State central agency that would be responsible for collecting and maintaining factual information on Federal aid programs as they affect not only the State and its agencies but also local governments, without further controls, might be viewed as both (a) a first step in improved State budgeting of Federal funds and (b) as a State effort to coordinate Federal grant programs as they affect local governments. If the cities, for example, are bypassing the States and dealing directly with the Federal Government, part of the problem may be the absence of effective State machinery for facilitating grants.

New York has recently enacted legislation that requires the budget director, the chairman of the Senate finance committee, and the chairman of the Assembly ways and means committee to be kept informed

"Whenever a State agency makes application, enters into a contract or agreement or submits State plans for participation in and for grants of Federal funds . . . which are not appropriated by the legislature." The agency is required to notify the same officials of amendments to the application, to furnish progress reports at intervals of 6 months, and to file a final report as to the final disposition of each application, etc.[13]

In New York also, in view of the growing complexity of Federal aid programs, Gov. Nelson Rockefeller in his 1966–67 budget message proposed that a Federal aid clearinghouse be established in the existing Office for Local Government, a division of the Governor's office. The new office would provide information concerning Federal aid programs and assist local governments in preparing applications for Federal aid and help expedite these applications. Offices would be set up in Albany, the State capital, and in two or three other locations within the State.[14]

The beginnings of such a program have already been made in Illinois. The 1965 General Assembly appropriated $151,300 to create a Division of Local Governments in the Governor's Office, and the division now consists of a head and his secretary. One of the activities of the head of the division is operating a State urban information center on Federal aids, to acquaint officials of municipalities with the availability of Federal aids and the way to apply for them.

According to one Federal official, 28 States have now established some "means for an overall consideration of their participation in Federal grant programs." The official is Harold Seidman, assistant director of the Bureau of the Budget, who told the 1966 National Legislative Conference that Alaska, New Jersey, New York, Rhode Island, Tennessee, and Washington have established State offices for urban affairs, and that the National Association of Counties has been instrumental in persuading over 150 counties to establish Federal aid coordinators. Seidman also said:

> Coordination of Federal grant-in-aid programs is a complex and continuing process involving vertical and horizontal communications among and between Federal agencies, State and local governments and their various agencies and actions at each level of government separately and in conjunction with other levels . . . .
>
> The function of establishing State, regional or local goals, developing comprehensive plans, and determining priorities among grant proposals in terms of these goals and their relationship to comprehensive plans and financial restraints is and should remain a local, not a Federal responsibility.[15]

Washington Federal Aid Office

A logical extension of the clearinghouse mentioned above would be a Washington office which would seek to represent State and possibly also local government interests with respect to Federal aid programs. Presently the Illinois Department of Business and Economic Development has a Washington office which apparently can handle Federal aid matters but is primarily concerned with obtaining Federal contracts for Illinois industries, Federal installations for Illinois, etc.

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[13] McKinney's Session Law News, 189th sess., chap. 578, approved June 15, 1966.
[14] Gov. Nelson A. Rockefeller, Budget Message, 1966–67, to the New York State Legislature, Jan. 18, 1966, p. 58.
[15] Congressional Record, Proceedings and Debates of the 89th Cong., second sess., vol. 112, No. 147, Thursday, Sept. 1, 1966, p. 2.

New York has been cited as a State that for a number of years has maintained a Washington office which functions primarily through a bipartisan congressional steering committee to assist the New York congressional delegation in looking out after the State's interests, including Federal aid, in Congress.

Approval for Participation

A number of States have formal controls over State agency participation in Federal aid programs. The Tax Foundation in a 1965 study reported that 18 States require approval of the Governor prior to such participation.[16] New York, in addition, requires legislative approval, and North Carolina requires approval by the Governor and the budget commission. In Florida, budget commission approval is required, and in South Carolina, approval of the budget and control board. There remain the 18 States, previously mentioned and including Illinois, where the Governor's approval is not required, and 10 States where the situation varies, and approval of the Governor is sometimes, but not always, required.

In this connection, title I of the Intergovernmental Cooperation Act of 1965 (S. 561; it did not pass) would have accorded full Federal grant information to Governors or their designees and would have precluded Federal legal interpretations from preventing the Governor or State central control agency designated by him from controlling Federal funds in the same manner as State-raised funds.

Annual Budgeting

The fact that Federal grants are allocated to Illinois on an annual (fiscal year) basis and that Congress, the source of such funds, meets annually may put the Illinois legislature at a disadvantage in budgeting grants because it meets in regular session every 2 years and adopts biennial budgets. In the past, advocates of annual budgeting have placed emphasis on the difficulty of forecasting revenues from State sources, i.e., State taxes, over a biennial cycle, but there has not been emphasis on the annual pattern of Federal grants as making it desirable for the State to shift to annual sessions and annual budgets, yet it is now a fact that a quarter of the State's receipts come from Federal funds and some of its most important functions—highways, health, and public assistance—are heavily subsidized by Federal grants, so that the question can be raised as to whether the legislature, budgeting biennially, can do an effective job.

A proposed constitutional amendment for annual legislative sessions, with a session limited to fiscal matters in the even numbered years, was submitted to the voters in 1964. Although it received 2,290,263 affirmative votes as against 1,339,540 negative votes, it failed to receive the two-thirds majority or the majority of all votes cast in the election, which are the two alternative requirements for adoption of a constitutional amendment.

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[16] The 18 States were Alabama, California, Colorado, Connecticut, Hawaii, Kentucky, Massachusetts, Michigan, Minnesota, Nebraska, Nevada, New Hampshire, Oregon, Rhode Island, Tennessee, Texas, Virginia, and Wisconsin.

SOME IMPACTS OF INTERGOVERNMENTAL FISCAL RELATIONS IN GEORGIA*

BY JAMES L. GREEN and CHARLES D. CLEMENT

INTRODUCTION

In 1938, President Roosevelt, released a report on the South entitled "The Nation's Number One Economic Problem." In the ensuing years, industrialization, commercialization, and urbanization have modified the South from a singularly agricultural economy to one of increasing economic diversification.

In an environment of rapid change, Georgia has modified and has been modified in numerous economic, social, and governmental relationships. Concurrently the move toward economic diversification and adjustment has been accompanied by an expanded role of governments in the Georgian economy. Industrialization and urbanization have placed growing demands upon governments of all levels. Traditional governmental services have been added, and new standards have been involved. Within this developing complex, intergovernmental fiscal relations are inextricably reflected in the emerging complex of economic, social, and political patterns.

CHANGING SIZE AND IMPORTANCE OF INTERGOVERNMENTAL GRANTS

Intergovernmental fiscal flows are becoming increasingly important to governments at all levels. Since World War II, Federal Government grants to State governments have increased markedly. And, similarly, grants made by State governments to local county and city governments have been greatly augmented. Local governments have thus tended to become increasingly dependent upon grants from State and Federal sources, and State governments have become increasingly dependent upon grants-in-aid from the Federal Government.

Dependency upon intergovernmental fiscal flows is more prevalent in Georgia than for the Nation as a whole. In 1959, the Georgia State government received 24 percent of all funds it expended from the Federal Government. For the Nation as a whole, State governments averaged 19 percent. The 1957 Census of Governments indicates that local governments in Georgia received Federal and State grants comprising 32 percent of their expenditures. The average for all local governments in the Nation was much lower at about 25 percent. During 1961, some 8 percent of all Federal Government expenditures

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*Reprinted from: *Some Impacts of Intergovernmental Fiscal Relations in Georgia*, James L. Green and Charles D. Clement, Bureau of Business Research and Institute of Community and Area Development, University of Georgia, Athens, Ga., 1963, chapters I to IV.

were in the form of grants to State and local governments. In the same year, 29 percent of all State expenditures took the form of grants to local governments.

A COMPARISON: GRANTS IN GEORGIA AND IN THE NATION

It is rare to find a person who would claim that all intergovernmental grants should cease; rather, the question today is concerned primarily with the amount and variety of grants. One step toward a better insight into the question of the extent and size of grants in Georgia is to compare Georgia with other States. This chapter presents various data that should provide a better understanding of how grants in Georgia compare with grants in other States.

Table 1 presents a simple comparison between grants made by the Federal Government to State governments and grants, in turn, made by all State governments to local governments. Two outstanding facts are clear: first, the rapid upward trend of both types of grants and, second, the fact that State grants are much larger than Federal grants and are increasing at a more uniform rate.

TABLE 1.—*Intergovernmental revenue flow in the Nation*

[In millions]

Year	Total grants, Federal to State	Total grants, State to local
1946	$802	$2,092
1948	1,643	3,283
1950	2,275	4,217
1952	2,329	5,044
1954	2,668	5,679
1956	3,027	6,538
1958	4,461	7,943
1959	5,888	8,540
1960	6,352	9,283
1961	6,266	10,114

Source: *Facts and Figures on Government Finance*, (various issues), Tax Foundation, Inc., and *Governmental Finances in 1961*, U.S. Department of Commerce.

During the 15-year period ending in 1960, State grants increased about fourfold from just over $2 billion to over $9 billion. In the same period Federal grants to all States increased from $0.8 billion to $6.4 billion, a greater relative increase (about eightfold) but a smaller increase in total amount per year. While Federal grants have been increasing at an average of $457 million a year for this period, State grants have been increased at an average of $514 million a year for the same period.

Table 2 shows that these trends follow a somewhat different pattern in Georgia. Total payments made by the State government of Georgia to local governments exceed grants Georgia State government receives from the Federal Government, but the differences are much smaller. State grants in Georgia have increased by more than sixfold while Federal grants to Georgia have increased by about ninefold. The average increase per year is relatively similar: $11.1 million for State grants and $10.5 million for Federal grants.

TABLE 2.—*Federal and State grants in Georgia*

[In thousands]

Year	Federal grants to Georgia State government	Georgia State grants to local government
1946	$16,679	$27,912
1948	31,719	44,241
1950	49,782	58,404
1952	67,271	98,407
1954	73,598	109,620
1956	79,792	132,954
1958	112,942	161,066
1959	138,393	172,252
1960	153,200	176,535
1961	152,900	174,300

Source: *Facts and Figures on Government Finance* (various issues), Tax Foundation, Inc., and *Governmental Finances in 1961*, U.S. Department of Commerce.

During recent years, Federal grants to the Georgia State government have been about 75 percent of the dollar volume of State grants flowing to local governments in Georgia. Comparable figures for all States indicate the national average is below 60 percent. There are two possible explanations for this difference. First, State grants to local governments in Georgia may be lower than in the national State average. And, second, Federal grants to Georgia may be higher than the average for all States.

GEORGIA RECEIVES MORE FEDERAL GRANTS THAN THE NATIONAL AVERAGE

The State government of Georgia receives more from the Federal Government than the average State. Table 3 presents Federal grants as a percent of State expenditures and shows that aid to Georgia is considerably above the average. This ratio of aid to State government expenditures would be more nearly proportional if State expenditures in Georgia were below the average for other States. Comparing State general expenditures per capita, Georgia was above the national average in 1955 with $109 for Georgia and a $107 average for all States. By 1959, Georgia had fallen slightly behind with per capita general expenditures of $138 compared with a $148 average for all States.

TABLE 3.—*Federal grants to all States and Federal grants to Georgia as a percent of State government expenditures*

Year	Federal grants to all States			Federal grants to Georgia		
	Federal grants (billions)	Total State expenditures (billions)	Percent	Federal grants (millions)	Total State expenditures in Georgia (millions)	Percent
1946	$0.80	$7.06	11	$16.7	$100.3	17
1948	1.64	11.18	15	31.7	157.3	20
1950	2.28	15.08	15	49.8	204.0	24
1952	2.33	15.83	15	67.3	281.6	24
1954	2.67	18.69	14	73.6	361.0	20
1956	3.03	21.69	14	79.8	434.3	18
1958	4.46	28.08	16	112.9	515.8	22
1959	5.89	31.13	19	138.4	566.8	24
1961	6.27	34.69	18	152.9	592.0	26

Source: *Facts and Figures on Government Finance*, (various issues), Tax Foundation, Inc., and *Governmental Finances in 1961*, U.S. Department of Commerce.

On a per capita basis, Georgia received an average of over $35 in Federal grants per capita in 1961, as compared with an average of $33 for the Nation.

A comparison of Federal grants with total State and local government revenue is also revealing. In 1959, Federal grants, for the United States as a whole, average 14.1 percent of all State and local revenue. New Jersey was low State with 6.4 percent. Alaska and Wyoming were high States with 32.3 percent. The median State was North Carolina with 17.1 percent. Georgia was a little higher with 19.1 percent. The percentages for other neighboring States were: South Carolina, 19.7; Alabama, 22.4; and Florida, 11.5.

Another indicator that Georgia was above the average State in 1959 is the ratio of population to aid: Georgia had 2.2 percent of the Nation's population and received 2.4 percent of all Federal grants to States.

FEDERAL GRANTS BY FUNCTION

Table 4 shows Federal grants classified according to functions and indicates how Georgia compares with the Nation in each of six classifications. It is readily apparent that the overwhelming majority of all Federal grants are in the fields of highways and welfare.

TABLE 4.—*Trends of Federal grants by function: Per capita for the United States and trends of Federal grants in major areas; per capita in Georgia*

A. HIGHWAYS

Year	In United States		In Georgia	
	Total grants (in millions)	Per capita	Per capita	Federal grants to Georgia (in thousands)
1946	$66	$0.47	$0.74	$2,410
1948	303	2.06	2.15	7,003
1950	438	2.88	3.64	12,523
1952	413	2.61	2.78	10,015
1954	542	3.33	3.17	11,562
1956	739	4.37	3.20	12,047
1958	1,496	8.55	6.74	26,045
1959	2,610	14.66	11.17	43,584

B. PUBLIC WELFARE

Year	Total grants (in millions)	Per capita (U.S.)	Per capita (Georgia)	Federal grants to Georgia (in thousands)
1946	$432	$3.04	$1.84	$5,947
1948	731	4.97	4.36	14,199
1950	1,107	7.28	7.41	25,567
1952	1,149	7.29	9.41	33,867
1954	1,426	8.75	12.21	43,479
1956	1,452	8.65	12.68	47,676
1958	1,793	10.25	15.74	61,391
1959	1,959	11.01	16.98	66,215

C. EDUCATION

Year	Total grants (in millions)	Per capita (U.S.)	Per capita (Georgia)	Federal grants to Georgia (in thousands)
1946	$99	$0.70	$0.45	$1,467
1948	320	2.18	1.24	4,051
1950	345	2.27	1.25	4,324
1952	293	1.85	3.29	11,854
1954	277	1.70	2.31	8,442
1956	344	2.04	2.29	8,600
1958	492	2.81	2.94	11,237
1959	615	3.46	3.55	13,860

TABLE 4.—*Trends of Federal grants by function: Per capita for the United States and trends of Federal grants in major areas; per capita in Georgia*—Continued

D. EMPLOYMENT SECURITY ADMINISTRATION

Year	In United States		In Georgia	
	Total grants (in millions)	Per capita	Per capita	Federal grants to Georgia (in thousands)
1946	$63	$0.45	$0.33	$1,085
1948	152	1.03	.78	2,529
1950	168	1.12	.72	2,496
1952	187	1.19	.79	2,846
1954	198	1.22	.80	2,906
1956	219	1.30	.81	3,060
1958	280	1.60	1.02	3,948
1959	316	1.78	1.08	4,213
E. HEALTH AND HOSPITALS				
1946	(1)	(1)	$1.34	$4,324
1948	(1)	(1)	.67	2,198
1950	$95	$0.63	.55	1,887
1952	114	.72	1.77	6,374
1954	88	.54	1.16	4,238
1956	90	.53	1.15	4,227
1958	114	.65	1.03	3,988
1959	129	.72	1.31	5,098
F. ALL OTHER AID				
1946	$140	$0.99	$0.45	$1,446
1948	137	.93	.53	1,739
1950	122	.80	.87	2,985
1952	174	1.10	.87	2,315
1954	137	.84	.82	2,971
1956	183	1.08	1.11	4,182
1958	286	1.63	1.64	6,333
1959	259	1.46	1.39	5,423

[1] Not available.

Source: *Facts and Figures on Government Finance*, (various issues), Tax Foundation, Inc., and *Governmental Finances in 1961*. U.S. Department of Commerce.

It was noted previously that Georgia receives more than the average amount of Federal grants to States. Table 4 shows clearly that this difference is largely due to much more than average aid in the form of grants for public welfare. Differences between Georgia and the national average are relatively much smaller in other classifications. Georgia is only slightly above the Nation in grants for education but receives 182 percent of the national average in grants for health and hospitals. Georgia is only slightly below the national average in grants for employment security (unemployment compensation and employment offices), but is considerably below in grants for highways where Georgia received only $11.17 per capital, which was 76 percent of the national average of $14.66.

If Georgia had received an amount per capita equal to the national average, Georgia would have received over $13.6 million of additional grants for highways. Of course, the opposite situation existed in the field of public welfare where Georgia would have received some $23.3 million less than the amount actually received if Georgia had only received the average for the Nation in this field.

It is clear from table 4 that Federal grants have remained relatively stable except for the two largest classifications of highways and public welfare. The very sudden climb of grants for highways since 1956 reflects the implementation of the Federal decision to encourage construction of a national network of interstate routes.

The rapid climb in grants for public welfare continues at a fairly uniform rate in Georgia—still much faster than the average for the Nation. The continuing increase in both the national average and grants to Georgia reflects increases in both the number receiving aid and in the variety and amount of aid received. The much larger than average grants made in Georgia reflect the larger number of people who qualify for welfare payments, that is, a larger number in relation to population than in the "average" State.

GEORGIA STATE GRANTS TO LOCAL GOVERNMENTS: A COMPARISON WITH OTHER STATES

County and city governments in Georgia received $17.4 million in grants from the Federal Government and $174.3 million in grants from the State government in 1961. This indicates the increase from $10 million and $137 million in 1957 when local governments in Georgia received 32 percent of all they spent in the form of grants. They received 34 percent in 1961. Note table 5.

TABLE 5.—*Grants to local governments in the Nation and in Georgia as a percent of local expenditures (Federal and State grants)*

[Dollar amounts in millions]

Year	In the United States			In Georgia			
	Grants to local governments	Local expenditures	Percent of local expenditures	Federal grants	State grants	Local government expenditures	Percent of local expenditures
1946	$2,145	$9,156	23	(1)	$27,912	(1)	(1)
1948	3,501	13,406	26	(1)	44,241	(1)	(1)
1949				$2.9	(1)	(1)	(1)
1950	4,428	17,189	26	(1)	58,040	(1)	(1)
1952	5,281	20,229	26	(1)	98,407	(1)	(1)
1954	5,933	23,814	25	12.5	109,630	(1)	(1)
1956	6,899	28,273	24	(1)	132,954	(1)	(1)
1957				10.0	137,000	$462,964	32
1958	8,232	33,877	25	10.2	161,666	(1)	(1)
1959	8,739	36,192	24	16.0	172,252	(1)	(1)
1961	10,185	37,393	27	17.4	174,300	560,900	34

[1] Data not available.

Source: *Facts and Figures on Government Finances* (various issues), Tax Foundation, Inc., and *Governmental Finances in 1961*, U.S. Department of Commerce.

In 1957, the last year a census of governments was taken, local government expeditures totaled $463 million while the State government of Georgia spent an almost identical amount of $464 million. Of these expenditures, $137 million of State funds went to local governments but only $6.6 million went in the other direction from local governments to the State government.[1] If only net expenditures are considered, local governments spent almost 37 percent more than the Georgia State government.

Estimates made by the U.S. Department of Commerce for 1961, indicate net expenditures for the State government in Georgia of $376 million and $561 million for local governments in Georgia.[2] Local government net expenditures were 49 percent greater in 1961.

Local governments in Georgia receive a larger proportion of their expenditures in the form of grants than the average for the Nation. Local governments in the Nation receive about 25 percent of what they spend in the form of grants (up slightly to 27 percent in 1961), while local governments in Georgia received just over 32 percent in 1957 and 34 percent in 1961.

The rapid increases in State grants to local governments throughout the Nation (shown in table 1) has almost perfectly paralleled the rapidly increasing total expenditures of local governments. Both have had roughly a fourfold increase in the 14 year period covered in this study. This helps explain why grants have remained at such a stable proportion (about 25 percent) of all local expenditures during this period.

GRANTS IN GEORGIA BY FUNCTION: A COMPARISON WITH OTHER STATES

Table 6 shows State grants to local governments in the State of Georgia according to four classes or functions. Georgia has been consistently above the national average in grants for education. Furthermore, this difference has been increasing. By 1959, such grants in Georgia averaged $32.79 per capita in comparison to a $27.01 average for the Nation (21 percent larger). The basic reason for this is that local governments in Georgia do not provide as much of the money spent for education as the average local government in the Nation.

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[1] These funds flowing from local governments to the State consisted primarily of the one-fourth mill property tax local governments collect for the State and of certain welfare fund transfer payments.

[2] *Governmental Finances in the United States:* 1961, U.S. Department of Commerce.

TABLE 6.—*Trends of State grants to local governments: A comparison of grants in Georgia with grants in other States*

A. EDUCATION: STATE GRANTS TO LOCAL GOVERNMENTS

Year	For all States		For Georgia	
	Total grants (millions)	Per capita	Per capita	State grants in Georgia (thousands)
1946	$953	$6.71	$5.92	$19,274
1948	1,554	10.57	11.54	37,626
1950	2,054	13.51	14.27	49,225
1952	2,523	15.97	20.79	74,828
1954	2,930	17.98	22.92	83,654
1956	3,541	20.95	27.08	101,825
1958	4,453	25.45	30.28	116,899
1959	4,808	27.01	32.79	127,917

B. HIGHWAYS: STATE GRANTS TO LOCAL GOVERNMENTS

Year	Total grants (millions)	Per capita	Per capita	State grants in Georgia (thousands)
1946	$339	$2.39	$1.48	$4,817
1948	507	3.45	1.48	4,817
1950	610	4.01	1.40	4,817
1952	728	4.61	4.18	15,030
1954	871	5.34	4.48	16,359
1956	984	5.82	5.72	21,451
1958	1,167	6.67	9.13	35,231
1959	1,207	6.78	8.33	32,477

C. PUBLIC WELFARE: STATE GRANTS TO LOCAL GOVERNMENTS

Year	Total grants (millions)	Per capita	Per capita	State grants in Georgia (thousands)
1946	$376	$2.65	$0.24	$765
1948	648	4.41	.34	1,131
1950	792	5.21	.43	1,566
1952	976	6.18	.60	2,151
1954	1,004	6.16	.74	2,693
1956	1,069	6.32	.73	2,756
1958	1,094	6.25	.90	3,480
1959	1,210	6.79	.96	3,760

D. OTHER: STATE GRANTS TO LOCAL GOVERNMENT

Year	Total grants (millions)	Per capita	Per capita	State grants in Georgia (thousands)
1946	$424	$2.99	$0.94	$3,056
1948	674	4.59	.21	667
1950	761	5.01	.80	2,769
1952	817	5.17	1.78	6,398
1954	874	5.36	1.86	6,777
1956	944	5.59	1.80	6,767
1958	1.230	7.03	1.53	5,897
1959	1,314	7.38	2.03	7,920

Source: *Facts and Figures on Government Finance* (various issues), Tax Foundation, Inc.

Georgia is far below the national average in State grants for public welfare (only 14 percent of the national average per capital). The figures of $0.96 per capita public welfare grants in Georgia and $6.79 per capita in the Nation show clearly that Georgia would need a sevenfold increase to reach the average for the Nation. It would have taken some $22.7 million of additional funds in such grants in Georgia to meet the national average (in 1959).

Georgia has also been consistently far below the national average in State grants for health and other (miscellaneous) functions. The gap is not quite so large as for public welfare but is still large (only 27 percent of the national average per capita). The figures of $2.03 per capita in Georgia and $7.38 per capita for the Nation show how much Georgia is below the national average. It would have taken some $20.9 million of additional grants in Georgia to have met the national average in 1959.

Georgia has not been so consistent in grants for highway construction. During the first few years of the 14-year period, Georgia was well below the national average in such grants. Then, during the mid-fifties, grants in Georgia for highways were very closely parallel to the national average. For the last few years of the period, such grants in Georgia have been well above the national average.

LOCAL GOVERNMENT PAYMENTS TO STATES

The least important of intergovernmental revenues is the flow of funds from local governments to State governments. In 1961, a total of $370.5 million was received by State governments from all local governments in the Nation.

Georgia received less than the average from local governments on a per capita basis: $1.65 per capita in Georgia compared with $2.02 for the Nation. Georgia's State government received 1.1 percent of its total revenue from local governments. This compares with 1.3 percent for the average State.

The $6.6 million the State government in Georgia received from local governments in 1961 came primarily in the form of certain welfare transfers and the one-fourth mill property tax local governments collect for the State.

A FINAL NOTE ON STATE AND NATIONAL COMPARISONS OF GRANTS

The use of comparisons between State and national averages as an approach to the study of intergovernmental fiscal relations is not intended to lead the reader to the conclusion that Georgia should take some action to get its grants in line with the average for the Nation. It would clearly be a mistake to hold that grants should be equal for all areas within a Nation or within a State. In fact, the very purpose of grants would be largely defeated if such were the case.

Structural differences between States and between different areas within a State are too great for any system of uniform grants. Such differences as the urbanization of an area, industrialization, the amount of submarginal farm land, and other factors that either limit the revenue potential of an area or increase its need for expenditures, have a definite impact on the need for various types of grants.

(NOTE.—The following sources of data were used for this chapter: *Georgia Statistical Abstracts* (University of Georgia), *Statistical Abstract of the United States*, *Facts and Figures on Government Finance*—1960–1961 (Tax Foundation, Inc.), and various publications of the Bureau of the Census reporting results of recent Censuses of Government. Data for 1961 came from *Governmental Finances in 1961*, published by the U.S. Department of Commerce on Oct. 26, 1962.)

TRENDS IN INTERGOVERNMENTAL REVENUES AND EXPENDITURES IN GEORGIA

Growth of intergovernmental revenues and expenditures in the last 20 years is one clear reflection of the changing economic and social environment in Georgia. In appraising the expanded roles played by the State and Federal Governments, two primary explanations are apparent.

The first is that State aid programs have been designed to stimulate local officials to improve existing services and to develop new activities. Augmented Federal and State aid for schools has, and is, playing an important role in meeting the crucial need for upgrading education in Georgia. State and Federal aid for highway and air transport facilities is hastening the linkage of Georgia into a more closely integrated economic unit. And, in the last two decades in particular, Federal and State aid programs have been implemented to meet comprehensive public assistance and welfare needs at the local level.

The second explanation stems directly from the respective areas of jurisdiction of the several levels of government. With its extensive tax base and broad powers for deficit financing, the Federal Government is the least restricted governmental unit in its cash income-cash outgo position. Likewise, the State, with its broader base and wider area of support is enabled to administer a broader variety of taxes than local officials. To a large degree, State distribution of aid funds to the local jurisdiction has the effect of helping to equalize services provided for the citizens of Georgia in the various localities.

Trends in intergovernmental revenues are clearly apparent in the following table. Grants-in-aid from the Federal Government to the State government of Georgia increased over thirteenfold, or 1,332 percent, in 20 years. Local funds flowing to the State, as local governments participate more actively in various functional programs, increased some 334 percent.

The data in table 7 depict trends but are, however, incomplete without further analysis. In the 1960 Report of the Secretary of the Treasury of the United States, flow of specific purpose intergovernmental funds to the State of Georgia provides an interesting analysis of several major governmental activities of national interest in this State.

TABLE 7.—*Intergovernmental revenue to the State government of Georgia, by source and function, for selected years*

Revenue source	Percent increase, 1950–60	1960	1957	1950	1940
From Federal Government (total)	206	153,195	86,867	49,782	11,534
Education	198	12,781	8,533	4,324	1,161
Highways	356	56,968	14,486	12,523	4,500
Public welfare	163	67,215	49,163	25,557	1,843
Health and hospitals	281	7,101	5,442	1,857	710
Natural resources	96	4,040	4,650	2,061	932
Air transportation	NA	1,928	(1)	(1)	(1)
Employment Security Administration	94	4,841	3,594	2,496	862
Other	−63	340	1,000	924	1,526
From local governments (total)	250	6,529	7,244	1,870	1,950
Education	NA	2,029	(1)	(1)	(1)
Highways	76	247	1,110	141	1,580
Public welfare	121	3,437	2,869	1,564	368
Other	388	796	3,265	165	2

1 Included in "Other" revenue.

Source: *Compendium of State Government Finances*, U.S. Dept. of Commerce Bureau of the Census for the years 1960, 1957, 1950, 1940.

Federal grants-in-aid for education to the State government for 1960 as reported in table 7 totaled $12,781,000. This is broken down by the U.S. Secretary of the Treasury as follows:

Cooperative vocational education	$1,094,000
School construction and surveys	1,365,000
Maintenance and operation	4,651,000
School lunch [1]	5,300,000
School milk [1]	1,017,000
Other (libraries, defense, agricultural colleges)	1,200,000
Total	[2] 14,627,000

[1] These data obtained from the U.S. Department of Agriculture.
[2] The difference in totals is a reflection of reporting. Grants in kind, i.e., commodities such as milk, are excluded from Commerce Department figures.

Federal grants-in-aid for highways to the State, in 1960, amounted to $54,968,000. These funds are handled through trust funds and are allocated to designated construction projects.

Growth in public welfare grants-in-aid and functional expenditures reflect a vastly changed social ethic. Federal aid for public welfare flowing to the State of Georgia increased from $1,843,000 in 1940, to $67,215,000 in 1960—a 3,600 percent gain in 20 years.

By purpose, these Federal funds were distributed as follows for 1960:

Old-age assistance	$42,329,000
Dependent children	12,800,000
Permanently and totally disabled	9,911,000
Blind	1,692,000
Maternal and child aid (approximately)	1,300,000
Total (approximately)	[1] 68,032,000

[1] Differences in totals reflect alternative bases of reporting.

Health and Hospitals Aid is closely allied with public welfare and reflects a national concern with public health and the adequacy of facilities for medical treatment. Federal aid for this functional activity of government in Georgia amounted to $7,010,000. By purpose, this aid was designated as follows:

Hospital construction	$5,022,000
Waste treatment	1,115,000
Health assistance	425,000
Veneral disease and mental health	307,000
Other: Heart, TB, cancer, engineering	285,000
Total	[1] 7,255,000

[1] Differences in totals reflect alternative bases of reporting.

This analysis of the intergovernmental flow of funds by specific purpose adds understanding to the changing social, economic, and environmental relationships existing between levels of government and the mutuality of national interests among the people of the 50 States in our Nation.

Table 7, subsequent breakdown of figures by purpose, and trends, can be made more meaningful, perhaps, by one further note. Depression, three wars, rapidly changing technology, industrialization, and urbanization have reshaped the economic, social, and political configuration of the United States. Concurrent with these changes, demographic movement and a reshaping of the composition of population, significantly changed the scope and nature of economic, social, and political relationships. Efforts of the three levels of governments—Federal, State, and local—to adapt traditional roles and relationships to meet the surge of pressing new problems are crucial in this period of development.

The Federal Government's endeavors to meet the "problems of the times" and to adjust to the changing requirements of the higher standards of living are discernible in table 8.

TABLE 8.—*Dates of establishment of current Federal grants-in-aid programs*

Grant-in-aid program items	*Year originally established*
Education of the blind	1879
Agricultural experiment stations	1887
Homes for disabled soldiers and sailors	1888
Colleges for agriculture and mechanical arts (cash grants)	1890
State Marine schools	1911
Forestry cooperation:	
Forest fire protection	1911
Tree planting	1924
Forest management	1937
Agriculture extension work	1914
Highways:	
Federal-aid highway system	1916
Secondary roads	1944
Urban highways	1944
Interstate system	1944
Vocational Education:	
Salaries of teachers of agriculture	1917
Salaries of teachers—trades, industry, home economics	1917
Teacher training	1917
Education in agriculture	1946
Education in trades and industry	1946
Education in home economics	1946
Education in distributive occupations	1946
Public health:	
Venereal disease control	1918
General health	1935
Mental health activities	1944
Heart disease control	1944
Tuberculosis control	1944
Cancer control	1944
Vocation rehabilitation services:	
Support of basic services	1920
Extension and improvement projects	1954
Special projects	1954
Maternal and child health services	1921
Employment Security:	
Employment service	1933
Unemployment compensation	1935
Administration of unemployment allowances for veterans	1944
National school lunch program (cash grant)	1933
School milk program	1954
Removal and donation of surplus agricultural commodities (grants in kind to state and local welfare agencies and school lunch program)	1933
Public assistance:	
Old-age assistance	1935
Aid to dependent children	1935
Aid to blind	1935
Aid to permanently and totally disabled	1950
Services for crippled children	1950

TABLE 8.—*Dates of establishment of current Federal grants-in-aid programs*—Continued

Grants-in-aid program items	*Year originally established*
Child welfare	1935
Wildlife restoration	1935
Annual contributions, low-rent housing program	1937
Defense community facilities	1940
School construction in federally-affected areas	1940
School operation in federally-affected areas	1941
Supervision of training of veterans	1944
Agricultural research and marketing	1946
Hospital survey and construction:	
General, TB, chronic disease, mental hospitals, public health centers	1946
Diagnostic and treatment centers	1954
Rehabilitation facilities	1954
Hospitals for chronically ill	1954
Nursing homes	1954
Federal airport program	1946
Disaster relief	1947
Slum clearance and urban renewal grants	1949
Civil defense	1950
Fish restoration and management	1950
Urban planning	1954
State conference on education	1954

Source: Commission on Intergovernmental Relations, *Report to the President* (1955) pp. 305 ff.

Since 1955, the trend toward enlargement and broadening of existing programs has continued, particularly as regards aid to education, medical care for the aged, rehabilitation and retraining of displaced workers, airport and highway construction, and urban renewal. Continued population growth, urbanization, and technological advance will tend to bring the role of governments into sharper focus as ways and means are sought to solve emerging new problems.

TRENDS IN STATE FINANCE

Nationally, the American economy has proven itself virile and vibrant in the last two decades. From 1776 to 1929 is a period of 153 years. It took this young country this many years to reach its first $100 billion national income level. Then, in the fall of 1929, came the great "crash." It was a long decade until, in 1940, the country once again, reached the $100 billion GNP level. Under the stimulus of wartime production demands, national income reached $200 billion in 1944. Then the Nation continued its expansion, reaching $300 billion in 1950. In 1955, GNP reached $400 billion and in 1960, the figure for national income was $503 billion. Thus, on the average of every 5 years since 1940, the economy has added $100 billion to its national income. Of course, some of this income gain was illusory due to inflationary pressures and consequent reduction in purchasing power of the dollar. However, with an annual improvement factor of 2.5 to 3.5 percent, real income has doubled about every 20 years during this century.

Georgia, perhaps belatedly, shared in this gain. Personal income in Georgia rose from $1,015 million in 1940, to $3.510 million in 1950, to $4,918 million in 1955, to $6,549 million in 1960. Georgia's gain in personal income was achieved with a sometimes agonizing change in patterns of life. The move from farm to city, from self-employed farm proprietors to management-directed industrial and commercial employees, from independent rural living to dependent urbanized living, had their costs and impacts. The subsequent challenge to the State government of Georgia and how it was met is revealed in table 9 following:

TABLE 9.—*Expenditures of the State government of Georgia by function*

[In thousands of dollars]

Year ending June 30	Total	Current operation	Capital outlay	Assistance and subsidies	Interest	Insurance benefits and repayments [1]	Intergovernmental expenditures
1940	72,326	45,499	26,770	9,916	57	(2)	18,336
1950	204,047	88,498	40,548	58,404	65	16,414	58,404
1957	464,364	112,343	103,829	72,494	7,485	25,421	142,882
1960	564,300	141,431	115,288	86,839	10,264	33,943	176,535

[1] Comparability of data between years is subject to slight variation due to the changed format of presentation and certain non-segregable tabulations of data.
[2] Not available.

Source: *Compendium of State Government Finances* (for the selected years). U.S. Bureau of the Census.

If expenditure trends as depicted in table 9 can be considered as one side of the coin, then the other side must be revenue trends and sources. As personal income increased in the State of Georgia, so did taxes. It needs pinpointing, however, that State taxes of $53,684,000 in 1940 were 5.3 percent of the $1,015 million personal income in the State and that the State tax take in 1960 of $369,080,000 constituted 5.6 percent of the $6,549 million personal income. While personal income increased by a multiple of 6.4, taxes imposed and collected increased by a multiple of 6.8. In broad perspective, the State tax burden is relatively less heavy on the much larger income base. As a supplement, Federal aid to the State government increased by a multiple of 13. Citizens of Georgia are being provided with broadened, improved and new services, which 20 years ago would have been financially impossible.

TABLE 10.—*General revenue sources for the State government of Georgia*

[In thousands]

Year ending June 30—	Total general revenue	Taxes	Intergovernmental revenue		Charges and miscellaneous general revenue
			From Federal Government	From local governments	
1940	$71,944	$53,684	$11,534	$1,950	$4,576
1950	201,594	137,988	49,782	1,870	11,949
1957	437,575	314,513	86,867	7,244	28,951
1959	563,967	369,080	153,195	6,529	35,163
1961	591,300	393,200	152,900	6,600	38,500

Source: *Compendium of State Government Finances* (for selected years).

As seen in table 11, intergovernmental expeditures by the State government of Georgia moved from $18,336,000 in 1940 to $176,535,000 in 1960, a 968 percent increase in 20 years. Significantly important is the distribution of these funds among the various local governmental units and the purposes for which the funds were distributed. Trends in this frame of reference are seen in table 11.

TABLE 11.—*State payments to local governments by type of receiving government and by function*

[In thousands of dollars]

Year ending June 30—	Total	Counties	Cities	School districts	Education	Highways	Public welfare	Health and hospitals	Other
1940	18,336				14,540	3,448	424		
1950	58,404	8,637	2,871	46,896	49,225	4,817	1,566	881	1,915
1957	142,882	31,217	3,158	108,412	108,517	24,152	2,104	7,137	NA
1960	176,535	35,407	6,453	134,675	134,814	26,920	3,944	10,739	68

Source: *Compendium of State Government Finances* (for selected years).

TRENDS IN MUNICIPAL FINANCE

The urbanization movement in Georgia has not been without cost. As people congregate in urban centers, the aggregate costs of required governmental services tend to rise rapidly. With approximately 40 percent of Georgia's population living and working in eight metropolitan centers, these eight cities were selected as representative of the trend in municipal finances.

TABLE 12.—*Expenditures for selected cities in Georgia*

[In thousands]

City	Year	Total expenditures	Current operation	Capital outlay	Intergovernmental	Retirement system
Atlanta	1950	$25,288	$16,352	$6,333	$25	$586
	1957	56,020	22,344	12,867	12,867	2,393
	1959	55,139	21,515	20,097	185	2,924
Savannah	1950	3,910	3,368	135		152
	1957	7,312	4,854	1,297	206	368
	1959	10,461	5,485	2,750	([1] [2])	272
Augusta	1950	5,303	3,897	1,146		24
	1957	6,474	3,844	1,928	384	149
	1959	4,989	3,890	429	([1])	163
Columbus	1950	2,635	2,089	184		
	1957	8,534	5,279	2,881	107	
	1959	7,421	5,604	357	([1])	
Macon	1950	1,949	1,877	72		
	1957	10,089	5,726	3,868	119	91
	1959	8,414	6,249	211	([1])	88
Albany	1950	1,115	904	95		12
	1957	4,423	2,912	1,353		23
	1959	6,217	1,809	1,959	([1])	15
Athens	1950	651	523	68		6
	1957	1,791	1,052	599	49	13
	1959	1,991	1,039	329	([1])	13
Rome	1950	1,162	1,106			11
	1957	2,558	1,500	899	22	54
	1959	1,811	1,264	211	([1])	67

[1] Not available.
[2] *Compendium of City Government Finances*. The U.S. Dept. of Commerce. Intergovernmental expenditure omitted in 1959.

Analysis of the figures showing trends in city finances reveals the growing financial pressures on municipal governments. In each case, however, the pressures are of different degree and intensity depending upon such factors as the rate of population influx, pressures exerted upon existing capital plant and service facilities, the type of industry in the community, income levels and stability, and the like. Clearly apparent, however, are the mounting financial requirements of city governments.

Local governments are squeezed between a limited and narrow tax base and mounting costs to provide necessary services. With increasing size, higher income levels in the community, and a general tightening of tax administration, cities have struggled to meet demands placed upon them. Revenue trends of the eight selected cities are shown in table 13.

TABLE 13.—*Revenue of selected cities in Georgia*

[In thousands]

City	Year	Total general revenue	Total from taxes	Intergovernmental revenue	Total charges and miscellaneous
Atlanta	1950	$22,150	$11,716	$3,504	$6,930
	1957	29,035	15,558	3,880	9,597
	1959	37,352	18,956	8,190	10,206
Savannah	1950	3,912	3,188	(1)	724
	1957	5,519	4,624	162	733
	1959	6,380	5,224	263	893
Augusta	1950	4,733	2,280	344	2,119
	1957	4,990	3,145	523	1,332
	1959	4,292	3,387	18	887
Columbus	1950	2,598	2,249	(1)	349
	1957	5,489	2,924	443	2,389
	1959	6,575	3,913	22	2,640
Macon	1950	2,051	1,562	(1)	489
	1957	6,446	2,630	575	3,241
	1959	6,793	2,841	323	3,629
Albany	1950	1,297	726	6	565
	1957	1,589	985	58	546
	1959	1,548	988	97	463
Athens	1950	610	420	(1)	180
	1957	774	633	25	116
	1959	1,186	742	91	353
Rome	1950	1,242	917	181	144
	1957	1,357	1,149	83	107
	1959	1,461	1,187	127	147

[1] Not available.

Source: *Compendium of City Government Finances*, 1960. U.S. Bureau of the Census.

TRENDS IN COUNTY FINANCES

County governments in Georgia operate essentially as autonomous and independent entities. Trend data are not available in any comprehensive and verifiable form. However, the last complete study by the Bureau of the Census does provide data subject to analysis and intercounty comparison. Table 14 shows the scope, nature, and relative importance of functions and activities of counties in Georgia and by relative size.

To make the data in table 14 more meaningful for comparative analysis, the data is presented in table 15 in percentage terms thus indicating the relative importance of revenue collections and expenditure activities by relative county size.

TABLE 14.—*Selected items of county government finances by population size, 1957*

[Dollar amounts in thousands]

Item	All counties with a population of—				
	100,000 or more	50,000 to 99,999	25,000 to 49,999	10,000 to 24,999	Less than 10,000
Number of counties	6	2	20	68	63
Revenue;					
Property tax revenue	$25, 661	$2, 857	$11, 813	$11, 033	$4, 432
Intergovernmental revenue from State	2, 294	225	5, 220	10, 180	6, 346
Charges and miscellaneous general revenue	2, 400	215	2, 402	858	321
Expenditures for—					
General control	5, 592	832	2, 308	3, 076	1, 603
Public welfare	3, 093	162	1, 246	1, 798	878
Highways	3, 970	1, 268	7, 116	12, 731	7, 319
Health and hospitals	8, 176	283	4, 853	1, 444	391
Total capital outlay	3, 536	986	4, 737	6, 228	3, 528
Expenditures for personal services	10, 821	1, 414	7, 619	7, 320	3, 510
Long-term debt outstanding	48, 403	6, 802	18, 262	11, 518	2, 457

Source; Bureau of the Census, *Finances of County Governments*, 1957, Vol. III, No. 4. Population categories are based upon 1950 Census figures.

TABLE 15.—*Percentage distribution selected items of all county government finances*

Item	All counties with a population of—					Total
	100,000 or more	50,000 to 99,999	25,000 to 49,999	10,000 to 24,999	Less than 10,000	
Revenue:						
Property tax revenue	46. 0	5. 1	21. 2	19. 8	7. 9	100
Intergovernmental revenue from State	9. 3	. 9	21. 2	42. 9	25. 7	100
Charges and miscellaneous general revenue	38. 7	3. 5	38. 8	13. 8	5. 2	100
Expenditure for—						
General control	41. 7	6. 2	17. 2	22. 9	12. 0	100
Public welfare	43. 0	2. 3	17. 5	25. 0	12. 2	100
Highways	12. 3	3. 9	22. 0	39. 3	22. 6	100
Health and hospitals	54. 0	1. 9	32. 0	9. 5	2. 6	100
Total capital outlay	18. 6	5. 2	24. 9	32. 8	11. 6	100
Expenditures for personal services	35. 3	4. 6	24. 8	23. 9	11. 4	100
Long-term debt outstanding	55. 4	7. 8	26. 9	13. 2	2. 8	100

Source: Bureau of the Census, *Finances of County Governments*, 1957, Vol. III, No. 4.

THE IMPACT OF INTERGOVERNMENTAL FISCAL RELATIONS ON TAX STRUCTURE AND FUNCTIONS OF GOVERNMENT IN GEORGIA

The continued expansion of grants-in-aid, at the rapid rate of the 1950's is leading toward great changes in government. The State acts, in many instances, as a primary fiscal agent of the Federal Government, and the county is becoming increasingly dependent upon grants-in-aid for fiscal resources. Many appropriations made in Georgia by the General Assembly for specific purposes are, essentially, dictated by terms of the grants-in-aid. A failure to make such appropriations would cause the State to lose grants-in-aid funds from the Federal Government. A glance at table 8 in the preceding chapter shows the variety of services involved.

County governments in Georgia (as in all States) find that funds coming from Federal and State sources determine a large part of their expenditure patterns. Grants-in-aid not only determine the direction and scope of many expenditures but frequently require changes in accounting, budgeting, reporting and personnel qualifications. Decisions by the Federal Government to substitute direct services for grants-in-aid would have an important impact on the number of government employees at all levels.

During the decade of the 1950's total public employment in Georgia grew by 48.5 percent (12th in the Nation in rate of growth) while State and local employment grew by a much larger 61.7 percent (10th in the Nation in rate of growth).[3] The difference in these rates of growth partially reflects the decision of the Federal Government to use State and local governments as expending agencies. Georgia now ranks 15th in total number of public employees (182,714 in 1960) indicating the increasing supply of public services necessitated by rapid industrialization and urbanization. Sixty-nine percent, or 126,904, are employees of State and local governments.[4]

IMPACT ON FUNCTIONS

Many functions and services now provided in Georgia would not exist, or would exist only in abbreviated form, without grants-in-aid. An example is the State Employment Offices, which receive all their funds from Federal grants. Much less would be done in the fields of public welfare and unemployment compensation. On the other hand, many functions such as highways and education would continue regardless of grants; although some parts of these programs would be very different without funds from the Federal Government. School lunch programs and programs to encourage better science teaching would almost certainly be drastically reduced if the Federal funds allocated for these activities were no longer available. Highway construction, especially primary and "super-highway" construction, would unquestionably be much slower without Federal funds.

Funds moving from the State to the local government insure that each local government will seek the objectives and standards set. Typically, all State governments require that local governments provide certain minimum levels and qualities of services to qualify for grants. States are in a similar position regarding grants by the Federal Government. Grants for education have contained few Federal controls. Most States, however, have adopted very specific requirements that lead to relatively uniform educational services among all school districts. Some local governments in Georgia go well beyond the minimum standards required to receive State grants, but such local "supplements" tend to be exceptions, especially in rural areas.

IMPACT OF GRANTS-IN-AID ON ADMINISTRATIVE PRACTICES

Both Federal and State programs for grants-in-aid have generally avoided actions dictating specific administrative changes or procedures to be followed by receiving governments. However, approval by

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[3] Bureau of the Census. *Distribution of Public Employment.*

[4] U.S. Department of Commerce, Atlanta Field Office, Release for Apr. 19, 1961.

Congress or the General Assembly could hardly be secured for programs providing grants-in-aid without some means of control to insure that granted funds would be used for intended purposes. Such controls require reporting on the actual expenditure of such funds with appropriate auditing procedures.

As reported in one national study,[5] the Federal "single agency" requirement has led to changes in organizational structure, at the State and local levels, in some functions. Required control procedures for some activities have set examples of administrative procedures that provide patterns for other state functions. The conclusion is that grants-in-aid have had some beneficial effects and some harmful effects on administration. If a net balance exists, it is too small to be significant.[6]

IMPACT OF GRANTS-IN-AID ON BUDGETING

Nowhere is the impact of grants-in-aid on lower government so direct as the impact on budgets. States do alter their budgets to take advantage of funds available in the form of grants. A State government may find some fifty or more items in its budget and appropriations bill that are directly affected by Federal grants-in-aid.

The funds involved in Federal grants-in-aid leave the State no possibility of avoiding impact on the budget. In 1960, the State government of Georgia received $153,195,000 from the Federal Government. The State government made grants to local governments totaling $176,535,000. Over 27 percent of the income of Georgia's State government was in the form of grants-in-aid and over 31 percent of expenditures were grants-in-aid. The practical effect is that the Federal Government directs the scope of State appropriations in many categories and the State government directs the pattern of expenditure for local governments in many categories.

A second major impact on State budgets (and to a lesser extent on local budgets) arises in the form of uncertainty as to the size of Federal grants-in-aid. State governments can predict their revenue from internal sources with a reasonable degree of accuracy. Funds coming from the Federal Government for some functions vary somewhat less predictably due to countercyclical spending policies. Thus, grants for highways, public construction, and other related government programs fluctuate according to decisions made by Congress, as well as the Executive Branch, as to the levels of unemployment or the need to stimulate the economy in time of apparent recession. The ever-present possibility of war is another cause of change in Federal grants that cannot be predicted. Disaster or emergency grants are also unpredictable.

A long-range budgetary impact may be seen in decisions concerning grants which are sometimes referred to as equalizing or redistributive grants—where Federal funds are distributed as a method of helping equalize income or services as between poorer and wealthier States. Relatively higher per capita tax burdens in wealthy States, combined with relatively larger grants-in-aid to poorer States, are used to accomplish this objective—a type of Federal aid to underdeveloped,

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[5] Governmental Affairs Institute, *The Impact of Federal Grants in Aid on the Structure and Function of State and Local Governments.* Submitted to the Commission on Intergovernmental Affairs, Washington, U.S. Government Printing Office, June, 1955. This report is frequently referred to as the report of the Kestnbaum Commission, Section pp. 6 and 8.

[6] *Ibid.*

nonforeign areas. Georgia is yet hardly one of the wealthier States—the payments from Georgia's citizens to the Federal Government are considerably less than Georgia receives in return.

IMPACT ON THE OFFICE OF THE GOVERNOR AND ON THE GENERAL ASSEMBLY

Grants coming for the State are usually a combination of State funds and grants received from the Federal Government. As the Federal Government is not insistent that Federal and State funds be kept separate, State governments commonly receive credit for all State grant funds regardless of primary source.

State financial controls may be reduced if a Federal audit is to be made. This eliminates some duplication of effort but may result in the Federal Government controlling grants-in-aid activities within the State that were formerly in the hands of State governments.

Usually grants from the Federal Government are larger for specific activities than the State would have considered without aid. The General Assembly may reject or accept program participation. If accepted, the Assembly may debate the point of appropriating more than the minimum needed to qualify for the grant. On the other hand, there is little need to debate the appropriation of less than the Federal grant calls for—otherwise, the State would receive less in the grant or no grant at all. The result is that many very controversial measures no longer require extensive committee study and prolonged debate.

The State government faces a problem when authority over the budget is in the hands of the General Assembly and appropriations bills are passed every 2 years. Changes in the size of Federal grants may demand special annual appropriations bills. Absence of interim administrative decisionmaking authority may lead to loss of Federal funds that would otherwise be available.

IMPACT ON LOCAL GOVERNMENTS

Local governments are much like the State governments in that they benefit from Federal audits and because extensive debate is no longer needed before decisions are reached regarding a broad range of expenditures. Grants-in-aid act as a means of redistribution at the local level also. Wealthy counties bear relatively more of the burden of the State grants-in-aid program, while poorer counties receive relatively more benefit. Grants-in-aid are usually given credit by students of government finance for resulting in a more equitable tax system. Without grants-in-aid, local governments would be faced with the choice of reducing the variety or extent of services, placing greater regressive tax burdens on property owners, or turning to local sales taxes, income taxes or other tax bases for revenue. Another alternative would be for State and/or Federal Government to provide some of the services now provided by local governments.

GENERAL CONCLUSIONS CONCERNING THE IMPACT OF GRANTS-IN-AID

Expanding use of grants-in-aid has carried with it a shift in some decisionmaking from local governments and from State governments. This movement to more centralized government and more power for the Federal Government has come quite inconspicuously and rapidly over a relatively short period of 30 years or so.

As noted previously, continued expansion, at the rate of the last three decades, will provide increasing net benefits for Georgia as a "poorer" State, but it will also be grave cause for concern for citizens of Georgia who hold traditionally strong beliefs regarding "States' rights."

However, grants-in-aid have resulted in a much more uniform level of services provided by governments throughout the State and Nation. Many services would simply not be provided by governments in Georgia without grants-in-aid.

Georgia participated in 28 spending programs conducted by the Federal Government in 1960, and eight additional major programs supervised by the State and local governments. Defense expenditures, (as contracts awarded to business firms for goods and services) and wages and salaries paid Federal employees in the State brought $1.2 billion into the State of Georgia. A major portion of this money was subsequently channeled into a growing consumer goods' market. Other Federal expenditures in the State in 1960 give a rough idea as to where Federal money goes and how markets in Georgia participate through subsequent money flows:

TABLE 16.—*Selected Federal expenditures in Georgia, 1960*

	Millions
Expenditures for defense	$622.0
Wages and salaries to civilian and military workers	595.0
Social security and education	176.4
Old age survivors and disability insurance	146.3
Veterans pensions, rehabilitation, etc	129.1
Farm credit and FHA loans to farmers	105.2
Public assistance	66.7
Other educational programs, school lunch, milk, etc	50.7
Cost of public buildings and land acquired	37.7
Payments to farmers, soil bank conservation, etc	22.9
Federal aid for airport construction	12.6
Federal aid for completed highways	3.1
Vocational rehabilitation of disabled	2.3
Maternal and aid to children	1.4
Vocational education	1.3
Unemployment insurance for ex-servicemen	1.2
Unemployment insurance for Federal workers	.9
State parks	.8

Source: U.S. Department of Commerce releases, Atlanta Field Office, Jan. 5, 1962, and Oct. 31, 1961.

Regarding State and local governments expenditures, relatively large sums of money were spent for education ($301.3 million), highways ($163.8 million), and public welfare ($94.2 million). In addition, tax money paid by Georgians flowed back to them through the economy as expenditures for health and hospitals ($85.6 million), police protection ($25.6 million), fire protection ($13.1 million), sanitation ($26.5 million), and part of the interest on public debt ($26.4 million). In addition, $33.6 million was expended for "general control" which includes the legislative, judicial, and executive branches of Georgia's government.

AN OVERALL VIEW: CONCLUSIONS

Data presented in this study depict and illustrate the growing fiscal interdependencies existing between the several levels of government. Concurrently, the data bring into focus some of the mutual interactions of the private and public sectors of the economy.

For the most part, the data reflect basic structural changes which have come with technological advances, economic development, population growth, demographic movement toward urbanized centers, and the like. As the nation evolved into a more closely knit economic and social unit, the relative influence of the several layers of governments as "power" centers in the fiscal sense has been reversed. At the turn of the century, taxes collected by the Federal Government were approximately 60 percent of that amount collected by State and local governments. Today, tax collections of the Federal Government are approaching three times State and local tax revenues.

In the flow of funds to and from the national level, Georgia's economy has gained in the exchange.

In 1960, Georgia's residents paid $1,570 million in all forms of taxes and received in return $2,854 million in expenditures in programs of the three levels of governments. These expenditures included Federal contracts awarded Georgia's business firms for goods and services, payments to veterans, and wages and salaries paid Federal Government employees. These major expenditure items do not show up in intergovernmental fiscal flows, but do exercise a strong impact upon economic markets and activity in Georgia. That this surplus in the balance of payments has promoted Georgia's progress is unquestionable. Incomes within the State are augmented, sales and production levels are raised, and the adequacy of public services at the State and local level is sustained at a level sufficiently high to make Georgia a more attractive area in which to invest, work and live.

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AN ANALYSIS OF FEDERAL AID IN WISCONSIN: A WISCONSIN PROPOSAL TO CONGRESS FOR UNCONDITIONAL GRANTS*

BY STATE OF WISCONSIN, DEPARTMENT OF ADMINISTRATION, BUREAU OF MANAGEMENT

Arguments for grants (either conditional or unconditional) from the Federal Government to States

1. There is a pressing need for more governmental services, partly because citizens today ask more of government at all levels, and partly because of the increasing population. The population pressures requires more health safeguards, educational facilities, and welfare aid, all of which have traditionally been provided at the State or local level. Yet it is at these levels that it is hardest to find more tax revenue today. The Federal Government can provide the money easily, the argument runs, from income tax revenues.

2. The ability to pay for services varies widely among States, as indicated by per capita personal income from $1,607 (Arkansas) to $3,386 (Nevada).

3. Many factors call for some equality in the level of services among States: mobility of population, temporary travel across State lines for recreational or business or educational purposes, military service. All of these suggest that it is in the interest of citizens anywhere in the United States to have some measure of equality across the country in highways, sanitation, education, employment services, public assistance.

4. Some measure of equaliy, but not uniformity, of services is needed. State/local administration and determination of details best provide for the flexibility which is desired in a Federal system of government.

Arguments for and against unconditional grants

These points cannot be listed simply as pro and con points, because the judgment of whether they are in support of or in opposition to unconditional grants depends on one's political philosophy.

1. *Constitutional questions, including State sovereignty.*—Unconditional grants would limit Federal control over the spending of Federal revenue.

Unconditional grants would make States stronger and more independent. Conditional Federal aid given in support of a traditionally State function (education, for example) is said to be an invasion of State sovereignty.

The provision which is in many Federal grants that aid may be

*Reprinted from *State of Wisconsin: An Analysis of Federal Aid in Wisconsin*, Department of Administration, Bureau of Management, September 1965, Appendix I.

withheld if the recipient does not meet certain conditions has been attacked as an invasion of State sovereignty. (The attack has been blunted by congressional inclusion in some grant legislation of judicial review procedures so that a State agency may appeal the Federal agency's ruling which cuts off its aid.)

2. *Problems of administration.*—The more specific a grant's regulation, the more points of friction may arise between levels of government; unconditional grants would avoid such problems. The State administrators would not have to clear every detail with the Federal agency but could easily make adjustments as needed for local conditions. Proponents of conditional grants, however, say that ideally these grants establish only policy, not details of administration.

The specific provisions in conditional grants for a State plan, an annual budget, a report, and available records for Federal audit provide protection to taxpayers that Federal funds will be carefully spent by States. The growing number and size of Federal grant programs are said to require an unwieldly Federal bureaucracy for administering the grants. Unconditional grant funds would simply be returned to the States, requiring no increase in Federal employees.

Peacemeal enactment of particular grants-in-aid, such as is now going on, is said to aggravate the divisive elements in federalism. Particular grants are not started in an area of greatest need but because Congress is influenced by some strong pressure group. Such special interest groups prefer to continue the present grant system, because they may influence national legislature more easily than 50 State legislatures.

3. *Selection of activity to be aided.*—Individual States might have insufficient interest in certain programs which are of concern to the Nation. A rural-dominated legislature might not make Federal funds available to aid urban mass transportation; an urban-dominated legislature might not provide Federal aid for pockets of rural poverty remote from urban centers.

The obverse of the above argument is that the present system of specific grants puts a premium within each State on providing or expanding the aided program in preference to one which may be more vital to that one State but for which it can get no Federal funds.

4. *Allocation of funds.*—Local officials, governmental and nongovernmental, fear that too much of the unconditional grants would be spent at the State level and would not be made available for local programs (urban planning, for instance, or local watershed improvements). Such fears might be allayed by a Federal provision that each State shall distribute a certain percentage of the subsidy to local governments.

Not only between levels of government but also between programs there is a problem of allocation of funds. It may be argued in support of the present system that it assures that Federal funds are used in the national interest as Congress sees it. Or it may be argued that States, too, see health, education, and welfare as the greatest needs as evidenced by present spending from their own funds; these areas plus highway construction are the chief spending areas; and so the States would also spend unrestricted Federal funds for health, education, and welfare. Matching provisions of many of the present grants insure that the States from their own revenue will make a proper effort. And what States call "escalation" provisions insure that States will spend no less from their own revenue on the aided functions than they spent before Federal aid was given. Without any matching requirement for Federal funds received or any "floor" on State spending for a function, some States might lower their taxes and their level of services, substituting Federal for State funds instead of enlarging services. The obverse of that argument is that a state may validly see some other service as more in need of funds.

5. *National homogeneity or heterogeneity.*—Unconditional grants would allow or even encourage variation among States. They could finance a State's experimentation in some new form of aid. It was an individual State (Wisconsin in 1932), not the Federal Government, which originated unemployment compensation. Conditional grants presume or prescribe a nonexistant uniformity among States; variety is the essence of federalism.

Supporters of conditional grants reply that States may differ, but the needs of citizens for services all over the United States are reasonably uniform; the aim of Congress in setting standards is not, however, uniformity but a national minimum standard of services, which leaves room for reasonable diversity of performance among the States; citizens move from State to State, and uniform minimum standards of health and eduaction are in the interests of all.

Senate Joint Resolution 56, relating to a return to the States of a portion of the revenues from the Federal tax on incomes

A resolution pending in the Wisconsin Legislature in 1965 would memorialize Congress to return to the States a portion of Federal income tax collections "equivalent to a percentage of their actual expenditures, excluding Federal aids, for health, education and welfare." It would further ask Congress to require the States to "distribute these additional Federal aids to each of the local governmental units within the State in ratio to their actual net expenditures for such purposes."

The form of this proposal for virtually unconditional Federal grants appears to provide for equitable distribution of such funds among States and within a State based on each governmental unit's effort as measured by its own spending. This proposal would not equalize spending among States or localities which differ in taxable resources.

Part 2

STATE REVENUE SHARING AND AID TO LOCAL GOVERNMENTS

PRECEDENTS FOR UNRESTRICTED REVENUE SHARING IN STATE-LOCAL FISCAL RELATIONS

BY JUDY N. MARGOLIS*

There are numerous precedents in State-local relations for unrestricted revenue sharing. In 1965 (the latest year for which detailed information is presently available), 44 States provided local governments with general grants which were not tied to any specific program.

The importance of such grants varies widely among the States. Delaware, Georgia, Illinois, Montana, and West Virginia do not have a program of unrestricted aid; Wisconsin devotes over 20 percent of its total annual expenditure to such a program. Most States assign only a small proportion of their total intergovernmental support to grants that are not restricted for use in specified programs. Several States devote at least a fifth of their intergovernmental payments to this type of aid. Hawaii spends $8 in unrestricted aid for every $1 devoted to restricted programs. It is the only State where the amount of unrestricted aid exceeds the earmarked aids.

Two compilations that help describe the position of unrestricted State aid to local governments are included in this report. First, appears a table that lists how much money each State devotes to unrestricted aid; how much of the State's total expenditure such aid represents; how much the State spends per capita for unrestricted payments; and how much, per capita, the State devotes to restricted programs of aid.

The second compilation (derived from the 1962 Census of Governments) presents each State's program of unrestricted grants as they were in 1962, and describes both where the money comes from and on what basis it is redistributed.

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*Research Assistant in Social Welfare, Legislative Reference Service, The Library of Congress, Washington, D.C.

I. UNRESTRICTED STATE PAYMENTS TO LOCAL GOVERNMENTS, FISCAL YEAR 1965

State	Unrestricted payments to local governments (thousands)	Unrestricted payments: Percent of total State expenditure	Unrestricted payments: Amount per capita	Restricted State payments to local governments (amount per capita)
Alabama	$6,308	0.8	$1.82	$60.36
Alaska	1,757	.9	6.94	81.75
Arizona	34,367	7.8	21.36	55.67
Arkansas	5,981	1.6	3.05	41.54
California	96,746	1.6	5.20	122.61
Colorado	219	(1)	.11	80.62
Connecticut	1,055	.2	.37	36.28
Delaware				126.77
Florida	366	(1)	.06	59.90
Georgia				61.14
Hawaii	23,407	8.6	32.93	4.12
Idaho	2,430	1.3	3.51	49.07
Illinois				46.59
Indiana	8,419	.8	1.72	69.98
Iowa	35,337	5.5	12.80	41.05
Kansas	4,696	1.0	2.10	53.30
Kentucky	1,936	.3	.61	44.32
Louisiana	55,906	5.2	15.82	70.74
Maine	468	.2	.47	29.53
Maryland	60,391	7.7	17.15	75.58
Massachusetts	93,718	7.4	17.52	58.33
Michigan	88,382	4.3	10.75	77.87
Minnesota	20,168	2.3	5.67	91.63
Mississippi	13,849	3.0	5.96	59.48
Missouri	6,904	.8	1.53	38.12
Montana				42.45
Nebraska	1,008	.4	.68	34.95
Nevada	2,652	1.6	6.03	70.34
New Hampshire	2,573	1.7	3.84	10.02
New Jersey	3,572	.3	.53	36.58
New Mexico	3,274	.9	3.18	101.85
New York	106,898	2.3	5.91	107.77
North Carolina	20,382	2.1	4.15	75.13
North Dakota	1,557	.8	2.39	43.29
Ohio	71,719	3.6	7.00	49.20
Oklahoma	2,316	.3	.93	57.64
Oregon	7,061	1.1	3.72	61.39
Pennsylvania	6,199	.2	.54	52.54
Rhode Island	7,214	3.0	8.10	34.40
South Carolina	14,452	3.2	5.68	48.63
South Dakota	1,592	.9	2.26	19.29
Tennessee	19,510	2.8	5.07	50.11
Texas	133	(1)	.01	49.08
Utah	1,000	.3	1.01	87.65
Vermont	11	(1)	.03	43.79
Virginia	13,666	1.5	3.07	47.12
Washington	15,811	1.4	5.29	100.65
West Virginia				43.55
Wisconsin	234,622	22.4	56.60	68.02
Wyoming	2,344	1.5	6.89	81.40

1 Less than 1/10 of 1 percent.

Source: U.S. Bureau of the Census, *Compendium of State Government Finances in 1965, Series GF-No. 4*, United States Government Printing Office, Washington, D.C., 1966, tables 4, 8, and 10.

II. STATE PROGRAMS OF UNRESTRICTED AID TO LOCAL GOVERNMENTS

ALABAMA

Alcoholic Beverage Control Board profits.—Of the first $2 million, 10 percent is divided equally among the counties, 20 percent is distributed to cities in which stores are located, in proportion to profits of such stores. The next $200,000 is distributed to all cities and towns in proportion to population. The remainder is distributed as follows: 10 percent to counties in proportion to population; 16⅔ percent to all cities and towns in proportion to population; and 3⅓ percent to cities in which stores are located, in proportion to population.

Beer (sales) tax.—One-fourth of proceeds distributed equally among counties.

Corporation franchise (license) tax.—Two twenty-fifths of proceeds distributed in proportion to distribution of taxable property of paying corporations.

Corporation net income tax (excise tax on financial institutions).—Twenty-five percent distributed to county of origin and 50 percent to city of origin.

Oil and gas production (severance) tax.—After allocation of specified amount to general fund, proceeds distributed as follows: Of the first $150,000, 42½ percent to the county of origin and 7½ percent to cities and towns therein, in proportion to population; of the remainder, 14 percent to county of origin and 2 percent to cities and towns therein, in proportion to population.

ALASKA

Alcoholic beverage retail license tax.—Proceeds distributed to city of origin.

Amusement device license tax.—One-half of proceeds, after specified deductions, distributed to city of origin.

Business license tax.—Sixty percent of proceeds distributed to taxing district of origin.

Electric and telephone cooperatives gross earnings tax.—Proceeds, after deduction for State administration, distributed to local government of origin.

Raw fish license tax.—Ten percent of proceeds from salmon canneries distributed to city of origin.

ARIZONA

Alcoholic beverage license tax.—One-third distributed to county of origin.

Bank income tax.—One-fourth distributed to county of origin and one-fourth to city of origin. Amounts allocated to unincorporated "cities" paid to the counties in which they are located.

General sales tax.—Twenty-five percent distributed to cities and towns in proportion to population; 60 percent of amount remaining after city distribution and certain other appropriations of proceeds distributed to counties in proportion to an average of the percentage of sales tax proceeds accounted for by each county.

Savings and loan income tax.—One-fourth distributed to county of origin and one-fourth to city of origin.

ARKANSAS

County aid.—Share of general revenues, as determined by statutory allocation, distributed three-fourths equally among counties and one-fourth in proportion to population.

Municipal aid.—Share of general revenues, as determined by statutory allocation, distributed to cities and incorporated towns in proportion to population.

CALIFORNIA

Alcoholic beverage license tax.—Ninety percent of proceeds distributed to city and county of origin.

Highway properties rental fund.—Twenty-four percent of proceeds from income received from lands held by State for highway purposes returned to county (including the city-county of San Francisco) of origin. County redistributes its share on basic of location and in proportion to assessed valuation to itself and other local governments.

Motor vehicle "in lieu" property tax.—After deduction for debt service on State highway bonds and for certain expenses of the State highway patrol, proceeds distributed one-half to counties and one-half to cities in proportion to population. There is no limitation as to use of funds by counties. Cities must use funds for law enforcement and fire protection of highway traffic.

Trailer coach license fees.—Proceeds distributed to county of origin. Counties must redistribute one-third to cities and one-third to school districts from which collections originate (one-half to school districts, where collections originate outside a city).

COLORADO

Motor vehicle penalty assessments.—Fifty percent of penalty assessment collected by State Motor Vehicle Department distributed to counties in which violations occurred.

CONNECTICUT

Loss of taxes on State property.—Amount of city and town taxes lost through exemption of State property distributed in accordance with such tax losses.

FLORIDA

Insurance agents' license tax.—Ninety-seven percent of proceeds distributed to county of origin.

Railroad company license tax.—Fifty percent of proceeds distributed to counties in proportion to railroad trackage.

Telegraph company license tax.—Fifty percent of proceeds distributed to counties in proportion to line mileage.

HAWAII

General sales tax.—Proceeds from general sales, consumption, and compensating taxes equal to 1 percent of tax base of all collections made at rate of 2 percent or more, distributed to counties (including the city-county of Honolulu) in proportion established by statute.

IDAHO

Alcoholic beverage monopoly profits.—Seven and one-half percent of profits distributed to cities and villages on population basis; 50 percent of profits distributed among counties in proportion to population. In counties with junior college districts, one-half of their share distributed to such districts, and one-half of remainder distributed to cities on population basis. In all other counties, one-half of their share distributed to cities on population basis.

INDIANA

Alcoholic beverage license taxes.—Two-thirds of proceeds from retail licenses issued for businesses in cities distributed to city of origin, and two-thirds of proceeds from retail licenses issued for businesses outside cities distributed to county of origin.

Alcoholic beverage sales tax.—One-half of proceeds from gallonage tax on alcoholic beverages distributed to cities in proportion to population.

Intangibles tax.—Twenty-two and one-half percent of proceeds distributed in proportion to assessed valuations.

IOWA

Alcoholic beverage monopoly sales—city allocation.—Amount equal to 5 percent of gross sales distributed in proportion to population.

Alcoholic beverage monopoly sales—military service tax credit reimbursement.—Amount equal to 5 percent of gross sales distributed among all taxing units in proportion to their losses arising from military service tax credits.

Homestead exemption reimbursement.—Amount appropriated distributed among all taxing units in proportion to their tax losses arising from exemption of homestead property.

KANSAS

Alcoholic beverage sales tax.—Four-fifths of proceeds from 2½ percent retail sales tax distributed to counties, one-half in proportion to population and one-half in proportion to assessed valuation. Each county redistributes one-half of its share to cities in proportion to population.

Cigarette sales tax.—Thirty-seven and one-half percent of proceeds distributed to counties in proportion to population, and one-half of each county's share redistributed among cities in proportion to population.

Sales tax residue.—As much as $12.5 million of that part of the retail sales tax fund which remains after statutory allocations, distributed to counties one-half in proportion to population and one-half in proportion to assessed valuation. Counties redistribute their shares to all taxing units, including themselves, in proportion to property tax levies, provided that the amount recieved by each unit from the sales tax residue is applied to reduction of its property tax levy.

KENTUCKY

County fees.—One-fourth of fees collected by county officials in counties of 75,000 population or more and paid to the State returned to the respective counties.

Tennessee Valley Authority payments in lieu of taxes.—Seventy percent of the revenue received by the State from TVA distributed to cities, counties, and school districts in proportion to property taxes that would be raised by applying current tax rates to book value of TVA property located in the various taxing jurisdictions.

LOUISIANA

Chainstore tax.—Proceeds distributed to cities and parishes in which chainstores are located, in proportion to population of such cities and parishes. Where chainstores are located in an unincorporated area, parish retains a part in proportion that the population of the unincorporated area bears to the total parish population.

Equalization of parish revenue.—Amount appropriated distributed to parishes with general fund revenue below a specified level in an amount sufficient to bring such revenue to the specified level.

Homestead exemption reimbursement.—Amount required distributed to specified local governments as reimbursement of tax losses arising from exemption of homesteads from property taxes.

Parimutuels tax.—Amount appropriated from proceeds at New Orleans Fair Grounds distributed to New Orleans. If racing meets held in other parishes, one-half of proceeds originating in those parishes distributed to them.

Severance taxes.—One-third of proceeds from tax on severance of sulpur, but not to exceed $100,000 for any one parish; 75 percent of proceeds from timber severance tax; and one-fifth of proceeds from all other severance taxes, but not to exceed $200,000 for any one parish, distributed to taxing units having jurisdiction over location from which severance was made, in proportion to property taxes levied by each.

Tobacco sales tax.—Thirty-seven and one-half percent of proceeds in excess of $1 million distributed: (*a*) to cities at specified rates per capita, graduated according to population size of city; (*b*) any surplus remaining distributed to parishes in which there are no incorporated municipalities, at a specified rate per capita; and (*c*) any surplus remaining used to increase the per capita allocations to cities. From the 62½ percent of proceeds remaining, an additional 50 cents per capita is distributed to cities of over 100,000 population.

MAINE

Bank stock tax.—Proceeds distributed to city or town of residence of holders of taxed stock or to city or town in which financial institution is located, if stockholder is nonresident.

Railroad and telephone and telegraph company taxes.—Share of proceeds equivalent to 1 percent of the value of stock in such companies distributed to cities and towns in proportion to the value of such stock held.

MARYLAND

Admissions tax.—Proceeds distributed to city of origin or to county of origin, where collections originate outside cities.

Alcoholic beverage sales tax.—Share of proceeds equal to 50 cents per gallon of distilled spirits sold in city of Baltimore and counties returned to city of Baltimore and county of origin.

Cigarette tax.—After deduction for administration, one-half of proceeds of 6 cents tax distributed to city of Baltimore and counties on basis of population.

Corporation franchise tax.—One-half proceeds from "ordinary business corporations" with principal offices in city of Baltimore distributed to Baltimore; one-half of proceeds from similar corporations with principal offices in other cities divided equally between city and county of origin; and one-half of proceeds from similar corporations with principal offices outside cities distributed to county of origin.

Individual income tax.—Share of proceeds equal to 1.7 percent of taxed investment income and 0.68 percent of taxed other income of taxpayers residing in city of Baltimore distributed to Baltimore; equal share of taxed income of taxpayers residing outside cities distributed to counties; equal share of taxed income of taxpayers residing in cities other than Baltimore divided equally between counties and such cities.

Motor vehicle license tax in lieu of personal property tax.—Fixed portions of motor vehicle registration fees distributed to city of Baltimore or county of origin. Outside city of Baltimore, one-half of county's share of fees originating in cities redistributed by county to city of origin.

Parimutuels and racing license taxes.—Twenty four thousand dollars plus one-quarter of all revenue from license fees and taxes on horse racing at fairs and agricultural exhibitions; one-half of breakage and license fees plus one-quarter of first $2 million parimutuels tax and nine-twentieths of tax in excess of $2 million from trotting and pacing races; plus one-half of all breakage and license fees and two-fifths of parimutuel tax derived from all other horse racing, distributed to the city of Baltimore and the counties on the basis of population. Counties must redistribute to eligible towns portions of gross amounts received, for certain specified purposes.

MASSACHUSETTS

Corporation excess and net income (license) tax.—Specified amounts distributed partly in proportion to 1935 collections from taxes on industrial machinery and partly in proportion to 1935 value of industrial machinery; and five-sixths of remainder (exclusive of surtaxes) distributed in proportion to last preceding State tax on cities and towns.

Individual income tax.—Remainder of proceeds after distribution for school purposes distributed in proportion to last preceding State tax on cities and towns.

Reimbursement for tax losses.—Amount appropriated distributed on basis of loss of property tax revenue arising from tax exemption of State-owned lands.

MICHIGAN

Alcoholic beverage license taxes.—Eighty-five percent of collections in cities and townships distributed to city or township of origin.

General sales tax.—One-sixths of proceeds distributed in proportion to population.

Intangible (property) tax.—Proceeds, subject to specified maximum total allocation, distributed in proportion to population.

Parimutuels tax.—Twenty percent of proceeds from tracks in corporate limits distributed to city of origin, subject to specified maximum amount per city.

Proceeds from sale of tax-reverted property.—Proceeds distributed in proportion to amount of delinquent taxes and interest due.

Veterans' homestead exemption reimbursement.—Required amount distributed as reimbursement for property tax losses of local governments arising from exemption of veterans' homesteads.

MINNESOTA

Alcoholic beverage sales tax.—Thirty percent of proceeds distributed to cities and townships in proportion to population.

Bank excise (corporation income) tax.—Proceeds distributed to county of origin for redistribution to taxing units in which taxpayers are located in proportion that personal property tax proceeds are distributed among such units.

Cigarette sales tax.—One-fourth of proceeds distributed to cities and counties in proportion to population.

Death and gift taxes.—Twenty percent of proceeds distributed to county of origin.

Gross earnings tax replacement.—Amount appropriated distributed as reimbursement of tax losses arising from exemption of property subject to gross earnings tax.

Mineral rents and royalties.—Eighty percent of proceeds from mineral lands or rights held in trust by State for taxing districts distributed to county of origin; county reapportions to taxing districts at a prescribed rate.

Taconite production tax.—One-half of proceeds returned to local government where operations were conducted and distributed one-fourth to counties, one-fourth to cities or townships, and one-half to school districts.

Taconite railroad (gross earnings) tax.—Ninety-four percent of proceeds distributed to taxing districts in which railroad operations are conducted, at a prescribed rate.

MISSISSIPPI

Homestead exemption reimbursement.—Amount appropriated distributed as reimbursement for losses resulting from exemption of homesteads from property taxation.

Municipal revolving fund.—Surplus in State general fund at each biennium, up to a specified maximum amount, distributed to cities in proportion to population.

Natural gas severance tax.—One-third of proceeds distributed to county of origin. Counties must redistribute up to one-third of their share to cities containing gas-producing properties on basis of origin of tax collections.

Oil severance tax.—One-third of first \$600,000, one-tenth of next \$600,000, and one-twentieth of remainder of proceeds distributed to counties in proportion to collections. Counties must redistribute up to one-third of their share to cities containing oil-producing properties on basis of ratio of oil production in each city to oil production in entire county.

Tennessee Valley Authority payments in lieu of taxes.—Portion of revenue received by State from TVA distributed as reimbursement for tax losses resulting from exemption of TVA property.

Timber severance tax.—Two-thirds of proceeds distributed to county of origin.

MISSOURI

Insurance premiums tax—domestic stock insurance companies.—Proceeds from tax distributed to counties (including St. Louis City) and school districts in which taxpaying companies are located in proportion to rates of property tax levies of such units.

Intangibles (property) taxes.—Ninety-eight percent of collections from each taxpayer distributed to county of origin for redistribution among taxing units in which taxpayer resides in proportion to rates of property tax levies of such units.

Forest-croplands tax reimbursement.—Amount appropriated distributed to counties in which such lands are located at a specified rate per acre.

Private car tax (public utilities sales tax).—Proceeds distributed to counties (including St. Louis City) in proportion to main line mileage.

NEBRASKA

Insurance premiums tax.—One-half of proceeds distributed to counties in proportion to population. Each county redistributes its share as follows: (a) 10 percent to county general fund, (b) 60 percent to school districts in proportion to number of pupils in average daily attendance, and (c) 30 percent to cities in proportion to population.

NEVADA

Cigarette (sales) tax.—Of the proceeds, 5½ percent distributed to county of origin and 28½ percent distributed to cities and counties in proportion to population.

Gaming license tax.—Proceeds from license fee, based on number of games operated, divided equally among counties.

NEW HAMPSHIRE

Interest and dividends (individual income) tax.—Proceeds, less administrative costs, distributed to city or town of residence of taxpayer.

Railroad (property) tax.—One-fourth of proceeds distributed to each city or town in proportion to value of buildings and rights of way of taxed corporations, plus that portion of the residue of collections determined by the ratio of capital stock of taxed corporations held by residents of cities or towns to total capital stock.

Reimbursement for tax losses on forest and flood control lands.—Amount appropriated distributed in proportion to property tax losses arising from exemption of public forest and flood control lands.

Reimbursement for tax losses on growing timber.—Amount appropriated distributed in proportion to property tax losses arising from exemption of growing timber.

Savings bank (license) tax.—Proceeds arising from deposits or capital stock owned by residents of cities or towns distributed to city or town of residence of depositor or stockholder.

NEW JERSEY

Financial business (license) tax.—Proceeds distributed one-half to taxing unit in which taxpayer is located and one-half to county in which taxing unit is located.

Inheritance tax.—Five percent of proceeds distributed to county or origin.

NEW MEXICO

Motor vehicle license taxes.—After deduction for administration, 15 percent of proceeds distributed to county of origin for redistribution among taxing units therein in proportion to the property taxes they levy.

Motor vehicle operators' license taxes.—After deduction of a specified portion of fee for each license, one-half of amount collected in cities and Los Alamos County, distributed to city or county of origin.

Oil and gas ad valorem production (severance) tax.—Proceeds distributed to county of origin for redistribution to taxing units on basis of value of product severed and sold.

Proceeds from tax sales.—Eighty percent of proceeds from sale of tax delinquent property returned to county in which property is located for distribution to all taxing units.

Racing license fees.—One-half of proceeds from daily license fee imposed for each authorized day of horseracing distributed to county of origin.

NEW YORK

Loss of taxes on exemption of railroad property and commuter railroads.—Amount appropriated distributed to compensate for loss of taxes on basis of legislative formula.

Per capita grants.—Amount appropriated distributed in proportion to population at specified per capita rates, currently $6.75 for cities, $3.55 for towns, and $3 for villages.

NORTH CAROLINA

Alcoholic beverage sales taxes.—Forty seven and one-half percent of proceeds from tax on beer and 50 percent of proceeds from tax on wine distributed to cities and counties in which sale of such beverages may be licensed, on basis of population of such cities and counties.

Intangible property tax.—After deduction for State administration, proceeds distributed partly in proportion to population and partly to county of origin. Counties must redistribute amounts initially received among all taxing units in proportion to property tax levies.

Public utility sales taxes.—Of the franchise tax (primarily 6 percent) on certain public utilities, an amount equal to three-fourths of 1 percent of gross receipts from sales within cities distributed to city of origin.

TVA payments.—Payments in lieu of taxes received from TVA distributed in amount equal to tax losses on TVA occupied land.

NORTH DAKOTA

Cigarette (sales) tax.—Proceeds from tax of one-half mill per cigarette distributed to cities in proportion to population.

Severance (oil and gas production) tax.—After deduction of 1 percent of proceeds from 5 percent tax on gross value of oil and gas production, remainder distributed to counties of origin as follows: 75 percent of the first $200,000, 50 percent of the next $200,000, and 25 percent of the remainder. Counties redistribute their shares 40 percent to the county road and bridge fund, 45 percent to the school districts in proportion to average daily attendance, and 15 percent to cities in proportion to population.

OHIO

Alcoholic beverage license taxes.—Proceeds from liquor control permits distributed to city of origin or to township of origin, where permits originate outside municipalities.

General sales tax and intangibles (property) tax.—Amount appropriated from general sales tax proceeds distributed among counties, 75 percent in proportion to assessed valuation within municipalities and 25 percent in proportion to county population, subject to a specified minimum amount per county; and proceeds from intangibles tax on financial institutions and dealers in intangibles distributed to county of origin. Each county redistributes its share to the county itself and to cities, park districts, and townships therein on the basis of needs for current operating expenses as determined by the county budget commission; but in counties of less than 100,000 population, not less than 10 percent must be distributed to townships.

OKLAHOMA

Alcoholic beverage excise tax.—One-third of 97 percent of proceeds distributed to counties in proportion to area and population and redistributed to cities and towns in proportion to population.

OREGON

Alcoholic beverage license taxes.—Sixty percent of proceeds distributed to city of origin or to county of origin, where license is located outside incorporated city.

Alcoholic beverage monopoly profits.—After specified deduction, 12½ percent of proceeds distributed to "wet" cities and 5 percent of proceeds to "wet" counties in proportion to population.

Alcoholic beverage sales taxes.—Three-thirteenths (30 cents of each $1.30 tax) of proceeds from tax on malt beverage and 10 percent of proceeds from tax on wine distributed in proportion to population to cities and counties not prohibiting sale of liquor.

Boat licenses and fees.—Proceeds distributed to counties in proportion to number of certificates issued.

Electric cooperative tax.—Proceeds from 2 percent on gross earning of mutual and cooperative electric systems apportioned to counties in proportion to transmission line mileage.

Liquor purchase permits.—One-half of proceeds distributed in proportion to population.

Rural telephone exchange tax.—Proceeds from 6 percent tax on gross earnings of companies electing to pay this tax in lieu of property tax distributed to counties wherein such companies are located, in proportion to wire mileage.

Sale of timber.—Seventy-five percent of proceeds from forests acquired from counties distributed to counties in which such forests are located.

PENNSYLVANIA

Alcoholic beverage license taxes.—Proceeds from specified license taxes distributed to city or township of origin.

RHODE ISLAND

Alcoholic beverage sales tax.—Fifty percent of proceeds from manufacturers' excise tax distributed to cities and towns in proportion to population.

Parimutuel tax.—After exclusion of "breakage" and deduction of one-eighth of proceeds and State administrative costs, 50 percent of remainder of proceeds distributed to cities and towns in proportion to assessed valuations.

State aid to cities and towns.—Amount appropriated distributed to cities and towns in proportion to amount of local property taxes levied.

SOUTH CAROLINA

Alcoholic beverage taxes—"alcoholic liquors".—Twenty percent of proceeds distributed to counties and 15 percent distributed to cities in proportion to population.

Alcoholic beverage taxes—"beer and wine".—Seven percent of proceeds distributed to counties and 8 percent distributed to cities in proportion to population.

Bank income tax.—Sixty percent of proceeds distributed to county of origin and 30 percent of proceeds from banks located in cities distributed to city of origin.

Individual and corporation income taxes.—Percentage of proceeds (except from banks), as determined annually by legislature, distributed in proportion to population.

Insurance premiums tax.—One-half of proceeds from certain insurance premiums taxes distributed to counties in which taxed premiums originated.

Motor vehicle license fees.—Proceeds from motor transportation taxes distributed in proportion to population, subject to a specified minimum for county seats and a specified maximum allocation for any one city.

Public Service Authority payments in lieu of taxes.—Amount appropriated distributed as reimbursement to local government affected for tax losses on property acquired by the Authority.

SOUTH DAKOTA

Alcoholic beverage sales tax.—One-half of proceeds distributed to cities and towns in proportion to population. (Any amounts so allocated to unincorporated towns located within organized townships distributed to townships; any amounts so allocated to unincorporated towns located within unorganized townships distributed to counties.)

Bank income tax.—Ninety-seven percent of proceeds from tax on net income of banks and other financial institutions distributed to county of location; county redistributes to taxing units in county in proportion to apportionment for personal property taxation.

Reimbursement for loss of tax revenue.—Amount appropriated distributed to counties containing certain tax exempt State and county school lands, in amounts sufficient to reimburse them for tax losses sustained from exemption of such lands.

TENNESSEE

Alcoholic beverage sales taxes—beer.—Two-seventeenths of proceeds distributed equally among counties and two-seventeenths of proceeds distributed to cities in proportion to population.

Alcoholic beverage sales tax—distilled spirits and wine.—After deduction of 15 percent of revenue received from tax on products of Tennessee distilleries (distributed to county of origin), one-half proceeds from tax of 25 cents per gallon of wine; 70 cents per gallon of distilled spirits; and 35 percent proceeds from additional tax of 35 cents per gallon of wine and $1 per gallon of distilled spirits distributed to county of origin. These proceeds distributed three-quarters in proportion to population and one-fourth in proportion to area; except that in certain counties, 60 percent of their shares from the additional taxes must be redistributed to certain cities within those counties.

General sales tax.—Twelve and one-half percent of two-thirds of proceeds, less specified amount for use of University of Tennessee Municipal Technical Advisory Service, distributed in proportion to population.

Individual income tax.—Of tax on net income of individuals from dividends or interest (6 percent tax), three-eighths distributed to city of origin or to county of origin, where taxpayer resides outside city.

Tennessee Valley Authority payments in lieu of taxes.—Portion of revenue received by State from TVA distributed in amounts sufficient to make up difference between actual tax losses resulting from exemption of TVA property and amounts received directly by local governments from TVA.

UTAH

Alcoholic beverage monopoly profits.—First $1 million of profits in excess of $2,250,000 distributed to cities and counties in proportion to population.

VIRGINIA

Alcoholic beverage monopoly profits.—Two-thirds of profits, after certain deductions, distributed to cities and counties in proportion to population.

Alcoholic beverage sales tax.—Two-thirds of proceeds from wine excise tax distributed to cities and counties in proportion to population.

Fees.—Two-thirds of State revenue from excess fees of certain city and county officials distributed to city or county of origin.

Motor vehicle carriers rolling stock (property) tax.—Proceeds distributed on basis of number of vehicle-miles operated by taxpayers in each city or county.

Poll tax.—One-third of proceeds distributed to city or county of origin.

WASHINGTON

Alcoholic beverage monopoly profits.—After deduction of up to $500,000 for administration of liquor control, 10 percent distributed to "wet" counties in proportion to population of unincorporated areas and 40 percent to "wet" cities in proportion to population.

Alcoholic beverage sales tax.—Thirty-five percent of proceeds distributed one-fifth to "wet" counties in proportion to rural population, and four-fifths to "wet" cities in proportion to population.

WISCONSIN

Alcoholic beverage sales tax.—After deduction of seven-tenths cost of State administration, 50 percent of proceeds distributed in proportion to population.

Forest crop land income.—After deduction of certain State expenditures, proceeds from forest crop lands distributed 20 percent to counties, 40 percent to towns, and 40 percent to school districts.

"*Highway privilege tax.*"—Amount appropriated from highway-user revenue, equivalent to 11 percent of proceeds from truck license taxes and 20 percent of proceeds from all other motor vehicle license taxes, distributed in proportion to collection of such taxes, subject to a minimum distribution of at least as much as local motor vehicle property tax collections in 1930. Part of amount distributed to city of Milwaukee redistributed to school district serving that city.

Individual and corporation income taxes.—Forty-nine percent of proceeds from corporation income taxes and 33 percent of proceeds from individual income tax distributed one-sixth to county of origin and five-sixths to city or town of origin.

Railroad terminal (property) tax.—Proceeds from taxes relating to docks, piers, wharves, grain elevators, and storage tracks in ore yards owned by railroad companies, distributed in accordance with location of such property.

Rural electric association (gross receipts) tax.—Deduction made for administrative expenses and for distribution to city or town in which a general office building and pole yard are located of an amount equivalent to 1 percent of value of such property. Remaining receipts distributed as follows: (a) 20 percent of proceeds from distributing cooperatives to counties and 80 percent to cities and towns, in proportion to value of property and retail sales of taxpaying associations; and (b) 20 percent of proceeds from generating cooperatives to cities and towns in proportion to value of transmission lines located therein; 35 percent to cities and towns in proportion to value of production and conversion property located therein; 15 percent to counties in proportion to value of transmission lines, production, and conversion property located therein; and 30 percent to cities and towns served by distributing cooperatives, in proportion to retail sales by distributing cooperatives located therein but subject to specified limitatons as to maximum amount receivable by any one city or town.

Telephone (gross receipts) tax.—Eighty-five percent of proceeds from local and rural "exchange" service distributed to city or town of origin.

Utilities property taxes.—Proceeds from specified types of utilities (water, light, heat, gas, conservation and regulation, street railway, and pipeline companies) distributed 20 percent to counties and 65 percent to cities and towns in proportion to value of property and retail sales of taxpaying companies. Part of amount distributed to cities and towns subject to redistribution or restriction in use for school purposes.

WYOMING

Cigarette (sales) tax.—Ninety-eight percent of proceeds distributed to city or county of origin.

Veterans' homestead exemption reimbursement.—Amount appropriated distributed as necessary to replace tax losses arising from exemption of veterans' homestead property from general taxation.

Source: U.S. Bureau of the Census, *Census of Governments: 1962*, vol. VI, No. 2, *State Payments to Local Governments*, United States Government Printing Office, Washington, D.C., 1963, pp. 19–109.

STATE PAYMENTS TO LOCAL GOVERNMENTS IN WISCONSIN*

BY ALAN H. SMITH**

The steadily mounting expenditures of local governments are producing in many areas strains on local finances of such severity as to call for a thorough and continuous reexamination of all the ways in which those expenditures can be met. None of those ways seems to be more important than the making of payments to local governments by their State government. Increasing pressure on the local tax base is bound to suggest the corresponding advantages of drawing upon the wider tax base available to the State. Indeed, it is somewhat surprising that there has not been in recent years any general trend for payments by States to their local governments to increase more rapidly than general State expenditures and that the trend has in fact been in the opposite direction. In 1942 State payments by local governments throughout the United States were 39.1 percent of State expenditure, in 1952 they were 36.8 percent and in 1957 they were 34.7 percent.[1]

The purpose of this article is to examine the system of State payments to local governments in one State, Wisconsin, using the comprehensive data available for the first time in the 1957 Census of Governments. Consideration of the Wisconsin system is particularly instructive because it differs substantially from that of other States in two important respects, in amount and in nature.

First, State payments to local governments in Wisconsin are larger than those to be found in States of comparable wealth. Table I shows one way in which States may be differentiated according to the amount of their payments to local governments. The 48 States (for the census year 1957) have been arranged in two ranking orders, according to the percentage of their local government revenue which is derived from State payments and according to their personal income per capita. The 48 States have then been grouped into six groups of eight each and it will be seen that there is an appreciable degree of negative correlation, so that the lower the per capita personal income within a State the greater the portion of its local budgets which tends to be met from State payments. This is only to be expected, since the poorer are the individuals within a State, the greater must be the problems of financing local governments and the greater the tendency for those

* Reprinted from *National Tax Journal*, vol. XV, No. 3, September 1962.

** The author is associate professor of finance, Marquette University. This article is based mainly upon a research study carried out for the Revenue Sources and Distribution Committee of the late Milwaukee Metropolitan Study Commission as well as upon a more comprehensive study of the whole local government system of Wisconsin.

[1] Bureau of the Census, *1957 Census of Governments*, vol. IV, No. 2, *State Payments to Local Governments*, table 6.

governments to depend upon the State for assistance. Wisconsin, however, is out of line in this respect, ranking fairly high (19th) in personal income per capita and yet ranking even higher (9th) in the proportion of local government revenue consisting of State payments.

TABLE I.—*Personal incomes and State aids as percentage of local government revenue, 1957*

	6 groups of 8 States arrayed in rank order of personal incomes per capita (from lowest (A) to highest (F))						
	A	B	C	D	E	F	All States
6 groups of 8 States arrayed in rank order of State payments to local governments as percentage of local government revenue) (from lowest (A) to highest (F)):							
A	--------	2	--------	3	--------	3	8
B	--------	2	3	3	--------	--------	8
C	1	--------	2	--------	2	3	8
D	1	1	2	1	3	--------	8
E	3	1	--------	1	2	1	8
F	3	2	1	--------	1	1	8
All States	8	8	8	8	8	8	48

Source: U.S. Bureau of the Census, *U.S. Census of Governments*, 1957, Vol. IV, No. 2, "State Payment to Local Governments," Table 5; and Vol. III, No. 5, "Compendium of Government Finances," Table I.

Secondly, and more important, State payments in Wisconsin differ radically in nature from those made in other States. The normal way of describing this difference is to say that Wisconsin uses shared taxes (collected centrally by the State and shared with local governments) to a greater extent than do other States. But the difference between shared taxes and the main other form of State payments, grants in aid of expenditure (called here, for the sake of brevity, "aids"), is only the technical one that the former have their legal source in a tax, the latter in an appropriation by the legislature. This is not a distinction which goes sufficiently deeply into the relationships between a State and its local governments. It is, therefore, proposed to adopt here two distinctions thought to be more relevant: (1) whether the State payments are earmarked for a specific type of expenditure or are spendable at the discretion of the receiving government; and (2) whether the payments are based in any way upon the needs of the receiving government. The latter distinction is not always easy to apply, since there are many ways in which local government needs can be assessed. Payments may be based upon some fairly specific and reliable measure of needs, as where educational aids are based upon the number of children actually in attendance at public schools, or on less reliable measures of need, such as figures of population. Between these two extremes are other measures of varying reliability, such as the number of motor vehicles registered in a locality as a determinant of highway needs in that locality.

The various types and amounts of State payments detailed in the 1957 Census of Governments have been compiled in table II. State payments are there classified into those based upon need and those not based upon need. The amounts are contrasted with total local government expenditure, so as to show the percentage met from net local sources. Each of the two types of State payments is further subdivided into payments for general local government purposes and payments earmarked for specific purposes. It will be seen that over 13 percent of local government expenditures in Wisconsin is met out of payments not based upon need, as against an average for all States of just over 2 percent. Further, by far the greater part of these payments not based upon need are unearmarked, given for general local governmenttal purposes, whereas for all 48 States, only about two-thirds of such payments are unearmarked. Finally, for all 48 States payments based upon need are over 12 times as great as those not based upon need, whereas in Wisconsin they are only a little over one and one-half times as great. A system which relies so heavily upon grants not based upon need and upon grants not earmarked for specific expenditure is worthy of special study to see precisely what effect it has upon the financial position of local governments.

Research is hampered by the very large number of governmental units involved—5,730 units in Wisconsin alone. As a first step toward evaluating the financial position of local governments as affected by State payments, the study on which the present article is based has been concentrated upon county areas, using the aggregate financial data of all local governments in each county area published in the 1957 census. While such a method of approach ignores the differences between municipalities within the same county—and it is perfectly obvious that such differences are very substantial in that they are frequently based upon arbitrary municipal boundaries—it should bring out many important points on the differences between areas which are often true economic and social areas.

TABLE II.—*Contributions by States to local government expenditures on basis of need and otherwise, 1957*

[Dollar amounts in millions]

State	Local government expenditures										
	Total general expenditures	Met from State grants								Met from local sources	
		Based on need				Not based on need					
		For general purposes	For specific purposes	Total	Percent of total general expenditures	For general purposes	For specific purposes	Total	Percent of total general expenditures	Amount	Percent of total general expenditures
Alabama	$311.6	$2.0	$104.7	$106.7	34.3	$3.1	$26.9	$30.0	9.6	$174.9	56.1
Arizona	117.0	3.5	32.7	36.2	20.5	15.1	.5	15.7	8.8	125.2	70.7
Arkansas	129.2	5.4	38.9	44.3	4.3	(1)	2.0	2.0	1.5	82.9	64.2
California	3,269.1	49.3	1,061.0	1,110.3	34.0	10.6	8.4	19.0	.6	2,139.7	65.4
Colorado	321.1	...	111.4	111.4	34.7	.1	1.2	1.3	.4	208.4	64.9
Connecticut	359.7	.4	34.5	34.9	9.7	3.2	.1	3.3	.9	321.5	89.4
Delaware	35.1	...	15.3	15.3	43.5	...	...	...	...	19.8	56.5
Florida	606.1	...	124.6	124.6	20.6	.2	12.0	12.2	2.0	469.3	77.4
Georgia	409.8	...	142.7	142.7	34.8	...	.2	.2	.1	266.9	65.1
Idaho	86.3	1.5	17.1	18.6	21.5	...	1.7	1.7	1.9	66.1	76.6
Illinois	1,562.2	...	246.3	246.3	15.8	...	...	...	...	1,315.9	84.2
Indiana	608.3	3.3	157.8	161.1	26.5	3.2	...	3.2	.5	444.1	73.0
Iowa	401.7	1.9	76.6	78.5	19.5	26.9	.1	27.0	6.7	296.2	73.7
Kansas	351.7	4.1	76.7	80.8	23.0	4.1	7.2	11.3	3.2	259.7	73.8
Kentucky	247.5	...	61.6	61.6	24.9	1.0	1.7	2.8	1.1	183.1	74.0
Louisiana	407.2	8.3	147.9	156.2	38.4	30.7	.5	31.2	7.7	219.8	54.0
Maine	94.1	...	13.7	13.7	14.6	.3	(1)	.3	.3	80.0	85.1
Maryland	456.2	9.0	103.6	112.6	24.7	18.4	...	18.4	4.0	325.1	71.3
Massachusetts	940.5	...	201.1	201.1	21.4	53.1	...	53.1	5.6	686.3	73.0
Michigan	1,311.1	60.6	414.1	474.7	36.2	10.0	.7	10.7	.8	825.8	63.0
Minnesota	615.5	6.6	153.9	160.5	26.1	2.8	1.7	4.5	.7	450.5	73.2
Mississippi	185.6	...	69.6	69.6	37.5	9.0	3.6	12.6	6.8	103.4	55.7
Missouri	487.8	...	84.6	84.6	17.3	5.8	1.5	7.3	1.5	396.0	81.2
Montana	102.6	...	13.0	13.0	12.7	...	1.1	1.1	1.1	88.4	86.2
Nebraska	192.4	.6	34.8	35.4	18.4	...	.1	.1	.1	156.9	81.5
Nevada	53.3	...	12.2	12.2	22.9	.1	.1	.2	.4	40.9	76.7
New Hampshire	69.4	...	2.5	2.5	3.6	2.0	(1)	2.0	2.8	64.9	93.6
New Jersey	997.6	...	122.8	122.8	12.3	1.6	...	1.6	.2	873.3	87.5

TABLE II.—*Contributions by States to local government expenditures on basis of need and otherwise, 1957*—Continued

[Dollar amounts in millions]

State	Local government expenditures										
	Total general expenditures	Met from State grants								Met from local sources	
		Based on need				Not based on need					
		For general purposes	For specific purposes	Total	Percent of total general expenditures	For general purposes	For specific purposes	Total	Percent of total general expenditures	Amount	Percent of total general expenditures
New Mexico	$107.1	----	$53.6	$53.6	50.0	$1.1	$1.4	$2.5	2.3	$51.1	47.7
New York	3,798.1	$90.5	835.3	925.8	24.4	----	----	----	----	2,872.3	75.6
North Carolina	314.6	2.3	80.4	82.7	26.3	6.8	.2	7.0	2.2	224.9	71.5
North Dakota	84.5	.6	16.9	17.5	20.7	.2	1.2	1.3	1.6	65.7	77.7
Ohio	1,459.8	----	294.2	294.2	20.2	53.8	28.6	82.4	5.6	1,083.3	74.2
Oklahoma	264.5	----	66.7	66.7	25.2	----	27.0	27.0	10.2	170.8	64.6
Oregon	278.2	1.0	56.1	57.1	20.5	1.7	10.0	11.7	4.2	209.4	75.3
Pennsylvania	1,405.6	----	398.0	398.0	28.3	6.0	14.8	20.8	1.5	986.9	70.2
Rhode Island	97.3	.2	9.9	10.1	10.4	5.9	----	5.9	6.1	81.3	83.5
South Carolina	205.4	6.8	86.8	93.5	45.5	1.4	.3	1.7	.8	110.2	53.7
South Dakota	87.1	.4	6.1	6.4	7.4	.3	1.7	2.1	2.3	78.6	90.3
Tennessee	346.7	9.8	113.0	122.9	35.4	1.6	.1	1.7	.5	222.1	64.1
Texas	1,230.9	----	272.9	272.9	22.2	.1	----	.1	(1)	957.9	77.8
Utah	114.3	1.0	26.3	27.3	23.9	----	.7	.7	.6	86.2	75.5
Vermont	44.4	----	9.8	9.8	22.2	----	(1)	(1)	(1)	34.5	77.8
Virginia	396.0	10.3	93.2	103.5	26.2	1.0	1.5	2.5	.6	289.9	73.2
Washington	449.8	11.8	130.9	142.6	31.7	----	20.7	20.7	4.6	286.5	63.7
West Virginia	154.0	----	60.7	60.7	39.4	----	(1)	(1)	(1)	93.3	60.6
Wisconsin	731.3	5.1	146.1	151.2	20.7	92.2	3.9	96.1	13.1	484.0	66.2
Wyoming	59.3	----	18.5	18.5	31.2	1.8	.6	2.4	4.1	38.4	64.7
Total	26,418.6	296.1	6,450.8	6,746.9	25.5	375.1	184.3	559.4	2.1	19,112.3	72.3
Less derived from Federal grant	810.9	----	781.5	781.5	----	.1	29.3	29.4	----	----	----
Net from State/local sources	25,607.5	296.1	5,669.3	5,965.4	23.3	375.0	155.0	530.0	2.1	19,112.3	74.6

[1] Less than 0.1.

Source: Bureau of the Census, *U.S. Census of Governments*, 1957, Vol. IV, No. 2, "State Payments to Local Governments," Table 2.

In order to assess the real effect of State payments, use has been made of the figures of total taxable property as equalized by the Wisconsin Department of Taxation. While the use of figures of equalized property values has in general to be made with great caution, there is reason to believe that the equalization process in Wisconsin is broadly reliable and that these figures are as dependable measures of local taxable capacity as can be obtained.[2]

Table III shows the result of expressing local government expenditures per $1,000 equalized property value and putting all county areas in ranking order. Details are given of the main heads of government expenditure (slightly compressed from the heads used by the Census Bureau) and of total expenditures both before and after State payments. The dispersion of expenditures is calculated by showing the average deviation from the median expenditure as a percentage of the median. With one small exception, total expenditures show a smaller dispersion than that of individual expenditures. This can only mean that there is some tendency for differences to cancel one another out, so that an area with a high expenditure in one field will have a lower expenditure in another field. But the significant fact is that the effect of State payments is to reduce the overall dispersion from 31 percent to 19 percent.

TABLE III.—*Dispersion of local government expenditure, per $1,000 equalized property valuation, for county areas, 1957*

	Education	Highways	Public welfare	Health and hospitals	Police and fire	Sewers and sanitation	Other	Total	Net after State grants
Highest	$52.20	$35.43	$27.28	$8.88	$8.63	$8.64	$16.39	$109.95	$51.25
Upper quartile	25.28	20.81	9.78	3.32	3.03	2.42	7.38	67.60	35.08
Median	19.54	14.84	6.51	2.29	2.36	1.37	5.84	55.52	29.25
Lower quartile	14.35	9.78	3.42	1.65	1.79	.94	5.14	41.69	24.57
Lowest	8.41	3.14	.83	.37	.82		3.46	28.12	15.29
Average deviation	6.88	6.56	3.60	1.21	.74	.90	1.65	17.09	5.67
Average deviation as percent of median	35	44	55	53	31	66	28	31	19

Source: Bureau of the Census, *1957 Census of Governments*, Vol. VI, No. 27, Table 36.

The significance of this can be gaged by comparing these figures with those for the six States nearest to Wisconsin. Coefficients of dispersion similarly calculated are as follows:

[In percent]

	Before State payments	After State payments
Illinois	31	21
Indiana	25	25
Iowa	15	18
Michigan	26	26
Minnesota	36	26
Ohio	20	20

[2] For a recent evaluation supporting this conclusion, see Clara Penniman, "Property Tax Equalization in Wisconsin," *National Tax Journal*, June 1961, pp. 182–189.

It will be seen that of the six States, two show a greater unevenness of expenditure after State payments than before, two show no change and only two show a reduction in unevenness of local expenditures because of State payments but this reduction is less than that effected in Wisconsin. So far as comparison with these neighboring States goes, the Wisconsin system is relatively effective in evening out the burden of local government expenditures in terms of local needs and fiscal ability. This is not what might have been expected where so large a part of State payments is not based upon need and it is important to attempt to discover just how this result comes about.

The 71 counties of Wisconsin vary considerably in many respects, one of the most important of which is density of population, varying all the way from seven to 4,148 inhabitants per square mile. Such a great variation seems likely to have a marked effect upon local government expenditures, since the less densely populated counties have to spread their expenditures, many of which are basic and inescapable, over a smaller number of taxpayers and a smaller tax base. An examination of a scatter diagram relating density of population and local expenditures per capita for each of the county areas shows a distinct pattern of relationship, but one which involves making distinctions between certain main groups of counties.

When all counties are arranged in rank order of population density, it can be seen that there is a definite break between the 18 counties with a higher than average density and the remaining 53. For many purposes it is also useful to deal separately with those six of the highly densely populated counties which form part of the major standard metropolitan areas; [3] these latter are here referred to as "metropolitan counties."

The relationship between density of population and local expenditures per capita may now be summarized briefly. For the 53 low density counties there is a broad negative relationship, expenditure tending to decrease as density increases. But for the 18 high density counties such relationship as there is not so marked—it is certainly not negative—and in the case of the six metropolitan counties there is some positive relationship, expenditures per capita tending to increase as density increases. The most densely populated county of all, Milwaukee County, has the highest per capita expenditures of all metropolitan counties and expenditures among the highest in the State.

Table IV gives a view of this relationship by grouping the counties in seven groups of 10 each, in ascending order of density of population, with Milwaukee County shown separately at the end. The tendency of per capita expenditures to fall at first and then to rise can be seen. The same pattern can be seen from correlation coefficients between the two variables under discussion. For all counties the coefficient is the insignificant one of 0.116, but if only Milwaukee County is omitted it becomes −0.385 and if all the metropolitan counties are omitted it becomes −0.458. For the 53 low density counties the coefficient is the significant one of −0.798.

[3] Not included is Douglas County which although forming part of the Duluth-Superior Metropolitan Area has a density of population of about one-half the State average. Sample calculations suggest, however, that the exclusion or inclusion of Douglas County figures would make no substantial difference to the conclusions reached here.

TABLE IV.—*Density of population and per capita local government expenditures, by county areas, Wisconsin, 1957*

	Per capita expenditures, all units of local government
Counties grouped in ascending order of density of population:	
1–10	$229.14
11–20	198.71
21–30	186.70
31–40	186.79
41–50	169.39
51–60	168.59
61–70	177.15
71 (Milwaukee County)	231.26

Source: Expenditure figures from Bureau of the Census, *1957 Census of Governments*, Vol. VI, No. 47, Government in Wisconsin, Table 36; population estimated by interpolation from the 1950 and 1960 *Censuses of Population.*

How do State payments fit into this pattern of expenditures? Here a distinction must be drawn between grants in aid ("aids") and shared taxes. First, there is a very definite tendency for aids, expressed on a per capita basis, to decline with increasing density of population. The correlation cofficient here for all counties is −0.219, but this very low figure appears to be due to the distorting effect of Milwaukee County with its very high density of population. If this county is omitted the coefficient becomes −0.582 while for the 65 nonmetropolitan counties and the 53 low density counties the coefficients are −0.637 and −0.664 respectively.[4] Thus as expenditures per capital decline with increasing population density, they are matched by declining State aids. But from what has been said above it can be seen that this only applies to the 53 low density counties and as expenditures tend on the whole to increase with increasing density in the high density counties, these latter tend to receive lower aids in relation to their expenditures.

Shared taxes have the opposite effect, however. The correlation coefficients between shared taxes per capita and population density are all positive, 0.416 for all counties, 0.604 if Milwaukee County is excluded and 0.672 if all metropolitan counties are excluded, while for the 53 low density counties the coefficient drops to 0.313. The reason for this positive relationship is fairly obvious. The taxes collected centrally and shared locally are mostly imposed upon income and income trends to be concentrated in the larger urban areas. The receipt by the more densely populated counties of the larger relative share of such taxes is strictly in accordance with the basic intent of the shared tax system, in which ". . . the Central Government has simply loaned its superior powers of administration to the municipality."[5] so that municipalities may thus be enabled to pay for a substantial part of their local government costs out of their own resources.

What is relevant to the present enquiry, and more than a little surprising at first glance, is the extent to which shared taxes do in fact make good the deficiencies in aids. If per capita expenditures were

[4] It would not be reasonable to expect any much higher correlation in view of the wide differences in density of population. This latter factor may well be the explanation for the fact that rank correlation cofficients are here much higher, −0.940 for all counties and −0.926 for the 65 nonmetropolitan counties.

[5] H. Groves, *Financing Government*, 5th ed., p. 482.

inversely correlated with population density, then aids, being also inversely correlated, would reasonably match those expenditudes, both increasing and decreasing together. But aids fail to match expenditures in the more densely populated counties, in the case of which aids decrease as expenditures decrease. It is the fact, whether intended or not, that shared taxes come in just where they are needed and compensate the high density counties for their smaller proportionate share of aids.

Since one main purpose of a system of State grants-in-aid is to make additional payments from State funds to local communities with exceptionally high expenditures, why is it that a system of aids should to some degree fail to meet adequately the expenditure needs of certain important county areas? The explanation is to be found in the varying importance of different types of expenditure and the extent to which each type is the object of State aids. In table V will be found details of local government expenditure for Milwaukee County, for the six metropolitan counties and for the 65 nonmetropolitan counties. The table also brings in another factor which has not yet been discussed, the relative fiscal ability of each area. This has been done by expressing expenditures in terms of full property valuation, as the most reliable measure of local fiscal ability, so that an evaluation can be made of the burden of local expenditures in terms of that ability.

TABLE V.—*Local government expenditures per $1,000 equalized property valuation Wisconsin, 1957*

	All units of local government in—		
	Milwaukee county	6 metropolitan counties	65 nonmetropolitan counties
1. Education	$12.96	$13.09	$17.50
2. Highways	5.74	5.94	12.34
3. Public welfare	3.15	3.02	5.04
Total, items 1 to 3	20.95	22.05	34.88
4. Health and hospitals	4.76	3.67	2.92
5. Police and fire	4.66	4.01	2.67
6. Sewers and sanitation	5.65	4.72	1.89
7. Miscellaneous	8.11	7.82	5.86
Total, items 4 to 7	23.18	20.22	13.34
Total expenditures	44.13	42.25	48.22
State payments	12.41	11.97	21.18
Net expenditures met from local sources	31.72	30.28	27.04

Source: Bureau of the Census, *Census of Governments*, 1957, Vol. VI, No. 27, Table 36.

The expenditures in table V are set out under seven headings, and these are subtotalled firstly for the functions of education, highways, and public welfare and secondly for all other functions. The significance of this division is that the main weight of State aids in Wisconsin (as in many other States) falls on the first class of functions. In the year under review, 1957, over 94 percent of State aids in Wisconsin were paid for the support of education, highways, and public welfare.

The first important fact which emerges from an examination of table V is the differing relative importance of the three aided functions. In Milwaukee County they account for 47 percent of total expenditures, in the metropolitan counties for 52 percent and in the nonmetropolitan counties for 72 percent.

The second important fact to grasp is the effect which this difference in relativity between aided and nonaided functions has on net local expenditures after State payments. These payments meet 28 percent of local expenditures in Milwaukee County and in the six metropolitan counties as a whole, while in the nonmetropolitan counties they meet as much as 42 percent. The effect of this on net local expenditures is easy to deduce. While gross expenditures for the nonmetropolitan counties are 14 percent higher than those of metropolitan counties, expenditures net after State payments are actually 11 percent *lower*. And it must be remembered that we are here talking of expenditures *in relation to ability to pay*. There would appear to be no escaping the conclusion that the Wisconsin system of State aids discriminates markedly in favor of those municipalities and those municipal areas which spend relatively more on the three aided functions.

It may be argued, of course, that the three aided functions are inherently deserving of special aid from the State. Yet as a matter of fact State aids have been developed in Wisconsin (as, perhaps, in most other States) not through any comprehensive plan and deliberate selection of certain functions as being worthy of aid but almost entirely by way of reaction to specific historical exigencies. Education had to be aided with the rapidly increasing population toward the turn of the century, highway expenditures became a serious local burden with the rapid development of transportation (especially mechanical transportation), while public welfare had to be accepted as a general community responsibility in the crisis years of the Great Depression. In each case local expenditure developed so quickly as to outrun the ability of the local fiscal mechanism to meet it. What happened by way of the development of State aids may have been quite inevitable but the actual result is that the incidence of those aids is such as to neglect certain functions which have come to be of great importance in certain areas. Those areas are the main urban areas in which an increasing part of the population is coming to live. Those neglected functions include the protection of persons and property (especially through police and fire departments), sewerage and sanitation, and health and hospitals. It is not too fanciful to connect this neglect with the old attitude that urban life is somehow an exception to normal living and with the heavier political weight that rural areas so frequently possess. And it may well be that the increasing concentration of population in urban areas is leading to a crisis, if indeed the crisis is not already upon us, that will call for the extension of State aids to the more specifically urban functions.

CONCLUSION

Whatever may be the historical or other reasons which have led to the Wisconsin system of State payments to local governments, it seems to be beyond doubt that a partial system of State aids does distort net financial burdens, measured in relation to local ability to shoulder those burdens, to the detriment of the more urbanized areas. But shared taxes do in large measure correct that distortion by giving to the more urbanized areas some at least of the financial assistance which they need because of their high cost urban functions. It can only be for this reason that local government expenditures (by county areas) in Wisconsin are equalized to an appreciably higher degree than in the six States neighboring to it.

The limitations of the county area approach adopted in this article should not be overlooked. In particular, two further factors have to be taken into account before a final judgment can be made on the Wisconsin system. These are—

(1) The extent to which State payments received by local communities are financed by those same communities through tax payments made by their residents.

(2) The particular application of the State payments to individual municipalities within each county area. In view of the frequently arbitrary nature of municipal boundaries, it is highly probable that the broad pattern of expenditures and State payments will be broken up into a highly variegated pattern characterized by considerable differences between individual municipalities.[6]

But the county area approach is at least a first step to the final evaluation of the State payments system. It does not prove that a proper and comprehensive method of calculating grants-in-aid by reference to overall local needs and fiscal ability might not be preferable to the present system in Wisconsin. But no such method has yet been proposed and, *prima facie* at least, there appears to be an unanswerable case for retaining the present system, with its high proportion of shared taxes, until a demonstrably better system can be devised.

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[6] For an attempt to evaluate both these factors in relation to Milwaukee County, see the writer's report on *Financial Relationships Between Municipalities in Milwaukee County* (Center for Business Services, Marquette University, Milwaukee, 1961). Tables LIII–LV of this report estimate the net financial contribution by each municipality (taxes paid less shared taxes and aids received) toward the costs of State government and table LVI estimates the net contribution made by local governments in each county area, demonstrating that the less densely populated county areas receive payments from the State far higher than other areas, both in relation to the net taxes which they pay and in relation to their fiscal ability.

INNOVATION IN TAX SHARING: THE WISCONSIN EXPERIENCE

BY HAROLD M. GROVES*

INTRODUCTION

The purpose of this paper is to relate the problem of Federal tax sharing to the Wisconsin experience of State sharing with municipalities. This experience is relevant because all versions of the Heller-Pechman proposal comtemplate some redistribution of grants to municipalities and some of these provide for this explicitly. None of them to the author's knowledge specify a formula for the redistribution, but this could be added without seriously violating the free-grant motif of the proposal. It is not our purpose here to argue the merits and demerits of Federal sharing as such. We here assume that some program of this kind will be adopted at least eventually and we focus our attention on its content.

The Plight of the Cities. It can be said without much fear of dissent that a major concern behind the Heller-Pechman movement is that for the plight of the cities. We need not belabor the well-known facts that most of our people live in cities and most of these in metropolitan areas; that the laudable objectives of improving the American environment is thus in large degree identified with the urban problems; that the urban problem embraces a formidable package of more specific problems including antipollution, housing, transportation, recreational facilities, and education.

A critical aspect that pervades several of these problems is minority group discontent. The ghettos of our large cities have become (continued to be) trash heaps of human and physical materials waiting a spark for explosion. While a comprehensive and adequate attack on urban problems might have to wait for better times in terms of international affairs, the urgency of the urban situation is immediate. The Vietnam war is unique in many respects; let us hope that it will not be accompanied by civil disorders approaching civil war.

We consider it highly doubtful that the forces which have brought cities into the foreground as an urgent problem will level off or reverse themselves in the years ahead. It is true that some studies are more optimistic: Selma Mushkin and Gabriel Lupo in their Project '70 study, find little or no gap in future revenues under optimistic assumptions including a doubling of Federal aid in the course of 5 years. But a more realistic view, we think, could be gained by talking with your mayor or alderman; most often, we are sure, you would hear a story of great financial duress with no prospect of respite. In New York City, for instance, administrations do change and new sources of

*University of Wisconsin.

revenue are pressed into use to meet this emergency or that; but the high pressure continues faithfully even between recurring crises. "This is no time to think small about the money our cities will need. It will cost not billions but *trillions* of dollars to correct what is wrong with our central cities today. . . ." [1]

The intergovernmental relations aspect of the urban problem includes an elaborate system of aids. Many of them go directly to cities, numbering in the thousands and greatly complicating the administration at both ends of the stick. Nevertheless many would prefer to continue and extend this system on the ground that it insures expenditure where it is most needed. Certainly in this author's view there is a place for such specific grants that a block grant should not aim to replace. But it is also true that the municipalities on their own could and would solve many of their problems if they were not so hard pressed for financial resources. They too might blossom with new ideas and fresh programs if they but had a bit more fiscal elbow room. Even so, it is commonplace to note that many of the Federal Government's best programs sprouted in the laboratories of State and Municipal practice. If the Federal Government has the advantage of a larger perspective, the municipalities have the opposite advantage of close proximity to the needs. It could be that a judicious combination of the two types of grants is the happy answer. It is here contended that the municipalities' share of a block grant should take the form of a federally directed redistribution of a block grant to the States.

We should not leave the impression that all the critical municipal problems are confined to the large urban centers. Many of the smaller and more rural municipalities (and some townships and suburbs) also find themselves in a financial bind. To be sure, their needs are simpler and their tax base is less often unbalanced by commuting. But their tax base is also much leaner and their bill for first-rate education comes very high. In its financial aspect, the problem in these cases is more properly described as "municipal" rather than "urban" or "metropolitan."

In conclusion, no program on the Heller-Pechman model is likely to be acceptable unless it provides some reasonable assurance that it will make a major contribution to the solution of the municipal and particularly the urban problem.

Metropolitan Fragmentation

Much of the problem of the urban centers is due to the dismemberment of the metropolitan community and the migration of the better part of what might have been its tax base to independently incorporated suburbs. Many factors have contributed to this trend: great improvements in transportation facilities; virtual laissez-faire in the determination of municipal boundaries, zoning and others.

We start our study of public finance with the proposition that people should be obliged to contribute to the community according to some principle such as benefits received or ability to pay. Most of the discussion then centers on the proper principle and how it can be ap-

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[1] "What Kind of City Do We Want?" A Special Report. *Nation's Cities*, April 1967, p. 20.

plied. But this ignores what in some cases is the major problem and that is the definition of "community". Presumably the term implies a group of people in some area that are tied by common economic, social and political interests and intercourse.

Differences in economic capacity among cities are as common and inevitable perhaps as those among people. We bear with these differences in large degree because we regard them as a necessary feature of a free society. But when what is in some sense an organic unity is artificially divided to create rich and poor units of government, the legitimacy of the product invites skepticism.

Most communities have in terms of their budgets what might be called plus and minus areas. The mercantile and industrial and the best residential sections fall into the first category and the poor residential districts (slums) into the second. The poor areas require more by way of city services than they contribute by way of tax base. In an unfragmentized city, the pluses and minuses neutralize each other. But when these areas segregate themselves with separate incorporation, the balance of the atom is upset. It is likely to leave the core city and some poor suburbs desperately short of tax base in relation to need.

The peripheral migration may involve businesses as well as people. A firm with a high capital-labor ratio is especially vulnerable to the property tax, but by the same token it especially enriches the tax base. When enough of such firms get together under separate municipal incorporation (industrial enclave) they can all but wipe out the property tax burden. The advantage is enhanced if the firms' labor force resides for the most part in the central city or other independent units.

These inequities in metropolitan finance are not likely to be corrected by local action. The vested interests created by fragmentation are formidable and the inertia of boundary lines once established is notorious. Some joint action to plan and manage certain functions through counties and/or councils has occurred and is likely to develop further. But they make only a small dent on the fundamental inequities. Differential State and especially Federal aids offer greatest promise. Unhappily some State grants and shared taxes aggrevate rather than relieve the problem. The Federal aid system if only in the selection of functions for assistance does have a considerable measure of built-in equalization among cities. If a block grant is to compete with them in this respect it too must make some contribution to the mitigation of metropolitan inequities. There are formidable political and implementation problems that impede such an achievement. It is here argued (later) that they are not insurmountable.

Property Taxation

Municipalities generally have quite limited taxing powers; some of them as in Wisconsin are confined to the general property tax. Their power to use the property tax is circumscribed by the fact that they have no wall to keep their industries and rich taxpayers within their boundaries. Central cities are expected to compete with rich suburbs both in the quality of the services they render and in tax rates. If high tax rates are not as potent a factor in the location of industries and wealthy taxpayers as is sometimes alleged, there is no doubt about the potency of threats as a restraining constriction.

The property tax when well administered and applied moderately is a tolerable source of local revenue. At best it constitutes a considerable load upon the poor—the very group that the poverty program aims to relieve. At best it constitutes a differential burden on housing—a "merit want" that Federal programs seek to promote. At best the local levy on industry on the one hand provides a built-in device for exporting burdens to outsiders and on the other carries the constant threat of firms to migrate. But all of the faults of the property tax are more than proportionately aggravated by its use to excess.

Gerald Sazama attempted a sophisticated study of market value tax rates on real estate in 22 of the large central cities in the United States (1962).[2] He found a variation from 58.88 mills in Boston and 48.30 in Newark to 11.64 in Seattle. These variations were accounted for in some degree by different policies with regard to the taxation of personal property and supplemental levies on income and sales. The median rate of 23 mills seems tolerable. But surely some of these rates are unconscionably high. No one has prescribed a top limit for the property tax. Presumably it becomes self-defeating when it so promotes migration and discourages building that more would be collected at lower rates.

Mordecaai S. Feinberg in a study of core-city decline[3] noted that of the 10 largest core-cities, eight experienced an absolute population decline from 1950 to 1960. Assessed value in constant dollars declined in seven of the 10 cities. In almost every case property tax rates increased substantially. Several of these cities already tax income and/or sales. In others the use of these levies is circumscribed by constitutional or statutory limitations. Tax critics are generally less than enthusiastic about these innovations. Anyway, and as in the case of high property tax rates, a point is reached before long where such taxes are self-defeating.

Look at the situation in Milwaukee. Here is a well-governed city that has won numerous prizes for excellence in this service or that. Its alert electorate is not satisfied with anything but the best in government and it gives top-rating to the amenities which government must supply. Its locally-raised tax revenue is confined to the property tax. It is now hemmed by suburbs that fill Milwaukee County and spill over into several adjoining counties. In the early 1960's, the periphery of Milwaukee County (outside the City) embraced 28 percent of the County's population and enjoyed 40 percent of the County's taxable wealth; 37 percent of its shared taxes, and 49 percent of its utility wealth.[4]

Milwaukee's full-value tax rate in the late 1920's stood at about 23 mills. It had risen to some 30 mills at the close of World War II, but property was then equalized by the State substantially below sales value. A study at that time[5] indicated that market value rates were

[2] Gerald Sazama, "Equalization of Property Taxes for the Nation's Largest Central Cities," *National Tax Journal*, June 1965, pp. 151–161.
[3] Mordecaai S. Feinberg, "The Implications of Core-City Decline for the Fscal Structure of the Core-City," *National Tax Journal*, September 1964, pp. 213–231.
[4] Harold M. Groves and John Riew, *Financing Metropolitan Municipalities in Wisconsin*, *Land Economics*, February 1964, pp. 29–40.
[5] *Report of the Commission on the Economic Study of Milwaukee*, 1948, p. 119.

only about 22 mills. By 1965, the mill rate had risen to 39.46, but the effective rate was reduced by a mill-rate sharing system (explained later) to 35.46. There is nothing in the record to indicate that without further State or Federal relief, the rate can be held at even its present level.

History of State Sharing in Wisconsin

Wisconsin is said to be one of the "sharingest" States in the Union. Currently some 50 percent of State collected taxes is earmarked for municipalities, about 45 percent of which is shared taxes. Thus municipalities are the principal function and concern of the State. The prominent rôle of shared taxes is the distinctive feature of the system. State aid for education, in the area of 25 percent of costs, is modest by national standards.

The Wisconsin experience with shared taxes is a story with two chapters. The longest and more important quantitatively concerns mainly the sharing of two taxes, income and public utility property taxes. A large though varying proportion of these two taxes has been distributed for many years according to origin as defined. It is our understanding that another paper in this symposium will relate this experience in some detail and so we may generalize briefly. The rationale for this distribution was twofold: (1) that the State inaugurated these taxes in some degree to replace an existing or potential local source; and (2) that the State has superior powers of taxation, at least in terms of administration, and it here offers its service to municipalities to do better for them what they might have done for themselves. This rationale was accepted with tolerable grace for many years but more recently it has been sharply challenged. The development which precipitated the criticism was the metropolitan disintegration previously discussed. It was noted that there was a strong positive association between an affluent property tax base and shared taxes received. Critics regarded it as ironic that an income tax ostensibly based on ability to pay should be used to aid progressively municipalities that are fiscally superior. The utility tax distribution was erratic, bestowing a handsome bonanza on some fortunate communities and very little on others.

Some defense of the system was made in terms of the proposition that State aids (particularly for education) and shared taxes strike a fortuitous balance, the aids helping the rural communities and the shared taxes, the urban ones. But the effect of the total transfer system—aids and shared taxes combined—within a single urban county like Milwaukee was found to be little if any better than that of shared taxes alone. The aids follow school expenditures primarily and this is one item of urban outlays where suburbs often find government more expensive than central cities. Moreover, statewide distribution of school aids based on numbers of pupils plus an equalization factor that gives special relief to those districts with a low valuation behind each child, differentiates mostly between rural and urban schools—it gives no special help to urban districts with ample valuation but very high other urban needs. School authorities have come to recognize this but have had trouble devising a viable formula to implement it.

The existing shared-tax system was sharply reconsidered in 1961 when a retail sales tax was added to the Wisconsin system largely in the interest of property tax relief. A study committee had made this comment:[6] "There are those who contend with a good deal of sense that the State should not consider new sources of revenue until it has eliminated the substantial inefficiency in its distribution of existing taxes." The committee added that this would involve facing up to some deeply entrenched vested interests. It noted also that while many taxpayers were burdened with high property taxes by no means all of them were. The range in city rates (equalized values) was from 12.62 mills in Port Washington (utility town) to 37.63 mills in Fountain City. Among villages the range was from 3.3 mills in North Bay to 49.10 in Rib Lake. The study noted that the range was aggrevated by the State's system of distributing shared taxes and by disintegration and segregation in metropolitan areas.

Another committee—a Blue Ribbon policy committee—also considered these facts and came to the conclusion that the time was ripe to propose a completely new deal in intergovernmental transfers; that all existing shared taxes—and possibly some aids—should be placed in one pot so to speak and earmarked for more equitable distribution by a new formula.

The committee found this assignment a very difficult one. Notwithstanding a resolve to ignore vested interests, it had to be recognized that too wide a departure from existing patterns would be politically unrealistic. Recognized too was the fact that capacities, efforts, and need are all legitimate factors in an optimum distribution formula. But no clear prescription for putting them together into a workable formula was available. Fortunately the committee was well staffed with computers and could subject various proposals to a trial run. Per capita distribution with and without weights (as in the New York Moore Plan) was originally preferred but regretfully discarded. The committee finally selected this: Half of the money would be distributed according to equalized value, net taxable income and population (40 percent by full value of locally taxable property, 40 percent by net taxable income, 20 percent by population); the other half according to equalized value tax rates. Considerable equalization was to be built into the latter half of the program. The State would contribute modestly to municipalities with rates below the State average of 25 mills, but for those which exceeded the average, it would contribute more generously ending with a top bracket where it would contribute 50 percent of the excess. The formula was defended as a neat compromise between rural and urban interests and on the ground that it would also distribute generously where help was most needed.

The legislature found this recommendation strong medicine and swallowed only a much attenuated dose of it. The principle of distribution according to full-value tax rates was accepted but for new sales tax money only and with the equalization feature much softened. On some $50 million of sales tax money the State would match the municipalities to the extent of the money available and on that part of their levies which exceeded 14 mills. In addition Wisconsin industries and

[6] University of Wisconsin Tax Study Committee, *Wisconsin's State and Local Tax Burden*, 1959, p. 116.

industrial communities would get some relief from a rebate to the taxpayer of about 50 percent of the personal property tax on industrial inventories. Agricultural communities also scored here with a similar rebate for the personal property tax on livestock.

The amount of direct relief thus made available looks modest. The $50 million to be distributed on the new formula amounts currently to only some 10 percent of the total levy of the State, but it is much more potent than this in terms of the marginal dollar of any levy above 14 mills. Some equalization is accomplished; other things being equal, a municipality with a 28-mill rate gets twice as much support as one with a 21-mill rate. As previously observed the effective rate in Milwaukee is reduced by the distribution from some 39 to some 35 mills. Differentials among rates in Milwaukee County which otherwise would range from 22 to 39 mills are reduced to from 20 to 35 mills. The important innovation was the new principle of distribution. More relief could be provided by making more money available, and more equalization by raising the level of the millage for which no matching is authorized.

How good is the millage factor as a basis for distributing State tax relief? First reaction is likely to be that it is loading the dice in favor of extravagance and carelesss spending: a little like saying to one's son: "If you spend modestly you are on your own, but if you are able in your budgeting to exceed the average, you will get a generous reward from your parents." One could argue that muncipalities like people are entitled to choose their standards of living (public living), but if they choose a high one, let them pay for it and take the consequences. Milwaukee does enjoy a high scale of services; very well, let them pay for it. A community that prefers to spend more of its resources privately should not be penalized for making a wise decision.

But the literature concerning intergovernmental transfers also mentions effort and need as legitimate considerations in distributing centrally collected revenues. To be sure, these factors, especially effort, are most often associated with conditional aids where there are obvious externalities and a clear partnership of interests between central governments and municipalities. But there is no discernible line between the municipal expenditures that are of general and those that are of particular interest. Nor is there a line between genuine urban needs and luxury expenditures. This much is certain: a municipal rate of 35 mills is no small concern to the officials and people of Milwaukee. Mayor and council are under constant pressure to keep the tax rate from mounting.

An equity of 80 percent in a marginal increase in tax (perhaps even 60 percent) should be quite adequate to preserve due caution in municipal spending. It is true of course that any divorce between the decision to spend and the direct obligation to tax weakens the restraint upon public spending. It is the conviction that such restraint may be too great that supports intergovernmental transfers. Especially in the case of the core cities of our metropolitan areas at the present time, the conviction seems well warranted.

Of course property tax rates are not a perfect measure of need and effort. All taxes are said to come out of income and there are taxpayers and areas that are "property rich and income poor." These tend to lose out in a system that stresses property tax rates. In other words high property tax rates supported by high per capita income can be less onerous than lower rates supported by much lower per capita income. Rural areas are the ones that might complain most here. The Blue Ribbon Committee recognized this in that part of its recommendations which proposed equalized value and population for consideration in a distribution program. However, high property tax rates and substantial relief under the new sales tax distribution are by no means confined to Milwaukee or highly urbanized areas. In 1965 there were five counties, in which cities and villages had an average tax rate of over 35 mills. The highest three of these were Milwaukee, a fairly good agricultural county, and one county in the far North suffering from a depleted mineral and forestry economy.

BEARING OF WISCONSIN EXPERIENCE ON FEDERAL SHARING

What does the foregoing exposition have to do with Federal sharing? First, it supports the conclusion, already stated, that municipalities, at least some municipalities, are badly in need of assistance to maintain proper public services and keep the property tax in bounds. It supports the further conclusion that if we are to have the Heller-Pechman type of block grant, it should assure a fair share for municipalities. Finally it supports the proposition that the Federal Government to get the most for its money should specify a degree of equalization in the grants redistributed to municipalities.

It can be argued of course that if the Federal Government granted money unconditionally to the States this would help municipalities indirectly. It is claimed that the State leadership will know how to distribute money where the need is, at least as well as Washington. For many years State legislatures were packed with rural representation, but under the influence of Supreme Court decisions and migration from the farms to the cities, this unequal voice in State affairs is probably destined to disappear. However, the trend is also toward more representation of suburbs as compared with central cities. Thus it may be as difficult to counteract the inequities of metropolitan finance in the future as it has been in the past. Of course the vested interests may be as strongly represented in Congress as in State legislatures. But it is nevertheless true that Congress has shown more awareness of urban problems than the States and in any event some insurance of relief is surely worth an attempt.

Whether the specific innovation in techniques of sharing introduced in Wisconsin in its recent property-tax relief program could be (should be) applied in national sharing is another and more difficult matter. One difficulty is that not all States have full-value tax rates (for municipalities) that are reliable. Most States now make an effort to ascertain comparative values of municipal property tax bases. There are a dozen important uses for such data. Where the reliability is less than it should be, some pressure from the Federal Government would be salutary. Bear in mind that it is not proposed to make comparisons among municipalities in different States with widely different tax systems—only those within a given State. Whether in distribution among States, equalization should be extended beyond the per capita rule, is a separate and different question which we are not here considering.

This leads to a second difficulty; namely, that some municipalities in some States supplement their property tax revenues with local levies on income and sales. These could perhaps be converted into property tax equivalents and added to the actual municipal levies on property. However, a municipality that kept down its property tax rate by a diligent administration of the personal property tax might still be penalized. Ideally this would be defeated by a first-rate equalization. Finally, a municipality might be discouraged in making use of special charges unless this too were converted into a property tax equivalent.

Of course, there are other formulas of equalization that might be considered. For instance per capita distribution would involve some element of equalization and may be commended for its simplicity. But as we have explained it does not adequately cover the factors of need and effort.

However, let us again stress in conclusion the more important lessons of the Wisconsin experience: (1) that municipalities should be assured (beyond State discretion) some portion of Federal block grants; and (2) that the Federal legislation should prescribe and require an equalization feature in this redistribution. Only thus could a block grant compete with conditional aids in assuring real progress toward the solution of urban problems.

REVENUE SHARING AND TAX CREDITS IN THE LIGHT OF WISCONSIN'S EXPERIENCE

BY ARTHUR P. BECKER*

INTRODUCTION

Fiscal federalism has passed its period of infancy and is ready to enter a phase of rapid growth. Technological and economic progress have reduced the size of the Nation and have forged an interdependence between many regions and urban areas. Since no State is a closed society it has been constrained in its tax and spending policies lest it drive industry and many of its most able citizens into some other State with a more amenable tax climate. Rather than carry this risk too far the role of the Federal Government has been enlarged with startling speed throughout the middle third of the 20th century.

The urgent need to provide financial assistance for many State and local expenditure needs has dominated this period. The last few years have seen a new flurry of Federal programs for education, welfare, the war on poverty, and urban problems. It appears now, however, that the very active role of the Federal Government has run up to a plateau. It might even be said that many Federal programs, although certainly not all, have generated an increasing resistance throughout the Nation. Many thoughtful persons have begun to debate more vigorously than at any other time in the last 35 years the desirability of an unabated Federal benevolence and active presence. Now that some of the most critical fiscal needs of State and local government have been met the ever heavier friendly Federal yoke is being questioned. It is a constructive questioning, and simply asks if there are not better ways of achieving many of the needs of State and local government. "Better ways" are taken to mean larger roles for State and local government and a smaller one for the Federal Government, without sacrificing the effectiveness of programs, or hopefully with an increase in effectiveness.

The possibility of new approaches to fiscal federalism is enhanced by a Federal tax system (developed under the pressures of World War II) with a tax yield far greater than Federal responsibilities require during peace. A second development is the reapportionment of State legislatures which has led the way to hope for a revitalized and more responsive and responsible State action.[1] Reappointment, however, provides only half of the political prerequisite to justify a sanguine future for fiscal federalism. Central city problems and metropolitan problems require a suitable metropolitan political organization to cope with the physical and economic interdependence and external economies and diseconomies within an urban area.

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*Professor of Economics, University of Wisconsin at Milwaukee.

[1] Walter W. Heller, *New Dimensions of Political Economy*, New York (1967), pp. 117–119.

Unless some adequate metropolitan governmental organization is provided, there would seem to be little reason for real optimism in any sort of tax sharing or tax credits for states. Reapportionment has shifted State political power from rural to suburban areas, the havens of segregation and the holders of greatest wealth and power. Central cities have gained little if any additional political representation. In fact suburban obstructionism to metropolitan cooperation and/or government has been made overwhelmingly powerful by reapportionment.[2]

The desirability of State and local governments sharing Federal revenues as alternate forms of aid is an oversimplified question that cannot be answered categorically. The basic premise assumed here is that some kinds of Federal sharing and alternatives, but not all, are desirable to strengthen the independence and fiscal resources of States. Moreover, some approaches are superior to others. Perhaps certain valuable lessons can be learned from experiences in Wisconsin with shared taxes and tax credits. Wisconsin's experience may be uniquely significant for possible Federal programs since the State stands among the leaders in terms of local autonomy and responsibilities in providing public services and yet depends most heavily in State financing of local services.

The view that the independence of States and local governments can be strengthened by additional tax legislation as would be needed if tax sharing or credits were enacted may seem paradoxical. Yet by decreasing the fiscal competition among States and increasing their revenue, they are released from a double bondage that has led to a preference for Federal action on dozens and perhaps hundreds of specific types of Federal programs. There is the possibility that some of these can or should be eliminated. However, the position taken here is that tax sharing or credits should be viewed mainly as a device to slow down, if not halt, the rapid expansion of Federal programs and power over innumerable details in the everyday lives of all of us.

THE DEVELOPMENT OF WISCONSIN'S SHARED INCOME TAX AND INCOME TAX CREDITS

In 1962 intergovernmental expenditures by the State of Wisconsin totalled 48.5 percent of its total general expenditures.[3] While most intergovernmental expenditures involved grants and aids for specified functions (education, highways, public welfare, hospitals, health, etc.) as in most other States, 31.9 percent was spent for general local government support.[4] This represented the local sharing of substantial sums of State taxes "without strings attached" as to how this money was to be spent locally. Moreover, the most important unit in Wisconsin's shared tax system is the individual income tax.[5] Of the five States that

[2] This does not mean to imply that reapportionment is not desirable. As a basic principle of democracy, the one-man, one-vote principle is not disputed here.

[3] U.S. Bureau of the Census, *State Payments to Local Governments*, vol. VI (Topical Studies). No. 2, October 1963. Wisconsin was exceeded only by New York with intergovernmental expenditures of 49.5 percent.

[4] *Ibid.* The percentage for Wisconsin was exceeded only by Hawaii with 76.7 percent.

[5] Wisconsin has a large and complex system of shared taxes, perhaps more so than any other State. Besides the income tax, other shared taxes are those levied on public utility property, the licensing of motor vehicles, the sale of alcoholic beverages, gross receipts of telephone and rural electric associations, railroad terminal property, and forest crop land income.

share their individual income tax receipts with their local governments, Wisconsin program is by far the largest.[6]

The primary support for enacting the individual income tax in 1911 came from those persons wanting to replace the tax on personal property. According to plan, legislative enactment of the income tax was accompanied by the exemption of most intangible property and several classes of tangible personal property from the general property tax. Besides the outright exemption of some personal property a tax credit was provided against the taxpayers' income tax to the extent of that liability. The income tax was designed to produce a tax liability large enough to allow for the personal property credit and still provide a yield sufficient to replace the loss of revenues to the various levels of government on account of the personal property exemptions.

Revenues from the income tax were distributed among the various units of government according to the residence of the taxpayer. Out of the income tax proceeds collected in a municipality, 70 percent was returned to that municipality, 20 percent went to the county of which the municipality was a part, and 10 percent was retained by the State government. It was in this manner that Wisconsin's individual income tax was created to be used almost entirely as a combined shared tax and tax credit for the purpose of eliminating the burden of the personal property tax.

In 1925 the personal property tax credit (or "offset" as it was called) was repealed. The increase in State revenues was largely used to increase State educational aids. These changes led to a revision of the formula for sharing income tax revenues to 40 percent for the State, 10 percent for the county and 50 percent for the municipality. The change in formula was necessary to minimize changes in the dollar revenue received by most municipalities and counties.

In 1961, just one-half century after the enactment of the individual income tax, the legislature took action to eliminate the income surtax, which produced revenue solely for the State and which had been in effect for a number of years, by raising the normal income tax rates. A change in the formula for distributing normal tax revenues was again necessary so each level of government would not experience any drastic change in revenues on that account. To that end the State arranged to retain 67 percent of the individual income tax revenues and return 33 percent to localities, five-sixths of which went to municipalities and one-sixth to the county of the taxpaying resident. Two years later, income tax rates were raised again making it necessary once more to reduce the percentage of the local share (since it was decided that the dollar amount for the municipalities should not increase proportionately) from 33 to 26.38 percent after March 1967.

A tax credit for homestead tax relief was added to the individual income tax in 1964. The tax credit is limited to a part of the property tax paid by any citizen over 65 years of age whose household income (including social security receipts) is less than $3,000, and general property tax exceeds 5 percent of his income. The size of the homestead relief credit varies directly with the size of the citizens' property tax

[6] Other States with shared individual income taxes are Maryland, New Hampshire, South Carolina, and Tennessee. *Tax Overlapping in the United States,* Advisory Commission on Intergovernmental Relations (Washington, 1964), p. 139.

and inversely with the size of his income up to $3,000. Citizens living in rental housing are also granted this credit and are presumed to pay property taxes equivalent to 25 percent of their rent.

The homestead tax relief is more than a tax credit provision. It guarantees the citizen a cash refund if his tax credit exceeds his income tax liability. The State individual income tax thereby has become a limited negative tax for persons over 65 years of age.

A Brief Evaluation of Wisconsin's Shared Individual Income Tax

ADVANTAGES

The shared individual income tax of Wisconsin achieved the legislature's original objective of exempting intangible personalty from the general property tax and eliminating the tax burden on tangible personal property of income taxpayers. Later changes retained only the exemption of intangible personalty but this represented a clear gain in eliminating the double taxation of much property and the establishment of the income tax which conformed better to the ability-to-pay principle. This historical reason for the sharing feature of the income tax may not be as valid today because a return to taxing intangibles under the general property tax does not have the faintest support. Moreover, the number of alternatives available for helping localities make up this loss in revenues are far greater now than in 1911.

Enacting the State shared income tax established a local revenue source that possessed a superior revenue elasticity reflecting economic growth and price rises. This automatic flexibility in revenues which does not require administrative and legislative agonizing has been very important in maintaining the desired level of local public services.

The administrative superiority of the State income tax over local taxing of personal property, especially intangibles is so obvious that it need merely be mentioned here. The advantage would remain even if local authorities were permitted to establish and administer their own income taxes as has sometimes been discussed in Milwaukee. The legislature has in this regard seen fit to prohibit the City of Milwaukee from establishing its own income tax. One argument is that the present local sharing of the State tax makes the tax really a local income tax as well as a State income tax, and that enacting a municipal income tax would establish a second municipal income tax which does not make any sense.

One advantage of both the shared income and sales tax in Wisconsin is that they have permitted a responsible growth in local public services without increasing the property tax burden as much as would otherwise have been necessary. It is a moot point, however, whether a very heavy State and local income tax is preferable to a very heavy property tax, provided that some reasonable adjustment is made for homeowners with low incomes. When one considers that much of the real estate tax is capitalized, resulting in lower prices of land, the tax has considerable virtues. The popular movement in many States as in Wisconsin to give general property tax relief, will inevitably lead to higher land prices.

A summary of the advantages of Wisconsin's shared individual income tax would include the following:

1. It has allowed the elimination of the tax on intangible personal property under the general property tax;
2. It allows a significant portion of the local revenues to be raised in accordance with the ability-to-pay principle;
3. The State shared individual income tax is administered far better than any locally administered tax would be, regardless of whether it is the property tax on intangibles or a local income tax;
4. The State income tax provides automatically an elastic source of revenues which avoids repeated administrative and legislative hurdling of political obstacles simply to maintain standards of services.

Points 2, 3, and 4 have minimized political struggle in maintaining and expanding reasonable services provided by local governments in the State of Wisconsin.

DISADVANTAGES

When the tangible personal property offset was repealed in 1925, the percentage of the income tax yield that was shared locally was reduced and the revenues retained by the State increased sharply. It was decided that these revenues would better help local governments if they were used to grant a substantial increase in educational aids and to eliminate the State's tax on general property.

The shared tax does not permit local independence in terms of the degree or extent that each locality wishes to rely upon the income tax. Decisions are made by the Wisconsin State legislature as to tax rates and the composition of the base, and local governments of the State must accommodate themselves to the income tax share that they receive. Furthermore, since the yield of local shares fluctuates with collections from year to year, the burden of adjusting expenditure levels by local governments is repeated annually. According to present practice the local property tax burden must be adjusted to meet local financial requirements. A local income tax would have the advantage of providing a certain flexibility and relieve the property tax from part of its present (almost sole) responsibility for making financial adjustments.

Wisconsin's income tax sharing plan has contributed a good deal to the wide disparity in property tax rates among the State's 1,825 local units of government. Since municipalities differ economically and socially, any income differences result in similar tax yield differences. Because income tax shares are returned to municipalities on the basis of taxpayer residence, those municipalities with the highest income recipients receive the largest tax shares. It is also because income tax rates are progressive, that the shares received by high income municipalities are more than proportionately higher than for low-income communities. The disparity between property tax rates (after adjusting for varying assessment ratios) is wider compared to what it would be without the shared tax. This distributional effect of shared income taxes has created much discontent and criticism. It has given rise to a variety of proposals offering alternate methods of determining the distribution of shares to municipalities and counties.

Because of the foregoing effect on property tax rates, economic segregation by means of local political fragmentation is encouraged. An affluent town (rural) on the fringe of a city can enjoy a far lower property tax by incorporating as a separate municipality rather than by joining the adjacent (usually central) city. The artifically widened disparity between property tax rates is self-perpetuating because it causes high-income municipalities to attract still other high-income residents. The property tax disparity also operates as a barrier to cooperation among municipalities that are part of a metropolitan area. This is particularly true of metropolitan Milwaukee.

Wisconsin's shared income tax has created many administrative problems involving allocation procedures, questions of residence, the expenditure of much time and money in auditing and making corrective refund payments.

The disadvantages of Wisconsin's shared income tax may be summarized by stating that it has—

1. Offered less independence in making tax decisions than, let us say, a separate local income tax or an income tax supplement;
2. Shifted the burden of adjusting expenditure levels from the State to local governments;
3. Widened the disparity in property tax rates (in terms of full value) between the State's 1,825 local units of government;
4. Encouraged the extension and preservation of economic and political fragmentation of urban areas into a multiplicity of municipalities;
5. Created many administrative problems;
6. Created much dissension as to its fairness and the desirability of its effect.

Wisconsin's shared income tax, along with other State shared taxes, came in for its heaviest criticism by the Continuing Revenue Survey Commission (1960) after a long and careful study.[7] The Commission recommended the replacement of the shared tax system with a new type grant-in-aid program. According to the latter all shared taxes would be pooled and then distributed to municipalities in terms of a formula considering population, income, property values, and the need for property tax relief. The recommendation was never followed. However, a selective sales and use tax was enacted in 1961 to provide tax relief in three programs:

1. The general property tax offset, which assists those general property taxpayers whose annual tax on their property exceed a full value rate of 14 mills;
2. The personal property tax offset, which in 1967 will reimburse personal property taxpayers 60 percent of their personal property tax on merchants' stock-in-trade, manufacturers' materials and finished products, and on livestock;
3. A special relief program, already mentioned, for general property taxpayers over age 65 whose annual income is less than $3,000, and whose general property taxes exceed 5 percent of their income.[8]

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[7] *Final Report*, Continuing Revenue Survey Commission, State of Wisconsin (December 1960), p. 65.

[8] *The State of Wisconsin Bluebook*, 1966, Wisconsin Legislative Reference Bureau, pp. 287–288.

While the enactment of these property tax relief provisions has assisted individual taxpayers, it has not eliminated the many criticisms of the shared tax program. Opposition to aspects of the sharing feature is probably as great today as ever.

Tax Sharing and Credits—A Brief Comparative Analysis

Prof. Walter W. Heller suggests six criteria which any Federal plan for State and local financial assistance should try to achieve. He believes that any new plan or approach should supply Federal funds to the States in ways that will—

1. relieve immediate pressures on State-local treasuries;
2. provide revenues that increase automatically and adequlately with economic growth;
3. improve the distribution of Federal-State-local fiscal burdens;
4. reduce economic inequalities and fiscal disparities among the States;
5. stimulate State and local tax effort;
6. build up the vitality, efficiency, and fiscal independence of State and local governments.[9]

While meeting these requirements is a formidable order in itself, there are still four others that Wisconsin experience would have us add. They would require that the plan—

7. shift the burden of adjusting expenditure levels from State and local governments to the Federal Government;
8. be neutral in its reaction to various sources of State and local revenue;
9. minimize administrative problems;
10. minimize dissension as to its equity and effect.

Perhaps no plan can be devised that will pass on all of the above criteria. However, unless it passes on most of them it may produce more trouble than good. We will very briefly examine tax sharing and tax credits in light of these criteria.

1. RELIEF FROM STATE-LOCAL FISCAL PRESSURES

Both tax sharing and credits are capable of producing substantial revenues without stirring up fiscal competition among States. However, because tax sharing requires no State action it has an advantage over a tax credit plan—but only slightly. A Federal credit is a powerful incentive to unify internal forces in the various States sufficiently that they might avail themselves of the full credit. In terms of the relief provided from fiscal pressures, tax sharing, nevertheless, is slightly superior to the tax credit approach.

2. A SOURCE OF REVENUES THAT INCREASE AUTOMATICALLY AND ADEQUATELY WITH ECONOMIC GROWTH

Sharing Federal revenue tax would be a tremendous advantage for those States (about one-third) that do not have a progressive income tax. It would give them a source of revenues which would auto-

[9] Walter W. Heller, *New Dimensions of Political Economy* (New York, 1967), pp. 144–145.

matically increase faster than economic growth. This is necessary if a State is to balance sales and property tax revenues which increase at a slower rate than economic growth. However, many States that have their own income taxes already have a balanced tax structure. Tax credits could be devised so as to induce most if not all of the remaining States to enact their own income taxes. In terms of providing adequate revenue automatically as economic growth occurs, tax sharing would seem to rank only slightly ahead of tax credits for the States without an income tax. For many States that already have income taxes, tax sharing may well be viewed as an unnecessary burden.

3. IMPROVE THE DISTRIBUTION OF FEDERAL-STATE-LOCAL FISCAL BURDENS

Tax sharing would undoubtedly increase the progressiveness of the Federal-State-local fiscal structure. This is obvious if the shared funds were used to increase State and local expenditure which are progressive in effect, i.e., they are designed to provide more public services for low-income persons than high income persons. If shared funds were used to reduce State or local taxes, the State-local tax system would become less regressive. This would hold true even for Wisconsin where the income tax is depended upon more than in nearly all other States. While Wisconsin's tax structure is progressive in the upper income ranges, it is proportional for the middle income groups and regressive in the lower income range.[10]

A tax credit would probably persuade those States without an income tax to enact such a tax, thereby (to the extent that Wisconsin's experience in applicable) reduce regressivity for the lowest income groups, replace regressivity for proportionality in the middle income ranges, and establish a slightly progressive tax structure in the higher income ranges in place of the present regressive effect. Needless to say, this would be a considerable gain for the very States that need a better balanced tax structure.

4. REDUCE ECONOMIC INEQUALITIES AND FISCAL DISPARITIES

Whether State and local sharing of the Federal income tax reduces economic inequalities and fiscal disparities depends upon the basis of distributing the shares. Wisconsin's practice since the income tax was established in 1911 has been to distribute the tax shares to municipalities and counties on the basis of taxpayer residence. This basis of distributing local shares has been found, as we have already noted, responsible for increasing economic inequalities and fiscal disparities between local governments.

In 1925 the State legislature reduced the local shares of the State income tax in favor of increased educational aids. The change constituted clear evidence that grants for the specific purpose of education were preferred to a more liberal sharing of the State income tax which attaches no expenditure restrictions. By this change Wisconsin gave priority to grants-in-aid to local governments to be spent on specified public services that are highly esteemed over general pur-

[10] *Wisconsin's State and Local Tax Burden,* University of Wisconsin Tax Impact Study Committee (September 1959) p. 56.

pose income shares. A Federal tax sharing program might well be looked upon as a hunting preserve in which many righteous and/or worthy causes will seek funds to be spent for specific purposes.

Growing criticism of the shared tax program in Wisconsin finally led to a recommendation in 1960 by the Continuing Revenue Survey Commission to replace the State's shared tax system with a general purpose "grant-in-aid" program. The latter involved essentially a change in the basis for distributing funds from the taxpayers' residence to a combination of criteria that would include population and need as reflected by the size of a municipality's (full value) property tax rate. However, the present basis for distribution; namely, residence, has enormous political support and no way has been found to modify it.

Wisconsin's experience suggests that political forces would insist that a Federal tax sharing plan distribute funds at least partly on the basis of the State of origin, i.e., residence of the taxpayer, and very likely other bases as well, such as population, need, fiscal effort, etc. If so, the opportunity to decrease inequalities and fiscal disparities between States will be minimal. Moreover, once funds are distributed to each State, they may not actually be distributed to various local governments in such a way as to reduce property tax disparities. In fact, the same forces that have widened fiscal disparities in Wisconsin might decide, unless Federal rules intervene, to do more of the same with Wisconsin's share of the Federal income tax.

The range of possible effects on economic inequalities and fiscal disparities through the use of tax credits also appears to be quite broad. A tax credit against Federal income tax liability of a uniform percentage of the taxpayer's State income tax payments, as suggested by the Advisory Commission on Intergovernmental Relations [11] would produce the same fiscal disparity among States as would tax sharing on the basis of origin. This problem can be overcome by basing tax credits on the sum of the three major State-local taxes (income, real estate, and sales) and allow a tax credit in the form of a decreasing percentage of income for taxpayers with higher income. Economic inequality and fiscal disparity between States could be reduced with this form of tax credit. In fact, it could be reduced still further if the principle of the Wisconsin homestead tax credit were utilized. In accordance with this principle, the Federal taxpayer would be given a cash refund if his tax credit were higher than his Federal income tax liability. The "tax climate" would vary less between States for individuals and business enterprise, and future economic growth and development would tend to iron out some economic inequalities between States and their people.

5. STIMULATE STATE AND LOCAL TAX EFFORT

A tax sharing plan can be devised with a distribution formula that takes State and local fiscal effort into account. It would require the sacrifice of a simple plan of distribution, which, as we have seen, may be difficult to achieve at any rate. The tax credit device is best suited to achieve maximum State and local fiscal effort. A tax credit for State income tax payments would exert considerable pressure on the remain-

[11] *Federal-State Coordination of Personal Income Taxes*, Advisory Commission on Intergovernmental Relations (Washington, 1965), pp. 14–19.

ing non-income-tax States to adopt income taxes. Even better, a minimum State-local effort for each of the three major taxes can be required for Federal taxpayers to qualify for the full credit.

6. BUILD UP THE VITALITY, EFFICIENCY, AND FISCAL INDEPENDENCE OF STATE AND LOCAL GOVERNMENTS

Both tax sharing and credit plans will build up the financial resources of State and local governments. Tax credits can elicit State-local action in enacting qualifying tax legislation, thereby increasing State-local financial resources. On the other hand, Federal tax shares will appear as a windfall to each State and may possibly result in less concern for efficiency and the benefits accruing from spending the tax shares. In terms of efficiency then, tax credits may have the edge over shares. With either plan, however, there need not be any undue restraint on the fiscal independence of State and local governments, as is the case with grants-in-aid for specific functions.

7. SHIFT THE BURDEN OF ADJUSTING EXPENDITURE LEVELS FROM STATE AND LOCAL GOVERNMENTS TO THE FEDERAL GOVERNMENT

Wisconsin's experience with its shared tax illustrates the need for local governments to accommodate themselves to whatever income tax shares come their way from year to year. Most of the time local governments do a pretty good job of predicting what they will receive in income tax shares and are able to make fairly easy adjustments in their budgets when the exact amount of their shares are known. Now and then, however, when economic conditions are changing rapidly or when significant changes have been made in the income tax law, actual shares deviate considerably from the predicted, and often spent, shares. Emergency measures may be forced upon the municipality such as a sharp and unprepared for rise in property taxes, a deletion of some budget items, a delay in public works of purchases, or unexpected indebtedness. It is possible, however, for a Federal shared tax program to have a fund and policy of making stable and quite predictable payments.

Tax credits, on the other hand, would place the entire burden of fiscal adjustment on the Federal Government which is in far a better position than State and local governments to make such accommodations. As the scope of the sharing program is modified (since it would be quite unreasonable to assume that if it were once established, it would never be changed) or economic and political conditions varied, it would seem that occasional changes in shares paid to the States would have to vary somewhat. Whether a stabilization technique can and should be devised to permit only an increase in state shares, would be difficult to speculate about.

8. BE NEUTRAL IN ITS REACTION TO VARIOUS SOURCES OF STATE AND LOCAL REVENUE

The shared tax plan that is currently being discussed in many places today would return a portion of the Federal income tax to the States. The plan does not directly involve the tax structure of any State. Indirectly, however, it may well affect the structure if a State decides, for example, to exempt or reduce one or more State and local taxes. This may be undesirable in that it may make State tax structures appear to be more disparate in their tax burdens even if they are not in fact. States would be subjected to more competition and fiscal pressures may even rise.

A tax credit against Federal income tax liabilities in terms of State income tax payments seems to have attracted a considerable amount of attention. It would probably establish a uniform treatment toward all States and the tax structures of the latter would before long consist of stable income taxes along with sales and property taxes. Fiscal pressures, however, may develop in time to favor State income taxes (because of its tax credit allowance), over sales and property taxes. In order to guarantee against this possibility and simultaneously remove perhaps the biggest objection to the tax credit plan, it would seem advisable to grant a certain tax credit for each of the income, sales, and property taxes. The tax credit plan would probably get more support if it were devised in this way to be neutral with respect to all of the major sources of State-local revenue.

9. MINIMIZE ADMINISTRATIVE PROBLEMS

If Wisconsin's experience with tax sharing can be fairly taken as a guide, a Federal tax sharing plan would be headed for many administrative difficulties unless its basis of distribution can be restricted to a very simple formula, such as population. But as we have already noted, it would seem quite difficult to avoid including several complicating factors in the distribution formula, such as fiscal effort, capacity, needs, and perhaps even actual collections. Each State would be much concerned that Federal administration is not operated to the disadvantage of that State. The administering of the shared tax trust fund and the distribution of money to the States will require the creation of a new Federal bureau or office. In tax credits, however, Federal income tax liabilities are reduced and possible refunds will be granted to Federal income taxpayers, a sure way to win many more friends.

10. MINIMIZE DISSENSION AS TO ITS EQUITY AND EFFECT

The continuing dissension and divisiveness caused by the tax sharing program in Wisconsin is a serious drawback of the plan in that State. It is difficult to imagine a formula and method of distribution for a Federal-State tax sharing plan that would satisfy all States on the basis of equity and its effect in terms of inequality, disparities, effort, administration, etc. States would be continually on the lookout for and campaigning to correct its strongly held "injustices," real as well as imaginary. This is far more serious that the "unhappiness" caused by inequities in the Federal income tax which are based upon provisions that grant privileges to various taxpayers who are scattered about in all States. A tax sharing plan can, however, set State against State, and thereby become a force that is not desirable for promoting healthy relations between the States and the Federal Government.

A broad based tax credit plan with reasonable limits and perhaps a refund provision would seem to be favored by citizens as far more equitable and acceptable in its effects, and thereby would tend to improve rather than strain relations between States and the Federal Government.

Conclusion

It is not an easy task to choose between the merits of tax sharing or tax credit plans to further develop fiscal federalism in the United States. So much depends upon the kind of tax sharing or tax credit plans that are considered as alternatives. This depends in turn on a judgment as to how people will react to the many variations of each program. An attempt has been made here to evaluate the plans in general and in terms of some specific features which ought to be included in or excluded from either plan.

In this paper, the experiences of Wisconsin were repeatedly brought to bear on this comparative evaluation. It appears to this urban-oriented writer that the shared income tax of the State may have fulfilled an important role historically, but today may create almost as many problems as it helps to solve. Carrying this experience to the Federal-State level, the establishment of a tax sharing program raises many misgivings as we examine it in terms of the criteria which constitute a desirable standard for any Federal plan to lend financial assistance to States. It would seem that political constraints would probably allow the forging of a better tax credit than tax sharing plan.

We may strip away assumed political realities and compare an ideal tax sharing plan with an ideal tax credit plan. Even then the tax credit plan would come out ahead on the basis of its own virtues as well as those of tax sharing, and it would carry few faults of either plan. It would appear that the value of the present debate could be enhanced if more attention were given to various imaginative, yet workable, tax credit plans.

COMMENT ON PAPERS OF PROFESSORS BECKER AND GROVES

BY CLARA PENNIMAN*

Professors Groves and Becker have summarized the Wisconsin experience in sharing taxes over more than half a century and have suggested some implications of this experience for the National Government in any decision for it to share revenues with the States. Beginning with much the same data and historical knowledge of Wisconsin as they, I can only express agreement with the larger part of their analysis. There are a few points, however, that I would modify and at times view from a different perspective.

I.

Although the State's income tax has been the tax longest and most heavily shared, it may be worth recording that Wisconsin actually shares five major taxes (in addition to numerous grants-in-aid) for a total of $265 million in 1966 and has used a somewhat different formula for each. The income tax (1911) uses residence of taxpayer as the major ingredient; the utility tax (1901) is distributed with physical location of the plant and lines as important factors; the liquor tax is returned on a straight per capita basis (1934); motor vehicle (1931) registration and title fees on basis of "home" of vehicle; and the sales tax (1961) is shared with communities through a formula based on local property tax rates so that there is some weighting of need and effort with some communities receiving no returned revenues.[1] These repeated sharing decisions included three elements: (1) a belief that local governments did not have sufficient resources for raising taxes needed; (2) a belief that the State was in a better position to levy and administer a particular tax held desirable than were local governments individually; and (3) a preference that local governments continue to make decisions about spending this money and carrying out governmental functions that would otherwise have had to have been transferred to the State.

Many today believe that the same three elements exists in the relations of the National Government and the States. The growth to highly interdependent, almost strictly national, economy with great productivity presses all States and communities to increase services and improve the amenities of living and to root out the blight of slums

*Professor of Political Science, University of Wisconsin.

[1] In an interesting use of language, the returned sales tax revenues are always classified by the Tax Department and others in the State as "property tax relief" payments rather than as "shared taxes". Only municipalities (towns, villages, or cities) with equalized property tax rates above 14 mills "share" the tax; but as ir any shared revenue, there is no restriction in freedom of use.

and poverty. Yet the States are unequal in resources for the tasks and the political problems of an individual State making choices it prefers either in particular taxes or in the height of its taxes multiply with economic mobility. Thus, repeating the Wisconsin choice of more than half a century ago, if we wish greater use of a flexible, growth tax with progressive features, the national income tax appears the desirable candidate. Sharing some of the national income tax with the States would permit increased revenues from a more desirable revenue source at the same time that the States and their local governments could continue to exercise present freedoms in determining and carrying out many programs in ways of their own choosing. The formula for any such sharing requires close consideration of differing fiscal needs and the varied nature of governmental demands among the States.[2]

II

Does the Wisconsin experience offer any evidence on the argument of tax credits versus tax sharing? To begin with I prefer Dr. Becker's point (p. 13) of the desirability of encouraging substantial use of State income taxes in all 50 States to provide a "balanced" tax system with built-in growth potential to his subsequent suggestion that all major taxes in the States be available to credit against the Federal income tax (p. 19). The *presumed* political liability of State tax choices has fallen hardest on the income tax, and yet that tax has offered State governments more revenue growth possibilities than any other. As Dr. Becker points out revenues that grow faster than the economy reduce the political frictions in expanding needed governmental services. At its best an income tax credit would encourage all States to adopt such a tax, add a little in State growth revenues, and reduce interstate competition on this particular tax choice; but it is unlikely to increase revenues for those States most in need. An individual tax credit by definition does not assist in equalizing the revenue base *among* the States. Any formula of tax credit that had equalization features would pose the same political and administrative problems that worry Dr. Becker in devising an appropriate shared tax formula without necessarily adding to the revenues of the State.

Our experience in tax credits and deductibility offer some illumination but little basis for sending up rockets. The Federal estate tax has provided tax credits since 1924 and the Federal income tax has permitted deductibility of State taxes. The National Government's unwillingness to expand the basis for the estate tax credit, the possible inherent limitations of the estate tax, and the unwillingness of all States to accept the National Government's lead have made the estate tax credit less exciting as a device either to encourage States to choose desirable taxes without fear of interstate competition or to increase State revenues substantially.

[2] I would like to insert a brief aside at this point. Nothing in this paper is intended to suggest a belief that tax sharing eliminates the need for Federal grants in aid nor excludes the possible adoption of block grants, the negative income tax or even an income tax credit. These could be made complementary decisions. Block grants and shared taxes, depending on formulas, may have few distinguishing characteristics between them. Presumably a block grant would have slightly less flexibility. The negative income tax or income tax credits would not automatically put more money in the hands of the States. Hopefully the negative income tax could reduce the necessity for government action in some present and prospective program areas. The income tax credit proposal would presumably encourage 50-State use of this tax.

In the case of the State tax deductibility against the Federal income tax, voters and legislators frequently fail to grasp the full meaning of the deductibility feature. The tax lawyer, in the interest of his clients, and taxpayers themselves regularly make the deduction; but I have found an amazing lack of understanding, even on the part of otherwise knowledgeable citizens, of the effect of this deductibility feature. A rational but subtle provision of this type does not easily convince State officials that low cost (in money and politics) revenues are available for the mining.

III

If State governments appear not to have used fully the leeway provided by the Federal Government in estate tax credits or in the income tax deductibility feature, would they use the shared taxes simply as a replacement or in fact to expand services and to meet growing needs? Would they waste their new affluence? There is no doubt Congress might find wisdom in gradual sharing rather than in setting a sudden banquet that could not be well digested in the available time. Occasional Wisconsin legislative committee investigations and public or private talk reveal little irresponsible local expenditures from the "free" shared taxes of the State. Such receipts appear to play a neutral role in the quality of budgeting by municipal councils or boards.

Wisconsin does demonstrate that a sharing with already well-off communities permits them to lower local effort, but there is no inherent reason a National (or State) distribution formula could not include a reasonably effective measure of "effort" as a basis for receiving shared revenues. Beyond a few favored governmental units, the evidence of moderate to very high property tax rates generally in the State indicates little slacking of Wisconsin local initiative or willingness to support government services.

IV

Both Dr. Groves and Dr. Becker have noted that Wisconsin's sharing of tax revenues has not been all roses. The colors appeal, but thorns grow sharp. The State's experience demonstrates the possibility of unplanned and unanticipated consequences of particular shared tax formulas and the vested interests that build to prevent change. Income and utility tax formulas developed out of the simple thesis of replacing part of the existing local property taxes by more equitable and better administered State taxes. Thought was not sufficiently given to the future growth of these new taxes nor the possibility of their encouraging multiplication or continuance of small governmental units to gain the special advantage of the State's tax return. The years have shown some communities inventive in incorporating areas whose residents can enjoy many services of the central city free, secure "unearned dividends" from the State in shared taxes, and maintain local property taxes at a minimum in the midst of bounteous local services.[3] Once the advantage is attained, woe to the Governor and legislators that would tamper with such a sacred natural right. "Home rule" and "States rights" can be rallying cries to cover narrow vested interests.

Congress must beware of distributing national largesse in *small*

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[3] The number of "free-riding" communities is small. Justly perhaps they receive attention out of proportion to their number or even importance in the amount of revenue inequitably distributed. It is important to emphasize formulas would not meet all of the demands for services without increased taxes.

ways. With all of the data and computers available, I would pray that close, detailed analysis of current and changing problems of a generation from now might be combined with wisdom to give us a sense of the future in the choices we make now. Unless Congress intends to develop formulas that assist some in equalizing revenues among the States and that still give greater leeway than the present grant system, there is little to be gained by sharing revenues.

Even great wisdom in decisions to share Federal revenues is not likely to solve all problems and eliminate all political friction for the future. (Do we really want computers that could do so much?) Who pays, how much, for what benefits in government will continue to create political stresses and strains. These are the stuff of political decisions.

Unlike Dr. Becker, I neither believe that most of the suburbs have been separately organized *simply* because of the Wisconsin shared tax formula nor do I believe that different formulas or more extensive grants in aid would have eliminated administrative problems or political stresses. Metropolitan community problems are nationwide. Suburban developments have many roots. True, Wisconsin's shared tax formulas unintentionally added a succulent carrot to the other attractions of separate incorporation. A single government in most metropolitan areas of the Nation, however, would not solve the political and administrative problems of securing adequate revenues locally. More likely the specter of *interstate* economic and tax competition would move from shadow to substance in the evolving attempts of each giant metropolis to export tax burdens and community problems or in concern for the spillover of program benefits beyond metropolitan boundaries. The metropolis as the State cannot meet these issues unaided.

V

Economic, political, and social interdependence in the Nation constantly increases to confuse the mix of spillover problems and benefits through the actions or inactions of individual States and communities. The disparity between revenues and needs has grown though Governors and legislators have gambled political careers to raise State taxes 110 percent from 1955 to 1965. Is it likely that a predicted growth of 78 percent in State-local revenues (with no allowance for change in purchasing power) in the period from 1965 to 1975 will satisfy? [4] We are not generally living today as well as we desire or can publicly afford. The pressures of these unmet needs will force the Congress to expand direct Federal programs and grants unless it decides to share revenues in some fashion.

The Wisconsin experience demonstrates the feasibility of sharing tax revenues and continuing local decisionmaking in a wide range of programs. This experience also raises warning flags to clarify objectives and to see the future large. Fiscal federalism in the seventies will mean more revenues raised nationally for State and local purposes. Our objectives should be to distribute new revenue to the creaking wheels of federalism—substantial differences in State resources and fears of interstate competition—without imposing a tight national administrative net.

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[4] Tax Foundation, Inc. *Fiscal Outlook for State and Local Government* (December 1966), tables pp. 97 and 107.

THE ROLE OF STATE AID IN ACHIEVING PROGRAM EFFECTIVENESS (IN NEW YORK STATE)*

BY BYRON T. HIPPLE

Associated with the concept of conditional grants is, by implication or otherwise, the assumption that oversight will be provided by the grantor jurisdiction to insure that the avowed purposes and objectives sought will be attained—effectively and economically. There are, moreover, general assumptions that the advice, supervision, oversight—however expressed—will be assured more receptive attention the more apparent its relationship to the flow of funds seems to be. To canvass these issues, an array of State aid programs needs to be examined, ranging from a selection of those in which oversight and flow of funds do not appear to be closely connected to a selection of those in which full intimacy of fiscal and program policy seems to obtain. To gain this degree of diversity, several nonsocial service programs, such as highway aid to counties and to towns, have been included here. Despite the seeming incongruity, the points of similarity and difference in program administration are not without interest.

The extent to which State aid for any governmental activity or purpose is essential to achievement of effective and economical local performance in that activity or purpose is a question which will doubtless always be debatable. State aid for a given objective certainly serves two purposes: it focuses attention on that object, and it provides some of the financial resources to accomplish it.

Effectiveness, simply defined, means producing a decided, decisive, or desired effect. In those terms effectiveness of aided programs becomes a factor of "saturation" or geographic scope, and of "program levels" in terms of quality or quantity of performance, or both. Economical, simply defined, means managing without waste. (Although "economy" may suggest the idea of limiting spending levels, this connotation has little relevance to State aid programs which, in the main, are designed to support or encourage expenditures, not deter them.)

In the context of State aid, these terms become closely associated with, often inextricable from, assumption concerning the intent of program effectivenes. In other words, considerations of what are criteria (a) for economical expenditure and (b) for effective expenditure are matters of judgment for experts in each respective field. (Frequently even the experts themselves will differ.)[1] Hence, expert judg-

*Reprinted from *Fiscal Policy and the Public Social Services*, Monograph No. 11, December 1965, Public Affairs Monograph Series, Graduate School of Public Affairs, State University of New York, Chapters VI and VII.

[1] Initially, the relevant statutes were examined for guidelines as to objectives, with quite mixed results. The extreme example of this is a reference in the New York State Comptroller's inventory of *State Aid to Local Government* to the authority underlying one aid program as "Administrative rules of the Commissioner of Health." (New York: Department of Audit and Control, 1963), pp. 58–59.

The statutory authority for this particular aid program (blood banks) was cited by the Department of Health as section 3100, Public Health Law—specifically subdivision 2, which reads: "The Commissioner may conduct such program (establish blood banks) solely as a State activity, or in cooperation with such institutions, hospitals, or municipal corporations as he may select, on such terms as may be agreed upon."

ment as to effectiveness of accomplishments tends to subsume economy, e.g., high quality of local professional services will produce the best end product for value expended.

The extent to which these expert judgments as to effectiveness depend directly on associated State aid to register their results, or, alternatively, are carried out through other means, operating in the shadow of State aid, is the crucial point. A brief examination into State aid operations in three major fields—highways, health, and welfare—suggests the following ranges in alliance of State supervision directed toward effective performance with the actual granting of the funds:

1. Programs in which State administration supervision is largely, if not wholly, disassociated from the flow of funds;
2. Programs in which State administrative supervision is associated with grants, but relies essentially on nonfiscal means to induce performance;
3. Programs in which State administrative supervision is meticulously intertwined with the flow of funds as a medium of control and enforcement.

The specific programs examined in this context are: county highway aid, town highway improvement aid, general public health aid, crippled children (medical rehabilitation) aid, and social welfare grants. Of the $332 million expended by the State in 1962 for aid to localities other than general purpose grants ($128.8 million) and education aid ($813.7 million), these particular grants accounted for $274 million. Ranking them according to the above groupings,

—county highway grants ($60 million) are illustrative of the first classification;
—town highway improvement grants ($6.7 million) and grants for general public health purposes ($20.9 million) fall in the second group; and
—crippled children ($5.2 million) and social welfare grants ($181.2 million) fall in the third class.

Before considering characteristics of each group, it is of interest to note that program effectiveness in the sense of saturation (participation by all eligible governmental jurisdictions) occurs only in the programs assigned to the first and third groups. Those in the second group are not taken advantage of by all eligible localities.

State Supervision Largely Dissociated From Grants

County highway aid is provided under two different provisions: (1) a relatively small grant ("Lowman Act") payable in consideration of county appropriations to the county road fund; (2) relatively large annual sums representing certain portions of motor fuel taxes and motor vehicle fees.[2] In each instance State statutory provisions are explicit as to the basis of apportionment to the counties. Except for statutory provision that these grants shall be paid into the county

[2] Counties also receive a certain portion of town aid for highway maintenance.

road fund, and thereby become earmarked for highway purposes, no "performance" requirements are stipulated. Expenditures as such are not a condition to receipt of these aids. If no expenditures for highways were made by a county, aid would continue to flow. The governing sections of the Highway Law (sections 112 and 112–A) make no reference to county compliance with any administrative conditions of State supervision. In fact, the nondiscretionary character of these dispensations of State aid is such that the Comptroller's report on *State Aid to Local Government* cites the "administering agency" as the Local Assistance Section of his department for so-called section 112 funds, and the Department of Taxation and Finance and Department of Motor Vehicles for section 112–A funds, although the appropriations are made nominally to the Department of Public Works.[3]

Elsewhere in the highway law, the State superintendent of public works is given wide and general authority for overseeing local highway performance. County superintendents must file maps of road systems,[4] plans, and specifications of undertakings for State approval, and the superintendents are subject to removal by the State superintendent under specified conditions. All in all, a close interconnected working relationship between county highway and State highway personnel seems predicated and does, in fact, exist. While the county road fund supplies the financial means for production, the quality and quantity of performance seem unrelated to the dispensing of State aid. In this latter connection—quantity of construction and maintenance—substantial balances appear to exist in county road funds. For instance, all counties had aggregate balances of $22.5 million at the end of 1959. At the end of 1960, these balances were $24.8 million and, in the succeeding year, $17.2 million. During 1960, $45 million of State aid was paid to the counties. Total highway expenditures amounted to $66.9 million, approximately an amount equal to State aid for the year plus the prior year's carryover balance. A similar situation occurs for 1961.[5] This suggests that local tax funds raised and appropriated to the road funds annually become the basis for the next year's construction program, prior balances plus current State aid insuring the financing of the current program. This seems a simple but effective means of "capital programing" which at least insures continuity of the work program over a 2-year cycle, the current and succeeding year. Aggregates can, of course, conceal wide internal variances. And the probability is that for some counties, State aid, under the circumstances by which provided, proves an embarrassment of riches while others may find it the reverse.

If State technical (highway) supervision, or professional cooperation, exists apart from regulating the flow of funds, a modicum of fiscal supervision does exist through audit of municipal accounts by the State Comptroller. Road fund expenditures are examined to insure that any expenditures made are for the purposes served by the county road fund

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[3] *State Aid to Local Government* (1963), pp. 73–76.

[4] The effectiveness of such maps has been called into question, along with those for towns, by a Department of Public Works survey in 1963–64 of all county and town highway and road mileages.

[5] State aid of $46.3 million plus carryover balances of $24.9 million from the prior year, approximating the total expenditures made of $69.3 million.

as defined in the State Highway Law. Assuming an "improper" (extraneous purpose) expenditure, the recourse which would or could be had to State aid grants—the deductions, adjustment, or other fiscal penalty which could be applied—remains quite an open question. Local action to make appropriate correction of the accounts seems to be relied upon.

From the foregoing it would appear that, given alternative resources at local disposal for appropriations for county road purposes, the relative effectiveness and economy of county road program administration would be little impaired were present State aid provisions not to exist; theoretically, it might be improved in some instances if "overbuilding" (a relative term) were to be encouraged by the degree of dedication of revenues to the county road fund. The effectiveness of State supervision rests, seemingly, not on financial leverage through the regulation of the granting of funds, but on close State-local working relations engendered by mutuality and interconnection of program interests and technical assistance—backed up, however, by large supplies of State funds earmarked for this general purpose.

State Supervision Associated With Grants but Relying on Nonfiscal Means

The two programs treated here, town highway improvement and public health, while dissimilar in many respects, have certain common characteristics in respect of attaining effectiveness in State aided programs. In the administration of both, little direct reference to the flow of funds occurs as a medium for State surveillance. Both programs deal with functions which, whether State aid is paid or not, are incumbent on appropriate local authorities to perform in at least minimal fashion. Both programs offer the inducement of added financial resources to encourage participation, yet neither program is universal in its coverage.

Six hundred and forty-four of 932 towns in the State, located in 51 of the 57 counties outside New York City, participated in the Town Highway Improvement Program in 1962. The program offers substantial aid (up to $6,750 per mile) for cost of road improvement, provided a town desires to participate, and has raised by tax levy its appropriate matching share as specified in the statutory formula. A participating town must file a long-range plan (a map) of projected improvements and phase this long-term plan according to annual project proposals (essentially, brief identification of road sections to be improved). Approval by the town board, the county superintendent of highways, the county board of supervisors, and the State (State district engineer, and the Bureau of Muncipal Public Works) are required by statute. Project standards and specifications are specified in the statute, and these are deemed sufficient for local observance. No State amplifying regulations or rules are promulgated in the official compilation of rule and regulations published by the Secretary of State. The general plans as filed are ordinarily approved intact—except where flagrant abuse of legislative intent may appear, such as proposed improvement of a town road serving one family, i.e., for practical purposes a private lane. Plans may be amended at local option. Annual project submittals seem essentially to serve (a) as a log of progress in relation to the master plan, and (b) more importantly, a means of totaling up actual cash appropriation requirements for the State budget. Thereafter, as projects are completed in whole or in part, vouchers for full or partial payment are forwarded by towns for payment, accompanied by certifications of approval (of inspection) by county and State district engineering staff. Cost data, whether based on advance estimates or final vouchers of charges allocated, generally reflect the cost per mile ceiling limit specified by law ($9,000). Actual costs are somewhat elusive.

Audit by the comptroller parallels these submission and review processes. Annual statements from counties are submitted to the comptroller certifying to town assessments and to town road fund levies both for general town road aid and for special town highway improvement aid.[6] Project ledgers for town highway improvement aid are set up for each project approved and forwarded by the Department of Public Works, and each project is assigned (by the comptroller's office) an allotment of the town share appropriate to each. As vouchers are paid, they are charged off against these constructed accounts, and residual balances, if any, are carried forward, either for later use (additional project work) or for transfer to other projects when estimated amounts available seem insufficient. (This bookkeeping is carried on in Albany and, therefore, seems somewhat tenuous, particularly as the hypothesized balances in project accounts are not reconciled either by mail or by field audit with local accounts.) Field audit of municipal accounts by the comptroller's staff also embraces town highway fund expenditures for these projects: the project disbursements and interfund transactions. The focus is on proper accountability (not economy or efficiency) especially among the several special accounts required to be maintained in the highway fund.

Certainly the visible instrumentalities of supervision—various filings and approval of plans, projects, and payments—are not complex. (In fact, some further simplification in the audit routine might be undertaken without any sacrifice in accountability, and perhaps some increase in reliability, by transferring to field examination the establishment of appropriate local contributions now hypothetically derived from secondary sources.) Measured in miles of town roads improved (11,552 miles of the 56,739 miles of town roads), the program may be considered effective and, despite uncertainty as to costs, the legal limit on State aid per mile probably does not invite extravagance.

Those engaged in the program attribute much in both effectiveness and quality of performance to (*a*) the cooperative relations existing between a county highway superintendent and his town counterparts; where these are good, and the county superintendent is interested, towns participate; (*b*) mutual association in and stimulation offered by the highway schools for local officials conducted by Cornell University; and (*c*) close field liaison between State engineering staff and county staff.

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[6] Each year some towns fail to report any data and thereby risk omission from State aid benefits for roads (benefits of either type, general purpose or improvement). The comptroller's office notifies supervisors from time to time of this, with mixed results. For instance, the Town of Elko in Cattaraugus County was advised in March 1963, of a possible "loss" of $1,873 ($1,572 for the town, $300 for the county) in general town highway maintenance aid and, as of late August that year, the comptroller's office had not received any response.

The general public health grants provide 50 percent of the aid for general health expenditures of counties and of cities over 50,000 population, plus an additional 25 percent of county (or county outside a city of 50,000) expenses for the first $100,000 if the county organizes a county department of health. Construction and operation costs of a county hospital, clinic, or dispensary may also be included for aid, "within limits to be prescribed by the commissioner [of health]." [7]

In contrast to the town highway improvement program in which the statutes prescribe standards and specifications and maximum cost per mile, the intent of the health statutes concerning which expenditures may be included for aid, the form and scope of services necessary for a county health department to be eligible for additional aid, and overall program levels (i.e., limits on total expenditure magnitude) is contingent on administrative regulation by the State health commissioner.

As of January 1, 1965, 25 counties are "organized" as county or part-county health departments. An "organized" district is one with a full-time health commissioner and two principal professional service directors under him: a sanitary engineering director and a public health nursing director, plus, of course, a supporting technical staff. Unorganized districts may have elements of some or all of these services but not the full complement of specified top positions. For such "unorganized" districts, critical functions and authority which otherwise would be exercised by the county health commissioner and his two principal subordinates (in the field of sanitary engineering and public health nursing) are provided and exercised by the staff of the State health department in district offices. Unorganized districts may or may not provide some operating staff (such as public health nurses). To the extent no such provision is made, they are dependent for such health services on the resources which the State allocates to the district office covering the territory. Hence, unorganized districts have "minimal" services; organized districts have specified services (although quantity and variety of such services, beyond minimum, vary widely). Some counties in the "unorganized" class receive no State aid for general health activities (except reimbursement on polio vaccine).

Dealing as it is with professional services of a highly technical character, general public health aid rests on two principal means or instrumentalities for State supervision of program: (1) review of local budgets and (2) standards for personnel. With regard to budgets, the primary focus appears to be, for the organized districts, mutual consultation between State health officials and the local commissioner on his plans and program for the next year—in other words, plans for extension and improvement in service objectives. For the unorganized districts, the State district health officer acts in lieu of a county health commissioner and develops directly such budget proposals as may be considered by the county board of supervisors for building up health services for the county. Because of this closely connected State-local budget and planning work, the budgets themselves, once adopted, serve largely as a medium against which State

[7] This is an indication of the somewhat ambiguous situation presented when one consults statutes as to overall limits and specifications of the intent of State aid programs.

office fiscal staff write off claims as they are submitted for reimbursement. Audit of these claims is made in some detail. Districts with relatively small expenditures send supporting vouchers covering their expenditures to Albany for examination by the staff of the health department and the comptroller's office. Districts with considerable transaction volume are subject to a field audit of supporting evidence to State aid claims. They are examined first by several field auditors from the health department and subsequently by the field audit staff of the State comptroller which examines fiscal records of all operations of local government. These audits do not assess medical and professional matters, but address themselves essentially to accuracy of accounts and proper inclusion of credits due the State (from local fee collections, etc.).

Quantity and scope of services, and of supporting facilities appear to be largely a reflection, county by county, of professional judgment of each county's program, its state of development, and its feasibility.

As to professional qualifications, the State sanitary code is quite explicit—whether a district is "organized" or not. Furthermore, in the medical and medically related fields (sanitary engineering, public health nursing, etc.), conventions as to requisite training and experience seem to be commonly accepted by the public and certainly are highly disciplined by the respective professions themselves. Because of this a close affinity of viewpoint and objective is found among public health officials, irrespective of the payroll they may be on—Federal, State, or local. In turn, this argues for latitude in individual judgment and assessment of situations and for restraint on the part of supervisory personnel in exercising review judgments over courses of action being pursued by their colleagues in operational contexts. This esprit de corps, or "elite" professional development is, in the judgment of health officials, the main bulwark for effective performance and has little if any relevance to State aid. As put by one State health official, "State aid is a reward for getting a local appropriation," and State-local health performance in this professional context functions "whether State aid is 50 percent or 10 percent."

The two programs, while evidencing superficial differences, are actually fundamentally similar.

As for differences:

—one is a construction program, and the other is a professional service program;

—one is quite explicitly delineated in statutes as to purpose and limits, and the other is subject to wide powers delegated by statute for administrative application.

In similarities:

—each rests achievement on technical and professional mutual cooperation, State and local;

—each deals with providing something beyond or additional to minimal community requirements, and at the option of the local community, e.g., better highways, extended health services; and

—neither is mandatory; hence, neither extends to all potentially eligible subdivisions.

In their similarities, these programs seem to typify the "incentive" grant. This, however, poses the question to what extent and for what reasons should the State offer additional resources (additional to other means, such as taxing powers or general purpose grants, of making resources generally available to all localities for local decision as to use) to get local communities to undertake improvements in certain areas of government in their own behalf? It seems clear that State technical advice and cooperation in these areas can be, and, in fact, is supplied through nonfiscal means, i.e., without detailed regulation of the funds supplied—in contrast to the following group of programs.

State Supervision Intermixed With Flow of Funds as Medium of Control and Enforcement

The two programs considered here, crippled children services (medical rehabilitation) and social welfare grants, have certain common elements: each deals with public services offered statewide to any individual who may be eligible for them; each deals with "case service" costs representing the end product of performance; each deals with presumptively "needy" citizens. (In the latter connection, neither, therefore, represents the sort of public program likely to engender most popular support, although this is less true for the health than the welfare programs. It is worth remarking, nevertheless, that the presence of this factor seems to be implicitly recognized in the health program by the dichotomy which has developed in State concentration on medical aspects of case services, largely relegating to local judgment the considerations of family economics leading to decisions of whether a family is too poor to pay for medical services provided the child.) Both tie State standards to "reimbursability," i.e., adherence to State standards determines whether State aid is paid.

The crippled children program operates under statutory authority which defines in technical terms the generally intended scope of services to be aided. The actual scope necessarily depends on medical judgment as to the diagnostic relevance of case situations to the medical terminology of the act. Hence, maximum State supervision—short of direct State assumption and administration of the program—has prevailed: central State medical staff review and prior approval of medical aspects of each case. In consequence, little in the way of policy, standards, and principles has developed. Case judgment, case by case, has prevailed. External limits have come into play over a period of time, largely through central (budget) concern for interagency consistency as to professional fee schedules, hospital rates, etc. The nonmedical aspect of this program—how much families shall contribute to costs—has apparently not been of cardinal interest to the medical administrative staff. While guidelines and suggested schedules for assessing ability to contribute have been formulated and issued, the State agency has taken refuge in the plenary jurisdiction of family court judges. Hence, local judgments vary from extreme liberality to extreme parsimony. Just as the State has set ceilings on certain rates to be paid (e.g., hospital rates) as a limit of its liabilities, so could limits be set on excessive liberality. However, this would not be consonant with the expressed view that "nearly everyone this day and age is 'medically needy'." This highly centralized program(from the medical standpoint) is being decentralized—to regional and district health offices, and further. It appears their role in the future will be that of postreview. As of 1965, local administrative jurisdiction has been removed from the family courts and placed in the hands of a county medical director who, in organized counties, is the county health commissioner. Exactly how this highly fluid (administratively speaking) program will evolve remains for future development, but that this will be critical is evidenced by the estimate of one of the chief State health officials that the broadening of program scope authorized in 1963 will see this program expand in dollar volume in a few years by many tens of millions.

Audit of claims for reimbursement by the State is made by the fiscal staff of the Health Department. This involves an examination of expenditure details against the prior approved "orders," e.g., that hospital days of care do not exceed the number authorized, that rates paid are within the governing fee schedules, etc. What will substitute for this in the plans for decentralization and postreview remains to be seen.

The social welfare grants, in which the focus is on the public assistance programs, operate under statutes in which the objects of aid—the programs or "categories"—are distinguished from each other with some degree of precision, e.g., age, degree of blindness, etc., but in which the critical elements which govern expenditure levels (what constitutes "need") are delegated to administrative regulation. The notable exception is the Medical Assistance for the Aged programs which, when adopted in 1961, stipulated certain statutory benchmarks relative to income, resources, etc., still leaving, however, latitude for administrative amplification.

Administrative expenses are separately treated in the statutes and with somewhat greater particulars as to scope and intent. This more apparent separability of end product (benefits paid by program) from means of production (local administrative machinery), together with the fact that public acceptability of the programs has been historically ambivalent, probably accounts for the fact that a considerable variety of methods is employed in attempting to provide oversight by the State to local expenditures subject to State aid. Federal aid requirements are also an important influence. Federal welfare aids now exceed State welfare grants. The tendency, for administrative simplicity, is therefore for Federal standards to supersede State standards even where Federal requirements permit deviation from standards which are strongly suggested but not required.

A brief cataloging of the various instrumentalities employed to oversee these grants includes:

(1) As to benefits paid:

—prescription of grant levels (standards of assistance) and, in turn, determination of what level of personal resources equals "need."

—maximum rates and fee schedules for services provided by third parties in the medical field (e.g., medical fee schedules and hospital rates), but not for nonmedical services (child-caring institutions) except by advice.

—review of local records of decisions (postaudit of program performance).

—power of review and issuance of orders to rectify improper grants (either on appeal or on own motion).

(2) As to administration:

—specification of minimum qualifications for local staff.

—individual prior approval of qualifications of each new local employee (now postreview in several large districts).

—specification of basic standard forms and procedures essential to performance of local job.

—standards of maximum limits or costing procedures for many items of expense (e.g., comparable rental values for publicly owned space; cost-finding procedures for inter-program expenditures, such as infirmary versus public home; time studies for segregating program expenses; etc.).

—workload (case-load) standards.

—preapproval of unusual and expensive items (e.g., data processing equipment).

—survey and evaluation of local organization and operations with advice for improvements.

The significant feature of all the above is that all are conditional, for their observance, on State aid. The standards do not disbar, for example, excessive rates (say, for medical or hospital services) or personnel without State qualifications. They merely mean that such departures from standard will be at the locality's entire expense. Thus focus of standards tends to be toward items, not aggregates of performance. Enforcement, by the same token, tends to be the sum of many small adjustments in State-aided items. Rarely are sanctions of a larger order invoked, and when such occurs, final settlement is generally compromised after corrective reforms in local administration are initiated. In fact, the massive quantity of funds involved at any time in any district and their ratio to local fiscal resources tend to be so great that wholesale withdrawal of State aid as a means to attain compliance becomes impractical, politically and tactically.

The following seems to be apparent in the social welfare grants:

1. Program effectiveness (or effectiveness of local administration) is identifiable neither with large projects, each with a visible character of its own (e.g., section of road), nor with a highly professionalized service (e.g., health protection) commonly recognized as such. Rather it is identified with the cumulative results of thousands of case judgments, each involving to some degree personal judgments which, while professional to those in the field, nevertheless touch sufficiently close to the personal experience of the general public to invite question by the public as to effectiveness or economy of values applied.

2. Administrative process is more readily distinguishable from the end product (assistance to needy persons) and permits separate regulatory attention. But the key to the process—effective and efficient local personnel—remains a somewhat ambiguous quantity as far as the public is concerned. Standards in this area are not yet wholly settled in the same sense as acceptance of medical personnel qualifications or the recognition of the necessity for expert engineering staff to perform technical design work in

construction enterprises. Hence, multiple means to underscore and shore up local administrative operations—regulatory devices directed toward who is employed and how they shall conduct their work—are utilized. Despite the conditioning of these means to State aid, the fact is that rarely can deviations in their observance be attached to a specific dollar value which in turn may be withheld for noncompliance. (An exception here is the case of individual salaries of employees not approved by the State; but instances where this occurs have become rare as local and State officials have developed mutually acceptable standards and an increasing sense of professionalism.)

Some Considerations and Questions

This limited review of a few major State aid programs poses questions which are exceedingly complex in their ramifications and, by extension, touch the heart of what part of authority and responsibility shall be assigned the localities.

First of all, if scope or coverage be taken as an indication of effectiveness, or accomplishment of purpose, then those programs lying at each extreme of the spectrum of administrative supervision qualify for full marks. The county road program, where funds are paid regardless of performance or production, lies at one extreme; the social welfare grants, with a vast quantity of regulation allied to "reimbursability," lie at the other extreme.[8]

And yet the purpose of funds in each instance serves differing ends in State supervision. For county roads, the funds serve to provide resources which, whether used now or later, may be used only for roads. This guarantees that roads will be a substantial object of local concern. But whether or not this will be exercised wisely is not a question allied to the flow of State funds. Rather, to the extent State views are registered, the effectiveness of State-local cooperative working relations called for under general sections of the highway law seems to be the determining factor. Hence, the only reasons remaining to be assigned the purpose of these grants are: (1) to provide supplemental financial resources, which may equally and, perhaps, more equitably, be provided through other means (e.g., expanded local revenue raising authority, or general purpose grants); and (2) to require local attention to roads as a special object of concern. This poses the collateral questions of why this should be provided only for counties and not villages and cities?[9]

At the other extreme, for social welfare, and crippled children grants as administered heretofore, the State aid funds serve essentially to "shore up" the level of program performance, and act as a retaining wall to benefit levels. Because of the massive levels of aid involved, the "sluice gates" exerting regulatory control operate at "trickle" levels. In effect, as has aptly been stated by one observer, the alliance of State supervision to the flow of funds has been one of constant "nicking away." These facts do not mean that State supervision has by any

[8] This is true also of crippled children grants, so far as medical interests are involved in their administration. The current change to decentralize determination by local authorities, subject to post-review, may result in a shift of this program to a classification approaching that of county road aid.

[9] In 1965 some aid to cities, towns, and villages was authorized from an increase in State motor vehicle fees, a recognition of the faults of the county road aid.

means been ineffective, but they do suggest that reliance on governing the flow of State aid funds for its effectiveness seems more apparent than real (e.g., Newburgh [10]). And yet, it would be folly to suggest that programs such as these, surrounded by considerable public apathy, if not antipathy, would fare as well without some special attention focus provided by the State through financial means dedicated to the purpose. As it is, these programs vacillate in the narrow range between (*a*) local administration under State supervision, and (*b*) State administration through local instrumentalities. The massive influence of Federal fund requirements in the welfare field tends to press the balance toward the latter direction—the direction of de facto State administration—for mutual safeguard of both the State and the localities in conforming to requirements to insure Federal fund "conformity." Apart from this Federal aspect, these facts suggest that, if functional aid is needed for safeguarding program effectiveness, it might have greater administrative utility were it provided in smaller proportions, subject to greater variability (as, for instance, special impact needs), provided that basic supporting funds always be available to the localities through alternative means, e.g., local taxing powers or general purpose grants.

If some distinctive level of performance achievement be taken as a measure of program effectiveness, both the town highway improvement program and the general public health grants qualify. Each is concerned with something above the minimum permissible; neither has the "mandatory" elements of the programs discussed immediately above. Each depends upon local interest to "opt" for the grants by undertaking the specific performance conditions prerequisite thereto. Neither has universal coverage. (This applies to both aspects of the general public health grants: for specified general health services, as well as for the premium grant to organize county health departments.) Both might be considered true "incentive" grants. Yet in different ways each poses the question to what extent would the results attained be achieved by local desires for better service in the absence of special State aid, assuming ample local resources. Or, conversely, to what extent should general State resources be offered to those communities or localities which desire a higher level of service? Or, to what degree does this result in those already having resources receiving most of the benefits? [11] These are questions of considerable import. They are troublesome questions, for example, in the health field where an apparent lack of local interest may well be a disguised decision to rely on basic, required local facilities supplemented by direct State services provided at State expense through district health establishments. In fact, the State Health Department has attempted to obtain statutory authority to "charge-back" direct State-supplied services as one remedy to this imbalance.[12]

[10] In the rather widely publicized controversy between the State Board of Social Welfare and the City of Newburgh in 1961, the State sustained its position, not by withholding funds, but by proceedings in the State courts.

[11] The town road improvement program has some measure of local effort and capacity in its formula.

[12] This is not peculiar to the health field. In social welfare, several years ago, measures along this line were taken. The State charged back to localities the cost of care of delinquents committed to State facilities, offering in turn partial reimbursement where other facilities were used involving local expense.

In all the programs reviewed here, program effectiveness rests, to a considerable degree, upon mutual interest, advice, and cooperation; upon training and development undertakings (formal and informal); and upon attaining accepted professional qualifications (in professional service programs).[13] These are matters which are pursued in both aided and nonaided areas of government. Granted sufficient alternative local resources to support basic costs of essential services, it well may be that State aid in this context serves—as the horse-breaker said when he hit the colt over the head with a club—to get attention; but then, attention can be purchased at less expense.

Implicit in the supply by the State to the localities of significant portions of their resources through functional grants is the centrifugal effect these aided programs have on local governments. Effective program direction and policy determinations affecting expenditure levels veer toward the source of outside fund supply. Within each aided field, moreover, a centripetal force tends to operate which may be at odds with local plans and development. For instance, economy and effectiveness in data processing in a given field may suggest State installation of functional service centers and systems.[14] It is also conceivable that all local health data might be processed through a data processing installation set up by the State Health Department. Similiar undertakings might be launched by the Social Welfare Department for local welfare agencies, and by the Education Department for local schools. If a county then desired to apply benefits of modern processing techniques to county operations at large, as well as to make them available to other municipalities in the county, significant portions of potential utilization would be gone, and the remainder of county work might be insufficient to support a local installation. In other words, objectives may be similar, but means of accomplishment may be disparate. With the tendency of special aid programs to expand, and in the face of the numerous programs now extant, how best to relate State technical and expert services to localities on the one hand, and State provision of the financial means for local government operations on the other, becomes a larger issue of governmental effectiveness which may or may not be wholly compatible with narrower measures and values of program effectiveness.

Summary

1. The principal means relied upon to obtain local compliance with State program objectives, regardless of whether or not the "power of the purse" or fiscal sanctions were initially used, veer increasingly toward reliance on "cooperative professionalism" as programs develop—reliance on attaining minimum standards of qualifications; on training programs for personnel, both formal and informal; and

[13] All programs have audits of varying type and character associated with them. Their net effect on program effectiveness is difficult to assess. To the extent they assure the moneys granted have gone to the general purpose intended, they are of value. But the State exercises similar surveillance over purely local funds in relation to State legal and constitutional requirements. Hence, this cannot be deemed any unique attribute of State aid supervision.

[14] An approach suggested by studies for the Temporary Commission on Coordination of State Activities: Cresap, McCormick and Paget, *The Administration of the New York State Department of Social Welfare* (Albany, 1961).

on development of mutually agreeable standards of expert practice and professional goals.

2. While State aid for special purposes may serve initially to focus attention on a problem or service of government in which the State has interest, and thus provide a financial incentive for localities to join in, it would appear that cooperation and interest can be purchased at much less in aid amounts than appears to be involved in many programs.

3. Where substantial sums of State aid to local governments are tied up with specific programs, they appear in fact largely to serve the purpose of providing local resources with funds to meet the costs of expensive programs—resources which might be made available to localities by other means (taxing powers, general purpose grants)—and to serve relatively little use as a means of insuring compliance; that is, the amounts can get too big to be withdrawn by administrative authorities to enforce compliance.

4. The trend in expansion of special aids to local government poses further issues concerning the State's exact policy and role with respect to local government. To date, this is somewhat ambivalent. Some functions are encouraged by incentive aids, but not others; some costly functions are supported in large measure by State aids, while other means, such as extended taxing powers through nonproperty taxes and general purpose grants, are made available to assist localities to meet costs of government generally. In essence, where are the decisions to be made in the future with respect to quantity, quality (above acceptable minima), and balance among governmental services—in Albany or in the localities? While the answer will never be wholly one or the other choice, where the balance will lie will depend on steps taken now (and in the future) in (*a*) how the State supports the needs of its localities—whether mainly through resources which they can dispose of (taxing powers or general purpose grants), or whether mainly through resources dedicated in advance by Albany (special State aids); and (*b*) how the State shares program jurisdiction with its localities—whether it assigns them participation in programs where latitude for local decision is nominal and inappropriate, or whether it assigns them roles in programs where flexibility of response is essential and provides them the requisite responsibility and facility for responding, each according to its requirements.

5. Since human affairs, and the problems they engender in government efforts to serve them, are neither static nor constant, a periodic overview of the entirety of the State aid system would seem appropriate to keep things in balance—periodic overview by a special commission created for that purpose. In the meantime, a coordinating agency of the State government might profitably review the conduct of administrative relations between State agencies and local government where substantial grants are concerned. In this respect, it is not a case of the absence of an appropriate agency; there are, in fact, a number of agencies, including the Budget Division, the Office for Local Government, the Division of Municipal Affairs of the State Comptroller's Office, and the Office of Regional Development. Each performs a useful task which touches the issues here posed, but their mutual diffidence leaves the needed role unfilled.

CONSEQUENCES AND POTENTIALITIES SUMMARY AND CONCLUSIONS

First, it is apparent that in one way or another, either in response to a Federal offer of funds for a particular purpose (as most recently in the Medical Assistance for the Aged Program of 1960 and the various extensions represented by the public assistance amendments to the Federal Social Security Act of 1962) or in response to civic concerns and interests (as represented by many State aid programs), present trends, if unabated by alternative cources of action, will see a continuing increase in the number of grants-in-aid programs in the social service area. In a sense, the designation of a problem or situation as a special program, and the appropriation of funds, especially funds in aid of local undertakings, seems to be the modern "purchase of indulgence"—a means to assuage conscience and to pass the problem on the others. Because of this, a considerable degree of splintering of related fields of concern has already occurred.

Second, each program develops a body of regulation and interpretations in order to govern the application, use, and accountability of the special aid funds associated with it. Similar issues arise in different program areas, are disposed of in different fashion, and eventually give rise to problems of overall equity and consistency. This is the case in varying approaches which have been taken in dealing with various aspects of "administrative expense" reimbursement. When these program distinctions are also coupled with variances in rate of reimbursement, or with variance in the local jurisdiction which might be responsible for the task, or with both factors, the equities of the situation become further strained. For instance, a child needing certain medical care and treatment, depending upon constructions applied, might be provided care under any of several auspices: child care (welfare) provisions, the aid to dependent children program, home relief, the physically handicapped children program, and possibly under a community mental health program. This might involve, alternatively, a county official, a town official, or a "part-county" (county area outside a city) official; rates of aid might range from 50 percent to 75 percent or more.

Third, locally administered State-aided programs cannot be viewed apart from the services or functions which the State may be performing directly in the same or related areas. This principle was recognized in 1946 for tuberculosis care when the State undertook to provide State aid to local hospitals for the tuberculous, but also instituted charges to localities where patients used State hospital facilities. In 1955 this type of plan was extended to the care and treatment of juvenile delinquents. In a sense, measures of this type attempt not only to correlate State and local program planning, but also to focus attention on alternatives (as in care of delinquents by institutional commitment, by probation services, by preventive youth service programs, et cetera), and to equalize costs of services as between localities which had been making efforts in their own behalf and those which were content to leave their problem to the services and facilities the State would provide.

Fourth, viewed in the much larger context of State-local fiscal relations, it would seem that special aid programs in the social service area pose serious questions. The burdens of communities are not equal, and efforts to make adjustments for this have had various consequences. Short of State assumption of function, as was the course taken in mental hygiene over half a century ago, efforts at "equalization" of burden have been spotty. In welfare for nearly 10 years subsidy by the State of 80 percent of local assistance expenditures represented one approach. Subsequently, substantially similar amounts of aid were distributed, but expressed in terms of a broader base of computation. A refinement was added, providing a safety factor of additional aid under certain circumstances for the home relief program, the program deemed to be most sensitive to abnormal (adverse) economic conditions. But shifts in program definitions and classifications in later years diminished the effect of this safeguard.

An indirect means of subsidizing localities for increased costs, and a tendency toward State assumption of function, is found in tuberculosis care and treatment. The last revision in State aid formula for this program was in 1954, when a ceiling limit of $10 a day was imposed on both State aid to localities and on payments by localities to the State for care of local charges in State facilities. By retention of this limit during a period in which hospital costs generally have skyrocketed, localities which use State tuberculosis facilities were provided superior care at bargain rates. Of course, the reverse does not hold; that is, those local tuberculosis facilities operating under similar strictures of State aid for their costs are adversely affected, and the invitation is strong to close them as tuberculosis hospitals and use the State facilities.

As all the service programs became more professionalized and specialized in work undertaken, the lines between what might appropriately and efficiently be done locally, in terms of both cost and results, and what might better be done by the State agencies concerned or by regional organizations designed to serve special purpose requirements may become more evident.[1] But the fiscal pattern underlying the source of funds for these programs can have significant effects in fostering or impeding sound program plans.

The centripetal tendencies toward State assumption of function are strong. It would be a means of insuring professional standards of high quality and uniformity; a means of bypassing local territorial units which are no longer commensurate with the magnitude of the problem to be dealt with; an assurance of full "equalization" of fiscal burden by placing program costs fully on the statewide tax system; a means of pulling together services heretofore performed partly under State auspices and partly under local ones. The question is, why not? While the ostensible advantages seem apparent, the disadvantages are less palpable. The advantages lie chiefly in the direction of simplification of administrative, procedural, and fiscal complexities and limitations. (Even issues such as minimum salary scales for professional staff do not arise primarily because localities are opposed

[1] Whether the technology (and expense) of computer facilities shall be undertaken locality by locality or by the State, in their behalf, is an open question which plagues many of the service fields, since the longrun implications of either approach are considerable.

to quality service; they arise because they cost money.) Central services and administration, however, do tend toward introspective concern wtih their own operations; their sheer magnitude does not invite initiative for novelty, experimentation, and interprogram development at operating levels. Nor does general public interest and concern focus readily on service performance and output. In fact, a general apathy by reason of disassociation of the local public from concern or contact with evolving issues of policy and operations may ensue. The fact is that local administration, representing in some form the public interest and attitudes of the locality, however defined, provides a means of correlating program goals as expressed in operational standards and policies with the expectations of the community—a process which may be, at times, both painful and healthy. Furthermore, the practical tasks of interprogram planning and selection of specific alternatives must be carried out on the local scene.

Local administration, however, is frequently confused with local license—each community to do as it sees fit. While in some of the newer State-aided social services, such as recreation projects for youth, no basic responsibility is imposed on all localities; in the other programs, responsibilities are fixed and a mandate exists to supply the service, although with varying degrees of flexibility of interpretation in different programs. In health, for instance, a basic responsibility for general public health concerns is imposed upon towns and cities, and on other jurisdictions for certain functions. State aid is designed, in part, to encourage different forms of organization, not merely the performance of certain basic functions imposed by statute. In welfare, on the other hand, the jurisdictions responsible have been reformed from time to time by State statute, not by incentive of aid, although aid continued to be paid. And the specified jurisdictions have a clear responsibility to observe State statutory requirements (and State regulations pursuant thereto), irrespective of aid. Their latitude for local initiative, while considerable in respect of projects, facilities, and plans for remedial, rehabilitative, or supportive services, is nominal with respect to the public assistance aspects of the various welfare programs.

In summary, the problems seem to resolve to these issues:

1. Are fiscal readjustments desirable and can they be designed in the public social services which presently involve both State and local jurisdictions so that no fiscal incentive or advantage lies within each program to rely on services performed or supplied by one jurisdiction versus another? (Should who currently bears the cost be the governing factor of who might best do a task?)

2. Similarly, should disparities of financing (both as to local units involved and as to State aid arrangements) be retained as among the various social services, or should they be all placed on fiscal parity? Since most aided programs follow a similar division of costs, roughly 50 percent (although limitations of "ceilings," etc., interpose), this would mean essentially consideration of greater consistency among the local units of government involved in the partial financing of these programs—presumably counties.

3. Might those programs which represent the most severe cost burdens and which reflect problems and conditions originating far

beyond the confines of any one jurisdiction be assumed by the State without a sacrifice of the values of local administration (e.g., public assistance).

4. Can State grants be supplied to localities for related programs in such a manner as to encourage local initiative for development of alternatives involving mutual program cooperation?

5. Can grants be supplied in such a fashion as to minimize definition and controversy over details—either as to their application (e.g., items of expense) or as to their calculation (e.g., complex formula based on transactions)—so as to simplify fiscal and administrative processes?

The answers to these and related questions cannot be simply arrived at, nor, in the complex area of the public social services, can it be assumed that any one scheme or approach would serve equally well in all respects. Nevertheless, if all functions and components, State and local, are taken into account, conceivably an approach toward a solution of the dilemmas posed by the present system might be advanced, which, if not necessarily undertaken in one step, might be taken gradually toward the following two ends.

1. Assumption by the State of the full cost of public assistance programs—the federally aided programs for the aged, blind, disabled, and families with dependent children, and the closely allied State-aided program of home relief.

Whatever their original design and whatever the attitudes associated in the public mind with respect to the public assistance programs, they have evolved into an essential economic maintenance program for individuals and families who have no other means of support. Government, through State and Federal instrumentalities, has provided the means of shoring up the economic subsistence requirements of persons associated or formerly associated with the labor force in a direct and measurable connection as, for instance, in State programs of unemployment compensation, workmen's compensation, and sickness disability insurance, and Federal programs of old age and survivors insurance including disability benefits. For those who, by misfortune of lack of opportunity, lack of skill, or other reasons, do not have the sufficient connection with the labor force to guarantee them subsistence income through the social insurances, the public assistance programs become the remaining resource. The conditions which generate dependency today, whether they be technological or social, do not originate solely, nor are they curable solely, within the confines of the geography of local governmental jurisdictions. Solutions must be originated and taken in terms of economic areas transcending many of our municipal subdivisions. The incidence of expense, furthermore, is not controlled by a political subdivision but may be a matter largely of chance. This was recognized in 1945 by the Commission on Municipal Revenues and Reduction of Real Estate Taxes in New York State in the following terms: "Local expenditures cannot be stabilized unless the municipalities are relieved of the expense of relief and welfare services or the local cost of such services is restricted to much narrower swings."[2] What was beginning to emerge then is much clearer today.

[2] State of New York, *Report* (Albany, New York State Commission on Municipal Revenues and Reduction of Real Estate Taxes, 1945), p. 21.

The basic standards and conditions with respect to the furnishing of public assistance to needy persons are fixed by the State in consonance with such national policy objectives as stated in Federal grant-in-aid legislation and accompanying conditions. There are no local substantive alternatives to furnishing such assistance as may be specified by State standards to those who are in economic need in accordance with such standards. Hence, the localities are, at best, the ministerial agents of the State in these programs today. To require the exercise of local taxing powers to raise a part of the funds to underwrite the costs of these State-mandated programs is, in effect, an indirect means of applying tax resources ostensibly reserved for local use to what is, in fact, a State purpose.

On the other hand, there might be much advantage to pursuing this course of action, apart from providing purely fiscal relief to political subdivisions from costs over which they have little if any control. Among these advantages would be the opportunity for the pursuit of Administrative simplification in an incredibly complex set of programs whose complexities arise, in part, from attempting to interrelate administrative and fiscal systems reflecting local government interests, State government interests, and Federal Government interests. It should be noted in this connection that the public assistance programs represent the only State-aided social services presently administered in which Federal and State funds are regularly commingled with local funds in the first instance for expenditure. This, in effect, places upon the localities the burden of administering their activities in a manner requisite to satisfy conditions of Federal plans. Much of the complexity that has baffled people who have studied these programs over the years arises from the fact that they do represent such an atypical situation. In the other social service areas where Federal aid is paid to the State, the Federal grants are reserved by the State agencies and applied to State purposes or, alternatively, if granted to localities, are done so on a project or demonstration basis where the terms and conditions can be clearly identified and segregated from the conduct of normal daily business and current local operations.

Substantial economies might well develop from such a move, apart from the simplification opportunities which might be offered. For instance, the application of modern machine technology to the processes of public assistance operations, statistical, administrative and financial, might be undertaken with a rapidity which cannot be achieved if these must be introduced through the complex of local government administration. Processes might be standardized; compliance with Federal requirements for data and records and reports might be eased; standards with respect to quality and quantity of staff and utilization of specialty and technical staff might be developed much more fruitfully.[3]

[3] It is of interest to note that a recent report on the administration of welfare programs suggests that earnest consideration be given to State administration of all present locally administered welfare programs. State of New York, *Report to the Governor* (Albany: New York State Citizens Committee on Welfare Costs, April, 1965). Moreover, the House bill incorporating 1965 amendments to the Social Security Act provided for assumption by States within a limited period of time of all non-Federal portions (i.e., local share) of costs of medical assistance furnished recipients of federally aided public assistance (89th Cong., 1st Sess., 1965, H.R. 6675, proposed Title XIX)., indicating a Federal legislative viewpoint somewhat lacking in sympathy with "trilevel" financing in public assistance programs.

The equities of the situation in terms of financing costs in this area, which are susceptible to fluctuation for reasons beyond the control of any jurisdiction, through the broad taxing base of the State government would be a significant fiscal gain. On the positive side, there is also the possibility that many of the minor political subdivisions currently engaged fractionally in welfare programs (certain small city public welfare districts, the town of Union, many towns in counties which still require home relief to be administered and charged to town budgets) would be encouraged to disband residual operations and consolidate remaining local welfare functions on a county basis. This, too, would be commensurate with the general direction of the times toward larger political subdivisions for economy and efficiency in providing public social services which entail skilled and costly staff.

The disadvantages of such a move cannot be overlooked. Among them would be the tendency to disassociate what has heretofore been kept in close association, that is, the public assistance programs and other welfare programs. Yet such a disassociation would not necessarily be realized in either program or administrative terms to the degree it might have been in the past. The tendency has been for the public assistance programs to recognize other facilities and services, such as child welfare, public home infirmary care, etc., as being types of services which can be paid for by the assistance recipients or charged to the public assistance programs (the most recent instance being purchase of basic functional education for those who are otherwise unemployable because of the lack of elementary literacy facility). If the State, in assuming the costs of public assistance, were able to contract, at its option, with political subdivisions to carry out administrative services in connection with them, a close relationship might be retained between the public assistance programs financed in whole by the State and the residual welfare programs financed in part by the localities with State aid.

2. *In the remaining fields of the public social services being dealt with here, that is, those apart from the public assistance programs treated above, the scope of the localities' responsibilities should be broadened to include all services coming within the purview of the program field, whether provided presently by the State or by the localities*

The implications of this proposal would be that the localities would be responsible not only for the services and benefits now provided directly by them, with or without State aid, but also would be responsible for the care furnished under State auspices to persons from their communities utilizing such State facilities. Coordinated comprehensive planning in the field of the public social services cannot well be undertaken either by the State or by the localities when a sharp dichotomy exists in service benefits and in the provision thereof. For instance, the problem of the elderly is one occupying much attention and concern these days. It involves not only concerns within the field of public health, but those of welfare interests, and, particularly, those interests in the field of mental health concerned with institutional care. The high concentration of elderly inmates in State mental hospitals has been long deplored. The lack of adequate community facilities which would entail much less expense both in construction and maintenance is, in part, responsible for this condition. So long as communities may engage or not engage in community mental health activities without considering the relationship of these to the burden being assumed by all the taxpayers of the State in providing State facilities for many of their citizens and residents, the concepts of community responsibility, community planning, and community action, guided by evaluation of the optimum use of all resources available, will remain an illusion. The same could be said for special youth facilities provided by the State, and State health services provided by the State Health Department where communities and localities have failed to act on their own initiative. It should be noted that the State, little by little, has been moving in this direction for many years. For some time, services provided in State tuberculosis hospitals have been assessed against the communities from which the inmates come (although under statutory ceilings of per diem care costs). Similarly, in the field of delinquency, the use of State facilities for the care of children adjudged delinquent are a charge upon the communities from which the children come. These are not merely fiscal devices, but a very practical means of registering the alternative measures which may be taken by communities in terms which lend themselves to appraisal, evaluation, and decision. Lacking knowledge of the extent of free services being supplied by the State in behalf of citizens in their communities, localities have not had a true incentive to take dynamic action.

It should be noted here that the burdens which will be assessed against the communities in carrying out a proposal of this order would be somewhat less than the burdens transferred to the State by the State's assumption of the local costs of public assistance as proposed elsewhere above.

If an adequate basis and incentive for local planning is to be provided, additional corollaries arise:

(*a*) Costs of all services supplied by the State should be fixed at full value. This would mean the elimination of artificial limitations, such as those presently prevailing in respect of chargeback of costs of State tuberculosis hospital care to local communities, a practice which, in effect, provides a hidden subsidy to those communities utilizing the State hospital facilities.

(*b*) The fullest opportunity for cooperative agreements between the State and municipalities in respect of the agency most suited to provide a particular span of services should be insured. This might mean that, for instance, the State could act in behalf of several municipalities in the construction of some regional facility for common use among them with the charges being proportionately shared among the localities. It might mean that the State would provide a group of services to be used commonly or used in behalf of several municipalities, the State acting as agent for them with the costs being assessed among them. Devices such as this might foster more vigorous interdistrict planning and cooperation and a most economical and efficient use of available resources. It might provide a practical beginning to a positive attack on the so-called "urban sprawl" so far as the public social services are engaged.

(c) Latitude should be provided to municipalities to pool interests within their governmental structure in these related fields, even to the extent of authorizing the creation of a new agency in the community to provide a "diagnostic" service utilizing existing specialized agencies as resources to draw upon to provide such care, treatment, and service as may be needed by citizens seeking help.[4]

(d) To facilitate all of the foregoing, the provision of existing State aid for these interrelated health and welfare programs (excluding public assistance) should be commuted into a block grant for these broad purposes and allotted to the respective recipient communities as soon as an appropriate block grant formula is developed. The objective of this would be to provide the necessary State support of the essential services which are invested with a statewide public concern, but to provide it in a manner which avoids preoccupation with detail, exceptions, and auditing; in sum, preoccupation with nonprogrammatic considerations. A block grant for these related programs would further encourage initiative by localities to view the problems of people and families in their totality rather than in fragmented components. If a nursing home is required, then a nursing home should be provided by the community, without worrying and wondering whether it should be under the nominal auspices of health or of welfare, or of something else.[5] The community should not be placed in the threat of any jeopardy in respect of the funds that would otherwise be available to it if it chooses to operate its services in these areas on a coordinated basis in the manner and by the means most appropriate to the community's assessment of its needs. Whether a block grant formula can be evolved which can be pegged wholly or partly to independent quantities, such as, for instance, an adjusted per capita basis, depends upon development and analysis of a highly complex body of data. Superficial manifestations of available data, however, suggest that such an undertaking would not be unfruitful.[6]

Were such a move accompanied by adjustments in the distribution of general purpose (per capita) aid to localities, especially

[4] In this connection should be noted the frequency with which strivings toward some local means of correlating or coordinating the public social services is being attempted in various spots throughout the State. In Rochester, N.Y., for instance, proposals were advanced in September 1964 on behalf of public and private social agencies to establish a joint program which would provide a pooling of staff resources, and an assignment of staff of all of the agencies on such pooled basis within the community to avoid duplication in dealing with people in need. *The New York Times*, Dec. 6, 1964, carried a news article describing a pilot project in Rockland County, financed out of grants from the New York State Health Department, to provide a countywide information and referral service to advise people in need of help as to the appropriate public and private health and welfare services available in the community. This project was begun in September, 1961 and has had, according to the press report, widespread success as a result of which it has been continued to date. A third item appeared in *The New York Times*, Dec. 20, 1964, describing a project in the Bedford Stuyvesant area to be financed from Federal antipoverty funds. This plan contemplated dividing the community into small sectors of about five blocks each, each sector to be staffed by personnel trained in respect of the services and facilities available under various governmental programs. Thus, the citizens in each of these sectors could be directed to the most appropriate program and agency for their particular problem. Since then, this sort of community organization approach has become a signal element in the Federal antipoverty plans.

[5] Legislation of 1965 authorizes State aid for construction of public nursing facilities by localities and prescribes relationships between State health and social welfare authorities in connection therewith.

[6] See app. B.

with respect to counties to counter any severe hardships or apparent inequities, the chances of feasibility would be increased.[7]

If an approach along the above lines is not pursued, the consequences for the State and localities, and for the programs at stake, can be readily perceived. In the first place, there will be further fractioning of governmental services in closely allied and related areas. There will be further confusion engendered as a result of continued pursuit of a fractioned approach—confusion in respect of public comprehension and understanding of the services available, and certainly confusion with respect to administrative efforts to maintain coordination among a constantly expanding group of fragments. There will be further controversy because, as the various expansions of aid programs, or rather of their components, proliferate, the greater will be the opportunity for misconception as to borderline areas of responsibility and function, and the more rigid and vigorous will become the fiscal and other controls to insure discreteness among funds being advanced. Ultimately, there will probably be further centralization, first of controls in order to attempt to maintain order in an increasingly complex environment, and later of services, in order to overcome the fractioning which will have been engendered by this course of action. Centralization of services in these sensitive areas of human affairs will pose the risk of substituting rigid absolutes for matters which should remain individualized and flexible.

[7] Incentive grants are important as an instrument of program development, and this approach to a block grant need not nullify them. They might continue to be provided by State supervising agencies, limited, however, to relatively small sums, for special projects or demonstrations, and with the widest latitude and discretion in their disposition granted to the dispensing agency.

RESPONSIBILITY OF STATE GOVERNMENT FOR FINANCING PUBLIC SERVICES IN NEW YORK AND OTHER LARGE STATES*

BY MORRIS BECK

The most prominent features of the intergovernmental fiscal landscape in New York State can be simply described:

1. In comparison to most other States in the Nation, local governments in New York State bear a disproportionately large share of the responsibility for providing governmental service.
2. In New York State the State government finances a much smaller proportion of local expenditures in metropolitan than in nonmetropolitan areas.
3. New York City, in common with central cities elsewhere, receives far less State aid, relative to expenditure requirements, than do local governments in the rest of the State.

By themselves these findings do not "prove" that New York City has been the victim of discrimination. They do, however, raise questions about the efficiency and equity of existing fiscal relations between the State and local governments in New York.

STATEWIDE PATTERN OF GOVERNMENT FINANCE

As questions of this kind—especially those of equity—are resolved in relative, not absolute, terms, the statewide pattern of government finance is an especially useful point of departure. How is the responsibility for providing public services divided between State and local government in New York State? Who finances what share of these expenditures? Is the Federal Government an important source of local revenue, as well as a contributor to the combined funds of State and local government? How does the division of fiscal responsibility in New York compare with that in the average State and with the division in other populous States? This paper provides answers to some of these questions, on the basis of 1962 Census of Governments evidence.

The lower half of table 1 presents the evidence of disparity in State support of metropolitan and nonmetropolitan programs. It also shows that Federal revenue is a minor element in the *local* revenue structure, particularly in New York, where the Federal share of local revenue is less than half the nationwide average. The upper half of the table, however, contains the major clue for the student of State and local government finance in New York. In 1962 the State government's share of general expenditures in New York was only 22 percent. This was less than two-thirds of the national average and lowest among the 50 states.

*Reprinted from *Financing Government in New York City*, Graduate School of Public Administration, New York University, 1966.

TABLE 1.—*Allocation of expenditures and revenues, 1962, in New York State and nationwide, by level of government*

	All States, percent of total	New York State		
		Percent of total	Rank	Index (U.S.=100)
State and local general expenditures:				
By disbursing level:				
State share	33.8	22.0	50	65.1
Local share	66.2	78.0	1	117.8
By financing level: [1]				
Federal revenue	13.1	6.9	50	52.7
State revenue	39.5	37.4	36	94.7
Local revenue	47.4	55.7	4	117.5
Local government finances:				
State aid as percentage of local expenditures:				
Entire State	27.3	27.8		101.8
Within SMSA's [2]	23.7	25.5		107.6
Outside SMSA's	35.8	44.7		124.9
Sources of local revenue, excluding interlocal:				
Federal Government	1.8	.8		44.4
State government	25.2	23.0		91.3
Own sources	73.0	76.2		104.4

[1] After allowing for the effect of intergovernmental revenue.
[2] Standard metropolitan statistical areas.

Sources: U.S. Bureau of the Census, *Census of Governments, 1962*, Vol. IV, No. 4, and Vol. V.

The State share was generally low among the States selected for comparison (table 2), with Delaware the major exception on the list. While the high-income States typically assign major responsibility to local governments for administering public functions, New York's position is an extreme one. The "home rule" tradition and the makeup of the legislature help to explain the allocation of responsibility; but, whatever the full explanation, New York State's minimal participation on the spending side of State-local finances does not ease the fiscal problem of New York City or any other local jurisdiciton faced with heavy public service requirements.

TABLE 2.—*General expenditures of state and local governments, 1962, by final disbursing level*

[Dollar amounts in millions]

	Total general expenditures	Direct State expenditures			Direct local expenditures		
		Percent of total	Rank	Percent of all States average	Percent of total	Rank	Percent of all States average
All States	$60,205.6	33.8		100.0	66.2		100.0
California	7,437.2	27.7	47	82.0	72.3	4	109.2
Connecticut	948.1	41.3	26	122.2	58.7	25	88.7
Delaware	156.4	51.8	6	153.3	48.2	45	72.8
Illinois	3,246.5	29.2	44	86.4	70.8	7	106.9
Maryland	1,037.1	30.4	42	89.9	69.6	9	105.1
Massachusetts	1,782.7	28.0	46	82.8	72.0	5	108.8
Michigan	2,778.0	34.4	36	101.8	65.6	15	99.1
New Jersey	1,968.2	25.0	49	74.0	75.0	2	113.3
New York	7,046.5	22.0	50	65.1	78.0	1	117.8
Ohio	2,879.7	28.4	45	84.0	71.6	6	108.2
Pennsylvania	3,185.7	37.6	33	111.2	62.4	18	94.3

Source: U.S. Bureau of the Census, *Census of Governments, 1962*, Vol. IV, No. 4.

On the revenue side also New York ranks low among the urbanized States. Here the analysis is complicated by the varying importance of Federal revenue in the State-local totals. In New York State, Federal funds accounted for a mere 6.9 percent of total financing—lowest among the 50 States and barely half the nationwide average (table 3). After allowing for intergovernmental transfers, the State government's share of revenues used to finance general expenditures was 37.4 percent—about the same as in California, where the Federal contribution was much larger. As a result, local governments in New York had to finance 55.7 percent of all State and local expenditures—fourth highest among the States—whereas in California the local share was 49.5 percent—13th from the top.

TABLE 3.—*State and local government expenditures, 1962, by financing level of government*

[Dollar amounts in millions]

	Total general expenditures	Sources of funds [1]								
		Federal			State			Local		
		Percent of total	Rank	Percent of all States average	Percent of total	Rank	Percent of all States average	Percent of total	Rank	Percent of all States average
All States	$60,205.6	13.1		100.0	39.5		100.0	47.4		100.0
California	7,437.2	13.5	33	103.1	37.1	37	93.9	49.5	13	104.4
Connecticut	948.1	10.0	47	76.3	40.9	28	103.5	49.1	14	103.6
Delaware	156.4	9.8	48	74.8	65.7	1	166.3	24.5	48	51.7
Illinois	3,246.5	11.1	40	84.7	31.8	48	80.5	57.1	2	120.5
Maryland	1,037.1	11.5	39	87.8	45.4	14	114.9	43.1	22	90.9
Massachusetts	1,782.7	11.1	40	84.7	33.6	44	85.1	55.3	5	116.7
Michigan	2,778.0	10.4	44	79.4	43.2	19	109.4	46.3	19	97.7
New Jersey	1,968.2	8.5	49	64.9	26.1	50	63.5	65.4	1	138.0
New York	7,046.5	6.9	50	52.7	37.4	36	94.7	55.7	4	117.5
Ohio	2,879.7	12.4	35	94.7	34.9	43	88.4	52.7	6	111.2
Pennsylvania	3,185.7	10.7	43	81.7	41.7	25	105.6	47.6	17	100.4

[1] Allowing for the effect of intergovernmental revenue.

Source: U.S. Bureau of the Census, *Census of Governments, 1962*, Vol. IV, No. 4.

Interstate differentials in fiscal arrangements notwithstanding, the beginning of wisdom for the analyst of State and local government finances in New York lies in an appreciation of the State's extreme position with respect to the division of fiscal responsibility. The unusually large burden assigned to local governments in the aggregate is a significant factor in the recurrent fiscal crises of New York City and other urban centers.

FINANCING OF SHARED FUNCTIONS

The aim of this section is precise measurement of the State government's role in financing shared functions—education, highways, public welfare, health, and hospitals—as of the 1962 Census of Governments. For each function, the outlay of the State government is broken down into direct expenditure and State aid to local governments. Each component of State spending is then related to the base which is appropriate for judging the State government's share of the cost of individual functions.

Appended is a series of tables (tables A–1 to A–5)* which present for New York, its neighbors, and other populous States a comprehensive portrait of the States government's role in financing shared functions. The more significant findings, for each of the four major functions, are discussed below.

Education.—State and local government expenditures for education in New York in 1962 amounted to $123.30 per capita, or about 4.5 percent more than the nationwide average of $117.97. The State government's share of total outlay, however, was slightly below average. Table 4 presents the evidence.

TABLE 4.—*Educational finances in New York and all States, 1962*

	New York	All States
State and local expenditures (billions)	$2.2	$22.2
Direct expenditure, as percent of total:		
State government	8.0	19.2
Local governments	92.0	80.8
Sources of funds, as percent of total:		
Federal	1.5	4.4
State	46.4	43.9
Local	52.1	51.7
State government expenditures:		
Total (billions)	$1.0	$10.7
Direct, as percent of total	16.7	39.7
Aid to local governments, as percent of total	83.3	60.3
Total, as percent of State and local expenditures	47.9	49.0
State aid, as percent of local government expenditures	43.4	36.1
Exhibit—Local schools only:		
State and local expenditures (billions)	$1.9	$17.7
Sources of funds, as percent of total:		
Federal	1.7	-------------
State	41.6	-------------
Local	56.6	-------------

Source: U.S. Bureau of the Census, *Census of Governments, 1962.*

Local schools account for an overwhelming proportion—more than 80 percent in the average State—of all State and local outlays for education. Although a few State governments, including California, Delaware, Illinois, Ohio, and Pennsylvania, spend nominal amounts directly for local schools, direct State expenditure is, with the excep-

*Tables A–1 to A–5 are not included in this excerpt as reprinted herein. Refer to original text.

tions already noted, used to finance State institutions of higher education.

Local government expenditures for education include the outlays of locally administered colleges, which generally receive a portion of their funds from the State. Unfortunately, neither these payments nor the Federal grants to local schools (for vocational education, guidance, school lunch and school milk programs, and programs for the improvement of science, mathematics, and foreign language instruction) are separately tabulated even in the voluminous 1962 Census of Governments. Hence a sources-of-funds analysis for local schools does not appear in the All States column of table 4 but is shown for New York State.[1]

Direct State expenditure for education, as a percentage of the State total or the State and local aggregate, is relatively small in New York compared with the all-States average. The explanation is twofold:

1. The network of State colleges in New York had not by 1962 reached the proportions found in the average State.

2. State aid to local governments accounted for a relatively large share of both the State and the local outlays for education.

When direct and indirect expenditures are combined, New York State's educational expenditures, as a percentage of the State and local total, turn out to be below the all-States average and below the percentage for other populous States, except for Illinois (see table A-2, original text). After allowing for Federal grants the State government's share of funds in New York proves to be above average and above the contribution in populous States other than Michigan.

In short, New York State's share of the total cost of public education is reasonably close to that of similar States, although its direct expenditure is relatively low and its support of local programs is relatively high.

Highways.—Per capita expenditures for highways in New York—$51.86 in 1962—were significantly lower than the $55.65 expenditure of all State and local governments; the State government's share of highway financing, however, was, by almost any test, well below the all-States average.

As table 5 shows, New York State's direct expenditure for highways constituted about the same proportion of the State government's total outlay as in the average State. Its share of local highway spending, however, was barely half the nationwide average and an even smaller fraction of the share in other populous States (see table A-3, original text). The local share of highway funds in New York was, at 45.9 percent, nearly twice the average for all States.

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[1] State support of local schools was found by extracting Federal grants to local schools and State aid for local colleges from the individual State descriptions in *State Payments to Local Governments, Census of Governments, 1962,* vol. IV, No. 2.

TABLE 5.—*Highway finances in New York and all States, 1962*

	New York	All States
State and local expenditures (billions)	$0.9	$10.3
Direct expenditures, as percent of total:		
State government	44.4	64.1
Local governments	55.6	35.9
Sources of funds, as percent of total:		
Federal	13.9	26.6
State	40.2	50.4
Local	45.9	23.0
State government expenditures:		
Total (billions)	$0.5	$8.0
Direct, as percent of total	82.0	83.3
Aid to local governments, as percent of total	18.0	16.7
Total, as percent of State and local expenditures	54.1	76.9
State aid, as percent of local government expenditures	17.5	35.6

Source: U.S. Bureau of the Census, *Census of Governments, 1962.*

Whatever the explanation, the State government in New York assumes a relatively small share of total highway costs.

Public Welfare.—At $30.97 per capita New York's expenditure for public welfare was somewhat higher than the nationwide average of $27.43 per capita. The State government's share of welfare outlays, however, was clearly below the average and below the share in other populous States in which are found the Nation's largest cities (tables 6 and A-4)*.

TABLE 6.—*Financing of public welfare in New York and all States, 1962*

	New York	All States
State and local expenditures (billions)	$0.5	$5.1
Direct expenditure, as percent of total:		
State government	1.6	49.4
Local governments	98.4	50.8
Sources of funds, as percent of total:		
Federal	35.9	48.2
State	33.4	36.1
Local	30.7	15.7
State government expenditures:		
Total (billions)	$0.4	$4.3
Direct, as percent of total	2.3	58.5
Aid to local governments, as percent of total	97.7	41.5
Total, as percent of State and local expenditures	69.3	84.3
State aid, as percent of local government expenditures	68.8	69.1

Source: U.S. Bureau of the Census, *Census of Governments, 1962.*

As in California and a few other states, the State government of New York accounts for a negligible fraction of *direct* expenditures for public welfare. The State of New York, however, does not share in the cost of local welfare programs to the same degree as does California. As a result, New York State's share of the combined State and local expenditures for public welfare is, at 69 percent, well below California's 80 percent and the nationwide average of 84 percent. It is also below Illinois' 95 percent, Michigan's 88 percent, and Pennsylvania's 84 percent. Only in New Jersey, among the States listed in table A-5*, is the State government's share of all welfare expenditures as small as in New York.

*"A" tables not included in this excerpt. See p. 379 for text reference.

The Federal Government's share of State-local welfare expenditures in New York is also below average. Local governments, as a consequence, had to raise 30.7 percent of welfare funds, a proportion which is nearly twice the national average. The burden was especially high in New York City, where a large part of the welfare burden is concentrated.

Since the forces producing high welfare costs are beyond the control of local governments, a shift toward additional financing by the State government of New York seems indicated.

Health and Hospitals.—In 1962 New York's per capita expenditure for health and hospitals was $38.89, nearly two-thirds higher than the national average of $23.37. Moreover, the State government's contribution to locally administered health and hospital programs is well above the national average. However, the State government's share of all State-local expenditures for health and hospitals, as well as of the supporting revenues, is somewhat below average (table 7).

TABLE 7.—*Health and hospitals financing in New York and all States, 1962*

	New York	All States
State and local expenditures (billions)	$0.7	$4.3
Directed expenditure, as percent of total:		
State government	43.1	49.8
Local governments	56.9	50.2
Sources of funds, as percent of total:		
Federal	0.8	3.6
State	49.3	50.5
Local	49.9	45.8
State government expenditures:		
Total (billions)	$0.3	$2.4
Direct, as percent of total	85.8	91.9
Aid to local governments, as percent of total	14.2	8.1
Total, as percent of state and local expenditures	50.2	54.2
State aid, as percent of local government expenditures	12.5	8.8

Source: U.S. Bureau of the Census, *Census of Governments, 1962.*

Among local governments the incidence of public health and hospital costs is much higher in crowded cities than in low-density jurisdictions. If the existing system of fiscal relations in New York is to be revised, the possibility of shifting a portion of health and hospital costs to the State ought to be considered.

A Changing Pattern? The analysis heretofore has focused on the picture as of 1962, because ample data are available for that year. Is the 1962 pattern repersentative of the present situation? Has it been changing over time?

At this writing, the most recent detailed data on State-local finances are for the fiscal year ending in 1963–64. These data indicate that little change has occurred in patterns of State-local finances since 1962, although of course the magnitudes have all grown larger. However, between 1957 (a year in which a census of governments was conducted) and 1963–64, some changes in pattern have occurred. Table 8 summarizes the growth in per capita expenditures—the best, although imperfect, measure of service level—in New York and the average State.

TABLE 8.—*Per capita general expenditures of State and local governments in New York State and the United States: 1957 and 1964, and percentage increase, 1957–64*

	New York			United States		
	1957	1964	Percent increase 1957–64	1957	1964	Percent increase 1957–64
All functions	298	458	53.7	237	362	52.7
Education	89	152	70.8	83	139	67.5
Local schools	84	125	48.8	70	107	52.9
Highways	40	55	37.5	46	61	32.6
Public welfare	22	36	63.6	20	30	50.0
Health and hospitals	33	46	39.4	19	26	36.8
All other	114	169	48.2	69	106	53.6

Sources: U.S. Bureau of the Census, *Census of Governments, 1957*, Vol. III, No. 5, and *Governmental Finances in 1963–64*.

For all functions, the percentage increase in New York State was approximately the same as the nationwide average; in most functional categories also, New York's experience over the 7-year period was reasonably close to that of the average State. The major exception is in public welfare, where the rise in New York's expenditure per capita exceeded the nationwide increase of 50 percent by more than a fourth.

Nationwide and for all functions the State government's share of direct expenditure, table 9, had risen, imperceptibly, to 35 percent by the end of the period. In New York the rise was more than 10 percent, although the State government's share remained the lowest in the Nation. Among the major functional categories only health and hospitals shows a decrease. The large increase in educational expenditures (direct State, as percentage of State and local) is attributable to the launching of the State University of New York.

TABLE 9.—*State and local shares of direct general expenditures: 1957 and 1964, and percentage change, 1957–64*

	New York			United States		
	1957 [1]	1964 [1]	Percent change, 1957–64	1957 [1]	1964 [1]	Percent change, 1957–64
All functions:						
State share	21.2	23.4	10.4	34.1	35.0	2.6
Local share	79.8	76.6	−4.0	65.9	65.0	−1.4
Education:						
State share	5.5	14.3	160.0	17.4	21.5	23.6
Local share	94.5	85.7	−9.3	82.6	78.5	−5.0
Highways:						
State share	46.4	49.1	5.8	62.4	67.3	7.9
Local share	53.6	50.9	−5.0	37.6	32.7	−13.0
Public welfare:						
State share	1.4	1.8	28.6	51.3	48.5	−5.5
Local share	98.6	98.2	−.4	48.7	51.5	5.7
Health and hospitals:						
State share	44.9	41.2	−8.2	51.6	50.2	−2.7
Local share	55.1	58.8	6.7	48.4	49.8	2.9

[1] Percentage of State-local total expenditure.

Sources: U.S. Bureau of the Census, *Governmental Finances in 1963–64*, and *1957 Census of Governments*, Vol. III, No. 5.

In summary, New York's fiscal experience between 1957 and 1964 roughly paralleled that of the average State. Adjusted for population growth, general expenditure in New York grew by about the same percentage as in all States. The disproportionate increase in public welfare expenditures, which account for 8 percent of the total outlay, did not materially affect the overall experience. Marked shifts did take place in the allocation of expenditures between States and local governments in New York. New responsibilities in higher education produced a sharp rise in the State's share of direct expenditure for education. More modest increases in the highway and welfare shares were offset by a reduction in the State's share of expenditures for health and hospitals. The net effect of these shifts was a 10.4-percent increase in the State's share of direct expenditure (still the smallest share in the Nation), about four times the average increase.

A 20-YEAR PERSPECTIVE

Comparative analysis of State and local finance over the long run is handicapped by paucity of data. Prior to 1957 the last complete Census of Governments was that of 1942. Selected data for that year and from the 1962 Census of Governments are shown in Table 10, which affords a 20-year perspective.

TABLE 10.—*Selected items of State and local government finance, 1942 and 1962, in New York and all States*

	All States			New York		
	1942	1962	Percent change, 1942–62	1942	1962	Percent change, 1942–62
Total general expenditures:						
Amount (billions)	$9.2	$60.2	554.3	$1.3	$7.0	438.5
Per capita	$69	$324	369.5	$101	$403	299.0
As percent of personal income	7.5	13.7	82.7	8.6	13.8	60.5
Total general revenue:						
Amount (billions)	$10.4	$58.3	460.6	$1.6	$6.9	331.3
Per capita	$78	$313	301.3	$121	$394	225.6
As percent of personal income	8.5	13.2	55.3	10.3	13.5	31.1
Federal grants:						
Amount (millions)	$858.0	$7,870.8	817.3	$59.6	$486.8	716.8
Per capita	$6.41	$42.36	560.8	$4.59	$27.82	506.1
As percent of total general revenue	8.2	13.5	64.6	3.9	7.1	82.1
Tax revenue:						
Amount (billions)	$8.5	$41.6	389.4	$1.4	$5.5	292.9
Per capita	$64	$224	250.0	$107	$312	191.6
As percent of personal income	7.0	9.4	34.3	9.1	10.7	17.6
State share (percent)	45.8	49.5	10.8	34.9	42.7	22.3
Local share (percent)	54.2	50.5	−6.8	65.1	57.3	−12.0
EXHIBIT						
Population (millions)	133.9	185.8	38.8	13.0	17.5	34.6
Personal income amount (billions)	$122.4	$439.7	259.2	$15.2	$51.0	235.5
Per capita	$909	$2,366	160.3	$1,169	$2,914	149.3

Source: U.S. Bureau of the Census, *Census of Governments, 1962.*

Over the two decades government expenditures and revenues in New York grew less rapidly than in the rest of the Nation. Per capita general expenditures, for example, quadrupled in New York, while in the average State they were 4.7 times greater in 1962 than they were in 1942. The relative size of New York's public economy, measured by the ratio of government expenditures to personal income, was at the end of the period approximately the same as in the composite of all States. In 1942 the New York ratio had been considerably above average.

The behavior of total general revenues over the period roughly paralleled that of expenditures. Two components of total revenue, however, Federal grants and tax revenue, deserve close attention.

Federal Grants. Both the aggregate and per capita amount of Federal revenue coming into New York State increased by less than the average for all States. For New York, however, the Federal share rose from just under 4 percent in 1942 to more than 7 percent in 1962. Although the Federal contribution to New York's fiscal requirements remains well below that of other States, there can be no doubt that New York improved its relative position in this regard over the period.

Tax Revenue. Although New York's tax collections nearly quadrupled, and the per capita amount nearly tripled, the ratio of State and local taxes to personal income rose by about a sixth. In the average State the tax increase, relative to personal income, was twice as great. At 57.3 percent the local share of tax revenue in New York was still considerably larger than the State share, but the State government had significantly increased its tax effort compared with that of local governments in New York and of State governments elsewhere.

To summarize, over the past two decades government expenditures in New York multiplied as they did in other States. The public sector, measured by either expenditures or revenues, expanded noticeably relative to personal income, but, because the expansion was smaller than in other States. New York emerged at the end of the period with a public economy of approximately the same relative size as in the average State. Although local governments in New York are still called upon to raise an abnormally high percentage of the tax required for financing public services, the State government's tax share had risen markedly, and Federal grants now represent a much larger share of total general revenues in New York.

A word of caution is in order. The relative increase in the State and Federal contributions does not imply that New York City (or any other local jurisdiction in New York) now has the fiscal resources to meet its obligations. Given the present distribution of functions and revenue sources, local governments, and especially the big cities, remain fiscally hard pressed.

Comparisons Within New York State

In New York State, as in most other States (regardless of the extent to which governmental responsibilities are assigned to local rather than State government), local governments outside the major urban areas receive relatively more State aid than those within the big urban areas (table 11). Within New York State, this applies not only to urban areas in general, but to New York City in particular, as table 12 shows. This, at any rate, was the situation as of 1962.

TABLE 11.—*State contribution to local government expenditures, 1962, within and outside standard metropolitan statistical areas*

[Dollar figures are in millions]

	Direct general expenditures of local governments	State revenue as percent of expenditures	Index (United States equals 100)	SMSA's share of State revenue		Other areas' share of State revenues	
				As percent of expenditures	(United States equals 100)	As percent of expenditures	(United States equals 100)
United States	$39,830.6	27.3	100.0	23.7	100.0	35.8	100.0
California	5,375.5	30.6	112.1	29.8	125.7	35.2	98.3
Connecticut	557.0	13.8	50.5	12.7	53.6	18.0	50.3
Delaware	75.4	49.6	181.7	45.0	189.9	60.4	168.7
Illinois	2,299.1	18.4	67.4	17.6	74.3	22.1	61.7
Maryland	721.8	34.9	127.8	32.5	137.2	48.3	134.9
Massachusetts	1,283.5	25.5	93.4	26.1	110.2	22.2	62.0
Michigan	1,822.6	29.6	108.4	26.4	111.4	39.8	111.2
New Jersey	1,476.3	13.1	48.0	12.5	52.7	14.9	41.6
New York	5,497.1	27.8	101.8	25.5	107.6	44.7	124.9
Ohio	2,063.0	25.5	93.4	22.0	92.8	34.8	97.2
Pennsylvania	1,986.8	23.4	85.7	19.6	82.7	39.9	111.5

Source: U.S. Bureau of the Census, *Census of Governments, 1962*, Vol. V.

TABLE 12.—*State aid to New York City and other local governments in New York State, 1962*

[Dollar amounts in millions]

	New York City	Other local governments	All local governments
Direct general expenditures of local government	$2,783.2	$2,713.9	$5,497.1
Revenue from State	640.3	889.7	1,530.0
Percent of local expenditures	23.0	32.8	27.8

Source: U.S. Bureau of the Census, *Compendium of City Government Finances in 1962* and *Census of Governments, 1962*, Vol. IV, No. 4.

A DECADE OF FISCAL EXPERIENCE

Census data do not permit detailed intrastate comparisons which begin in the early postwar years. For this purpose, an exhaustive study sponsored by the New York State Comptroller can be used, however. That study provides the basis for the next set of tables.

To summarize in advance, the main finding is that, in the period 1949–59, when total State aid more than doubled, aid per capita to New York City grew more slowly than did either current or total expenditures per capita. In the rest of the State, taken as a whole, the increase in State aid per capita exceeded the growth in operating outlays per capita and almost matched the increase in total expenditures per capita.

The Expenditure Side. Aggregate expenditures of New York local governments in 1959 came to $4.6 billion, an increase of 120 percent over the preceding decade (table 13). Capital outlay, representing nearly a fifth of total expenditure, almost tripled over the period, while current expenses of education, the largest item in the current component, rose by 158 percent. Among the other specified items (not counting higher education, which is peculiar to New York City) the largest increases took place in current expenditures for welfare and public safety, both of which loom larger in the New York City budget than in the combined budgets of other local jurisdictions.

TABLE 13.—*Aggregate expenditures in New York State local governments, 1959, and percentage increase, 1949–59*

[Dollar amounts in millions]

	1959			Percent increase, 1949–59		
	All local governments	All excluding New York City	New York City	All local governments	All excluding New York City	New York City
Current:						
General government	$241.3	$126.3	$115.0	52	71	36
Public safety	382.9	139.1	243.3	95	120	84
Highways	220.2	174.1	46.2	76	96	27
Welfare [1]	671.7	223.4	448.3	82	80	82
Hospitals	177.8	42.9	134.9			
Other welfare	493.9	180.5	313.4			
Health	70.9	32.8	38.2	76	52	104
Education	1,151.4	763.9	337.4	158	220	87
Higher education	38.0		38.0	102		102
All other	699.0	316.5	382.3	143	193	112
Total current	3,475.3	1,776.1	1,699.2	111	147	84
Interest	203.6	68.8	134.3	63	240	29
Capital outlay	894.9	495.5	399.4	190	345	102
Total expenditures	4,573.8	2,340.4	2,233.4	120	175	82

[1] Hospital expenditures are included in welfare data to preserve comparability with 1949 data.

Source: State of New York, *Comptroller's Studies in Local Finance*, No. 1.

On a per capita basis New York City's expenditures in 1959 were more than 10 percent above those of other local governments in New York State (table 14). This is so for total expenditures, including interest and capital outlay, as well as for total current expenses. Among the specified items of current expense, New York City's outlay was twice as high as the up-State level in welfare and safety, and about 40 percent higher in the catchall category "all other," which includes sanitation, recreation, libraries, and museums, on which City expenditure is above average.

TABLE 14.—*Per capita expenditures of New York local governments, 1959, and percentage increase, 1949–59*

	1959			Percent increase, 1949–59		
	All local govern-ments	All ex-cluding New York City	New York City	All local govern-ments	All ex-cluding New York City	New York City
Current:						
General government	$14.38	$14.03	$14.78	34	32	38
Public safety	22.82	15.46	31.33	73	69	86
Highways	13.12	19.34	5.93	55	51	28
Welfare [1]	40.03	24.82	57.61	60	39	85
Hospitals	10.60	4.77	17.34			
Other welfare	29.43	20.05	40.27			
Health	4.23	3.64	4.90	56	17	106
Education	68.61	84.88	49.79	128	147	90
Higher education	2.26		4.88	78		105
All other	41.63	35.17	49.13	114	126	115
Total current	207.08	197.34	218.35	87	91	86
Interest	12.13	7.65	17.32	44	162	31
Capital outlay	53.32	55.05	51.32	156	243	105
Total expenditures	272.53	260.04	286.99	95	112	85

[1] Hospital expenditures are included in welfare data to preserve comparability with 1949 data.

Source: State of New York, *Comptroller's Studies in Local Finance*, No. 1.

In school costs per capita—the largest single item in local budgets—New York City's expenditure of $49.79 in 1959 was well below the statewide average. This was due to an extremely low ratio of pupils to population—about 13 percent. On a per pupil basis the City's current expenditures for schools in 1959–60 stood at $526.13, well above the average for all school districts. In addition, alone among the local jurisdictions of the State, New York City incurred expenses of nearly $5 per capita in 1959 for institutions of higher education. With the establishment of community colleges this item now appears in the budgets of other local governments.

The Revenue Side. Among the major sources of local government revenue we are concerned primarily with State aid, which in 1959 accounted for a bit less than a quarter of all local revenue in New York State (table 15). For New York City, however, the State-aid fraction was less than a fifth, partly because the City sales tax contributed a large share of total revenue. On a per capita basis also, State aid was smaller in New York than in other local jurisdictions.

TABLE 15.—*Local government revenues in New York State, 1959, and percentage increase, 1949–59*

	1959			Percent increase, 1949–59		
	All local governments	All excluding New York City	New York City	All local governments	All excluding New York City	New York City
Total:						
Property taxes	$1,977,900,000	$1,030,100,000	$947,900,000	109	145	80
Nonproperty taxes	480,900,000	53,100,000	427,800,000	96	184	89
Assessments	78,300,000	74,300,000	4,000,000	213	223	95
State aid	1,007,200,000	624,100,000	383,200,000	119	167	70
Federal aid	172,200,000	60,200,000	112,000,000	137	124	144
All other revenue	446,500,000	263,900,000	182,500,000	90	131	51
Total revenue	4,163,000,000	2,105,700,000	2,057,300,000	110	152	79
Per capita:						
Property taxes	118	114	122	85	89	83
Nonproperty taxes	29	6	55	73	119	91
Assessments	5	8	1	176	149	96
State aid	60	69	49	94	106	72
Federal aid	10	7	14	109	73	148
All other revenue	27	29	23	68	78	53
Total revenue	248	234	264	86	94	82

Source: State of New York, *Comptroller's Studies in Local Finance,* No. 1.

Over the decade ending in 1959, when State aid more than doubled, the percentage increase in New York City was considerably less than in other jurisdictions of the State. This was so on a per capita basis, as well as for the unadjusted totals of State aid. Outside of New York City the increase in State aid per capita, 106 percent, exceeded the increase in current expenditures per capita, 91 percent, and came reasonably close to the increase in total expenditures per capita, 112 percent. For New York City, however, the increase in State aid per capita, 72 percent, was considerably less than the increase in current expenditures per capita, 86 percent, or total expenditures per capita, 85 percent.

A CASE STUDY: STATE-LOCAL AID IN INDIANA

BY SHARON A. GONGWER*

State intergovernmental expenditures covered a wide range in 1964. During this year, Indiana spent $161.65 per capita on an intergovernmental basis. Wisconsin spent more than $121 per capita whereas New Hampshire returned to the localities an average of $13.46 per resident. Indiana's total was relatively close to the median—a hypothetical State returning $54.12 per capita to the various governmental units.

Intergovernmental expenditures cover such items as education, highways, public welfare, hospitals and health, and local governmental support. Support of local governments is a vast and general category and is especially significant in regard to how much each State returns to its localities for use as they see fit.

During 1964 Indiana returned $1.66 per capita for general local government support. This amount is less than half of the amount computed, $3.80, for the hypothetical median state. The figure for Indiana is expected to be changed when the next statistical report on State governmental finances is computed by the Census Bureau. The most significant change, however, will be based on the 1967 General Assembly's decision to share 8 percent of the State's sales and individual income taxes, Indiana's chief sources of revenue, with all units of local government.

The 1965 and 1967 sessions of the State legislature took significant steps in recognizing the financial needs of the localities. Of particular importance is a research study: Intergovernmental fiscal affairs are getting intensive attention in the Hoosier State for the first time. Increasing financial needs of Indiana localities have prompted the State Budget Agency to undertake the first comprehensive study of State aid to local governments. Research work is presently underway and the results are expected to be published in 1968. The report is intended to describe all State-local aid programs, their purpose, funding source, administration, formula distribution, and effects. One of its most significant aspects will be the analysis of the effects of this State's financial aid on local governmental finance and taxation. Summed up: as Indiana continues to assume a larger share of local government expenses, what results will this have on the cities and towns?

Recent legislation, Indiana's overall proximity to the median in intergovernmental expenditure, and the study on State aid to localities contribute to the value of an Indiana case study on State-local fiscal affairs at the present time.

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*Former Legislative Assistant, Legislative Advisory Commission, House Ways and Means Committee, Indiana State Legislature, with the assistance of J. Knoll, Indiana Budget Agency.

As previously noted, the latest developments took place during the January–March 1967 Legislative Session. The most significant enactment gave 8 percent of the State's sales and individual income taxes to local units of government. The mechanics of the shared tax are relatively simple: funds first go to the county treasurers who then divide the receipts among all the taxing units in that county. The money goes to the city and town governments in the same proportion that property taxes are allocated. The Hoosier legislators obviously intended this State aid to reduce the soaring property tax rates of the localities resulting from increasing responsibilities. In the first year of the new program, the total distribution is made in proportion to the amount of income tax paid by residents of each county. After this initial period, the distribution of the income tax revenues will continue on the same basis, but sales tax revenue will go back to the county where the retail merchants, doubling as tax collectors, have their places of business.

Another source of assistance to cities and towns is obtained from the State's cigarette tax. From the 6 cents tax charged on each pack of cigarettes, ½ cent is distributed semiannually. This money goes into the general funds of Hoosier cities and towns. More money is expected from this source this year, and the extra sum will be put into municipal cumulative capital improvement funds. The legislators intend for the money to be used to construct or improve any city-owned property, build streets and sewers, and retire general obligation bonds issued for construction projects. The cigarette tax distributions will be made on a relative population basis.

The fourth major source of revenue for the communities in Indiana is obtained from the motor vehicle-highway fund taxes. After certain deductions, the State distributes 15 percent of the collections from such motor vehicle oriented sources as gasoline taxes, operator license fees, and yearly vehicle plate charges. The money is returned to the cities and towns on the basis of population. These funds may be used only for construction, repair, maintenance, snow removal, traffic signs, signals and similar purposes. The State will not allow more than 10 percent of this allotment to be spent on police salaries and equipment.

The remainder of the State's distribution of major tax funds to Indiana communities is obtained from alcoholic beverage taxes and license fees. The general funds of cities and towns receive two-thirds of the State's collections from alcoholic beverage retailer and dealer permits, plus one-half of the gallonage tax receipts.

The Indiana State Budget Agency expects to account for the distribution of $149,521,297 under these State-aid to localities programs during the forthcoming biennium. The motor vehicle-highway taxes will doubtless make the greatest contribution, while the alcoholic beverage taxes will make the least. According to official estimates, the breakdown will be as follows:

Alcoholic beverage taxes	[1] $14, 348, 000
Cigarette tax	31, 500, 000
Motor vehicle-highway taxes	53, 298, 297
Sales tax	[2] 26, 119, 300
Individual income tax	[2] 24, 255, 700

[1] A small portion of this is distributed to the counties.
[2] This money is shared by all local taxing units and does not go exclusively for city government.

As noted, the Hoosier State does not reach the median State total contribution to localities on a per capita basis when the category of general governmental support is selected. This compilation of data, however, was for 1964, whereas the current revenue estimates include several new sources of revenue for distribution without specifications other than property tax reduction.

Indiana has long offered a number of services beyond the strictly financial realm. These services are, of course, offered in some form by most States. In some cases, the State services are aided by the Federal Government.

The Commissioner of the Department of Administration, John T. Hatchett, recently pointed out that the Hoosier State offers nine categories of State services of interest to community officials. During a recent workshop held for mayor candidates from cities throughout the State, Hatchett described services available, ranging from reasonably priced public office furniture from the State's Prison industries to library services for rural communities lacking local facilities. Tax and budget advice are also available to local administrators if they contact State officials. Another new provision permits municipal, county and State government to contract with one another for specific services or buy and sell from one another. The purchasing facilities of the State Department of Administration are also available as aids to cities.

The funds to make these services available are, of course, provided for by the State Legislature meeting every 2 years. As is customary, the legislators receive the State revenue estimates, the budget draft, and consider their alternatives in providing for the needs of the local units of government. For the past few years, the State's revenue estimates have been conservative, and the General Fund has been blessed with a surplus awaiting distribution decisions.

Unlike some States with a year-round legislative budget staff as well as executive, Indiana has a single Budget Agency charged with preparing biennial State budgets for presentation to the Governor and to the General Assembly. It also maintains general budgeting administration charges after it has been approved by the Legislature.

A five member State Budget Committee provides analysis throughout the year. The committee is composed of the director, appointed by the Governor, two members of the Senate appointed by the President of that body from nominations made by the President pro tempore and the minority floor leader. Legislative members are appointed for 2-year terms and receive $30 per day for their services whenever they officially meet.

In addition to these details affecting the appropriation process, it should be noted that the State is both manufacturing and agrarian, producing steel, corn and soybeans. Known as the "crossroads of America," Indiana is divided into 92 counties, each county divided into townships. Indianapolis is the largest city with a population of 500,000 covering an area of 78 square miles in the center of the State. The needs of Indianapolis are unique and the charge that the needs of the State's biggest city have been ignored is often heard.

State aid to local schools accounts for approximately one-third of local school expenditures. Forty-one percent of the current biennium budget is allotted to the schools. This is 61.6 percent of the General Fund appropriated for 1967–69. Indiana aid to education encompasses four major areas—aid for local schools; support for higher education; handicapped and similar special school financing and State library facilities; and various programs and activities administered by the Department of Public Instruction.

The responsibility for financing and administering the public schools is shared by the State and local units of government, but the State is held chiefly responsible.

Article 8, section 1 of the Indiana Constitution notes:

> Knowledge and learning, generally diffused throughout a community, being essential to the preservation of a free government; it shall be the duty of the General Assembly to encourage, by all suitable means, moral, intellectual, scientific, and agricultural improvement; and to provide, by law, for a general and uniform system of Common Schools, wherein tuition shall be without charge, and equally open to all.

Since Indiana in 1966 celebrated her 150th birthday as a State, the Indiana Sesquicentennial Commission has published a series of booklets, one of which is devoted to State and local government written by Philip Wilder, Jr., and Karl O'Lassker of Wabash College. The publication notes that prior to 1933, most of the costs of elementary and secondary education were met by the local units of government. These local units, of course, were relying on the property tax. When the Great Depression came, many communities were unable to raise enough money to keep the schools open. To meet this emergency, Hoosier lawmakers enacted a gross income tax. Most of this money was allocated to the local school units according to a school-aid formula devised and revised by the General Assembly. Since then, computations show that the amount of State aid to local schools has varied between 25 and 40 percent of the total cost. The 1965 school aid from the State amounted to 35 percent of the total local school costs and this year the State percentage is slightly higher. The amount of local school aid recomemnded by the Governor this year was 12.8 percent greater than the 1965 appropriation and represented an average cost of $250 per student.

Education represents the largest appropriation of State resources. In terms of educational expense per capita, Indiana gave $36.94 in 1964 whereas Delaware and New Mexico spent $90 per resident, and Nebraska $10.

The financial squeeze on the States is well illustrated in the following quote from the Governor's 1967 budget message:

> Proposals have been made to increase the minimum salary of all teachers to $6,000 a year. This is a noble goal. But its cost is estimated from $80 million to $140 million, enough to chill the fondest hopes of the taxpayers for property tax relief.

Country roads, city streets, and highways within the State are an example of intergovernmental relations. More than 11,000 miles of pavement are included in the State highway system with legal responsibility resting with a four-man State Highway Commission appointed by the Governor. Administrative work is done by the executive director, an additional gubernatorial appointee. County, city, and township roads are not a part of this system, but they receive approximately $72 million annually in State aid. The cost of this combined operation was $539.3 million for the last biennium—41 percent provided by the Federal Government and 59 percent by the State itself from motor fuel and vehicle taxes as previously outlined. State level expenditures for highways are second to the costs of education, but considerably more than all remaining State activities.

Since approximately 40 to 60 percent of highway expenses are shared between the State and Federal Governments, Indiana is greatly affected by Federal policies. The Governor observed in his recent state of the Union message that the effects of the recent decision by the Federal Government to cut back the national construction program 17½ percent resulted in Indiana feeling the effect of a 53-percent cutback.

Although Indiana does not follow the Illinois pattern of including Federal funds in appropriation bills, the complex pattern of Federal-State and local fiscal affairs if complicated by biennial State sessions while Congress continues to meet annually. Legislators have expressed a need for more information in regard to Federal programs available to State departments and universities, and to partially meet this need, a study on Federal aid is being undertaken in addition to the present research underway concerning Federal aid to States and localities.

As previously observed, Indiana is close to the median of 1964 when average intergovernmental expenditure was computed, but much more distant when the computation is limited to the single category of general local government support without specification regarding use. With the new sales and income tax returns allotted to the general funds of the various communities, however, this statistical evaluation may soon become less dramatic.

The first official study of State aid to localities plus recent legislation means that Indiana, as one of 50 States facing similar problems, is attempting to find solutions for local problems.

Just prior to the 1967 enactments of the State Legislature, the Governor's Annual Budget Message concluded with this observation:

> The staggering sums requested for the essential services of our government, such of which will be built into your final appropriation act, indeed give us pause in the matter of direct tax refunds. If in your judgment, such refunds or distributions, in whatever form they take, should be made, I would hope that they are geared to permanent property tax relief. How you ask? By annual spillover of surplus funds at tax-paying periods and by forbidding any taxing unit to enter into binding contracts for personal services until the funds for use are determined. This action would brand you as statesmen.

The effects of the Legislative enactments and the projected results of the State aid to localities study presently being conducted by the budget agency remain to be seen. Although each State bears the burden of its own unique administrative structure, the background and the projected results of Indiana's programs into the future might serve the progress of another State.

Part 3

INTERGOVERNMENTAL FISCAL EXPERIENCE IN OTHER COUNTRIES

THE FINANCING OF CANADIAN FEDERATION*

BY A. MILTON MOORE, J. HARVEY PERRY, and DONALD I. BEACH

HISTORICAL BACKGROUND: 1867–1941

FINANCIAL ARRANGEMENTS—1867

At Confederation the founding fathers of Canada, when determining the financial relations of the Provinces with the new Federal Government, assumed quite naturally and perhaps of necessity, that the sphere of Government action would remain what it was at that time. Since they assigned the more costly responsibilities to the Dominion, they also gave it the principal revenue sources. The important job of the day was the development of a still pioneer economy by means of railways, roads, canals, harbours and bridges. This task was assigned to the Federal Government. The provincial governments were allotted welfare and education, but since the prevailing political philosophy dictated that expenditures on these services be kept to a minimum they were not costly. In fact, the provincial burden was actually expected to grow lighter in per capita terms as municipal institutions were developed.

TAXING POWERS

The precise division of revenues reflected this general approach. The Federal Government was given unlimited powers of taxation. This meant in particular that the tariff, which had been the backbone of the colonial revenue system, would in future belong to it. On the other hand the four provinces which entered Confederation in 1867—Ontario, Quebec, Nova Scotia and New Brunswick—were given tax sources which in total had produced less than one-fifth of their revenues in 1866. In short, provincial powers were restricted to direct taxation.

Taxation in direct form was so detested in almost all provinces but Ontario (where municipal property and income taxes were well developed at Confederation) that it can be assumed that there was no serious expectation that the provinces would use these powers. Indeed it is evident from some speeches of the day that the founding fathers counted on the very unpopularity of direct taxation to prevent its extensive use. Nonetheless the power had to be given the Provinces so that it could in turn be conferred upon the municipalities to enable

* Reprinted from "The Financing of Canadian Federation"; The First Hundred Years, Canadian Tax Foundation, (chs. I and V) by A. Milton Moore and J. Harvey Perry (1867 to 1953) and Donald I. Beach, Toronto, April 1966.

them to continue to collect property taxes. Furthermore it is obvious that only in direct form can taxation be restricted to the citizens of the Province levying the tax.

STATUTORY SUBSIDIES

Since other available revenues, such as fees and receipts from natural resources, were insufficient to balance provincial budgets, and since there was little expectation that the power of direct taxation would be used, the inevitable choice seemed to be that the Dominion must either concede to the Provinces some power of indirect taxation or else provide them directly with revenues through subsidies. There was a strong desire on the part of the founding fathers, particularly those from the Central Provinces, to avoid subsidies, but they were even less disposed to allow the Provinces a concurrent power of indirect taxation, fearing that it would be used to establish interprovincial trade barriers. Small annual fixed subsidies were therefore introduced to make it just possible for the Provinces to balance their budgets. So reluctantly was this step taken that the subsidies were stated to be in "full and final" settlement of all claims of the Provinces on the Dominion.

To avoid discrimination it was desirable to find a subsidy plan of uniform application, but in the circumstances this was most difficult. The deficiencies of the revenues of the Maritimes were much greater than those of the Province of Canada. Municipal development had scarcely begun in Nova Scotia and New Brunswick, and consequently public expenditures in these localities were financed largely out of general provincial revenues. In addition the tariff had yielded considerably more per capita in the Maritimes than in the Province of Canada. To arrive at a uniform subsidy that would neither give Ontario far more than it needed nor absorb an undesirably large percentage of total Federal Government revenues, Nova Scotia had to reduce sharply her estimate of required future expenditures. Owing to the prevailing social philosophy it was apparently taken for granted that the subsidies would be best expressed as a uniform per capita amount. The final arrangement provided a general subsidy of 80 cents per person (but not to be paid on any population over 400,000), together with subsidies in aid of Government and subsidies arising out of the assumption of provincial debts by the Dominion, this last form of subsidy being of no significance at Confederation. An important departure was made in paying New Brunswick an extra 10-year special grant, on the grounds of the special need of that Province.

These subsidies represented 80 to 90 percent of expected revenues in Nova Scotia and New Brunswick, and between one-half and two-thirds in Ontario and Quebec where revenue from natural resources and other sources were more important. In total they aggregated about $3 million, and represented about 20 percent of the expected revenues of the Dominion.

The course of events following Confederation disappointed the hopes of the founding fathers in many respects. The initial phase of the new venture was sure to present problems enough, but actual developments were fraught with so many more hazards than had been expected that statesmanship of a caliber at least equal to that which had created the union was required in order to maintain it.

EARLY DIFFICULTIES

The difficulties arose from several sources. The first to emerge stemmed directly from the 1867 financial arrangements. Nova Scotia, the most reluctant of the original four partners, soon found that the deal it had accepted was quite inadequate. Following a bitter wave of protest led by Joseph Howe, at the crest of which the Imperial Parliament was petitioned to release the Province from the Union, the Dominion in 1869 conceded a special additional grant for a 10-year period dating from Confederation. Each admittance of a new Province—Manitoba in 1870, British Columbia in 1871 and Prince Edward Island in 1873—strained the flexibility of the original terms, and minor variations were introduced. In turn these provided the precedent for requests for revision from the other Provinces. Within 6 years of Union "special" grants were being paid to Nova Scotia, New Brunswick, Prince Edward Island, and British Columbia; and Ontario and Quebec had been relieved of penalties imposed on them in the 1867 terms because their per capita debt assumed by the Dominion had been higher than that of New Brunswick and Nova Scotia. This concession in turn had called for some compensating payment to the other Provinces, so that following 1872 the "debt adjustment" provisions of the terms of Union became an additional source of payments which after a process of strange evolution eventually produced payments even for Ontario and Quebec.

Most of these developments could be attributed to the inflexibility of the original terms and the insistence that it had been a "final" settlement. No more convincing evidence that compromise is the essence of Canadian statesmanship could be given than the success with which a series of unexpected problems were dealt with in the 6 years following Union without seriously altering the original framework of Union. By 1873, however, events had taken a turn that no one had foreseen. In place of the continued prosperity that had been confidently expected under the new Union, there descended a worldwide depression which lasted for almost 25 years. As the depression deepened it had two results. On the one hand it stultified provincial economic development and increased provincial pressure for more generous financial terms. On the other it made so onerous the execution of the Dominion's first and all-important assignment of building railways from coast to coast that its resistance to provincial appeals stiffened considerably. With major adjustments, therefore, the subsidy payments as developed in the first 6 years of Union stood unchanged until 1907, despite constant provincial clamoring. The principal changes arose from the "debt allowance" subsidy and from the introduction of grants to Manitoba in lieu of natural resources.

THE RISE OF PROVINCIAL TAXATION

The Provinces, thus thrown on their own resources, followed widely separated paths. British Columbia immediately and energetically began to exploit its powers of direct taxation by levying provincial income and land taxes in 1876, and Prince Edward Island also put on a land tax from 1877 to 1882. Quebec, which had become deeply involved in financing provincial railway lines, was under serious pressure to obtain additional revenues. During the 1880's Quebec became the spearhead of a drive to obtain a new deal from the Dominion, and was the first Province to tackle corporation taxes seriously. A charge on insurance companies levied in the late 1870's was declared ultra vires by the Privy Council, but with the knowledge gained by this experiment in the 1880's the Province enacted a valid statute imposing the now-familiar set of charges on places of business, paid-up capital, and so on. This example was gradually followed by the other Provinces. Ontario also provided a useful precedent by imposing a constitutionally valid succession duty law in 1892, which all the other Provinces immediately copied. Prince Edward Island restored its land tax in 1894, and in the same year levied a personal income tax, being the only other Province beside British Columbia to do so in a half century following Confederation.

In one respect this development might be said to have disappointed the expectations of the founding fathers, since it had apparently been their hope that the powers of direct taxation given the Provinces would not be used. However, it was made inevitable by the refusal of the Federal Government during the 1880's and 1890's to grant higher subsidies. Furthermore, until World War I almost all Federal revenues came from the tariff and from excises on liquor and tobacco, and this concentration on indirect taxes seemed to imply that the Dominion was prepared to leave the direct tax field to the Provinces. Indeed, this belief became so firmly accepted in the minds of provincial Premiers that in World War I, when the Dominion levied its first income tax, the step was generally challenged as an "invasion" of provincial taxing powers.

The importance of the provincial direct taxes adopted during this period could easily be exaggerated; they produced only about 10 percent of provincial revenues in 1896. In the Maritime Provinces and in Manitoba the Federal subsidy remained the principal support of the revenue. Manitoba was particularly dependent on its subsidy, because the Federal Government had retained ownership of the lands of the Province when it was created (as it was to do also in Saskatchewan and Alberta later). This policy was designed to keep in Federal hands control over settlement, but it deprived the Province of important revenues and created the contentious "natural resources" question. The new direct taxes were significant for the future, however.

Of equal importance for the future were decisions of the Privy Council given during those early days which widened the scope of provincial powers beyond that apparently intended by the founding fathers. These decisions gave broad meaning to the provincial power to legislate in matters relating to "Property and Civil Rights", and established their priority over the powers given the Dominion to legislate for the "peace, order and good government of Canada." These decisions meant that the provinces were legally responsible for areas of expenditure—relief and social welfare, for example—which in the fullness of time were to impose on their revenue resources demands which had not even been contemplated in 1867.

PROSPERITY AND PROGRESS IN THE EARLY 1900'S

The long depression of the last quarter of the 19th century ended about the mid-1890's. The new century opened for Canada in an era of general prosperity, stimulated by the long-anticipated influx of settlers to the Western Plains. With the rush of settlement came a flood of capital from abroad for building new cities on the Prairies, for new transcontinental railways and for a marked industrial expansion in the central Provinces. Federal revenues from the tariff rose rapidly, and the generous terms on which Saskatchewan and Alberta were brought into Confederation in 1905 were evidence of a new attitude towards the Provinces. In 1906 Sir Wilfrid Laurier called a general conference in Ottawa to reconsider the whole subsidy question and arrive at a truly "final" basis. Since most of the Premiers present were of the same political allegiance as the Federal Government the conference was one of those rare occasions of general amity and accord.

A settlement was worked out which seemed to satisfy most claims—British Columbia remained somewhat disgruntled—and in 1907 an amendment was made to the original subsidy provisions of the British North America Act by the Imperial Parliament, once more setting forth the "final" arrangements. The main outlines of the original terms were retained, but their details were revised to produce an increase of about one-third in existing payments. The principal amendment was the removal of the limit of 400,000 population on the 80 cents per capita subsidy, and the introduction of a sliding scale, based on population, for the subsidy in aid of Government. While the subsidies remained a major element of revenue in the Maritime and Prairie Provinces, in Ontario because of the increasing importance of other revenue sources in the boom period their overall importance declined from about two-thirds of total provincial revenues at Confederation to a quarter prior to World War I, despite the upward revision of 1907. In the Federal budget they increased in the aggregate from about $3 million a year in 1868 to about $9 million after the 1907 revision. In relative importance, however, they declined from about 20 percent to less than 10 percent of the Federal budget.

The revision of 1907, as events turned out, was to be no more "final" a settlement of Dominion-Provincial financial relations than had been the original terms of Union. In one sense however it marked the closing of the first phase—the phase during which all efforts had been directed toward coping with each new problem within the framework of the original financial terms. Although a more detailed study than that attempted here would reveal that some ingenious variations had been introduced, in the first 40 years no new ingredients were added to the original recipe. However, while the economic tempo in general had greatly accelerated in the new century, one basic economic problem of Confederation remained: the regional disparities which had called for special payments to the Maritime Provinces from the beginning had if anything become more acute in the first 40 years. On the other hand there was one very important new development that had not been anticipated at Confederation. Far from retiring to relatively inconspicuous roles, the Provinces and municipalities by the turn of the century were launched on a period of expansion that was to carry on through to the 1920's, interrupted only by the war and the short depressions that preceded and followed it. Causes which could never have been foreseen by the founding fathers were responsible for this development. The rapid trend toward urbanization that accompanied industrial development, with the resulting heavy capital expenditures on roads, schools, public buildings, etc., and the advent of the motorcar, requiring heavy new expenditures for highways, were only two aspects of a trend which could scarcely have been foreseen at Confederation. It posed serious new problems in intergovernmental finance that were to be largely resolved in the buoyant prosperity of the 1920's by the further exploitation of provincial taxing powers, which had just begun to be tapped in the last years of the first phase.

World War I and the Booming 1920's

WARTIME TAX MEASURES

The war was significant in the context of this study primarily because it brought an end to the implied principle that the Provinces alone would impose direct taxes. After much hesitation caused in part by fear of offending provincial feelings, the Federal Minister of Finance finally announced in 1917 that the Dominion would impose both personal and corporation income taxes. Other significant changes during and following the war included new excise taxes and a general sales tax. The overall effect of the shift in revenues that resulted is indicated by the fact that while in 1913, 78 percent of Federal revenues came from customs and excise duties, in 1921 less than one-third came from these sources.

During the war no marked new developments in Federal-Provincial financial relations occurred. In 1912, Manitoba had been given improved terms in its grants in lieu of lands, and a small additional subsidy had also been paid to Prince Edward Island. British Columbia presented alleged grievances to the Federal Government with such force that a Royal Commission was promised, and a proposal that the Provinces be given a specified share of Federal customs revenues received general provincial support in the immediate prewar period. But the outbreak of war forestalled the appointment of the Royal Commission to investigate British Columbia's grievances, and brought an end to active canvassing for higher Federal grants.

Significant tax increases were made by the Provinces during the war, particularly through the medium of a temporary provincial property tax that was collected by the municipalities. The land boom in the Prairies collapsed in 1912, and had it not been for the new stimulus of the war serious economic difficulties would have ensued. As it was, the depression of 1912–15 and the war put a damper on local and provincial capital expenditures for 5 or 6 years.

THE POSTWAR PERIOD

In the postwar period, burdened with war debts, war pensions, and the cost of running the railway system it had taken over during the war, the Dominion followed an extremely conservative financial policy. With the passing of the railway and canal age, its main work in the furthering of the development of pioneer economy seemed at an end. The great new tasks of Government—building highways, harnessing waterpower, and expanding welfare services—fell to the Provinces. Nor was any inclination shown by the Federal Government to play a major part in achieving these new national objectives, preoccupied as it was with carrying its greatly enlarged debt. The only major new obligation it assumed was its share of one-half the cost of old-age pensions inaugurated jointly with the provinces in 1927.

The attempt to return to "normality" was reflected in Federal revenue policies. By 1912 the war-enforced recourse to new fields had reduced the contribution of the traditional sources of customs and excises to one-third of total revenues, but by 1930 their share had again risen to two-thirds. By that date the corporate and personal income taxes had been substantially reduced and the sales tax lowered from 6 to 1 percent.

By comparison the 1920's brought a sharp upsurge in provincial capital expenditures, a consequence of the growing use of the motorcar, and of the development of electrical energy. The former meant the building of more new and costly highways, and the latter the incurring of debt for building powerlines for the long-distance transmission of electricity and, in the Prairies, the introduction of public telephone systems. For the first time governmental housing projects, drawing upon loans of Dominion funds, were undertaken on an appreciable scale. Owing to rapid urbanization and the growing demand for community services, expenditure for public buildings and miscellaneous works led to a great increase in deadweight debt. The flow of spending for all these purposes was later to bring financial difficulties, since much of it was financed by 12- to 15-year debentures which matured in the depression.

In contrast to the great increase in capital outlay and debt, current expenditures of the Provinces remained about the same per capita as in 1914, but by the early 1920's their composition was changing and continued thereafter to change. A larger proportion was spent upon education, mothers' allowances, child welfare, mental hospitals, and similar welfare services; and in the postwar depression of 1921–22 expenditures were made for direct relief of the unemployed. Conversely, spending upon the traditional functions of justice and legislation, public domain, agriculture, and transportation declined relatively.

Notwithstanding the beginnings of the old-age security program, there was no marked change in social philosophy. Welfare expenditures grew but there was no deliberate effort to expand the nature of the services. Although rising, expenditures constituted only one-fifth of combined provincial and municipal outlays. Most services were still considered to be a municipal responsibility requiring only incidental assistance from the Provinces. The effect of this allocation of responsibility was to be acutely felt in the next decade.

To finance rapid development, the Provinces and municipalities, by contrast with the Dominion, moved into new revenue fields in strength. During the war prohibition had removed liquor as a source of revenue. Early in the 1920's most Provinces introduced sale through provincial outlets, and liquor became a considerably more important revenue source than it had ever been previously. The motorcar was also beginning to have a considerable effect on provincial revenues. Receipts from licenses became a principal item, and gasoline taxes, first introduced during the 1920's, immediately became a major revenue producer. The older revenue sources—succession duties and corporation taxes—also provided good revenues, while municipal tax receipts grew rapidly with new residential and business construction.

It is apparent in retrospect that while the new sources provided substantial revenues, provincial finances had become increasingly vulnerable to cyclical fluctuations. Heavy capital expenditures meant increasingly rigid outlays for interest on debt and other forms of expenditure involved high fixed costs. On the other hand most of the new tax revenues sources were such that their yield would vary directly with the business cycle. The only stable element—the statutory subsidies—had become a relatively unimportant source of revenue in most provincial budgets.

THE BIRTH OF CONDITIONAL GRANTS

In keeping with the new emphasis on capital expenditures and welfare programs, the character of subsidy payments from the Dominion to the Provinces had altered. In the immediate postwar years a new form of subsidy—the conditional grant—had made its appearance. Under this form the Dominion offered to share the cost of a specified function provided certain standards of performance were met. A first experiment had been made with such grants in the field of agricultural instruction in 1913. This measure fell short of ideal standards, since the Dominion put up the whole amount of the money and made little effort to supervise its spending. However after the war a number of projects were embarked upon with the Provinces sharing up to half the cost and being required to meet at least general standards laid down by the Dominion. These projects included vocational education, highway construction, employment offices, venereal disease prevention and finally, in 1926, the old-age pension plan. This last was the first major experiment of the Federal Government in the area of social welfare and it long outlived any of the other shared-cost schemes, lasting until January 1952, when it was replaced by the payment of universal old-age pensions at age 70.

DUNCAN COMMISSION GRANTS

These conditional grants did nothing, however, to alleviate the problems that had arisen because of the uneven impact of prosperity. Depression dragged on in the Maritimes after it had lifted elsewhere, rekindling the acute feeling of grievance that the national policies had not worked to their advantage. In 1926 the Dominion appointed the Duncan Commission to investigate these grievances. The Commission recommended that additional annual grants be paid on an interim basis, amounting to $875,000 for Nova Scotia, $600,000 for New Brunswick, and $125,000 for Prince Edward Island, as a result of which the annual statutory payments to the three Maritime Provinces would be nearly doubled. The Federal Government acceded only reluctantly to this proposed after a provincial conference in 1927 showed clearly that all the other Provinces approved the increase. Concurrently all but Ontario and Quebec immediately requested increases in their own subsidies on the ground that their fiscal resources were not adequate to their obligations. Proposals for the redistribution of Government functions and revenues ranged from demands that the Federal Government take over the new services, to suggestions that the Dominion withdraw from some tax fields, particularly the income tax field which it was accused of having preempted during the war. Neither suggestion was heeded by the Federal Government; it countered provincial claims with the plea of heavy responsibilities of its own in reducing the national debt and maintaining Canada's credit in order to encourage the inward flow of investment.

NATURAL RESOURCES SETTLEMENTS

Appeals of the Prairie Provinces for the return of their national resources met with great response, however. The basis of their retention by the Dominion had been their use to effect the settlement of the West. With this excuse gone the Prairies pressed for their transfer, together with reimbursement for their past use. In 1930 the Dominion acceded by giving over the resources and appointing Royal Commissions to consider compensation. Following the recommendations of one of these Commissions, a payment was made to Manitoba but a final settlement was not reached with Saskatchewan and Alberta until 1947.

SUMMARY OF THE 1920'S

The position at the end of the 1920's may be summed up generally as follows: the first 40 years had ended with those Provinces in the areas of active economic development beginning to exploit their powers of direct taxation but, except for British Columbia, in a relatively small way. The Federal Government had made an upward adjustment in the basic subsidies in 1907, but the total of just over $9 million a year was no longer of major significance in the budgets of the rapidly growing provinces. It was becoming evident that further provincial expansion would have to be financed either by much more generous grants from the Dominion or by provincial taxation on a scale much more extensive than had been hitherto contemplated. The war postponed the necessity for finding a solution to the problem thus posed, but it reemerged immediately afterward. A new device—the conditional grant—gave promise of providing a means for general Federal assistance to provincial services, and some experiments of mixed success were tried. By 1930 some $43 million had been paid over to the Provinces by the Federal Government, exclusive of payments under the old-age pension plan. By the early 1930's the latter were running at slightly over $10 million a year.

A more aggressive policy by the Federal Government along this avenue might have yielded better results than were achieved, but the shared-cost grants had four serious disadvantages. First, there were a limited number of functions suitable for shared-cost treatment that were of equal concern to all Provinces; second, the fact that a grant could be obtained frequently encouraged a Province to undertake a function it could support only with difficulty after the grant was withdrawn; third, because of the problems of control and administration, the conditional grant was a faulty vehicle for the transfer of any large amounts of funds from the Federal Government to the Provinces and fourth, the grants provided no answer at all to the basic problem of regional differences in Canada.

The limitations of the conditional grant left therefore only the alternatives of further development of the historic statutory subsidy mechanism, the exploitation of provincial taxing powers or some combination of both techniques. An imaginative leadership on the part of the Federal Government would have suggested other alternatives, but this was conspicuously lacking in the 1920's. In general the drift of events was toward provincial taxation. Gasoline taxes, motor vehicle licenses, and liquor control provided most of the funds required to support the expanded level of provincial operations, and the rising base for the property tax was fairly adequate for municipal purposes. The only development along traditional lines was the special subsidies paid to the Maritime Provinces after 1926. In one sense these marked a new trend, however, in that they were frankly paid to assist Provinces whose development had lagged behind that of the rest of the country.

At the close of the 1920's the Provinces and municipalities were spending in total almost half as much again as the Federal Government, a state of affairs hardly foreseeable in 1867. The statutory subsidies on which the founding fathers had relied amounted in 1929 to $12½ million, between 8 and 9 percent of total provincial revenues. Provincial taxing powers had by no means been strained to the limit, but a substantial structure of fixed charges had been erected on a base that was extremely uncertain. Little room had been left for carrying the heavy burdens that were to fall on provincial and local governments in the 1930's.

The Great Depression and the Rowell-Sirois Report

Much could be said of the depression and the severity of the economic distress which it brought, but for the purpose of this study its two principal effects on intergovernmental finances in Canada may be stated briefly. (1) The uncoordinated efforts of all governments to maintain solvency reduced the tax system to chaos; and (2) the failure of this effort in the less wealthy Provinces and the uneven incidence of the depression forced the Federal Government to make large intergovernmental and interregional transfers of funds.

In the scramble for tax revenues, corporate and personal incomes were particularly the subject of attack. Only the Dominion, British Columbia, and Prince Edward Island taxed corporation profits in 1930; a decade later all Provinces were in the field. Similarly the number of Provinces levying personal income taxes, in addition to the Dominion's, increased from three to seven. While these new provincial taxes were being imposed the Federal income tax rates were approximately doubled. The Federal sales tax was increased from a rate of 1 to 8 percent and many new excises were introduced. Provincial gasoline taxes were raised 50 percent on average; retail sales taxes were introduced in the Provinces of Saskatchewan and Quebec and in the cities of Montreal and Quebec; succession duty rates were raised, exemptions lowered and enforcement stiffened. New flat rate taxes on corporations were introduced and old ones increased. In terms of increased rates and new levies the onslaught on the taxpayer was comparable to that of World War II, but in addition the hidden burden in the form of double or triple taxation, overlapping administration, multiple accounting, and multifarious forms was also onerous. It was one of the major accomplishments of the tax agreements of the first postwar decade that this welter of taxes and forms was replaced by uniform laws and administration over large areas of the country.

Federal Government transfer payments took several forms. First, direct assistance was extended to a few severely depressed industries. Attempts were made, for example, to stabilize the price of wheat and subventions and bonuses were paid on Canadian coal. The absorption of the deficit of the C.N.R. also indirectly represented a subsidy to industry. Second, direct assistance had to be extended to all provincial governments to help finance costs of relief to the unemployed—a function with which the municipalities had hitherto been saddled. Even if economic distress had been uniformly distributed, for the municipalities to have met the whole cost of relief would have required an increase of 50 percent in the yield from real property taxes at a time when property values had collapsed. Neither was any provincial government able to meet the new burden, and the Federal Government was obliged to extend aid to farmers and to urban unemployed, using the device of grants-in-aid. In all about $317 million were given in grants for relief to provincial and municipal governments and another $175 million loaned. Much of the amount loaned was later written off. The grants alone amounted to several times the total of the statutory subsidies that had been paid up to that time. In the aggregate, during the depression, a third of provincial revenues came from the Dominion, largely in relief assistance. In some provinces the proportion was nearly twice that. In all, 40 percent of the cost of relief was met by Federal grants-in-aid to provinces. In addition the Federal Government also undertook a Federal works program and gave direct payments to single unemployed transients. In total, Federal relief expenditures, including grants-in-aid, exceeded $400 million.

SPECIAL MARITIME AND PRAIRIE ASSISTANCE

Along with the relief grants, special assistance had to be given to the most hard-pressed provincial governments to prevent defaults in debts and to make possible the continuation of essential services. As recommended by the White Commission in 1934, the special Duncan grants to the Maritime Provinces were raised from $125,000 to $275,000 for Prince Edward Island, from $875,000 to $1,300,000 for Nova Scotia, and from $600,000 to $900,000 for New Brunswick. Following a Bank of Canada study of the particular problems of the Prairie Provinces in 1935, substantial annual grants were made for several years to Manitoba and Saskatchewan. The former Province was paid $750,000 and the latter $1,500,000 annually from 1937 to 1941. Saskatchewan also was paid an additional grant of $2 million in 1938 and 1939, following the most disastrous crop failures in Canadian history. (A grant of $600,000 a year was recommended for Alberta but was not paid until later because of the default by that Province on its bond interest.) As a final culmination of longstanding agitation British Columbia also was given, starting in 1935, a special interim subsidy of $750,000 a year, which it received until 1941.

ROWELL-SIROIS COMMISSION

These were all salvaging operations, and effected neither prevention nor permanent cure. They were done hastily and with little thought for anything but meeting the immediate problem. However, so marked was the breakdown of the Federal financial structure that had emerged at the end of the 1920's that there was general concern as to what might be done to remodel it. In particular, the breakdown of the finances of the Western Provinces almost made them wards of the Federal Government and rendered a realinement imperative. To provide an answer to this question the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission) was appointed in August 1937. The Commissioners were charged with the investigation of the distribution of functions and revenues between the Dominion and the Provinces, and were instructed "to express what in their opinion, subject to the retention of the distribution of legislative powers essential to a proper carrying out of the Federal system in harmony with national needs and the promotion of national unity, will best effect a balanced relationship between the financial powers and the obligations and functions of each governing body, and conduce to a more efficient, independent, and economical discharge of governmental responsibilities in Canada." [1]

The Commission was faced with two distinct problems. The pressing one of the moment was to devise a set of fiscal relationships that would enable the Federal Government to coordinate the activities of all governments in the common task of ameliorating the distress caused by economic depression; the other was to recommend a division of Government functions and revenues that would be efficient, would meet the problems that had arisen from the increased needs of the Provinces and municipalities, and would effect the realization of a set of national objectives not envisaged at Confederation.

UNEMPLOYMENT RELIEF RECOMMENDATIONS

On the first score the Commission raised a serious indictment against the Federal Government for its insistence that the relief of unemployment was primarily a provincial-municipal responsibility. The Commission held that as a consequence of this policy large Dominion expenditures were made without the exercise of adequate control. As a result there were marked regional differences in standards of relief, loans were made to municipalities and farmers without safeguards for their repayment, the homeless unemployed were pushed from pillar to post, and local relief regulations impeded labour mobility. In addition, the enforced contraction of outlays by some Provinces countered and offset the expansionary deficit spending of others. By reason of the Federal Government's attitude that municipalities and Provinces must bear as much of the burden of relief as possible, some municipalities became entirely, some Provinces nearly, bankrupt; almost all Provinces and local governments piled up onerous deadweight debts; and the Prairie Provinces temporarily lost their financial independence.

To prevent a recurrence of this situation the Commission recommended that relief of unemployed employables (as distinct from

[1] "Report of the Royal Commission on Dominion-Provincial Relations," Book 1, p. 10.

unemployables) should be transferred to the Federal Government. A step was taken in this direction when the Dominion, with the concurrence of the provinces, enacted a measure of compulsory unemployment insurance in 1941. Subsequent measures took the form of the unemployment assistance programs of 1955 and 1957 and their development is discussed more fully later in this study.

With respect to the other aspect of their task, the division of responsibilities between the two levels of government, the Commission was of the view that responsibility for the great body of social welfare functions (except contributory old-age insurance if this should be adopted), should be left at least temporarily under provincial jurisdiction and financed from provincial treasuries. These schemes included widows' pensions, mothers' allowances, child welfare, health insurance, workmen's compensation, provision for unemployables, and education. The Commission opposed joint jurisdiction in this area, and criticized the shared-cost grant mechanism.

Besides lifting from the shoulders of the provinces the single but crippling burden of relief for cyclical unemployment, the Commission recommended a redistribution of revenues between the provinces and the Dominion and among the provinces themselves. Personal and corporation income taxes and also succession duties were to be utilized solely by the Dominion. This would have several advantages. Centralized control would remove undesirable forms of corporate taxation, bring greater efficiency in collection, reduce costs of compliance, and eliminate double taxation. It would also institute a greater measure of redistribution of the tax burden among provinces, since common services would be met by general levies according to ability to pay, without regard to the Province in which the citizen happened to reside.

NATIONAL ADJUSTMENT GRANT PROPOSAL

The most controversial recommendation of the Commission was the proposal of a new system of "National Adjustment Grants"—unconditional subsidies to equalize provincial finances. Despite its awareness of the past difficulties with Federal subsidies and the fact that they contained a large and necessary ingredient of political bargaining, the Commission would have the Canadian Federation start afresh, subordinating local interest to the common good in a manner never fully achieved by a unitary state, let alone a federation. The Adjustment Grant to a Province was to be equal to the excess, if any, of the expenditure necessary to provide the average Canadian standard of Government services over the revenue that would be derived from taxation of average severity. The amounts were set at a minimum, but were to be subject to increase on review every 5 years. The object was to enable the poorer Provinces to provide a level of social services equal to the Canadian average. But the actual level of service provided by a given Province was to be no concern of the dominion—the latter's responsibility was ended with the establishment of the ability of a provincial government to discharge its responsibilities.

Of the available methods of raising the level of welfare services in all localities in the national interest, the Commission chose the Adjustment Grant for two reasons. First, provincial autonomy was vital because of "the wide differences in social philosophy and economic and social conditions among the Provinces." Second, in social services "local, detailed, and highly personal administration is often required."[2] In matters in which detailed administration was not required or social outlook did not differ sharply—for example, old-age insurance—complete centralization was recommended.

In addition to the Adjustment Grant it was proposed that the Dominion pay an Emergency Grant for a year at a time to any Province in special temporary difficulties. It was proposed that such a grant be paid immediately to Saskatchewan.

DEBT PROPOSAL

Partly to make a clean start, and partly as a quid pro quo for the relinquishing of tax fields by the Provinces, it was proposed that the Dominion assume outstanding provincial debts. The net cost of servicing these was substantial, absorbing over one-fifth of provincial revenues in 1937.

SUMMARY

The financial effect of the Commission's proposals may be summed up briefly as follows: Federal expenditures would be increased by $115 to $125 million by the assumption of $65 million for interest on provincial debt, and $50 to $60 million for relief; Federal expenditures would be reduced by about $6 million on unconditional subsidies, and revenues would be increased by $65 to $75 million through assumption of provincial taxes. The effect on actual subsidy payments is shown in table I.

TABLE 1.—*Federal unconditional subsidies to the Provinces existing in 1938 and proposed by the Rowell-Sirois Commission*

[In thousands of dollars]

	Total of existing subsidies in 1938	Proposed national adjustment grant
Prince Edward Island	657	750
Nova Scotia	1,953	800
New Brunswick	1,567	1,500
Quebec	2,592	8,000
Ontario	2,941	
Manitoba	2,453	2,100
Saskatchewan	5,620	[1] 1,750
Alberta	1,776	
British Columbia	1,625	
Total	21,184	14,900

[1] In addition, Saskatchewan was to have received an emergency grant of $4,000,000.

THE 1941 CONFERENCE

The report of the Royal Commission was presented to the Government in May of 1940. Since the recommendations called for a long-term revision of financial relations between the Dominion and the provinces there were grounds for not endeavoring to implement them in wartime. However, the energetic prosecution of the war effort re-

[2] "Royal Commission," op. cit., Book 11, p. 44.

quired that the Federal Government levy high income taxes and invade tax fields then used only by the Provinces. At least a limited immediate agreement was therefore needed to make possible the maximum use of income taxes and to avoid financial attrition of the Provinces. In November of 1940, Prime Minister King requested the provincial governments to attend a conference "in order to secure, if possible, the adoption of the Commission's recommendations." [3]

To have framed the purpose of the conference in this way may have been a tactical blunder. At the meeting held in January 1941, it became apparent almost at the outset that the recommendations of the Royal Commission were unacceptable to Ontario, Alberta, and British Columbia—the three Provinces not eligible for National Adjustment Grants under the Commission's plan. The Premiers of some of the other Provinces also expressed only modified approval.

The conference broke down on the second day, but two things of importance were achieved. All the Premiers declared their willingness to cooperate with the Dominion in every conceivable way in the prosecution of the war. Secondly, the Minister of Finance, J. L. Ilsley, was provided with a suitable occasion for warning the provinces of the forthcoming severity of wartime taxation. He made it clear that in the existing chaotic condition of provincial taxation the new levies would fall very heavily on the citizens of some provinces. He also stressed that in the absence of a tax agreement the Federal Government could not undertake to compensate the provinces for any fall in revenue resulting from war measures such as the rationing of gasoline, which would lessen the yield of the gasoline tax. The stage was thus set for the temporary coordination of Government finances during the war period.

SUMMARY AND PROSPECTS

The Immediate Task

The two most important tasks to be faced in 1966 in the field of Federal-Provincial fiscal relations are:

(*a*) the development of new tax-sharing and equilization arrangements for the 1967–72 period; and

(*b*) the formulation of a suitable system to succeed the interim opting-out arrangements when they expire in 1967 and 1970.

If one central objective is to stand out above all others in the search for solutions to these two problems, it will surely be to reconcile the conflict between our constitutional concept of provincial identity and purpose and the fiscal policy role of Government in the modern economy. This key objective may well be realized through coordination of programs and cooperation in the development and exercise of fiscal policy. But no such easy and optimistic solution can be assumed. Before these resolving concepts can be applied the current tasks and objectives must be viewed against a background of the more fundamental elements of Federal finance.

[3] *"Dominion-Provincial Conference,"* Jan. 14–15 (King's Printer, 1941) p. v.

The Mechanics of Federal Finance

When governmental responsibility is divided as it is in Canada between central and regional bodies, the effective allocation of public financial resources between the two levels is crucial to the success if not the continuation of the system. This balancing of responsibility and financial resources between Canada and the Provinces has been a continuing task since Confederation, and it is likely to remain so as long as social, economic, and technological change occurs across the nation.

Until recently, however, each new set of Federal-Provincial fiscal arrangements was discussed and drafted mainly on the basis of experience with the preceding arrangements and the political and economic conditions existing at the time negotiations were carried on. Attempts to forecast events over the period new arrangements would run were generally limited to the uncoordinated efforts of individual governments; the one notable exception was the work of the Rowell-Sirois Commission.

In contrast with earlier efforts, the current approach to devising satisfactory fiscal arrangements consists of a coordinated attempt by the Federal and Provincial Governments to forecast economic and political developments over the period of the arrangements and then to tailor a system that will meet these developments as they occur. This method undertakes to approach the problem of making available to each level of government the financial resources required to carry out its responsiiblities effectively, in four preliminary steps:

(*a*) Forecasting government spending programs at each level, including a consideration of amounts that may be needed for fiscal policy reasons as well as those required to meet social demands;

(*b*) Forecasting the cost of carrying out the programs in (*a*);

(*c*) Identifying feasible revenue fields both for Federal and Provincial needs and fiscal policy purposes, and the extent to which these fields may be utilized;

(*d*) Forecasting the yields of the revenue resources determined in (*c*).

FORECASTING PROGRAMS

The history of Federal-Provincial fiscal responsibility in Canada has been compared with the motion of a pendulum, the balance swinging between the two government levels as various factors have had an impact on the economy or security of the nation.

For the first 7 to 8 years following 1867 the National Government overshadowed the provinces, and Federal powers were used to disallow provincial statutes. From 1874 to about 1896 an international economic recession impeded several large national projects, and decisions of the Judicial Committee of the Privy Council strengthened the authority of the provincial legislatures. During this period several Provinces entered the corporation and personal income tax and succession duty fields. From 1896 to 1913 increased economic activity on a worldwide basis and the opening of the Canadian west raised the National Government to a renewed level of importance—a trend that continued throughout World War I until about 1921. From 1921 to

1930, domestic prosperity, world peace and technological advances enabled and required the provinces to again play a more active and in many ways a new role. The automobile brought the provincial highway systems which in turn helped to open up natural resources. Development of hydroelectric power also helped to strengthen the provincial position during this period. Then, beginning with the 1930's came a swing in the direction of stronger Federal power when the depression years nearly bankrupted certain provinces and emphasized the importance of national monetary and banking systems as economic tools. This concentration of power in the Central Government continued throughout the forties, largely because of the national war effort and postwar planning. Since the end of the Korean war, the swing has again been in the direction of the Provinces as peace, prosperity, and technological changes have brought increased demands in the fields of education, highways, and social security. Federal initiatives in these fields, however, together with the unequal incidence of prosperity in different parts of the country, have slowed the swing to the Provinces and at times obscured it.

In addition to these broad sweeps of history, changing preferences for public services bear significantly on the role each level of government is called upon to play. If the demand for public services of a kind constitutionally or conventionally allocated to one level of government rises more rapidly than for those provided by the other, the former's share of total public spending will increase. A first step, therefore, in making 5-year Federal-Provincial fiscal arrangements, is some consensus, or at least understanding, on programs to be expanded or initiated by each level of government over the period. This is a difficult phase. With the rapidity of change in recent years and the virtual impossibility of predicting political developments, neither level of government wishes to have its powers of initiative restricted much in advance. Some consensus does seem essential, however, at least on basic assumptions. In a sense it involves coordination of government policies at the Federal and Provincial levels—a goal now usually described as "cooperative federalism".

FORECASTING THE COST OF PROGRAMS

Once a forecast of programs at each level of government has been established, a separate and more mechanical element in the process must follow—that of forecasting program costs. This is a step that enables the different programs, already approved from a policy standpoint, to be viewed in a practical perspective and ultimately related to revenue sources. As anyone who has been faced with cost forecasting knows only too well, it is a difficult task beset with many imponderables. It is, however, an integral part of the fiscal balancing process in a Federal system of government.

IDENTIFYING AND ALLOCATING REVENUES

The changing productivity and political acceptability of different revenue sources has probably been just as much a cause of fiscal imbalance in Canada as the growth and change in government responsibilities. Real property taxes in Upper Canada were the only significant type of direct taxation in use at the time of Confederation, and the possibilities of this revenue source in a developing economy were as yet unknown. Because of their unpopularity, income taxes were not looked upon as a source which would ever be widely used. While the Provinces at first levied few direct taxes apart from continuing the real property tax at the municipal level in Ontario, they began to adopt them in the early 1890's in the form of succession duties, corporation charges, and income taxes. Perhaps because the possibilities of direct taxation had become somewhat better known by that time, or perhaps because there just was no other way to raise the necessary revenue, the Federal Government moved into the field during World War I and then by agreement took it over almost entirely during World War II. In the early post-World War II period the Provinces, facing rapidly rising costs, devised new sources of tax revenue—particularly the retail sales tax—which they managed to frame to meet the legal requirements of a "direct tax". Both the Federal and Provincial levels now recognize the increasingly remunerative direct tax field as the most likely means of financing their respective programs. Thus negotiation of direct tax allocation, particularly in the income and death tax fields, has come to be largely the stuff of which Federal-Provincial fiscal negotiations are made.

FORECASTING REVENUE YIELDS

As with forecasting the cost of spending programs, the task of determining the yields of different revenue fields is a fundamental part of fiscal planning. In spite of what seems from historical accounts like a fumbling beginning, governments have now become quite skilled in forecasting the yield of different tax sources, providing they can forecast the trend of economic activity with reasonable accuracy. Skills in forecasting the pace of economic activity are developing, and revenue forecasting currently appears to be a less troublesome aspect of fiscal planning than forecasting the cost of services.

POSSIBLE METHODS OF FISCAL BALANCING

Recognizing that a primary objective of Federal-Provincial fiscal relations is to channel to each level of government the financial resources necessary to carry out its programs, the next issue becomes the choice of method to use in resource allocation. There are a number of possibilities.

1. The outright allocation of certain revenue sources to each level of government for its exclusive use. This is a method that has the virtue of apparent administrative simplicity. It would, however, result in an extremely rigid system, not easily adaptable to changing requirements. This method was attempted in 1867 with little enduring success.
2. A loose or uncoordinated arrangement by which each level of government could occupy the different tax fields of its choice at will. While this type of system would leave plenty of flexibility for governments, it would almost certainly result in joint occupation of almost all tax fields without uniformity of tax laws, leaving a nightmare situation as far as taxpayers were concerned.

3. Joint occupancy by both levels of government in all the major tax fields with the use of a system of allocation rules or tax credits to eliminate double taxation. This method would result in a good deal of administrative duplication for both government and taxpayer. It is the prevailing system in the United States.

4. The sharing of tax fields through the use of uniform legislation and a single collection system delegated to one or the other government level. Generally speaking, this is the type of system that has prevailed in Canada in the form of tax-rental and tax-sharing arrangements.

5. A system of central revenue collection and distribution to the different governments on a formula basis. The extreme development of this method would be the Federal collection of all tax revenue and its distribution to the Provinces on the basis of need. The concept of central collection promises administrative efficiency but the problem of devising a distribution system acceptable to all concerned is formidable, to say the least. This alternative would also face serious obstacles resulting from provincial views on their fiscal autonomy.

6. Some combination of the foregoing methods.

Essential as it is, however, to balance revenues and responsibilities at each level of government, this is not the only ingredient in a satisfactory system of Federal finance.

Other Federal and Provincial Objectives

Before agreement on a fiscal system can be reached by Federal and Provincial Governments a wide-ranging and diverse group of other objectives must be sorted out. While the primary duty of government at both levels is to discharge its constitutional responsibilities in as satisfactory a manner as possible, other factors affect the attitude of each toward different methods of carrying out the same programs.

Spokesmen for the Federal Government, for example, have expressed views that revenues should be raised in a manner—

(*a*) That is most likely to maintain a favorable economic environment in the country as a whole;

(*b*) That will allow maximum use of national fiscal policy measures to stimulate economic activity and create employment when necessary;

(*c*) That will enable some element of redistribution of resources to enable the poorer regions of the country to provide a minimum national standard of services; and

(*d*) That eliminates unnecessary tax collection machinery and duplication of requirements made on taxpayers, e.g., duplication of tax returns, etc.

Provincial government spokesmen, on the other hand, have stated—

(*a*) That the only way the Provinces can effectively remain responsible for their own constitutional responsibilities is to raise the revenue needed to discharge them;

(*b*) That Federal intervention in the determination of provincial revenue policy is undesirable interference with provincial self-government;

(c) That provincially imposed and collected taxes can enable the Province to encourage economic growth within its jurisdiction; and

(d) That equalization of provincial resources based on fiscal capacity is or is not a desirable objective, depending on a particular government's point of view.

The Problems of Unequal Provincial Resources

This chapter has centered upon Federal-Provincial revenue-expenditure "balancing" as an essential feature of fiscal relations between the two levels of government. There remains, however, another balancing problem that has long been regarded as crucial to Canadian federation—the question of adjusting uneven public resources at the provincial level.

From the time of Confederation some Provinces have had stronger and more stable fiscal foundations than others. The idea of Federal contributions toward the equalization of fiscal capacity and fiscal need first appeared in the establishment of the Confederation payments now known as statutory subsidies.[1] Changes in these subsidies have been almost continuous since 1867.

Section 118 of the B.N.A. Act, after setting out a scale of Federal payments to the Provinces totaling $260,000 annually, goes on to say: "Such grants shall be in full settlement of all future demands on Canada . . ." A second so-called final adjustment by the Laurier government in 1907 further recognized the particular needs of the Maritime and Western Provinces, but the changing conditions made continued alterations a more practical course. With the coming of the depression in the 1930's the Maritime Provinces received additional subsidies of about $2¼ million per year.[2]

Provincial hardships and the resulting Federal role during the depression years gave rise to the fiscal need grant recommendations of the Rowell-Sirois Commission in 1940. At the 1941 conference the Provinces were not willing to pay the price of the Commission's proposals in terms of relinquished taxing and other powers, but owing to the emergency of World War II they were obliged in the corporation and income tax fields to step aside until 1946. Then came what some regard as the "Ottawa knows best" philosophy reflected in the 1947 and 1952 tax agreements and the rise of conditional grants and shared-cost programs in the fields of health, social welfare, highways, and education.

A revolutionary new concept of redistributing funds among the Provinces took effect in the 1957 arrangements. Until this time, provisions for Federal redistribution of provincial revenues had been built into the tax rental system and thus were available only to Provinces that signed tax rental agreements. In 1957 redistribution took the form of a quasi-scientific equalization formula by which the Federal Government agreed to make supplementary payments in amounts necessary

[1] See ch. I.

[2] An idea of the role of Federal payments and their varying importance to different provinces in the 1930's may be gained from the fact that in 1937 they represented the following percentages of total provincial revenue: Prince Edward Island 41 percent, New Brunswick 20 percent, Quebec 4.5 percent, Ontario 3 percent, Saskatchewan 33 percent, and British Columbia 5 percent.

to bring every Province's per capita yield from the uniform provincial share of the three standard taxes up to the average level in the two wealthiest or highest-yielding Provinces. Such payments were made regardless of whether a Province accepted the uniform provincial share of the standard taxes or levied and administered its own rates. The introduction of unconditional equalization in 1957 gave a considerably greater measure of fiscal freedom to the poorer or lower capacity Provinces since it assured their equalization payments and made the choice between signing a tax rental agreement or levying and administering their own taxes a more realistic one.[3]

Although the 1957 formula of equalization was regarded by the Atlantic Provinces, Manitoba and Saskatchewan as a step in the right direction, it was also viewed by these Provinces as deficient in two respects: (*a*) the provincial share of the three standard taxes was considered to be too narrow a base for equalization purposes, and (*b*) the formula was inadequate since it did not bring all Provinces up to the level of the richest one. (The latter objection may have been voiced on occasion only with the intention of illustrating the feeling of unequal opportunity that existed in some Provinces.)

The original equalization concept has remained unchanged since 1957 but the formula has been altered on a number of occasions. The Diefenbaker government added provincial natural resource revenues to the base in 1961 and changed the level from the top two Provinces to the national average. On resuming office in 1963 the Liberals returned to the top two Provinces' average yield from the standard taxes and retained resource revenues as a payment adjustment. All increases since 1957 in the provincial share of the standard taxes have been incorporated into the equalization base except the additional 25 percent share of estate tax granted in 1964. The Atlantic Provinces Adjustment Grants were also incorporated into the guaranteed equalization base from 1962 but the special grant to Newfoundland was not.

Although Quebec governments have always been relatively silent on the subject of equalization and have preferred to raise the topics of tax room and provincial autonomy in their discussions with Ottawa, the Province has always been a source of Federal difficulty when it came to working out a satisfactory equalization formula. As the principal exception to the Canadian pattern of the big Provinces being rich and the small Provinces poor, Quebec has always stood to receive by far the largest Federal payment under any general formula of fiscal capacity grants. Since the concept of equalization to the level of the wealthier Provinces is practical only if the poorer ones are relatively small, the Quebec situation has created a dilemma for Ottawa.

The original 1962 fiscal arrangements appear to have been partly designed to alleviate this problem. The general equalization formula was moderated by changing from the level of the two top Provinces to the national average and by adding natural resource revenue to the base. (Except for New Brunswick, Quebec had the highest per capita natural resource yield among the low fiscal-capacity Provinces—see table 16.) In addition, the Atlantic Provinces Adjustment Grants effected a redistribution of funds to those four Provinces out-

[3] For a fuller discussion see "The Historical Development of Federal Provincial Fiscal Relations," by J. H. Perry. *Canadian Public Administration,* March 1962.

side the general equalization formula. The 1962 equalization formula did prove to be a moderating one (total equalization payments declined in 1962–63 and again in 1963–64, and Quebec's payment continued to rise only sligthly).

The return in 1964 of equalization to the top-two-Province average brought a sharp rise in the total amount of equalization, with over half of the increase going to Quebec. British Columbia and Ontario were the losers under the increased redistribution, since all others received more while nothing went to them. However, had the natural resource component in the formula not been changed in 1964 when the level was raised, Ontario would have become the recipient of Federal equalization payments (see table 16).

The impact of the 1962 arrangements and 1964 adjustments on the equalization payments are reflected in the per capita increase or decrease in the subsequent years.

TABLE 24.—*Per capita increase (decrease) in equalization payments,[1] years following the 1962 arrangements and 1964 adjustments*

	1962–63 over 1961–62	1964–65 over 1963–64
Newfoundland	$0.24	$8.93
Prince Edward Island	7.04	6.60
Nova Scotia	(1.51)	5.60
New Brunswick	(2.28)	7.98
Quebec	.64	4.44
Manitoba	.85	4.36
Saskatchewan	(.45)	3.33

[1] Figures do not reflect stabilization payments or Atlantic Provinces Adjustment grants. (See table 25 for per capita figures on total redistribution payments.)

Source: Based on figures in table 25.

Table 25 illustrates the distribution of equalization, stabilization and adjustment grant payments since 1957 and gives each Province's share of these payments in per capita terms and as a percentage of provincial net general revenue.

TABLE 25.—*Distribution of equalization and stabilization payments and adjustment grants including Newfoundland additional and transitional grants, 1957–58 to 1965–66*

[Dollar amounts in millions except per capitas]

	1957–58	1958–59	1959–60	1960–61 [1]	1961–62 [1]	1962–63 [1]	1963–64 [1]	1964–65 [1]	1965–66 [2]
Newfoundland:									
Equalization	$11.8	$12.6	$14.6	$12.5	$13.2	$13.7	$13.9	$19.1	$22.6
Atlantic Provinces adjustment, transitional, and additional grants	8.0	15.5	15.5	15.5	15.5	18.5	18.5	18.5	18.5
Total grants	19.8	28.1	30.1	28.0	28.7	32.2	32.4	37.6	41.1
Total grants, per capita [3]	46.72	65.06	68.28	62.53	62.74	68.50	67.29	76.63	83.10
Total grants as a percent of net general revenue	50.2	45.1	50.0	43.5	41.7	42.3	40.1	42.0	----------
Prince Edward Island:									
Equalization	$3.1	$3.1	$3.5	$3.0	$2.8	$3.6	$3.9	$4.7	$5.5
Stabilization	.3	.2	----------	.2	.1	----------	----------	----------	----------
Atlantic Provinces adjustment grants	----------	2.5	2.5	2.5	2.5	3.5	3.5	3.5	3.5
Total grants	3.4	5.8	6.0	5.7	5.4	7.1	7.4	8.2	9.0
Total grants, per capita [3]	34.26	57.66	58.94	55.47	51.84	67.12	68.96	77.04	82.94
Total grants as a percent of net general revenue	35.9	45.9	43.1	35.5	30.4	37.1	38.4	39.0	----------
Nova Scotia:									
Equalization	$17.2	$18.7	$20.3	$19.1	$18.6	$17.7	$20.2	$25.5	$30.2
Atlantic Provinces adjustment grants	----------	7.5	7.5	7.5	7.5	10.5	10.5	10.5	10.5
Total grants	17.2	26.2	27.8	26.6	26.1	28.2	30.7	36.0	40.7
Total grants, per capita [3]	24.47	36.96	38.70	36.62	35.41	37.79	40.62	47.41	53.44
Total grants as a percent of net general revenue	26.6	34.6	30.7	28.9	25.5	24.8	26.9	28.9	----------
New Brunswick:									
Equalization	$8.6	$15.1	$17.1	$16.1	$16.5	$15.4	$16.8	$22.5	$25.9
Atlantic Provinces adjustment grants	----------	7.5	7.5	7.5	7.5	10.5	10.5	10.5	10.5
Total grants	8.6	22.6	24.6	23.6	24.0	25.9	27.3	33.0	36.4
Total grants, per capita [3]	15.31	39.58	42.25	40.06	40.21	42.69	44.39	53.50	58.55
Total grants as a percent of net general revenue	14.0	31.8	31.8	27.2	28.5	28.8	28.6	32.0	----------

See footnotes at end of table, p. 424.

TABLE 25.—*Distribution of equalization and stabilization payments and adjustment grants including Newfoundland additional and transitional grants, 1957–58 to 1965–66*—Continued

[Dollar amounts in millions except per capitas]

	1957–58	1958–59	1959–60	1960–61 [1]	1961–62 [1]	1962–63 [1]	1963–64 [1]	1964–65 [1]	1965–66 [2]
Quebec:									
Equalization	$43.3	$60.2	$74.7	$64.7	$67.4	$68.9	$69.9	$99.0	$117.0
Total grants, per capita [3]	9.08	13.28	14.86	12.59	12.82	12.85	12.78	17.81	20.80
Total grants as a percent of net general revenue	8.4	12.8	12.3	10.1	8.9	8.0	7.4	8.8	----------
Manitoba:									
Equalization	$14.2	$13.4	$14.7	$13.2	$12.9	$13.9	$14.3	$19.2	$22.4
Total grants, per capita [3]	16.47	15.35	16.52	14.54	14.02	14.87	15.06	20.09	23.29
Total grants as a percent of net general revenue	19.3	17.5	14.7	12.7	10.9	10.6	10.5	13.1	----------
Saskatchewan:									
Equalization	$20.3	$20.3	$23.4	$21.6	$23.0	$22.7	$22.1	$25.0	$28.7
Total grants, per capita [3]	23.03	22.79	25.83	23.62	24.82	24.37	23.65	26.53	20.38
Total grants as a percent of net general revenue	14.9	14.4	16.1	14.5	14.7	11.3	10.0	11.2	----------
Alberta:									
Equalization	$12.0	$13.5	$16.4	$15.3	$14.0	$11.8	$6.4	$0.4	----------
Total grants, per capita [3]	10.33	11.17	13.16	11.83	10.50	8.61	4.58	0.26	----------
Total grants as a percent of net general revenue	4.9	5.7	5.9	6.2	5.1	4.0	2.3	.1	----------
British Columbia:									
Equalization	$5.5	$6.7	$5.9	$6.0	$5.8	----------	----------	----------	----------
Stabilization	3.8	2.3	----------	1.5	.1	----------	----------	----------	----------
Total grants	9.3	9.0	5.9	7.4	5.9	----------	----------	----------	----------
Total grants, per capita [3]	6.28	5.84	3.77	4.62	3.61	----------	----------	----------	----------
Total grants as a percent of net general revenue	3.3	3.0	1.9	2.3	1.7	----------	----------	----------	----------
Total equalization grants	$136.0	$163.6	$190.6	$171.5	$174.3	$167.7	$167.4	$215.6	$252.1
Total stabilization grants	4.1	2.5	----------	1.6	.2	----------	----------	----------	----------
Total Atlantic and Newfoundland transitional and Provinces additional grants	8.0	33.0	33.0	33.0	33.0	43.0	43.0	43.0	43.0
Total grants	148.1	199.1	223.6	206.1	207.5	210.7	210.4	258.6	295.1

[1] Figures subject to future adjustments.
[2] 1st estimate.
[3] Estimated population at June 1; 1965–66 at Jan. 1.

Source: Department of Finance; DBS "Financial Statistic of Provincial Governments' Revenue and Expenditure."

The Provinces with lower fiscal capacities have traditionally argued for increased equalization payments. Other Provinces, however, have resisted greater revenue redistribution for a number of reasons, chief of which are probably the following:

(*a*) The belief that more slowly developing areas, particularly those with less urban development, have not the same need for some Government facilities or at least do not need them as rapidly as other areas; i.e. the idea that provincial and municipal government should keep pace with overall economic development (this point has been stressed by Ontario).

(*b*) The possibility that at least some Government services are relatively less costly to provide in lower income areas.

(*c*) An overall shortage of available funds and the reluctance of the more wealthy Provinces to see the equalization concept carried too far too quickly, since they see the revenue as coming from them. (It has been pointed out how impractical complete equalization to the top Province would be if that Province also happened to be a small one.)

(d) Greater redistribution might retard optimum overall economic growth.

Equalization and Tax Sharing

The tax-sharing arrangements of 1957 instituted the use of a single base both for Federal-Provincial sharing of the major taxes and for calculating equalization payments. Since 1957, however, some previously mentioned exceptions to the coupling of tax sharing and equalization have emerged. While these have not been major exceptions in dollar terms, they illustrate the possibility of departing from the basic coupled formula of 1957, thus making room for a fuller development of the sharing and equalization concepts in future agreements. A number of interesting alternatives exist, should it be decided to allow the Provinces an increased proportion of revenues after 1967. Some samples are as follows:

(*a*) The 1966 equalization base of 24-9-50 with the resource revenue adjustment could be maintained, but the Provinces could receive a higher percentage of the yield of one or more of the three shared taxes or a portion of other Federal revenues; for example, Federal sales taxes or excises could be reduced, making room for increased provincial benefit from these fields. This alternative would amount to further sharing without corresponding equalization, a possibility that would appeal to the wealthier Provinces since it would probably result in greater proportional revenue increases for them. A precedent for this type of adjustment to the Federal-Provincial arrangements was the increase in the provincial share of estate taxes from 50 to 75 percent on April 1, 1964, without a corresponding adjustment to the equalization base.

(*b*) The equalization base could be broadened to include other non-shared revenue sources (in addition to provincial resource revenues), without changing the basic 1966 formula for sharing major taxes. This possibility could result in extended equalization without corresponding tax share increases for the Provinces. It might for example bring the yield from a uniform provincial sales tax levy into the equalization base. The success of this scheme would depend on the continuing capacity of the Federal Government to make equalization payments without sharing in the revenue sources upon which they were based. A precedent of general application for this type of adjustment would be the original introduction of natural resource revenues into the equalization base in 1962. (Other examples of revenue redistribution without tax sharing are the Atlantic Provinces Adjustment Grants and the special grants to Newfoundland.) This type of adjustment would be likely to appeal to the low-capacity Provinces since it would result in a greater redistribution of funds.

(*c*) The level of equalization in respect of different types of tax revenue could be varied. For example, personal income taxes could be equalized to the level of the highest yielding Province while corporate yields could be brought to the national average.

(*d*) Any provincial revenue source could be used as a basis for adjustment to the equalization payment (after the fashion of the resource revenue adjustment instituted in 1964). The result of any such adjustment would, of course, depend upon its nature.

(*e*) The equalization level could be raised to the level of the Province with the highest revenue yield, with or without payment adjustments or limitations of the kind based on resource revenues imposed in 1964. A formula of this kind without adjustments could normally be anticipated to be costly for the Federal Government and the wealthiest Province (which Province this would be would depend upon the revenue sources used in the formula). With the proper payment limitations, however, this alternative holds the possibility of basing equalization on the level of the wealthiest Province without actually increasing the total amount of equalization payments. It is worthwhile to observe in this respect that while equalization to the average level of the top two Provinces may normally be expected to give payments to nine Provinces (all but the top one), only seven actually receive payments under the 1964 formula because of the resource revenue adjustment.

(*f*) Payments bridging the gap between fiscal capacity and fiscal need could be introduced into the equalization formula, perhaps utilizing per capita personal income or provincial per capita yield from a model provincial revenue system for measuring fiscal capacity. Since no satisfactory measurement of fiscal needs seems likely to be found and as equalization of capacity without recognition of variations in need seems illogical, idealistic solutions of this kind have their limitations.[4]

(*g*) The cost-sharing bases of joint programs could be varied among Provinces depending on their ability to participate. This possibility has long been resisted by Ottawa on the basis that it would splinter and complicate Federal-Provincial relationships. An example of varying conditional grants does already exist, however, in the hospital insurance arrangements.

A final observation on all equalization schemes based on adjustments to the standard tax yields or tax shares concerns the neutralizing effect

[4] Any detailed discussion of fiscal capacity and fiscal need grants is necessarily omitted from this general summary. For reference see Eric J. Hanson: *The Fiscal Needs of the Canadian Provinces*, Canadian Tax Foundation, 1961 and *The Public Finance Aspects of Health Services*, Appendix G. "Fiscal Capacities of Provincial Governments". The Royal Commission on Health Services, Queen's Printer, Ottawa, 1965.

they have on the arbitrary tax allocation rules used to distribute the provincial share of the major taxes. Under the current equalization formula, for example, if corporation income tax is allocated in unrealistic measure to the wealthier industrialized Provinces, the poorer ones benefit almost correspondingly. Consequently, equalization based on the shared tax yields helps to avoid potential disagreement over different allocation methods.

Some Requirements of a Solution

In summary, if new fiscal arrangements are to be successful, they must meet the following objectives to some degree.

1. The Federal Government and each of the Provinces should have the financial resources necessary to fulfill their respective responsibilities without levying taxes that are judged to be undesirably high relative to the taxes in other Provinces, taking into account the level of services rendered by each. Within this framework there should also be some room for a Province to choose a different level of services and taxation.
2. The arrangements must respect the autonomy of the Provinces and in so doing preserve the financial responsibility of the provincial governments. More specifically, they must—
   (*a*) Provide for some fiscal transfer to low fiscal-capacity Provinces; and
   (*b*) Accommodate Quebec's desire to steer an independent course.
3. The overall tax system should be as efficient as possible. For example:
   (*a*) Each type of tax should be administered by the level of government best suited to do so;
   (*b*) The cost of tax collection and of compliance with tax laws should be kept as low as possible;
   (*c*) The most economically harmful forms of taxation, particularly of corporations, should be eliminated; and
   (*d*) There should be no overlapping of provincial taxes; in practice this means keeping competing Provinces from occupying the same tax base. (This should not be confused with joint occupancy of the same tax base by two levels of governments.)
4. The financial arrangements must be adaptable to—
   (*a*) A long run growth in the responsibilities of one level of government relative to the other level; and
   (*b*) Sudden changes and crises—the Federal Government must be able to expand its tax fields in time of national emergency.
5. The system should allow optimum scope for countercyclical fiscal policy measures particularly at the national level, and also on a cooperative basis among the Provinces and the Federal Government.
6. The overall system should aim toward the achievement of currently acceptable concepts of tax equity and tax incidence and should facilitate whatever degree of redistribution of income among individuals that may be expected from the tax system.

Views on Recent Arrangements

Recent Federal-Provincial arrangements measure up fairly well on this scale of requirements for a satisfactory system. However, some old and newer cracks appear in the plaster.

1. Federal occupancy of the direct tax fields coupled with constitutional restrictions on the taxing powers of the Provinces have left the Provinces little room for flexibility in formulating their tax systems. While recent Federal-Provincial arrangements have recognized increasing provincial need and allocated an increased share of revenues to the Provinces, too much use of the personal income tax has been made for this purpose. Even with provincial inability to levy indirect taxes, Federal revenues from alcohol and tobacco, for example, could be shifted to the Provinces through the provincial tobacco taxes and liquor store operations.

2. Until 1964 it could be said that the Federal Government was continuing to play a "guardian role," preferring to work out programs of conditional assistance with the Provinces rather than to vacate tax fields in their favor or make available more unconditional assistance. While the conditional assistance programs raised questions of provincial autonomy, they did spur Provinces to introduce more and better services than they might otherwise have provided. The recent opting-out arrangements are considered to be interim, but now that they have been established it is unlikely that there will be a reversal in the trend. The major question remaining is: how much further will the Provinces care to press the issue once the interim period is over and with what consequences for the effectiveness of national fiscal policy?

3. Administrative duplication and lack of a uniform tax base result in an inefficient cultivation of the sales tax field in Canada. The administration by one government level of a uniformly based retail tax combining a basic Federal rate and a supplementary rate levied by each Province to meet its own needs could benefit Government and taxpayer alike. If the tax were to be provincially administered, an improvement in current provincial practices covering interprovincial and international transactions would be necessary.

4. Long lived Federal-Provincial joint occupancy of the death tax field has added to the awkwardness of the tax system. At the present time the three largest Provinces administer their own provincial succession duties. Quebec has repeatedly protested Federal occupancy on the grounds that the transfer of property comes under provincial jurisdiction. The Federal Government countered in 1959 by imposing an indirect estate tax, a kind of levy outside the provincial authority. The Federal offer to increase the estate tax abatement to 75 percent in the sake of uniformity and as a device for helping to administer the Provinces as long as the Federal position in the field is maintained for the sake of uniformity and as a device for helping to administer the income tax. The continued joint occupancy in three Provinces, however, leads to administrative duplication for taxpayers and Government alike.

5. The trend toward greater occupancy of the personal income tax field by the Provinces has left the Federal Government with a less

flexible revenue system.[5] Federal flexibility is particularly important in the event of national emergency and in the employment of countercyclical fiscal policy techniques. With a satisfactory level of employment and national development apparently so dependent on such measures, the importance of this factor cannot be underrated. It is difficult to say, however, just what proportion of the different major taxes must be left in Federal hands to allow an adequate degree of flexibility at the national level. It might be argued, for example, that a 30-percent Federal occupancy of the personal income tax field would allow the Central Government to raise necessary amounts of new revenue or to reduce income tax by up to 30 percent as a fiscal policy measure. On the other hand, if unanimity of purpose at the Federal and Provincial levels cannot be achieved on important issues in the future, a 30-percent occupancy by the Central Government would likely be insufficient either to sustain strong central leadership or to offset provincial programs that may conflict with the economic objectives of the Federal Government. In conclusion, it would seem that the optimum desirable provincial occupancy of the personal income tax field has already been reached in 1966.

Conditional Grants and Joint Programs

Once relegated to the sidelines in the negotiation of Federal-Provincial fiscal arrangements, shared-cost programs have emerged in recent years as a central issue that will assume new importance in the forthcoming discussions. One reason for this new role is the tremendous growth that has occurred in conditional grants made to the Provinces under these programs.[6] A more important aspect of shared-cost programs to be reckoned with, however, concerns the future course of the Ottowa-Quebec relationship, the interim opting-out legislation and its successor provisions.

Growth in the relative importance of conditional grants rising from 19 percent of total Federal payments to the Provinces in 1955 to 72 percent a decade later, resulted in large measure from two developments over this period. These were—

(*a*) The demise of the tax rental payments and their replacement with the Provinces' own levies in the major tax fields; and

(*b*) The preference by Ottawa to use "purse power" assumed during World War II to coordinate and stimulate provincial programs rather than give further "tax room" or make greater unconditional payments to the Provinces.

Through the adroit use of conditional grants the Federal Government has been able to gain and hold the initiative for instituting a wide range of services at the provincial level. Some aspects of this system have been a source of discomfort for the Provinces, and the

[5] An example of this inflexibility was the complicated method the Federal Government was obliged to use in implementing its 1965 10-percent personal income tax cut so as not to disturb provincial revenues.

[6] Federal payments to the Provinces under the Hospital Insurance and Diagnostic Services Act alone have risen from \$54.7 million in 1959 to about \$419 million in 1965. In 1964, payments under this program accounted for almost 35 percent of all Federal conditional and unconditional payments to the Provinces. The nationwide implementation of the hospital insurance program by 1961 together with the expiry of the last tax rental agreements shortly afterward, significantly changed the complexion of Federal grants to the Provinces. In 1962 conditional grants surpassed unconditional payments for the first time by some \$65 million.

Premiers have voiced their objections on a number of occasions. The substance of the grants, however, has made their form tolerable for all but Quebec. Premier Duplessis often chose to forego the benefits rather than subject his Province to the humiliation of accepting direction from Ottawa on matters where it had the constitutional right to govern itself. Mr. Lesage was no more enamored of conditional grants than his predecessor, but his unwillingness to forego the benefits first brought him to participate and later was the main factor leading to the opting-out arrangements of 1964–65.

The current interim provisions covering Quebec's opting out of shared-cost programs will expire during the course of the next 5-year arrangements (if indeed 5-year arrangements any longer exist) and successor provisions must form part of the overall fiscal plan. The role of conditional grants in the overall Federal-Provincial relationship, as distinct from the purely fiscal relationship, will probably loom greater in the forthcoming negotiations than ever before. Shared-cost programs have been viewed by some as ideal Government cooperation—the coordination of the resources of two government levels for the provision of badly needed services. Others have regarded them only as Federal legislation regulating provincial activity in fields that are the Provinces' own constitutional responsibility. One thing does seem certain—shared-cost programs have enabled the Federal Government to accomplish a combination of objectives that otherwise would not have been possible.[7]

Canada—A Model for Progress?

The Canadian experience in financing the federal form of government is being examined closely by both emerging and highly developed Federal States around the world. (The American "Heller Plant,"[8] for example, would utilize tax-sharing arrangements similar to those developed in Canada.) More than ever before, cooperation at every stage from research to legislation is necessary if success with the federal form of government is to be achieved. And, at this important juncture of the history of federalism in this country, the very existence of the Tax Structure Committee and the joint studies it is conducting are evidence of an increasing awareness in Canada of the need for cooperation.

[7] "It is a matter of some interest to note that the conditional grant in Canada has developed more in isolation than as a conscious part of joint fiscal policy.

Programs tend to be developed at the level of operating departments. It would not be too much to say that up until fairly recently in most cases Treasury control has been more honored in the breach. However, regardless of our views of their place in fiscal policy, there can be no doubt that a tremendous amount of national development has taken place through these programs that would not otherwise have been possible, and provincial standards of performance (and not only in the less wealthy areas) have benefited to a very substantial extent."—"Inter-governmental Relations in Canada—Further Developments"—R. M. Burns, *National Tax Journal*, March 1965.

[8] This was a proposal advanced by Walter W. Heller, Chairman of the U.S. Council of Economic Advisers from 1961 to 1964, that a share of Federal income tax receipts be transferred to the States (or to State and local governments).

THE HISTORICAL BACKGROUND AND DEVELOPMENT OF FEDERAL-PROVINCIAL FINANCIAL RELATIONS (IN CANADA)*

BY J. HARVEY PERRY

To give a brief dissertation on the historical background and development of Federal-Provincial relations is not an impossible task, but it is very difficult to do except in rough and ready fashion. However, it is worth trying, because our Federal-Provincial arrangements at any point of time when taken out of their context usually look pretty strange. Often it appears that we are moving convulsively in one direction or another, whereas only a fairly modest shift has been made in a prior course.

The basic problem of Federal finance of course is that all governments need funds to carry on. This is not particularly a characteristic of governments in federations, since in this respect governments are the same in any form of political organization, and the battle for the revenue dollar is fairly fierce. The difference in a federation, however, is that with so many more governments engaged in the struggle there have to be ground rules. These rules are quite evident in the Canadian federation, and I propose to examine our history largely in the light of them.

What are these rules?

First—the competition among the stronger governments must not become so disorderly that it wrecks the economy. This we can call tax organization.

Second—in the process of dividing the available revenues, a conscious effort must be made to see that the weaker members of the family of governments are given special consideration. The experts refer to this as fiscal need.

In our long history of experience with Federal financial arrangements, the first rule—avoiding chaotic competition in taxation—is of relatively recent origin. The other rule—help for the less prosperous Provinces—has been there from the beginning.

It should also be mentioned that there have been at least two additional factors that have conditioned the application of these rules. One of these might be termed an assumption, or presumption, that "Ottawa Knows Best." Even in a federation there has to be some element of leadership, and this has frequently appeared in the inauguration by Ottawa of new programs alleged to be for the benefit of the whole country, or the proposal of fiscal arrangements for reasons of economic control.

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*Reprinted from *Canadian Public Administration*, March 1962, vol. V, No. 1. This paper was presented to the 13th Annual Conference of the Institute of Public Administration of Canada, Sept. 6 to 9, 1961, Ste. Foy, Quebec.

The other conditioning factor has been the historic imperative of paying regard to provincial autonomy and in particular for the special interests of Quebec. In a sense this has offered a counterpoise to the "Ottawa Knows Best" assumption. We are more fortunate than we realize in having a hard core of provincial autonomy that simply will not be assimilated into a uniform pattern of government inspired from Ottawa. The pull of the center is now so strong that we are lucky to have some continuing strong element of resistance to it. Otherwise in no time we would have one big government.

Given this general background, how have things worked out in actual practice?

We can divide our history into three broad periods since 1867 which show one or more of the distinctive characteristics I have mentioned. In fact, one could sum up the evolution as an increasing attention to all the basic rules and conditions postulated. At the outset the emphasis was primarily on one condition, that of fiscal need, but now all four—tax integration, fiscal need, Ottawa leadership and provincial autonomy—are given prominent recognition. No wonder the formulas became more and more complicated each decade.

Going back to the beginning, we can see signs of tax organization and fiscal need in the original arrangements.

Tax organization appeared in the surrender of provincial customs duties to the Federal Government and the allocation of tax sources between governments—provincial direct only—Federal any source. To my mind this is just as sensible an arrangement now as it was then. Fiscal need appeared in the establishment of what are now statutory subsidies, under which, despite superficial effort to give equal treatment, some provinces were favored relatively over others.

The succeeding half century—say until the introduction by the Federal Government of the Excess War Profits Tax Act in 1916—was characterized by intense activity on the fiscal need front and relative calm regarding tax organization. Nearly every 2 or 3 years some adjustment was made in the statutory subsidy grants from Ottawa, usually in favor of the weaker economic areas. These were quite inadequate toward the end of the century to meet increasing pressure on provincial budgets, and some provinces began to use their tax powers. This was tactily encouraged by Ottawa by its abstention from direct taxation, but after 1916 this period ended. The war forced Ottawa into direct taxation, and it has been in it ever since. In fact, even the Premier of British Columbia recently conceded that Ottawa was probably in to stay—from that Province a notable admission.

The second general phase I should say extended roughly from the end of World War I to the beginning of World War II. It was characterized by a growing disorganization of the tax structure, ending in the almost chaotic conditions of the late years of the depression, some rather striking signs of recognition of special provincial needs, and some small beginnings of the "Ottawa Knows Best" philosophy. The fact that half this phase was in a period of boom, during the twenties, and the other half in a period of depression, during the thirties, concealed the nature of fairly fundamental changes that were taking place.

During this phase it became amply apparent that the revenue sources given the provinces would be quite inadequate unless exploited on a scale not foreseen at Confederation. All during the twenties, new provincial taxes were being imposed, and this was tolerable because Federal taxation was gradually being reduced and had almost disappeared by 1929. But came a challenge like the depression, with all governments raising rates and exploiting new sources, tax organization virtually broke down. It is probably this experience of the depression years that is still the prime factor in making our governments so conscious today of the dangers of letting the tax system run riot.

The striking instances of fiscal need recognition, during this period, were the additional subsidies paid to the Maritime Provinces under the so-called Duncan and White awards. These are the direct predecessors of the present Atlantic Provinces grants, and incidentally are still being paid, buried away now in the maze of the statutory subsidies. Special assistance also had to be provided the Western Provinces during the drought years, which are back with us again. There is very little new under the sun in Federal-Provincial relations.

The one feature of this phase between wars that was relatively new was the introduction of the first large scale shared-cost social security measure. This would come under the Federal leadership heading, and took the form of old-age pensions on a means test basis commencing in 1927 on a 50–50 basis, later raised to a 75-percent Federal contribution. A precedent for shared-cost programs was vocational education inaugurated before World War I, but the old-age pension plans was the real forerunner of our present array of social security measures.

The third broad phase of development started with the Rowell-Sirois Report of 1939 and the Wartime Tax Agreements and has been in progress ever since. It is for us, of course, the most interesting and in many ways the most instructive. In this era, now completing its third decade, almost every major premise of Federal finance has reached full flower—indeed at the present time they can all be identified more clearly than ever before.

Take tax organization, for example. The wartime tax agreements were the ultimate in tax planning and integration, because they simply froze all parts of the system but the Federal, which was given free scope to expand to meet wartime requirements. The subsequent Tax Rental Agreements and the Tax Sharing Arrangements were also ingenious devices for maintaining a well-managed tax system while leaving one or two Provinces relative freedom of action. The new arrangements for 1962–66 only superficially abandon the basic concept of the tax rental system. It is very doubtful if the pattern that emerges in the next few months will be much different in substance from that which has prevailed now for three decades.

The largest change has come about in the realm of fiscal need. Where all previous efforts to recognize the special disabilities of some sections of country were rather rough and crude, in recent years we have approached something like a scientific formula, even though a partial one. The leveling up effect of the equalization payments, which raise the per capita revenues of all Provinces from certain taxes to a common standard, are a far cry from any previous crude measures. In addition, the Atlantic Provinces' special grants, while in a familiar pattern, are more significant in amount than any previous grants of the same type.

The "Ottawa Knows Best" premise has had a checkered history during this time. Even during the war some brave steps were taken, such as the inauguration of unemployment insurance, and immediately after the war we had family allowances. Much of the argument in support of continuing central control of the main taxes following the war was based on the proposition that Ottawa's plans for stabilizing the economy required such control. The reasons this position was abandoned are obscure and involved, but the fact is that nothing has been heard of the gospel in some time. The most probable reason is the discovery that the massiveness of a budget as large as the Federal neither allowed nor required the sort of tinkering with taxes that was thought scientific immediately after the war. Now the Federal budget acts like the gyro deep in the bowels of the ship, taking the shock of the big rolls in the economy, rather than as a rudder by which it can be steered from place to place.

There is also the point of course that even the new tax arrangements with the Provinces will fairly well stabilize the main direct tax elements in the tax system for another 5 years. Despite the increase in its financial liabilities to the Provinces and the fairly inflexible areas of taxation being guaranteed to the Provinces, it is still the Federal Government that will enjoy the greatest latitude in its taxing powers—which of course is as it should be in view of its enormous responsibilities in these times.

Finally, on the matter of provincial autonomy, I think we have made some progress in recent years. As much by oversight as anything—certainly I do not believe it was by design—the tax rental agreements had drifted into a position where a Province could only stay out at considerable financial sacrifice. This was bad, because it meant that there was undue pressure to conform. The 1957 agreements overcame this feature completely, and the new arrangements go even further toward autonomy by forcing the Provinces to levy their own taxes. Based on previous experience any tax of which it can be said that it is being levied as the result of the actions of the Federal Government gets by a provincial legislature fairly easily, but the exercise will be a salutary one in any event. At least Mr. Fleming will derive some comfort in knowing that he and Mr. Lesage will now be joined by nine other Treasurers in having to explain the intricacies of a modern Income Tax Act.

Summing up, in my opinion we are closer to giving recognition to all the fundamental requisites of a Federal system of finance at the present time than we have been ever before. There are still many shortcomings, but in a world in which relations between governments are often highly irrational, our own Federal-Provincial relations are a bright spot.

RECENT DEVELOPMENTS IN FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS IN CANADA*

BY R. M. BURNS**

Government in any form and at any level can be a supreme test of most human virtues in these days of advanced scientific and retarded sociological development. I suspect that these difficulties are not made the less by the stresses and strains of the conflicting jurisdictional interests of a Federal system, under which Canada and the United States both must operate.

We are concerned here only with current developments in Canada, a country which has taken, in recent years, a somewhat different path toward intergovernmental cooperation than has the United States. In this connection, it is necessary to make very brief reference to what has passed in history. British North America in pre-Confederation days was made up of a number of British Colonial possessions, Canada (which was a composite of Ontario and Quebec, or Upper and Lower Canada as they then were), Nova Scotia, New Brunswick, Prince Edward Island, and Newfoundland.

It was no easy process by which the colonies in Canada became one federation in 1867. In fact, on more than one occasion both before and after the event the continued success of the Union was a doubtful and speculative investment. But it did come about and it did remain and from the original four, Ontario, Quebec, Nova Scotia, and New Brunswick, have come the present 10.

There were, of course, the usual motivations of commercial advantage in confederation, and this was true in substantial measure in the concept of Maritime Union, which was first considered by the Provinces other than Canada, but in addition there had developed a need for identity. Particularly this was so by reason of the ever-increasing power of the United States, then a somewhat less benevolent neighbor than today.

Canada was born as she has lived, in compromise. The Fathers of Confederation, as we call them, planned in and for a far different world, in the years leading up to 1867, than that we now know. It is sometimes surprising only that what they made has bent but never broken in the stresses of these past nearly 100 years. There is no doubt that individually some of the most influential of them saw the problems of the federated form—they had a recent example in the events in the United States before them—and would have preferred the stronger ties of legislative union. But the pressures of race, religion, language, economic interests, and geography made anything so direct and clear

*Reprinted from *National Tax Journal*, vol. XV, No. 3, September 1962.

** The author is Deputy Provincial Treasurer of the Province of Manitoba. Any views expressed are personal and do not necessarily represent those of the Government of Manitoba.

cut an impossibility, although their views have reflection in the greater central authority in Canada where, in contrast to the United States, the residual power is with the Federal Government. If at times we become impatient of the labyrinth that seems to restrain the course of effective action, we must take care to ask ourselves if we are prepared to accept the logical alternative of a unitary state. In Canada today we are not.

The wisdom of the founders must be weighed in relation to the fact that for about 60 years only relatively minor financial surgery was performed on the body politic. It was really not until the great depression of the 1930's that, in Canada (as in the United States), the pressures of the times and the burdens of the changing concepts of governmental responsibility threw the system so badly out of balance that important modifications became inevitable.

Canada has always faced serious inequalities in the financial capacities of its various units. While these did not exist at the coming together of the Provinces and had been of sufficient importance then and over the years to justify special constitutional subsidies, particularly for the Maritime Provinces, they had been of the nature that would respond to relatively minor adjustments.

But the social and economic developments of the 20th century were beginning to have important effects. While the original division of powers and responsibilities had served its purposes in general terms, it became increasingly clear by the middle 1920's that eventually some changes must come. The provincial responsibilities for education, public works (particularly highways), health, welfare, and resource development, among others, assumed a greater relative importance. While the direct revenue fields, in which the Provinces shared jurisdiction with Canada and of which they had actually had for a considerable time enjoyed effective and exclusive use, were reasonably adequate, it soon was apparent that joint occupancy, with an increasing Federal bias, would soon leave insufficient financial resources for necessary provincial expansion. The impact of the depression emphasized all these problems. It was obvious that most, if not all, the Provinces lacked the ability to meet the new economic and social burdens thrust upon them.

While there had been some previous recognition of approaching change, one tends to set the year 1935 as the turning point in the development of our modern concept of intergovernmental fiscal relations in Canada. It was in that year that the Bank of Canada, at the request of the Dominion Government, made an investigation into the financial affairs of two of the Western Provinces most severely hit by the dual onslaught of drought and depression. This led to what has been probably the most important step in this field in Canadian history from Confederation to the present day.

Any discussion of these matters, cannot but refer to the Report of the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Report). Appointed in 1937, the Commission made its report late in 1940. This Report, conceived in depression and presented in war, never received the formal acceptance it might otherwise have had, but it did bring to the Canadian scene a basis for study, and concern for the form and operation of the Government that cannot be underestimated. Many of the ideas that have become effective measures in this field in recent years had their genesis in the efforts of the Royal Commissioners.

It may well be asked why, if this report sought out a cure for an economy sick with the ills of depression, its ideas should be considered pertinent to a later period when the problems were those of high and often inflationary prosperity. The simple fact is that it, for the first time, gave formal recognition to factors already realized but not recognized—that the nation could not continue to exist unless there was a reasonable measure of equality of standards throughout; and, secondly, that the relationships of revenues to responsibilities allotted to the two levels of government in 1867, were no longer consistent with the development of new social and economic concepts. New ideas, new principles, and new approaches were required.

The Rowell-Sirois solution was toward a greater centralization of power in the Central Government. This may well have had appeal in the years of depression and was perforce accepted in time of war. It was not, however, a practical political solution, particularly in more normal times. What we have had to work toward, while at the same time retaining some of the basic principles put forward in the report, has been a system of cooperative effort, both in taxation and administration, that will meet the changing problems of the times without altering the basic concepts of the Constitution as set out in Sections 91 and 92 of The British North America Act.

The statutory subsidies, important as they were in the original terms of Union and revised as they had been on several occasions, no longer played an important part in the financial charade. Neither was there at this stage in Canada's development, any permanent philosophy of shared-cost programmes although a start had been made, especially in the health and welfare field, as in old-age pensions and unemployment relief. The Report saw no particular merit in them as a general approach, although admitting a specialized usefulness. Its real impact came in its outright recommendations of central control of the income tax system as well as a substantial measure of debt management. These were to be part of a system with the Federal support of a reasonable level of essential provincial services through direct grants-in-aid.

While the recommendations were well received in some areas, the vehemence of their rejection, particularly in the more wealthy and populated parts, may have settled for many years any approach to the problem so directly proposed. However, it was a time of crisis and in 1941 it was soon apparent that some system other than that in effect would have to be devised.

The Government of Canada was determined to pay as great a share of the costs of war as possible from revenue. This meant an increasingly heavy reliance on the taxation of income of all kinds. But the Provinces had their various feet in this door, to differing degrees, and heavy Federal imposts would have created immeasurable conflicts and difficulties.

So that which was not to be achieved directly began to be achieved by more devious means. The Federal Government's solution was to resolve this problem of joint occupancy by offering to buy out the

Provinces temporarily by rental of their income taxing rights for the duration of the war and 1 year thereafter. Patriotism accomplished what financial reasoning could not, and for 6 years until March 31, 1947, Canada had full control of the taxation of the income of individuals and corporations in return for a price related to the immediately previous annual return in each Province from these tax fields.

Under the restricted local activity of wartime these tax suspension agreements served the Provinces well enough. So well, in fact, that the planners of the brave new postwar world came to regard central control as the common denominator of all economic progress. Thus the plans offered the Provinces at the Dominion-Provincial Conference on Reconstruction of 1945 and 1946 went far beyond the wartime agreements. In the fiscal terms alone they included a measure of fiscal subsidy in the rental payments developed from an equal per capita base. This recognition of fiscal need, even indirectly, was significant in view of past history and future developments. There was as well the important inclusion of a factor for economic growth, related to the gross national product. It was thus to the advantage of most, and seven of the then nine Provinces eventually signed individual rental agreements for income and corporation taxes and succession duties for a further 5-year period ending on March 31, 1952. Ontario and Quebec alone remained out—important abstentions, however, in terms of population and influence.

After 1952, there was little change in principle, although the pot was sufficiently sweetened to attract Ontario into the fold in respect of income and corporation taxes. Quebec, as has been said, "continued to sell its potage for a mess of birthright" and stood by its principles regardless of the cash.

During the course of the agreement, except for an increasing interest in conditional grants, there were few developments. Some concessions were made in the personal income tax field which Quebec had decided to enter in 1955, and while these were also made available to other Provinces, none was interested. It soon became apparent, however, as negotiations began for the 1957 renewal that some new approach must be developed. Both Federal and Provincial negotiators were forced to stand back and take a careful look at the system that had been in effect in more or less the same general form since 1941.

Objective judgment of the accomplishments of the latter two agreements of 1947 and 1952 is not easy, but there can be little dispute as to certain practical advantages that followed on from the somewhat pragmatic system that had evolved or had been created.

1. The rental system, incomplete as it was, nevertheless had permitted the effective administration of personal and corporation income taxes and succession duties at the high levels required, without excessive duplication or conflict and with a considerable saving in time, money and effort, to the taxpayer and the governments alike.

2. Provinces which would otherwise have been in financial difficulties were able, as a result of the fiscal need elements introduced into the payments, to provide a more satisfactory level of service.

3. Although taxation as a tool of fiscal control was never fully tested, there seems little doubt that what use was made of it was made

more practicable by the centralization of taxing powers under these rental agreements.

All, however, was not clear again. Not the least of the problems was the loss of fiscal autonomy by the Provinces in these fields—a decisive factor in Quebec thinking. The tying of the equalizing factor into the surrender of taxing powers constituted an inequitable position for that Province, or for any other that wished to remain aloof from central financial control.

The question of fiscal equity was probably a matter of even greater concern in the broad national approach. The wide economic disparities among the Canadian Provinces had always been a problem in the Federation. Variations in economic wealth from the high to the low of four to one could be indefinitely ignored, regardless of whether the reasons were those of regional economic inadequacies or the results of national policies. The solution of this aspect of the problem became one of the central points in the Federal approach to the plans for the next 5 years.

After negotiations covering a number of conferences over a number of months, Canada offered a plan to the Provinces which broke the proposed payments into three main parts:

1. Tax rental of personal and corporation income tax and succession duties—with payments at direct reflection of the taxable capacity of each Province in these fields at agreed rates; in the case of individual income tax, 10 percent of the Federal tax at 1956 rates; corporation income tax, 9 percent of corporation taxable income; and succession duties, 50 percent of the Federal duties, in each Province.
2. Equalization payments, which were to bring the level of per capita return from these taxes in each Province up to the average of that in the two wealthiest—(currently Ontario and British Columbia, in that order).
3. Stabilization payments—which meant that the levels of annual payments could not fall below certain agreed levels related to payments under the previous arrangements and for previous years.

The differences in wealth can best be illustrated by the fact that Ontario received no equalization while in Prince Edward Island and Newfoundland the equalization was three times the tax rental return.

Even those with the least to gain admitted that the proposals were a substantial improvement over what had gone before. In the first place, for the first time fiscal equalization was openly recognized, and secondly, no province was penalized for its independence of Federal control; that is, equalization was paid as a right and not related to whether a Province collected taxes on its own or rented to the Central Government.

As things turned out, only two Provinces preferred to levy their own taxes. Quebec, as before, retained control in all three fields. Ontario resumed collecting its own corporation taxes and continued its succession duties but left to Canada the privilege of collecting the politically less attractive personal income tax on its behalf through a rental agreement.

It would be very wrong to leave the impression that the final word had been said. Few, if any, of the Provinces were satisfied with the level of payments and the arguments on the division of the tax fields in which both levels of government had equal constitutional rights, continued. Equalization was more favorably received, except by Ontario, which, while accepting the general principle, privately continued to regard herself, in the words of one of her former Premiers, as the benevolent "milch cow" of the Canadian Federation.

The pot was "brought forward from the back of the stove" by the Federal election campaign of 1957. The Progressive-Conservative Party indicated in broad terms its sympathy wtih the provincial position and promised early remedies for the complaints. When, somewhat unexpectedly, it was successful at the polls, some action was required. In November 1957, a conference with the Provinces was called to discuss the matter, and early in 1958 they were informed of an increase in their share of the individual income tax from 10 percent of the Federal tax to 13 percent, and at the same time a special fiscal need grant-in-aid of $25 million a year to the four Atlantic Provinces was proposed. This was a good deal better than nothing but by no means satisfied the Provinces, although the Atlantic Provinces were thus considerably mollified. The efforts to secure more favorable treatment from the new Government in power continued without noticeable abatement.

The Government, having come into office without any operative experience of how it should deal with a complex problem of this kind, would have had its work cut out under any circumstances. But it was also faced with a recession with all its attendant decisions. In the budgetary effects—falling revenues, increased defense costs, and a broad spending program particularly in the welfare field—the Federal Government found little freedom for financial concession to the Provinces.

Under these circumstances, it is fairly clear that a reorientation of thinking occurred. There can be little doubt that Canada soon began to regard the tax-sharing arrangements as an open and continuing invitation to the Provinces to use the Federal purse for their own purposes. Too, the appeal of a budgetary reduction of $300 million by the elimination of rental payments was not forgotten. The Government, impressed by that old saying that "he who pays the piper calls the tune," argued that a return to the Constitution required the Provinces to collect their own revenues. This interpretation of Canadian economic and constitutional history and needs may have been open to serious question but nevertheless it had practical appeal.

The Government was also faced with a real political conundrum. The 1957 Agreements had provided more equitable treatment for Quebec—but had left Ontario, the most powerful influence among the Provinces, economically and politically dissatisfied. This dissatisfaction was constantly fed by a need for funds, the requirements of explosive growth, which the Government and that Province felt could most effectively be obtained by an increased share of the personal and corporation income tax fields. It is hardly necessary to say that this need was never fully understood or appreciated by other Provinces, particularly those where the problem was of the opposite kind.

Despite their financial dissatisfaction with what they had, there can be little doubt that the majority of the Provinces were fully appreciative of the merits of the 1957 arrangements. They were prepared, with certain obvious exceptions (Quebec and Ontario, and perhaps to a much lesser extent, Alberta and British Columbia; i.e., the four wealthiest) to sacrifice the fiscal autonomy about which the Federal Government expressed such fatherly concern, in exchange for a continuation of the fiscal arrangements at a more satisfactory level of return. The provincial proposal, coupled with a number of more imaginative and expansive suggestions for Federal assistance came before the Government of Canada at the Conference of July 1960. Perhaps the tone of the meeting can best be conveyed in the words of Premier Frost of Ontario who said in concluding his formal presentation:

"In conclusion, Sir, I repeat that Provinces cannot plan a program of expansion nor can they meet the incidence of the expansion which has already taken place on indefinite and uncertain premises. Certainly this is the case as far as we are concerned. The present series of fiscal arrangements will soon be expiring. We must have a definite decision within the next 6 months on the fiscal arrangements which will succeed them. Again, I urge bold and decisive action to make it possible for the Province and Municipalities—which as I have said, are the right arm of development in peace time—to move forward vigorously, providing the basic service and the environment for a prosperous people and nation." Or, in the words of Premier Roblin of Manitoba—"Manitoba is not in search of ideal solutions, but rather pragmatic ones, designed to deal forcefully with problems of the sort that face us today. We can readily see from the history of these conferences that whatever solutions we reach today will inevitably have to be revised, replaced, or extended as Canada grows or as circumstances change. 'Final solutions' are not the answer to serve a growing nation: we urge that in concert we grasp this nettle firmly."

Demands were not limited to direct financial ones but covered a wide range of operational fields as well. Canada has had a slow but rapidly growing experience with conditional grants and shared-cost programs, and the Provinces indeed were willing to grasp that nettle firmly. Their ideas extended to joint interest under broader terms in such things as unemployment assistance, vocational and technological training and education, urban redevelopment, resource development, highways, a national power grid, financing aid especially for municipalities, and many others. The Minister of Finance of Canada, after some figurative arithmetic, stated that if he were to grant all the requests it would cost Canada over $2 billion a year. His mathematics was found wanting by the provincial representatives.

Having thrown the cold water of restrained official ridicule on the overall provincial proposals, the Dominion Government made no move at this time to offer any counterproposals on its own behalf. The representatives contented themselves with merely expressing concern at the problems faced and the extent of provincial demands. Obviously, if these demands were to be taken seriously there was good cause for worry. But it was fairly obvious, also, to those who had been around the course before, that they were largely in the nature of moves toward the establishment of a bargaining position—at least in some of the more extreme manifestations—although the sincere concern of the Provinces (and presumably Canada as well) in the matter of growth was an important influence. Conferences which eventually decide anything, usually work on this basis, and the Federal-Provincial Conferences are no exception.

The July meetings adjourned with no positive action, but in October 1960, when the Conference reconvened the Dominion representatives were not slow in bringing the shock treatment into play.

Amid the awed but temporary silence of stunned provincial delegates, the Prime Minister proposed a complete departure from the scheme of things which had been the development of over 20 years. In what was termed an effort to restore to the Provinces their constitutional rights, Canada proposed that the Federal Government should retire from the fields of personal and corporation income taxation to the extent of current provincial participation under the existing rental agreements and allow the Provinces to resume their activities as collectors in these tax fields. Recognizing the essential need of some form of fiscal aid, it offered to continue the payment of equalization at the levels already reached but devoid of any factor for future growth. The somewhat improbable suggestion was made that the Provinces should redistribute this among themselves as they saw fit—hardly a proposal likely to be of practical value.

The provincial Premiers came out of shock breathing fire, for far from giving the Provinces what they had asked, this Federal proposal left them with a position considerably worsened from that which they had before, not only in principle but in fact as well. To Provinces used to 5 yearly improvements in their financial arrangements the whole thing was a shattering fiasco. No greater share of tax fields was to be available; equalization of fiscal capacity was to be frozen—unrelated to future growth or future needs.

Even Ontario could see very little merit in the practical facts of the approach, although she did view the abandonment of the rental feature and the downgrading of equalization with some approval. It is not difficult to hazard the view that the Federal Government expected no reaction other than the once they got. The offer in fact had all the aspects of a smart piece of "gamesmanship," but as so often is the case it had practical results in softening up the opposition.

The stage was set for an amended proposal and in February 1961, this was unveiled at the reconvened Conference in Ottawa. Starting from the same two premises—

1. That he who pays the piper calls the tune; and
2. That the Constitution should be restored to the Provinces;

Canada presented a plan which for the 5 years 1962–66 inclusive, provided:

A. That the Provinces should resume their taxing powers in the fields of personal and corporation income tax, with Canada withdrawing to make room to the extent necessary to avoid an overall increase in taxation. These rates were to be—

(i) on personal income:
Sixteen percent of the Federal tax in the 1962 tax year.
Seventeen percent of the Federal tax in the 1963 tax year.
Eighteen percent of the Federal tax in the 1964 tax year.
Nineteen percent of the Federal tax in the 1965 tax year.
Twenty percent of the Federal tax in the 1966 tax year.

(ii) On corporate incomes, 9 percent of taxable income in each year 1962 to 1966.

As Canada imposed an estate tax, which as an indirect tax was "ultra vires" of the Provinces, which by constitutional powers are limited to direct taxation, she offered to pay over half the proceeds of the yield in each Province where no succession duties were imposed. Where a succession duty was imposed the 50-percent credit on Federal tax would continue as before.

It was explained that the personal income tax field had been chosen over the corporation as an area for greater provincial interest, as the tax was thought to be more suitable for provincial use due to its greater stability and more local effect.

Canada expressed the view that as the tax rental principle was to be abandoned it would be in the general interest if unnecessary administrative duplication could be eliminated. For this reason it was stated that the Department of National Revenue would be prepared to collect, without charge, any provincial income tax which met the Federal requirements. These, as originally stated, were that the definition of taxable income in a provincial act should not vary from that in the Federal act. In practical fact it was determined that any provincial act would have to be parallel to the Federal in all effective clauses and be applied as a percentage of the Federal tax itself.

This seriously limited the new-found "freedom" and while these requirements were eminently desirable from the point of effective administration, some of the Provinces regarded these restrictions as an important departure from the view expressed on more than one occasion by the Minister of Finance—that there was room for provincial taxation of personal income in the areas not covered by Federal tax—presumably the lower income brackets. Any such approach, even if it could have been considered politically practicable, was removed from practice by the Federal requirements.

It was in the area of equalization that most Provinces took the gravest exception to the Federal proposals. The acceptance of the principle openly and in substantial measure, had become an achievement of the 1957 arrangements which the Provinces other than Ontario, were loath to release. It had been regarded in most quarters as an advance of some merit in the approach to the problem of differing provincial economic capacities. Whereas these 1957 arrangements had been based on the equalization to the two wealthiest Provinces of a per capita return from the individual and corporation income taxes and succession duties at agreed standard rates, now it was proposed that equalization be only to the national per capita average—a change of more than fact, but one of principle and concept as well.

Apparently the arithmetic of this had shocked even the Federal representatives, and some compensating factor was sought. This they found in an argument put forward by Manitoba, that in the field of national resource revenue there was the widest variation from Province to Province. Therefore, they decided to use as an additional equalizing factor, the statistical summary of these revenues as produced by the Dominion Bureau of Statistics on a 3-year average divided by two. All factors in these matters tend to be arbitrary, and some are more arbitrary than others. Whether or not the inclusion of one more provincial revenue source of the many has theoretical validity has been open to argument, but there can be the doubt that of all the indicators which could have been used natural resource revenue was the only one which produced the necessary financial effects.

One further concession was provided. In 1958 a special grant of $25 million a year had been provided for the Atlantic Provinces, which have for many years been economically subdued. This was now increased to $35 million a year but was to be now incorporated in the calculations for arriving at the final equalization payment. This change in approach had the end effect of reducing the benefit substantially in the case of New Brunswick.

Newfoundland was also promised a continuation of a special payment of $8 million a year related to its terms of union with Canada for a further 5 years, an extension of an existing grant which had previously been refused.

Even with the new level of standard tax rates promised, it was evident that failing totally unexpected levels of growth, most Provinces would receive less than under the old agreements, at least in the first 3 or 4 years. This was difficult to support and it was, therefore, considered necessary to introduce a guarantee. This was provided on two different and quite arbitrary bases:

(*a*) Any Province receiving equalization under the national average formula was guaranteed that it would be no worse off than it would have been under a continuation of the existing arrangement, including the Atlantic Provinces Adjustment Grants.

(*b*) No Province would receive less than it did in the last year of the existing agreements (1961–62) or the average of the last two, whichever was the greater.

The element of stabilization was carried forward into the proposal from the previous agreements, and all Provinces were guaranteed that in no year would their revenues from standard taxes and equalization be allowed to fall below 95 percent of the average of the 2 preceding years or the preceding year, whichever was higher.

Assuming the Federal Government had no continuing interest in the central control of the principal tax fields as an essential instrument of fiscal policy, the new proposal from their side had much to recommend them. By returning these tax fields to the Provinces they had eliminated from the Federal budget over $300 million gross, and had probably at the same time dulled the attack of the Provinces on the level of rental shares.

Secondly, by reducing the equalization payments to Quebec and Alberta in particular, it had been possible to still the complaints centered in the largest and wealthiest Province, Ontario. Ontario over the years has been unable to escape the conviction that such transfer payments are in fact the removal of her own funds to other Provinces, which in some cases at least she considered as being well able to look after themselves.

Thirdly, by departing from the formula developed by its predecessors in office, the Government of Canada had moved into a field of policy decision in which it owed nothing to its opponents—and judging from the debates one in which no claims will be stated.

Fourthly, it could claim that as a gesture toward provincial rights it had restored a large measure of fiscal autonomy to the Provinces—reluctant as some of them appear to be to accept the release from "bondage."

In the minds of many of the provincial ministers there were misgivings. Any advantages there might be seemed more than outweighed by a serious departure from principles that had been built up over the years. In their hearts was the belief that something developed by years of trial and error had been replaced by a scheme which seemed to them on examination to be without any real basis other than expediency.

This feeling was clearly if somewhat extravagantly expressed in the Throne Speech at the opening of the Special Session of the Saskatchewan Legislature called to deal with the problem in October 1961. "It is the view of my Government that this is a retrograde step which makes more difficult the attempt to achieve a measure of equality of services for all Canadians. Any departure from the principle of equality interferes with the realization of effective Canadian unity."

This reaction was particularly strong among the less favored Provinces when they came to a consideration of the factor of equalization as now restated. While Canada has professed continued allegiance to the original principles there can be no doubt that the Government's concept of equalization as a form of fiscal need payments, ex gratia, is basically different from the understanding of some, at least, of the Provinces whose views have been that it is by nature a price paid for the acceptance of the varying effects of national policies on the constituent parts of the Canadian Federation.

It would not do, however, to overestimate the concern of all provincial ministers or to deny that advantages lay in the proposals for many of the Provinces. Politicians, if they are to be successful, must be practical, and it was to the end results of the proposals in actual dollar terms that attention was soon directed. Canada, quite properly and wisely, refused to make any public estimate beyond the first year of the new proposals. However, it is possible to anticipate, on the basis of certain assumptions stemming from the estimates for the first year, 1962–63, that only Ontario of all the Provinces would benefit to any noticeable extent over what had gone before. Perhaps this was rough justice for her role in the past. The Atlantic Provinces by reason of the increased Adjustment Grant, and Newfoundland by the special annual payment of $8 million, were also beneficiaries to a lesser extent. But of the rest, Quebec, Saskatchewan, and Manitoba, stood to gain little if anything from the new arrangements. British Columbia in the earlier stages, and Alberta throughout the whole period, largely due to the effects of the natural resource factor, were likely to be actual losers. Canada has justified the proposals as being a realistic approach to the problems of financial need. The Provinces have been harder to convince.

This is the situation as it now stands. It appears inevitable that all Provinces will reenter the personal and corporation income tax fields and that some at least will take advantage of the release from the rental agreements with Canada to utilize these further sources of revenue. The temptation is strong, for nearly all are heavily pressed for additional funds. In fact at time of writing, Manitoba and Saskatchewan have both announced a surtax of 6 percent of the Federal tax on personal income and an increase of 1 percent in the corporation tax rate, in each case for the support of special health services, and others may eventually follow. The end result is that the level of income taxes will tend to vary from Province to Province, complementing a situation which has already existed in Ontario and Quebec in the corporation income tax and succession duties, and in Quebec in personal income tax.

The administrative difficulties of the reentry into active taxing efforts of a number of new jurisdictions are likely to be largely met by the centralizing of collections under the Federal Department of National Revenue with standardized tax legislation. All Provinces except Quebec are likely to utilize this service for the collection of taxes on individual incomes, and presumably only Ontario and Quebec will operate on their own in the corporation tax field, as they have for the past several years.

As one looks back on the work of the past 20 years, it is difficult not to feel a twinge of deep concern that the line of progress has been so diverted from its original goal. Perhaps it was not a straight clear road that has been followed, but the alternative seems a singularly ill-defined trail. But the Government obviously places greater emphasis on its budgetary position and in the alleged merits of the provinces being forced to stand on their own financial feet than on the value of central fiscal control. It is something of a paradox that there now seem to be more dedicated believers in this central authority of taxation for fiscal purposes at the fringes in the Provinces than at the centre.

Under this new and pragmatic approach to the problems of intergovernmental financing some reorientation of our thinking seems inevitable and the development of some greater measure of direct intergovernmental cooperation more than ever necessary in the years ahead, if we are not to slip back from the advances of 20 years of fruitful experiment in fiscal cooperation. It is doubtful if the taxpayer has either the capacity, the patience, or the thirst for further adventure in the "tax jungle" of unrestricted jurisdictional competition for his funds.

With the increasing recognition of the vital role of the Provinces and municipalities in our hopes for continued growth, we may well be heading for a greater reliance on the conditional grants and shared-cost programs. Until comparatively recently these have been of secondary interest, unlike in the United States where they have been the principal instrument of Federal-State financial cooperation. But with the growing weight on the economy of welfare and health expenditure and the need for greater economic growth to support them, we must expect increasing attention to this approach. Their importance now exceeds substantially the fiscal assistance extended through the medium of the unconditional grant. In view of this recent experience, the Federal Government may one day look back on the days of unconditional payments with nostalgic affection.

The developments of the next 5 years will likely call the tune. There has been an increasing degree of intergovernmental cooperation in Canada in recent years, particularly at the official level and the machinery exists for more. Despite the difficulties and disappointments I suspect there has never been a time when there was a greater appreciation of mutual problems. This is most evident in the changed attitude of the new Government of the Province of Quebec. It is up to those responsible, Federal and Provincial, to see that the opportunities at hand are fully utilized in achieving the harmony that is so necessary if the moulding of a nation, a task of difficulty in any federation, is to continue.

APPENDIX A

Illustration of hypothetical projection of Provincial receipts under the new Federal Provincial tax arrangements for 1962–63

[Dollar amounts in thousands]

	New-foundland	Prince Edward Island	Nova Scotia	New-Brunswick	Quebec	Ontario	Manitoba	Sas-katchewan	Alberta	British Columbia	Total
1. Standard tax yields (16-9-50)	$6,037	$1,314	$13,052	$10,371	$169,193	$314,480	$29,482	$20,201	$45,758	$72,835	$682,723
2. Equalization of taxes plus 50 percent of natural resource revenues to national average	14,412	3,402	19,440	15,403	51,452		9,979	8,335			122,423
3. Standard tax yields plus equalization	20,449	4,716	32,492	25,774	220,645	314,480	39,461	28,536	45,738	72,835	805,146
4. Guarantee amount [1]					20,855		2,835	13,992	12,617	977	51,276
5. Atlantic Provinces adjustment grants, 1962	[2] 18,500	3,500	10,500	10,500							43,000
6. Total receipts, 1962–63)	38,934	8,213	43,011	36,265	241,500	314,480	42,296	42,528	58,375	73,812	899,422
1961–62 Provincial revenue proportion represented by Federal payments (exclusive of program recoveries, statutory subsidies, and tax receipts):											
Equalization payments	15,369	3,461	20,752	17,779	78,255		14,054	22,684	17,688	7,329	
Stabilization payments		81								1,244	
Adjustments for fiscal need [3]	15,500	2,500	7,500	7,500							
Total	30,869	6,042	28,252	25,279	78,255		14,054	22,684	17,688	8,573	
As percent of revenue	36.0	27.2	27.8	24.6	11.3		13.2	15.6	5.7	2.6	

[1] The guarantee amount is the difference between the yield of standard taxes plus equalization and the revenues under the agreements ending in 1962. In the case of those Provinces falling below the national average per capita in tax yield, the guarangee is simply the amount necessary to bring their receipts to the total they would have received had the old agreements been projected. In the case of Provinces receiving more than the national average per capita in tax yield, the guarantee is the amount necessary to equal the total paid in either the last year of the old agreements (1961–62) or on the average for the last 2 years of the old agreement. The Atlantic Provinces adjustment grants are included in the computation for guarantee in the benefiting Provinces; hence, the guarantee, as such, does not become effective for those 4 Provinces.

[2] Includes $8,000,000 special Newfoundland grant.

[3] Atlantic Provinces' adjustment grants and special Newfoundland grant.

APPENDIX B

Summary of Federal conditional grants to the support of Provincial programs for the fiscal years 1956–57 to 1961–62

[In thousands of dollars]

	1956–57	1957–58	1958–59	1959–60	Preliminary, 1960–61	Estimates, 1961–62	Total
1. Agriculture	938	1,037	1,864	6,732	3,716	2,036	16,323
2. Health	36,438	34,596	45,909	45,974	47,878	45,373	256,168
3. Hospital insurance			54,708	150,593	189,000	274,491	668,792
4. Welfare	38,353	48,149	74,072	90,861	102,935	96,034	450,404
5. Vocational training, etc	4,668	4,765	8,057	8,372	8,677	27,336	61,875
6. Highways and transportation	26,909	50,943	53,669	56,746	48,696	54,110	291,073
7. Resource development	2,717	4,314	8,741	15,266	17,946	21,150	70,134
8. Civil defense	814	968	1,025	1,564	2,966	2,628	9,965
9. Municipal winter works			249	6,584	8,908	26,946	42,687
10. Other	137	72	62	62			333
Total	110,974	144,844	248,356	382,754	430,722	550,104	1,867,754

Postscript: Since this article was written all Provinces except Quebec and Ontario have signed the collection agreements with Canada. Ontario has made an agreement covering the individual income tax but has continued to collect its own corporation taxes and succession duties. Quebec has retained active control of all its collections.

Further, on June 18 a Federal election was held with indecisive results. Should the Government be defeated in Parliament the whole situation with respect to Federal-Provincial tax arrangements could again become fluid as the Government's plan was vigorously attacked by opposition parties during the election campaign.

FEDERAL-STATE FISCAL ARRANGEMENTS IN INDIA

BY A. T. EAPEN [1]

INTRODUCTION

In no Federal union existing today does the allocation of financial resources between the Federal Government and its constituent units correspond to the allocation of functional responsibilities between them. Such imbalance is aggravated by considerable interregional differences in the distribution of wealth and income within a federation. And yet for the effective functioning of a federation and for its continued existence, it is imperative that each level of government must be able to command the means essential to meet the calls made upon it. This requires a substantial transfer of resources made from one level of government—usually the Federal—to the other—generally the States. The pattern of financial arrangements between the National and the State Governments which achieves this transfer in a federation is bound to be influenced by its peculiar economic, social, and political characteristics and historical accidents. [2] Such pattern of financial arrangements between the National and the State Governments in India is the subject matter of this paper.

Important aspects of Federal-State fiscal arrangements since the inauguration of India's Federal Constitution in 1950 will be considered here. Of course, the history of intergovernmental financial relations in India spans a much longer period. [3] In fact, the year 1970 would mark the completion of a century of such relations. Needless to say, the financial and other provisions of the present constitution have been very much influenced by the various prior Acts of the British Parliament concerning the governance of India. In particular, the Government of India Act of 1935, and the financial arrangements made thereunder have leavened the present Indian constitutional provisions. Moreover, being a relatively new Federation, India, through the architects of its constitution, was able to profit from the experience of others. A study of Indian fiscal federalism should prove to be of

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[1] State University of New York at Binghamton. The author is indebted to Ana N. Eapen for many valuable comments and suggestions.

[2] Even a cursory study of the three Anglo-Saxon federations—the United States, Canada, and Australia—reveals this. Federal-State financial transfers in the United States have been largely devised for the principal purpose of encouraging the performance of specific activities at the State and local levels. In Canada, the history of Dominion-Provincial financial relations is fraught with political bargaining and at present Dominion financial transfers to provinces are subject to quinquennial review by the Dominion and the Provinces. The Commonwealth of Australia has developed some successful institutions like the Commonwealth Grants Commission and the Australian Loan Council to put Commonwealth-State financial relations on as objective a basis as possible, even though Commonwealth payments to States under the Uniform Income Tax Plan continue to be subject to political pressure.

[3] For a brief historical account, see *"Report of the Finance Commission, 1952"* (New Delhi, 1953) (hereinafter cited as the First Report).

considerable interest to other federations however much they may differ from India.

This paper is divided into seven sections. The first section gives a summary view of the nature of the Indian federation. Following this, Section II deals with the constitutional allocation of legislative powers. The disequilibrium in the State and Federal budgets resulting from the division of financial powers and functional responsibilities is examined in the third section. The financial adjustments envisaged in the constitution to remedy the disequilibrium are considered in the fourth section. The fifth section presents a trend of the magnitudes of these adjustments in the Federal and State budgets during the period 1952–66. The sixth section is primarily an appraisal of Indian fiscal federalism. Finally, some alternative proposals for modifying the existing Federal-State financial adjustments are put forward in the seventh and last section.

I. Nature of the Indian Federation

Unlike other federations such as the United States, Canada, or Australia, the progress of India toward a federation was through very gradual steps beginning in 1871 and culminating in 1947. The Federation of Indian States is unique in many respects. It is the result of a process of centralization as well as decentralization. The highly centralized administration of British India of 1858 was gradually decentralized and finally Provinces with more or less automonous powers slowly began to evolve. The princely States in India were a class by themselves in their relation to the British Crown. Their political relations with the British Crown were defined by treaties which largely respected their autonomy in internal administration. In 1947, when the British left India, they became legally sovereign in all respects. Therefore, as far as princely States are concerned, the federation is the result of a process of integration.[4] By and large, the Indian Federation is not the result of an agreement among its constituent units. The constituent units have no freedom to secede from the Federation. The Indian Union indeed represents a Federal structure with many unitary features.[5]

II. Allocation of Legislative Powers

The distribution of legislative powers between the Federal and State Governments in the Indian Constitution adopted in 1950 has been largely influenced by similar arrangements in the Government of India Act, 1935.[6] The constitution gives a rather exhaustive enumera-

[4] The constitution adopted in 1950 classified the States into three groups: Part A States corresponded to the former provinces of British India, Part B States to the former princely States either single or merged, and Part C States to the former Chief Commissioner's Provinces. In 1956 after the reorganization of the boundaries of the States on a linguistic basis, the three separate classifications of States were abolished by the Constitution (Seventh Amendment) Act, 1956.

[5] Under art. 353(a) of the Constitution of India, when a proclamation of emergency is in operation, then "notwithstanding anything in this Constitution, the executive power of the Union shall extend to the giving of directives to any State as to the manner in which the executive power thereof is to be exercised".

[6] See *"The Government of India Act, 1935,"* sec. 100, and the Seventh Schedule for the enumerated items in the Federal, Provincial, and concurrent legislative lists. There were 59 items in the Federal list, 54 in the provincial, and 36 in the concurrent.

tion of legislative powers classified under three groups: (1) exclusively Federal subjects, enumerated in the Union List; (2) exclusively State subjects, enumerated in the State List; and (3) concurrent subjects, enumerated in the Concurrent List.[7]

The Union List includes defense, external affairs, currency, coinage and legal tender, customs, Union excises and taxes, etc. The State List includes, among others, maintenance of law and order, local government, public works, public health, education, agriculture, roads and State taxes. The Concurrent List covers criminal law and procedure, marriage and divorce, economic and social planning, social insurance, etc. In the event of any conflict between Federal and State legislation over matters in the Concurrent List, the former shall prevail over the latter.[8] The constitution vests residual powers in the Union.[9]

TAX POWERS

The allocation of fiscal powers in the Indian Constitution is quite complex. This complexity arises primarily because of an elaborate scheme of demarcation of tax powers between the Federal and State Governments. This demarcation is designed to mitigate a variety of tax problems endemic to Federal systems such as double taxation between the Federal and State Governments, tax rivalry among States, overlapping taxation by States, duplicate tax administrations, excessive compliance costs, and tax evasion. To be sure, the Indian Constitution has succeeded in reducing such problems to a minimum; but this has left the States with inadequate tax resources of their own to carry out the responsibilities placed on their shoulders. In order to correct this situation, but thereby adding to the complexity of financial provisions, the constitution explicitly provides for both mandatory and optional sharing of receipts of certain taxes levied by the Federal Government. These provisions, being essentially methods of financial adjustment, are discussed later. With a view toward safeguarding the interests of the States in Federal taxes that are shared with them, Article 274 of the constitution provides in effect that no proposal, which in any way affects existing or prospective financial interest of a State, shall be presented to Parliament except on the recommendation of the President.

The Indian Constitution is fairly explicit on the division of tax powers between the Union and the States. The Federal Government has the exclusive power to levy the following: customs, taxes on corporations and non-agricultural income, estate taxes on property other than agricultural land, and all excises except those on alcohol and

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[7] See the *"Constitution of India,"* Sevenuth Schedule (hereinafter cited as C. I.).
[8] *Ibid.*, art. 254.
[9] *Ibid.*, art. 248. The three lists are, however, so exhaustive as to leave very little in the residual category. The constitutions of the United States, Canada, and Australia do not have any elaborate scheme of division of legislative powers. The residual powers in the United States and Australia rest with the States whereas in Canada they rest with the Dominion.

narcotic drugs. The States have the exclusive power to levy taxes on agricultural income and estate taxes on agricultural land.[10]

Just as in the Government of India Act of 1935, the Indian constitution of 1950 permits the States to levy sales taxes. However, a State is prohibited from levying such taxes on transactions which occur outside its boundaries or which arise in the course of interstate or international trade. In spite of this prohibition, it still required a constitutional amendment in 1956 to clear the conflicts that arose concerning the taxation of interstate and international commerce.[11] Furthermore, the 1956 amendment gives the Indian Parliament power to restrict State tax laws on goods declared to be of "special importance." [12] in interstate trade. Following the constitutional amendment, Parliament enacted the Central Sales Tax Act in 1957, which levied a Federal interstate sales tax and which defined the restrictions on State sales tax laws concerning goods declared to be of "special importance" in interstate trade. The proceeds of the Federal interstate sales tax are collected by the States. In the same year, in order to eliminate tax evasion and minimize tax compliance problems, the Federal and State Governments agreed to replace State sales taxes on three widely used commodities—namely factory-made textiles, sugar, and tobacco—by additional Union excises on these items. This is in the nature of a tax rental agreement, with the net proceeds from the additional Union excises being allocated among the States.

BORROWING POWERS OF THE STATES

The borrowing powers of the States in the Indian Union are very much restricted by the constitution and in this regard the Indian States differ considerably from the States in the United States or the Provinces in Canada which enjoy independent powers to raise loans. The Indian States, although denied the right to borrow outside India,[13] may borrow within Indian territory. However, if a State is already indebted to the Union, it may not raise any additional loans without the prior consent of the Federal Government.[14] With the advent of

[10] Until the adoption of the Government of India Act, 1935, agricultural incomes were exempt from any income tax. This Act permitted a provincial levy on agricultural incomes. Owing to significant disparties in land taxes between the Provinces and presumably for administrative reasons, it was considered desirable that the provinces administer agricultural income tax. To eliminate one of the glaring inequities in the Indian tax system, the Taxation Inquiry Commission of 1953–54 recommended standardization of land revenue and the eventual merging of agricultural and nonagricultural income for income tax purposes. See Government of India, Ministry of Finance, Department of Economic Affairs, Report of the Taxation Enquiry Commission, 1953–54, vol. III (New Delhi, 1955) pp. 220–236.

[11] See R. N. Bhargava, *"Indian Public Finances"* (London, 1962), pp. 126–138.

[12] These goods as defined by the Central Sales Tax Act of 1957 include coal, cotton, cotton fabrics and yarn, hides and skins, iron and steel, jute, oilseeds, rayon or articial silk fabrics, sugar, tobacco, and woolen fabrics. See Bhargava, Ibid., p. 137.

[13] C. I., art 293(1).

[14] *Ibid.*, art. 293(3).

the 5-Year Plans, all the States have borrowed heavily from the Federal Government in order to finance various developmental projects. Consequently, the borrowing powers of the Indian States are pretty much under Federal control.

FEDERAL-STATE TAX IMMUNITIES

Tax immunities are a source of friction in Federal-State relations as demonstrated by the United States experience. In the case of India, the constitution provides for three immunities. It exempts Federal property from State and local taxation; however, the Indian Parliamen may waive this exemption.[15] Similarly, the property and income of the States are exempted from Federal taxation; however, again Parliament may waive such exemption in the case of State business undertakings.[16] The constitution also exempts the Federal Government from State taxation on the sale or consumption of electricity.[17] The States are prohibited from levying taxes on water or electricity supplied by interstate river authorities established by the Federal Government; there is a saving clause under which the States may do so with the consent of the President of the Indian Union.[18]

III. Effects of Allocation of Fiscal Powers on Federal and State Budgets

The imbalance between the constitutional allocation of fiscal powers, on the one hand, and functional responsibilities, on the other, has inevitably left the States vis-a-vis the Federal Government with inadequate resources to meet their needs. A rough measure of the imbalance between resources and needs both at the Federal and State levels, before Federal-State financial adjustments, is indicated by a cursory study of their estimated tax collections and expenditures in the fiscal year 1965–66. The total tax and nontax revenues of the Federal Government in 1965–66 were estimated at Rs24.5 billion (see table 1). Characteristic of underdeveloped economies, excises and customs accounted for about 65 percent of Federal tax revenues. Income and corporation taxes accounted for practically the rest of Federal tax revenues. Considering only the revenue account (i.e. excluding the capital account), before any Federal-State financial adjustments, the Federal budget had an estimated surplus of Rs5 billion.

[15] *Ibid.*, art. 285.
[16] *Ibid.*, art. 289.
[17] *Ibid.*, art. 287.
[18] *Ibid.*, art. 288.

TABLE 1.—*Revenue and expenditure of the Federal Government, 1965–66* [1]

[In millions of rupees; 1 rupee=13.3 U.S. cents]

	Amount	Percent of total taxes
Taxes on income and expenditure	6,671.5	34.2
Taxes on personal income	2,940.0	15.1
Corporation tax	3,716.0	19.0
Expenditure tax	15.5	.1
Taxes on property and capital transactions	291.5	1.5
Estate tax	74.0	.4
Tax on wealth	135.0	.7
Gift tax	31.0	.2
Stamps	49.4	.3
Land revenue [2]	2.1	
Taxes on commodities and services	12,523.9	64.3
Customs	4,195.0	21.5
Excises	8,141.7	41.8
Other taxes	187.2	1.0
Total tax revenues	19,486.9	100.0
Net receipts from public undertakings [3]	792.0	
Administrative and other receipts	4,207.3	
Total tax and nontax revenue	24,486.2	
Total expenditure on revenue account	19,520.0	
Surplus on revenue account	4,966.2	
Shared taxes and grants-in-aid	6,372.6	
Deficit	1,406.4	

[1] Budget estimates.
[2] Land revenue from Federal territories.
[3] Railways, posts and telegraphs, currency and coin.

Source: Report of the Finance Commission, 1965 (New Delhi, 1965), table 16, pp. 184–85.

The situation was exactly the reverse in the case of States which had an estimated deficit of Rs7 billion in revenue account, before any intergovernmental transfers. The States derive most of their tax revenues from sales taxes and land revenue. Land revenue used to be the most important tax levied and collected by the States. For political and other reasons, despite the abolition of the "zamindary" (i.e., tax farming system), the receipts from land revenue have lagged behind. Efforts to supplement land revenue by an agricultural income tax have been halfhearted. In fact, the States of Bombay, Madhya Pradesh, Punjab, and Jammu and Kashmir do not levy any agricultural income tax at all.[19] In the fiscal year 1960–61, receipts from agricultural income tax amounted to only 2 percent of the total tax revenue collected by the States.[20]

[19] Bhargava, *op. cit.*, p. 124.
[20] *Ibid.*

TABLE 2.—*Revenue and expenditure of State governments, 1965–66* [1]

[In millions of rupees; 1 rupee=13.3 U.S. cents]

Tax receipts	7,649.4
Nontax receipts	5,004.0
Total receipts	12,653.4
Total expenditure on revenue account	19,721.6
Deficit	7,068.2
Shared taxes and grants from Federal Government	6,372.6
Deficit	695.6

[1] Budget estimates.

Source: Report of the Finance Commission, 1965 (New Delhi, 1965), table 23, p. 202; table 20, p. 192.

The total estimated tax and nontax receipts of the State governments, before intergovernmental transfers, during the fiscal year 1965–66 were Rs12.7 billion, while their expenditures—an inadequate index of their needs—were Rs19.7 billion. The estimated deficit of the States on their revenue account in 1965–66 was more than half of their tax and nontax receipts. Of course, the constitution provides for various kinds of transfers from the Federal Government to make up the deficits of the State governments. The mechanism that governs this transfer of financial resources from the Federal to the State Governments in India is considered below.

IV. MECHANISM FOR FINANCIAL ADJUSTMENTS

In contrast to the United States, Canada, and Australia, where most of the financial adjustments between the Federal Government and its constituent units are extraconstitutional, in India these arrangements are spelled out in some detail in the constitution itself. The constitution provides for a variety of subventions to the State governments in the form of shared taxes and grants-in-aid. The determination of the actual tax shares and grants-in-aid of the various States is subject to the recommendations of a statutory body, viz, the Finance Commission. Every quinquennium, or earlier, the President of the Indian Union is required to constitute a Finance Commission which is directed to study and make recommendations in this regard.[21] The President of the Indian Union may also refer to the Finance Commission any matter which is of importance to intergovernmental fiscal relations. So far, four such Commissions have studied Federal-State financial relations and most, if not all, of their recommendations have

[21] C. I., art. 280. The contrivance of a Finance Commission to make recommendations in regard to Federal-State financial relations was undoubtedly inspired by the example of the Commonwealth Grants Commission in Australia. There are, however, several important differences between the Indian Finance Commission and the Commonwealth Grants Commission. The former derives its status from the constitution while the latter is an extraconstitutional body. The Grants Commission's recommendations are confined to "special grants" whereas only "public purpose" grants are outside the purview of the Finance Commission. The Grants Commission makes a more thorough and detailed analysis of the Australian State budgets, their tax efforts and economy in administration than the Finance Commission does of the Indian States. Furthermore, the Commonwealth Grants Commission is a continuous body whereas the Indian Finance Commission is appointed only once in 5 years in order to make a review of Federal-State financial relations. The Finance Commission thus suffers from a serious lack of continuity which has evidently hampered its effective functioning. All the four Finance Commissions have complained about the serious lack of statistical and other information which are necessary in order to make meaningful recommendations with regard to intergovernmental financial transfers. For a comparison of Federal-State financial relations in India and Australia, see W. Prest, "Federal-State Financial Relations in India," Economic Record, April 1960, pp. 191–219.

been accepted by the Indian Parliament. The last Finance Commission submitted its recommendations in 1965 for financial transfers to the State governments for the 5 years covering the fourth 5-year plan, viz, April 1, 1966, through March 30, 1971.

In addition to grants-in-aid and shared taxes, the constitution also provides for grants for public purposes; these grants are, however, completely outside the purview of the Finance Commission. They are provided for in the constitution in order to meet special or emergency situations; they were never intended to be part of the normal Federal-State financial adjustments. Since these grants have actually come to occupy an important place in the existing scheme of intergovernmental financial transfers, they are considered first.

GRANTS FOR PUBLIC PURPOSES

Article 282 of the Indian Constitution empowers the Union and the States to make grants for any public purpose irrespective of whether or not the purpose is one with respect to which Parliament or the legislature of a State (as the case may be) may enact laws. Thus, the spending power of the Union and the States is not coterminous with their legislative powers.

Initially the Federal Government made grants to the States under Article 282 for the rehabilitation of persons displaced as a result of the partition of India. Later, with the introduction of centralized economic planning, developmental grants to States under the 5-Year Plans have been awarded under Article 282, on the recommendations of the Planning Commission. In fact, the Planning Commission makes a comprehensive study of the existing resources of the country as a whole and of the States individually. It then formulates plans for economic development in the light of the needs of each State. It sets goals for the standards of public services, the expected tax effort on the part of the States, and the extent of Federal aid necessary to achieve the targets of the Plan. A large part of the Federal aid required for executing Plan projects is given by the Federal Government in the form of tied grants in order to ensure planned development in the States in specific directions.[22]

SHARED TAXES

The constitution provides for a variety of taxes to be shared between the National and State Governments. These taxes may be classified into four groups. In the first group are taxes levied by the Federal Government but are collected and appropriated by the States;[23] the purpose of this arrangement is evidently not financial adjustment but administrative convenience. Stamp duties and excises on medicinal and toilet preparations fall in this category. A recent addition to this group is the interstate sales tax mentioned earlier, which is imposed by the Federal Government but collected by the States.[24]

In the second category are taxes levied and collected by the Federal Government but assigned to the States;[25] however, in these cases the

[22] *Report* of the Finance Commission, 1961 (New Delhi, 1962), p. 51 (hereinafter cited as *Third Report*).
[23] C. I., art. 268.
[24] Bhargava, *op. cit.*, p. 136.
[25] C. I., art. 269.

Federal Government is allowed to impose a surcharge for its own exclusive use.[26] Estate taxes on nonagricultural property, taxes on railway fares, and taxes on interstate trade appear in this group.

The third group consists of tax on income (other than agricultural income) which is levied and collected by the Federal Government, but mandated to be shared with the States.[27] The mandate to share income taxes with the States is not as restrictive as it seems at first sight, since the constitution permits the Federal Government to levy a surcharge on income for its own exclusive use.[28] Income tax on Federal emoluments, however, are retained wholly by the Federal Government.

In the fourth group are taxes levied, collected, and retained by the Federal Government which, on its own volition, may share the proceeds with the States.[29] Union excises except those on medicinal and toilet preparations comprise this group. Also, the additional Federal excises levied on factory-made textiles, sugar, and tobacco in lieu of State sales taxes on these commodities, as a result of the tax rental agreement between the Federal and State Governments mentioned earlier, fall in this group.

The Indian Constitution enumerates the taxes that fall into the four groups above; but it leaves the task of allocating the taxes between the Federal and State Governments, on the one hand, and the State Government inter se, on the other, to the study and recommendations of the Finance Commissions. A fairly discernible pattern of allocation of shared taxes has evolved as a result of the past recommendations of the four Finance Commissions.

In regard to the first group of taxes which are levied by the Federal Government but collected by States, the allocation of taxes among the various States is automatic.

The taxes in the second group are levied and collected by the Union government and, except in relation to Federal territories and to the extent of Federal surcharge, if any, the Union government has no share in these taxes. The Union government is merely entrusted with the levy, collection, and distribution of these taxes. The Finance Commissions have therefore rightly felt that these taxes have been placed under the jurisdiction of the Federal Government in order to insure uniformity in taxation and economy in collection. In view of this, even though Parliament is free to formulate any method of distribution, the Commissions have felt that each State should receive from these taxes, as nearly as could be reasonably ascertained, the amounts it would have raised if it had the power to levy and collect them.[30]

Thus in the case of Federal estate taxes, the Finance Commissions have made a distinction between such taxes on immovable and movable property; the taxes on the former have been allocated among States in proportion to the gross value of such property located in each State and on the latter in proportion to population.[31] Two percent of the total receipts has been set aside for Union territories.

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[26] *Ibid.*, art. 271.
[27] *Ibid.*, art. 270.
[28] *Ibid.*, art. 271.
[29] *Ibid.*, art. 272.
[30] *Report* of the Finance Commission, 1957 (New Delhi, 1957), pp. 16–17 (hereinafter cited as *Second Report*). Also Third Report, p. 13 and Report of the Finance Commission, 1965 (New Delhi, 1965), p. 12 (hereinafter cited as Fourth Report).
[31] The second, third, and fourth Finance Commissions were unanimous on the principle of allocation of estate taxes among the States. See Second Report, pp. 51–52; Third Report, pp. 13–14; and Fourth Report, p. 12. Since the estate tax was first levied in 1953, the first Finance Commission which was constituted in 1952 was not concerned with the allocation of estate taxes.

The same principle has been applied to the allocation among States of grants in lieu of taxes on railroad fares. This tax was imposed by the Federal Government under the Railway Passenger Fare Act of 1957 which was subsequently repealed in 1961 when the tax was merged in basic fares. The Federal Government then made a lump sum grant of Rs125 million per annum to the States for a period of 5 years from 1961–62 to 1965–66. The second Finance Commission in 1957 recommended that the allocation of the tax on railroad fares should be on the basis of actual passenger travel on railroads in each State. The Commission devised a formula based on the actual railroad track mileage and traffic density in each State.[32] The fourth Finance Commission has recommended continuation of this grant beyond 1965–66 and its distribution on a similar basis.[33]

In regard to the sharing of the remaining two groups of taxes, viz, Federal income taxes and excises, the Finance Commissions have to consider not only the basis of distribution among the States but also the proportion of the total receipts to be set aside for the States.

With respect to income tax, every Finance Commission has been urged by the States to increase their share of the total receipts. Their insistence has been due to two reasons: first, the Income Tax Act of 1959 reclassified income tax paid by companies as corporation tax, thereby excluding it from State sharing altogether; second, the yield from personal income tax has been relatively inelastic compared to that from corporation income tax. Each of the four Finance Commissions has recommended an increase in the prevailing States' share of the Federal income tax receipts. As a result the share has risen from 50 to 75 percent.

On the question of the distribution of the share of income tax assigned to the States, each State has in general put forward a scheme which is likely to benefit it most. Thus population, collection, contribution, needs, etc., have been advanced by the States as possible bases for distribution. It may be noted that the relatively industrialized States of Maharashtra (which includes the Bombay metropolitan area) and West Bengal (which includes the Calcutta metropolitan region) have argued strongly for distribution on the basis of collection [34] partly because these two States account for the bulk of receipts from income tax. In the year 1963–64, 33 percent of income tax receipts were from the former State and 18 percent from the latter; together the two States accounted for more than half of income tax receipts.[35] All the Finance Commissions, excepting the second, have been inclined to give some weight to collection because of the fact that "there is all over the country a core of incomes—particularly in the range of personal and small business incomes—which could be treated as of local origin." [36] The second Commission, however, felt that the principle of collection could not be considered an equitable basis of distribution since the bulk of

[32] *Second Report*, pp. 64–65.
[33] *Fourth Report*, pp. 14–16.
[34] Tax rental payments to provinces under Dominion-Provincial tax-sharing arrangements in Canada are based on the Dominion taxes collected in each province. In Australia, under the Uniform Income Tax Plan, division of taxes among the States is based on population weighted by the number of children and relative population density.
[35] *Fourth Report*, table 17, p. 186.
[36] *First Report*, p. 73.

the tax arises out of business incomes which is derived from the country as a whole. Furthermore, the Commissioners rightly observed that the relatively industrialized States are in a better position to raise substantial revenue from sales taxes, motor vehicles tax, entertainment tax, etc., than other States.[37] In general, the Finance Commissions have agreed that the primary basis of distribution of shared taxes should be a broad measure of need, like population, and that specialized indexes of need should be reserved for the consideration of grants-in-aid.[38] Thus 80 percent of the States' share of income tax has been distributed on the basis of population and the remaining 20 percent on the basis of collection.

The sharing of Union excises with the States, unlike income taxes, is not mandated by the Indian Constitution. The constitution merely *permits* Parliament to share excises with the States. The Finance Commissions have wrestled with the problems of what excises to share, what percentage of receipts to assign to States, and what criteria to devise for distribution among States. The first Commission restricted the shared excises to those on some staple commodities; the second Commission extended the base by adding more commodities on which excises were levied. The third broadened the base still further to cover practically all important Federal excises. As the base has widened, the share of total receipts allotted to States has decreased from 40 to 20 percent, although in absolute terms the divisible share has progressively increased. The fourth Commission, after a review of the entire range of excises levied by the Federal Government, recommended that all excises, except regulatory duties, special excises, and excises earmarked for special purposes, should be shared with the States. A broad base is needed to achieve coordination between the excise policies of the Federal Government, on the one hand, and the sales tax policies of the State governments, on the other. Further, the broader the base, the more stable will be the flow of resources to the States. Federal excise receipts have varied from time to time on certain articles of consumption, depending on economic conditions, and hence if a broad base is adopted, the buoyancy of receipts from excises on certain articles will make good the shortfall on others. Moreover, if a selected number of excises only are included in the base, a reduction or repeal of the excise of any included commodity will seriously affect the financial position of the States.[39]

As criteria for allocation of the divisible share of federal excises, the States have put forward population, consumption, contribution, and collection. Collection is ruled out as an equitable basis for distribution since an excise levied on producers in one State may in reality be borne by consumers of the taxed product all over the country. Distribution on the basis of consumption may unduly favor the more urbanized States which are also in a position to raise substantial revenue from sales taxes.[40] In any case, owing to lack of reliable data on the consumption of various taxed commodities, the Commissions have favored, as in the case of distribution of income tax, population as the primary basis for distribution of the divisible share of Federal excises.

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[37] *Second Report,* p. 40.
[38] *First Report,* p. 75; *Second Report,* pp. 39–40 and 44; *Third Report,* pp. 17–18 and 22; *Fourth Report,* pp. 19 and 28–29.
[39] *Fourth Report,* pp. 25–26.
[40] *Second Report,* p. 44.

The first Finance Commission distributed the States' share of excises solely on the basis of population.[41] The subsequent Commissions, while still holding population as the most important factor in distribution, have made some adjustments in favor of the relatively poorer States. Thus, the fourth Finance Commission has recommended that 80 percent of the divisible share be allocated on the basis of population and the remaining 20 percent on the basis of "economic and social backwardness" of States as indicated by a variety of factors like the percentage of scheduled castes and tribes in States' population, percentage of rural population, population per hospital bed, percentage of elementary school enrollment in the age groups 6 to 11, etc.[42]

The last three Finance Commissions had to consider the distribution of additional excise duties levied on factory-made textiles, sugar and tobacco by the Federal Government, as a result of the tax rental agreement between the States and the Union in 1957. The States consented to lift sales taxes on these commodities in 1957 if the Federal Government agreed to distribute the receipts from the additional excise duties on them, guaranteeing the revenues received hitherto by each State from sales taxes on them. Therefore, the first claim on the receipts from additional excises is compensation for loss of sales taxes in 1956–57. Distribution of the excess over the guaranteed amounts was based on consumption by the second Commission;[43] the third Commission distributed the excess on the basis of population and the percentage increase in sales tax receipts in each State since 1957–58.[44] The fourth Finance Commission felt that receipts from all sales taxes in a State are a more direct indication of the contribution made by each State to the divisible surplus over the guaranteed amount and recommended the distribution of surplus on the basis of the sales tax revenue realized by the States over the years 1961–62 to 1963–64.[45]

GRANTS-IN-AID

Important principles governing the allotment of grants-in-aid were laid down by the first Finance Commission[46] and were endorsed by the subsequent Commissions.[47]

The first Commission made it clear that the budgetary needs of the States are an important criterion for determining the eligibility of a State for grants-in-aid as well as for assessing the amount of such aid. In this respect distribution of grants-in-aid differs markedly from that of the divisible share of taxes. The Commission would, of course, take into account the effects of their recommendations with respect to sharing of tax receipts in the budget of the States before deciding upon the amount of grants-in-aid. Moreover, the budgetary positions of the States would be adjusted to insure comparability. Thus adjustments would be made for unusual or nonrecurring items of revenue and expenditure; due allowance would be made for clear cases of failure to maximize tax effort or to economize expenditure. Further-

[41] *First Report*, p. 82.
[42] *Fourth Report*, pp. 28–29.
[43] *Second Report*, pp. 60–61.
[44] *Third Report*, p. 27.
[45] *Fourth Report*, pp. 33–34.
[46] *First Report*, pp. 96–97.
[47] *Second Report*, p. 23; *Third Report*, pp. 28–29; *Fourth Report*, pp. 46–47.

more, grants-in-aid should help equalize the standards of basic social services in the various States, and should be given to States in order to meet special burden or obligations of national concern if they involve undue strain on their resources. The Commission further held that, independently of the budgetary criterion, grants-in-aid might be given to promote any beneficient service of primary importance in regard to which it was in the national interest to assist the less advanced States to go forward.[48] On this basis the first Commission recommended primary education grants to the States.

With regard to the question of whether or not grants-in-aid should be conditional, it was felt that both conditional and unconditional grants should be used in the scheme of assistance to the States. "Unconditional grants should reinforce the general services of the State governments, which they would be free to allocate among competing purposes according to their best judgment subject to the usual administrative and parliamentary checks. Grants for broad purposes may be given to stimulate the expansion of particular categories of services rather than specified schemes under those categories." [49]

Even though all the Finance Commissions have approved of the principles governing grants-in-aid formulated by the first Commission, none has so far succeeded in translating all these principles into actual practice. No Finance Commission has yet ventured into any detailed study of the tax efforts, expenditures, and budgetary needs of the States. Unfortunately, the Finance Commissions are not in a position to make such studies, since they have not been provided with an organization which does continuous study and research of State and local finance in India. In fact, all the Finance Commissions have urged the establishment of a permanent research organization to facilitate their work.[50]

The second Finance Commission agreed with the earlier Commission on the principles governing grants-in-aid. However, it made some important observations in regard to the application of these principles. The Commissioners observed that in a federation where the National and State Governments cooperate for planned economic development, priorities and provisions of the 5-Year Plans themselves should determine the fiscal needs of the States for the period of the Plans. Therefore, in assessing the needs of the States, the second Commission took into account the estimates made by the Planning Commission.[51] Moreover, the Commission assumed that if a State had raised the additional revenue which it had promised for the purposes of the 5-Year Plans, it should have met the criterion of adequacy of tax effort.[52]

Further, the second Commission felt that having accepted the Plan as insuring an equitable standard in the field of social services in all the States, it was inappropriate to make any special grants-in-aid for the expansion of any particular public service in certain States, like the primary education grants recommended by the first Commission.[53]

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[48] *First Report*, pp. 96–98.
[49] *Ibid.*, pp. 95–96.
[50] *Second Report*, p. 71; *Fourth Report*, pp. 62–63. The Commonwealth Grants Commission in Australia, which is a permanent body, is in this regard signally different from the Finance Commission in India.
[51] *Second Report*, pp. 11–12.
[52] *Ibid.*, p. 25.
[53] This observation by the second Commission did not stop the third Commission from making a special grants-in-aid to certain States for the improvement of communications, especially constructing roads. *Third Report*, pp. 32–33.

And the Commission went on to say that the gap between the ordinary revenue of a State and its "normal inescapable expenditure" should, as far as possible, be met by the sharing of taxes and that grants-in-aid should be given in the form of general and unconditional grants. The Commission approved of grants for broad purposes only if such purposes were not provided for in the comprehensive plan for economic development of the country.[54]

One of the serious problems faced by the Finance Commissions in making meaningful estimates of grants-in-aid required by the various States is that of dovetailing their role with that of the Planning Commission. In fact, the Planning Commission, as mentioned earlier, also makes a comprehensive survey of State finances, expenditures, and tax efforts in order to determine grants required for completion of Plan projects. These grants are, however, outside the domain of the Finance Commission.

A substantial part of the problem of coordinating the efforts of the Finance Commission with those of the Planning Commission arises out of the lack of a clear conceptual demarcation of the respective roles of these two bodies—a matter which seems to have been resolved, albeit formally, by the time of the appointment of the fourth Finance Commission. In part, too, the problem was aggravated by a want of correspondence between the quinquenniums covered by the first two Commissions and the first two 5-Year Plans; this anomaly was remedied by having the third Commission's recommendations cover a 4-year period so that the fourth 5-Year Plan running from 1966–67 to 1970–71 would extend over the same period covered by the fourth Finance Commission.

The second Finance Commission, in making its recommendations for grants-in-aid for the 5-year period, 1957–58 to 1961–62, was directed to take into account the requirements of the second 5-Year Plan running from 1956–57 to 1960–61. This required the Finance Commission to consider the requirements of the last 4 years of the second 5-Year Plan; furthermore, the Commission had to make estimates in 1957 of the needs of the States for the first year of the third 5-Year Plan commencing in 1961–62. In reality, however, the grants-in-aid recommended by the second Commission specifically for Plan purposes covered only the estimated gap between the State expenditures on Plan projects and the resources expected to be raised by the States in addition to the Plan grants (i.e., public purpose grants under Article 282) proposed by the Federal Government.

The third Commission was also directed to consider the requirements of the third Plan before recommending grants-in-aid to the States. The Commissioners felt that it would be arbitrary to draw a line between Plan and non-Plan expenditure of the States. They pointed out that a high proportion of what was classified as non-Plan expenditure was itself due to projects launched in previous Plan periods for which maintenance became a non-Plan expenditure for States.[55] They were also concerned about the propriety of using article 282 of the constitution, intended to be a merely permissive provision to meet a possible emergency, for purposes of grants-in-aid to the States under the

[54] *Second Report*, p. 25.
[55] *Third Report*, p. 30.

Plans.[56] The Commission noted too that the latter grants had risen from nearly 50 percent of total Federal assistance to States in 1952–53 to about 80 percent in 1961–62.[57] The Commissioners therefore reconmended that total grants-in-aid should be of an order which would enable the States, along with any surplus of receipts from tax sharing, to cover 75 percent of the gap between the Plan expenditures and the resources to be raised by the States themselves for the Plan. The rest was to be made up by grants under Article 282. The effect of this recommendation was to reduce the amount of discretionary grants given by the Federal Government under Article 282 and to bring the bulk of Federal transfers to States under the scrutiny of the Finance Commission.[58]

This recommendation of the third Finance Commission, however, proved to be unacceptable to the Federal Government. Grants under Article 282 are tied to particular programs. Since economic and social planning is a subject matter which falls under the Concurrent List in the constitution, the only effective way by which the Federal Government can require the States to undertake certain programs is through conditional grants. If grants for Plan projects were made without any conditions as recommended by the third Commission, it is feared that programs of national priority, like "grow more food," would suffer because of diversion of funds from such programs by States with agricultural surplus to other projects of lesser national importance.

The confusion between the respective roles of the Planning and Finance Commissions as regards financial transfers to State governments seems to have been partly resolved with the appointment of the Fourth Finance Commission whose recommendations cover the same period as the fourth 5-Year Plan (1966–67 to 1970–71). The directive to the fourth Commission did not say that the Commissioners should take into account the requirements of the fourth 5-Year Plan before assessing the amounts of grant-in-aid needed by the States; [59] but it did say that they should take into account the committed expenditure of the States for maintenance of Plan schemes completed during the third 5-Year Plan.[60] Thus a distinction is drawn between the roles of the Planning Commission and Finance Commission; the former will recommend grants under Article 282 for Plan projects and the latter will confine itself to non-Plan budgets of the State governments. Furthermore, the fourth Commission was required to make recommendations regarding grants-in-aid for the 5-year period from 1966–67 to 1970–71 on the basis of taxation levels likely to be reached by the States in 1965–66; [61] this directive excludes, by implication, any inquiry into the tax efforts of the States by the Commission. In fact, the question of additional taxation by the States is left outside the scope of the deliberations of the Commission.

It would appear that Plan grants would continue to be made on the recommendations of the Planning Commission and that the Finance Commissions would be concerned with the grants-in-aid required for

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[56] *Ibid.*, p. 40.
[57] *Ibid.*
[58] *Ibid.*, pp. 31–32. In a vigorous note of dissent, the Member-Secretary of the third Finance Commission disassociated himself from this recommendation. See Ibid., pp. 51–60.
[59] *Fourth Report*, pp. 1–5.
[60] *Ibid.*, p. 2.
[61] *Ibid.*

the non-Plan sector of the State budgets. Questions regarding adequacy of the tax effort of the States would be outside the scope of the Finance Commission which, however, would be free to investigate the non-Plan expenditure of the State governments.

In reviewing the needs of the States for grants-in-aid, the Finance Commissions have found that some States do not need such aid since receipts from shared taxes have covered the gap in their budgets. The States for which the fourth Commission did not recommend any grants-in-aid are expected to have surpluses during the period from 1966–67 to 1970–71. The Commissioners hoped that the surpluses would be taken into account when Plan grants would be made for the fourth 5-Year Plan.[62]

TRANSITIONAL GRANTS-IN-AID

Under Article 273 of the Indian Constitution, the jute-growing States were entitled to grants-in-aid in lieu of a share of the jute export duty for a transitional period of 10 years. This temporary provision was made to avoid any abrupt effects on the budgets of those States by sudden withdrawal of privileges enjoyed prior to the inauguration of the constitution. The transitional period expired with the fiscal year 1959–60. During the interim period, the Finance Commissions recomended these grants by a formula which took into account both the yield from the export duty and the production of new jute by different States.[63]

OTHER MATTERS REFERRED TO THE FINANCE COMMISSIONS

Indebtedness of the State governments.—The mounting debt of the State governments and the cost of servicing such debt and providing adequate amortization for it have caused concern for both the State and Federal Governments. The indebtedness of the State governments rose from about Rs2 billion in 1950 to about Rs52 billion in 1966. About 80 percent of the States' outstanding debts in 1966 was owed to the Federal Government. Almost all the State borrowings from the Federal Government was to finance projects under the various 5-Year Plans.

The question of State indebtedness to the Federal Government was first referred to the second Finance Commission appointed in 1956. The large number of loans given and the wide variations in the rate of interest and terms of repayment had introduced avoidable complications in Federal-State financial relations. The second Commission endeavored to consolidate these loans and rationalize the rates of interest and terms of repayment. The consolidation suggested by the Commissioners was basically as follows: All State loans due for repayment within a period of 20 years from April 1, 1957, to be consolidated into a single loan repayable at the end of 15 years, that is, March 31, 1972; the remainder of the State loans to be consolidated into another single loan repayable at the end of 30 years, that is on March 31, 1987. The rate of interest on these loans was fixed at the average cost of Federal borrowings. The Commissioners suggested

[62] *Ibid.*, p. 10.
[63] *First Report*, p. 89; *Second Report*, pp. 45–46.

that the basic feature of their scheme may be considered for adoption in future years. This would mean that all the advances made to a State during a year will be converted into two loans at the end of the year: a medium-term loan and a long-term loan at a rate of interest approximately equal to the net cost of all Federal borrowing during the year.[64]

With the continuing reliance on loan finance for Plan projects, service charges on debt have continued to climb. The State governments stressed before the third Finance Commission that interest liability on their debt alone absorbed a substantial portion of their current revenues. The third Commission did take into account the interest liability of the States in determining their grants-in-aid.[65] The fourth Finance Commission was directed to take into account service charges on the States' debt before determining their grants-in-aid. In addition, the Commissioners were required to consider the advisability of setting aside a portion of each State's share in the Federal estate tax for the repayment of its debt to the Federal Government; however, after a review of the debt position of the States, the Commissioners did not favor such an approach. They felt that an expert inquiry should be undertaken to decide the principles of a scheme of amortization of the borrowings of the State governments not only from the Federal Government but also from the public.[66] The State governments have used a large portion of the proceeds of the loans from the Federal Government to make loans and advances to local governments and farmers. In reality, some States have made such loans and advances with great care, and recoveries have been regular. In other States this has not been so and recoveries have been lagging.

Coordination between excises and sales taxes.—The pressure for financial resources both at the Federal and State levels in the wake of developmental planning has led to a tremendous expansion of Federal excise levies and State sales taxes. In 1950–51, the aggregate yield from the two levies amounted to Rs1.3 billion, representing 1.3 percent of the national income of that year: by 1963–64, the yield had risen about Rs10 billion, accounting for 5.8 percent of national income of that year. The growth rate of the excises has been higher than that of the State sales taxes. In 1965–66, these two levies were more or less of the same importance in the Federal and State budgets. Excises accounted for 42 percent of the tax receipts of the Federal Government in 1965–66; sales taxes amounted to 41 percent of the total yield of State taxes in the same year.[67]

The increasing reliance on excises and sales taxes on commodities has caused concern about the economic effects of these levies on the production, consumption, and export of these commodities. As a re-

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[64] *Second Report*, pp. 52–58.
[65] *Third Report*, p. 41.
[66] *Fourth Report*, pp. 63–68.
[67] *Ibid.*, pp. 39–40.

sult, the fourth Finance Commission was directed to make recommendations in regard to—

(*a*) The effect of the combined incidence of State sales taxes and Federal excises on the production, consumption, or export of those commodities or products, the excises on which are shared with the States; and

(*b*) The adjustments, if any, to be made in a State's share of Federal excises, if the sales tax rate levied by the State exceeded certain specified ceilings.

The Commissioners observed that to study the effect of the combined incidence of a State sales tax and Federal excise on a commodity was a heroic task indeed; even if the Commissioners could study the incidence, it would still be a formidable task to isolate the effect of that incidence on consumption, production, and export of the commodity, which would be influenced by a variety of other factors. Further, the Commissioners pointed out that in order to recommend ceilings on sales taxes, it would be necessary to determine not only the *combined* incidence but also the *separate* incidence of each.[68] Moreover, apart from the level of the rates of levies, the manner of imposition and collection would also affect production, consumption, or export.

In view of the difficulties mentioned above, the Commissioners felt that a more productive approach to achieve coordination between Federal-State policies on excises and sales taxes would be through intergovernmental consultation. In fact, Article 274 of the Constitution provides that no proposal which in any way affects existing or prospective financial interest of a State shall be presented to Parliament except on the recommendation of the President. The Commissioners urged the Federal Government to respect the spirit of Article 274 and initiate consultations with State governments on tax coordination as well as other matters.[69]

V. Trend of Federal Transfers to States During 1952–66

The rapid growth of subventions from the Federal to State governments during the period from 1951–52 to 1965–66 may be seen from table 3; total Federal transfers to State governments increased more than seven times, from Rs850 million to Rs6.2 billion. Of the various components of Federal transfers, the growth of grants under Article 282 (primarily Plan grants) has far outpaced the growth of shared taxes or grants-in-aid. The importance of shared taxes in total resources transferred by the Union government to the States has declined during this period; in 1951–52 shared taxes accounted for about 60 percent of total Federal transfers whereas in 1965–66 it was only 44 percent (table 4). Plan grants were about the same magnitude as shared taxes in 1965–66.

[68] *Ibid.*, pp. 41–42.
[69] *Ibid.*, p. 61.

TABLE 3.—*Federal financial transfers to the State governments during selected fiscal years, 1951–52 to 1965–66*

[In millions of rupees; 1 rupee=13.3 U.S. cents]

FEDERAL TRANSFERS

Year	Shared taxes [1]		Grants-in-aid		Grants under art. 282		Total	
	Amount	Index	Amount	Index	Amount	Index	Amount	Index
1951–52	528.6	100	173.0	100	149.6	100	851.2	100
1955–56	736.0	139	242.7	140	794.4	531	1,773.1	208
1960–61	2,029.3	384	488.1	282	1,137.8	761	3,655.2	429
1963–64	2,590.0	490	690.0	399	1,620.0	1,083	4,900.0	576
1965–66 [2]	2,710.0	513	770.0	445	2,670.0	1,785	6,150.0	723

[1] Includes taxes levied and collected by the Federal Government but wholly assigned to the States.
[2] Budget estimates.

Sources: Data for 1951–52 and 1955–56: *Second Report*, table 10, p. 193. Data for 1960–61: *Third Report*. tables 2(a) and 2(b), pp. 102–03. Data for 1963–64 and 1965–66, *Fourth Report*, table 19, p. 191.

TABLE 4.—*Federal financial transfers to the State governments during selected fiscal years, 1951–52 to 1965–66*

[In millions of rupees; 1 rupee=13.3 U.S. cents]

Federal transfers	1951–52		1955–56		1960–61		1963–64		1965–66 [1]	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Shared taxes [2]	528.6	62.1	736.0	41.5	2,029.3	55.5	2,590.0	52.9	2,710.0	44.1
Grants-in-aid	173.0	20.3	242.7	13.7	488.1	13.4	690.0	14.1	770.0	12.5
Grants under art. 282	149.6	17.6	794.4	44.8	1,137.8	31.1	1,620.0	33.1	2,670.0	43.4
Total	851.2	100.0	1,773.1	100.0	3,655.2	100.0	4,900.0	100.0	6,150.0	100.0

[1] Budget estimates.
[2] Includes taxes levied and collected by the Federal Government but wholly assigned to the States.

Sources: Same as table 3.

The proportion of Federal transfers to total Federal tax revenues has doubled during this period (table 5). Federal transfers were about one-third of the total tax revenues of the Union government in 1965–66. As a proportion of national income, the transfers have tripled during this period from about 1 to 3 percent.

TABLE 5.—*Federal transfers to State Governments in relation to Federal tax revenues and national income during selected fiscal years, 1951–52 to 1963–64*

[In millions of rupees; 1 rupee=13.3 U.S. cents]

Year	Federal transfers	Federal revenues	National income	Federal transfers as percent of—	
				Federal revenues	National income
1951–52	851.2	5,391.6	99,700	15.8	0.9
1955–56	1,773.1	5,520.8	99,800	32.1	1.8
1961–62	3,960.0	10,537.5	148,000	37.6	2.7
1962–63	4,460.0	12,850.4	154,000	34.7	2.9
1963–64	4,900.0	16,338.3	172,000	30.0	2.8
1965–66	6,150.0	19,486.9	(1)	31.6	(1)

[1] Not available.

Source: Data for 1951–52 and 1955–56: 2d report, table 10, p. 193; data for 1961–62, 1962–63, and 1963–64: 4th report, table 16, pp. 184–185; table 19, p. 191; and table 30, p. 232.

The extreme dependence of the State governments on Federal transfers is clearly demonstrated in table 6. In 1951–52 these transfers amounted to slightly more than one-third of the tax revenues of the States from their own sources. Although the revenues of the States from their tax sources more than tripled during the period under review, Federal transfers jumped more than seven times with the result that the latter amounted to four-fifths of the former in 1965–66.

TABLE 6.—*Federal transfers in relation to total tax revenues of State governments from their own sources during selected fiscal years*

[In millions of rupees; 1 rupee=13.3 U.S. cents]

Year	Federal transfers [1]	State tax revenues	Federal transfers as percent of State tax revenues
1951–52	851.2	2,325.3	36.6
1955–56	1,773.1	2,812.2	63.1
1960–61	3,655.2	4,395.1	83.2
1963–64	4,900.0	6,834.4	71.7
1965–66 [2]	6,150.0	7,649.4	80.4

[1] Includes tax levied and collected by the Federal Government but wholly assigned to the States.
[2] Budget estimates.

Source: Data for 1951–52 and 1955–56, 2d report, table 6, pp. 166–167; data for 1960–61, 3d report, table 3, p. 107; data for 1963–64 and 1965–66, 4th report, table 20, pp. 192–195.

VI. Appraisal of Indian Fiscal Federalism

A meaningful appraisal of fiscal federalism in any federation should take into account its historical background which influences the whole complex of its Federal-State relations. A federation may assume any of a wide range of possible relationships between the National Government and its constituent units—from a very loose to a very centralized framework. The nature of a federation, however, influences very significantly the pattern of Federal-State relationships.

The Federation of India is in many respects the antithesis of the Federation of the United States. The former came about largely through a process of decentralization, whereas the latter was the result of a process of centralization. In India the Federal framework emerged out of the willingness of a unitary administration to carve out semiautonomous political jurisdictions which later derived their powers which the Central Government was willing to delegate to them. Since the National Government fathered the States, it is reasonable to expect that the demarcation of sources of revenue and the allotment of functions between them will be such as to result in the financial dependence of the latter on the former.

One of the most salutary features of Indian fiscal federalism is that the problem of Federal-State financial relationships has been put in the hands of a statutory body, the Finance Commission. Federal-State financial adjustments are thus put above the realm of political bargaining as in Canada and, to a much lesser extent, in Australia. Being free from political pressure and maneuvering, this important problem is more likely to receive a careful, dispassionate, and objective scrutiny that it deserves than otherwise.

Another desirable feature of Indian fiscal federalism is that it minimizes nonneutralities arising from the operation of the Federal and State fiscs. The criterion of neutrality in Federal finance will require that, beyond raising the required revenue and furnishing the necessary public services, the public fisc shall not cause distortions in the regional allocation of resources. However, recognition of the principle of neutrality in no way excludes the use of tax or expenditure policy to accomplish desired objectives of economic control. "Neutrality is efficient only in the avoidance of effects that are not an intended part of an efficiently determined set of policy objectives." [70] The elaborate scheme of division of taxing powers between Federal and State Govments, explained earlier, and enactments such as the Central Sales Tax Act of 1957, have minimized nonneutralities by reducing the possibility of double taxation by State and Federal Governments, tax rivalry among States, and overlapping taxation by States.

A goal of Federal finance which is steadily gaining wider acceptance in all of the existing federations today is that every citizen of a Federal State, no matter where within the confines of the federation he might live, should be assured of a level of education and social welfare not below certain minimum standards. In order to assure some degree of equalization, the national pool of wealth and income may be drawn upon, wherever it is accessible, and redistributed. How successful has Indian Federal finance been in achieving the equalization objective?

Equalization as an objective of Federal finance is open to several interpretations. There are several possible schemes of equalization which Federal finance may adopt.[71] A meaningful scheme of equalization will be for the Federal Government to underwrite the cost of maintaining a certain minimum in the standards of all or some important public services throughout the country, having due regard to the fiscal capacity, tax effort, and needs of the States. Such an equalization scheme is perhaps beyond the financial capability of the Federal Government in India. In view of this, a somewhat limited approach may be employed in testing how far Indian Federal finance promotes equalization. If the need for services is taken to vary directly in proportion to the population of the States, the equalization objective is fostered if Federal grants do result in larger per capita aid to a State with lower fiscal capacity than to one with greater fiscal capacity, assuming that both are making the same tax effort.

The application of this test, of course, requires the construction of indices of fiscal capacity and tax effort of States. It is impossible to devise completely satisfactory indices of fiscal capacity and tax effort. However, per capita income of a State and State and local tax collections as a proportion of total State income are generally used as a State's indexes of fiscal capacity and tax effort respectively. Since data on tax collections of local governments are not readily available, only State tax collections are used in computing an index of tax effort. Table 7 gives these indexes and the rankings of the States in terms of these indexes during the fiscal year 1965–66.

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[70] Richard A. Musgrave, *"The Theory of Public Finance"* (New York, 1959), p. 141.

[71] Richard A. Musgrave, *"Approaches to Fiscal Theory of Political Federalism,"* Public Finances: Needs, Sources, and Utilization, a Conference of the Universities-National Bureau Committee for Economic Research, 1961, pp. 97–122.

TABLE 7.—*Indices of fiscal capacity and tax effort and per capita Federal transfers, plan grants, and expenditure of Indian States, 1965–66* [1]

[Amounts in rupees, 1 rupee=13.3 U.S. cents]

State	Index of fiscal capacity per capita income		Index of tax effort—State tax collection per 1,000 rupees of State income		Per capita Federal aid		Per capita plan grants		Per capita State expenditure	
	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank
Maharashtra	574.9	1	43.5	7	13.6	8	6.5	5	50.9	4
West Bengal	567.8	2	34.7	12	12.3	12	5.9	7	43.3	10
Punjab	541.7	3	39.8	9	14.0	7	7.2	3	54.9	2
Gujarat	480.1	4	39.6	10	15.1	4	5.7	8	48.2	5
Madras	426.1	5	46.9	2	12.4	11	5.4	9	47.2	8
Assam	401.7	6	46.0	4	28.5	2	17.0	2	52.1	3
Kerala	388.4	7	50.6	1	14.2	6	4.8	12	46.7	9
Mysore	377.3	8	43.7	6	14.4	5	6.2	6	48.1	6
Jammu and Kashmir	370.8	9	24.1	15	36.5	1	22.5	1	94.6	1
Uttar Pradesh	370.3	10	27.5	14	10.0	14	5.1	11	32.3	14
Andhra Pradesh	361.9	11	46.2	3	13.4	9	5.3	10	41.2	11
Madhya Pradesh	351.8	12	40.7	8	11.2	13	4.7	13	33.7	13
Orissa	343.8	13	28.4	13	20.6	3	7.1	4	47.6	7
Rajasthan	324.6	14	45.6	5	13.0	10	4.7	14	37.8	12
Bihar	274.0	15	35.6	11	9.0	15	3.4	15	22.2	15
Coefficient of variation among States (percent)	[2] 21.4		19.4		44.8		67.9		57.3	

[1] Budget estimates.
[2] Coefficient of variation of a distribution is the ratio of its standard deviation to its mean.

Source: 4th Report, table 20, pp. 192–195 and table 23, pp. 202–204; *Quarterly Economic Report of the Indian Institute of Public Opinion*, vol. XIII, No. 2, October 1966, p. 26, table I.

There is considerable variation in fiscal capacity, tax effort, and per capita Federal aid among the various States. Comparing the States at the extreme ends of the distribution in each of these cases, it is seen that per capita income in Maharashtra is more than double that of Jammu and Kashmir; the per capita tax effort of Kerala is more than double that of Jammu and Kashmir; the per capita Federal aid for Jammu and Kashmir is four times that of Bihar. In spite of the fact that income taxes and Federal excises are shared largely on a population basis, there is still considerable variation in per capita Federal aid among the States.

The extent of State variation in each of these cases can be measured by computing the coefficient of variation; the smaller the coefficient, the less the variation among the States, and the higher the coefficient, the greater the variance. There is greater variation in fiscal capacity than in tax effort. The variation in per capita Federal aid is more than double that of either fiscal capacity or tax effort.

Maharashtra which ranks highest in fiscal capacity, comes seventh in tax effort and eighth in per capita Federal aid. Rajasthan which ranks 14th in fiscal capacity (much lower than Maharashtra) comes fifth in tax effort (higher than Maharashtra) but only 10th in per capita Federal aid (lower than Maharashtra). Thus, in spite of a lower fiscal capacity and a greater severity of tax effort, Rajasthan ranks lower in per capita aid than Maharashtra. A similar picture may be drawn in the case of West Bengal and Madhya Pradesh, or Punjab and Mysore, or Gujarat and Kerala, and so on. However, in the case of Maharashtra and Mysore, per capita Federal aid tends somewhat to equalize the positions of the two States. The same is true of West Bengal and Andhra Pradesh, or Punjab and Assam, and so on. In short, fiscal federalism in India has a mixed record in terms of equalization; in some cases, between two States there is an element of equalization and in other cases the result is exactly the opposite.

Some significant weaknesses of Indian Federal-State finance come to view on a closer inspection of Table 7. The four highest ranking States in terms of fiscal capacity rank quite low in terms of tax effort. The State which ranks highest in tax effort is but seventh in fiscal capacity. Some of the States which rank very low in fiscal capacity make a greater tax effort than the four highest ranking States in fiscal capacity. This points to some serious problems which were pointed out by the third Finance Commission as follows:

Secure in the knowledge that the annual budgetary gap would be fully covered by devolution of Union resources and grants-in-aid, the States are tending to develop, as we have noticed, an allergy to tap resources in the rural sector on many considerations and also a disinclination to make up the leeway in others. They do not also attach the same importance to a proper and adequate control on expenditure in the matter of services and supplies as before. * * * While there is a close scrutiny of, and consultation on, the contents of the Plan, there is hardly any on the contents of the annual estimates; there is no counterpart at the national level in regard to non-Plan expenditure which is progressively increasing as a result of the planning itself.[72]

The Commission continued:

A similar situation obtains in the field of taxation and considerable disparities exist in the fields of revenue, sales tax, motor vehicles tax, etc. Though it is generally accepted that the rural sector could make a greater contribution to national economy, there is an understandable reluctance to revise even the rates of land revenue in operation, even when they have not been reviewed in the last 30 or 60 years. In one State, when a limited operation indicated that rates could be increased considerably an old accepted and established principles of assessment, the Government considered it inadvisable to continue the settlement operations. In another State, in real need of resources, the collection of betterment levy already introduced had to be suspended just because the neighboring State had done so in a more prosperous contiguous area. All these induce a chain reaction of enforced undertaxation on the one hand, and avoidable increase in public expenditure on the other.[73]

With the extreme reliance on Federal Government for financial resources, the State governments are reluctant to undertake the politically unpleasant task of an adequate tax effort and control over public expenditure. There is a crying need for a careful study of the tax efforts and economy in expenditure of the various States.

As pointed out earlier, the equalization aspects of per capita Federal aid to States are mixed; the same is true of per capita Plan grants. Generally speaking the States which rank very low in per capita income also rank very low in per capita Plan grants. Furthermore, the relatively low income States generally rank low in per capita State expenditures and the coefficient of variation of per capita State expenditure is more than double that of per capita income (table 7).

[72] *Third Report*, p. 38.
[73] *Ibid.*, pp. 38–39. Inadequate tax effort of the States, marked interstate variations in tax effort, and reluctance to tap the agricultural sector have been pointed out time and again by the Planning Commission in its appraisals of the progress of the Plans. See The Third Plan Mid-Term Appraisal (Planning Commission. New Delhi, November 1963), pp. 34 and 105–106; Third Five-Year Plan Progress Report (Planning Commission, New Delhi, March 1963), p. 39 and Appraisal and Prospects of Second Five-Year Plan (Planning Commission, New Delhi, 1958), pp. 13 and 20.

This would seem to suggest, at least tentatively, that the Plan's contribution to the improvement of the relative positions of the low income States is not very significant. Since the extent of Federal aid to a State depends on its needs as envisaged in the Plan, the equalization effects of Federal aid will be in proportion to the equalization effects of the Plan. It is only to the degree that the planners strive and succeed in achieving a regionally balanced plan that Federal aid may be expected to be equalizing.

Another desirable objective of fiscal federalism is the promotion of stabilization of economic activity. In a cyclical setting, it is not only the fiscal capacity of the State governments that is subject to variability but also the need for services rendered by them. It is therefore desirable to build countercyclical features into the scheme of Federal financial transfers to State governments. How does fiscal federalism in India rate in terms of the stabilization objective?

As pointed out earlier, a substantial portion of the financial resources of the State governments are derived from the Federal Government. Therefore Federal transfers are important enough in State budgets to exert compensatory influence, if designed properly. However, the structure of Federal financial transfers considerably limits their countercyclical potential. The State governments now share the elasticity of the yield of taxes levied by the Federal Government. Contributions from shared income taxes are quite sensitive to fluctuations of business activity, while other shared taxes (like Union excises, especially on essentials) present an element of stability in their yields. If the Federal Government undertakes anti-inflationary tax policies via an increase of existing excise or income levies, or addition of new excises, then State revenues would swell from such measures. The reverse is true in a deflationary situation. Thus, the present pattern of shared taxes has little by way of compensatory features to shield State finances from the vicissitudes of the business cycle. This deficiency will have to be overcome by ad hoc adjustments.

Some other weaknesses of Indian Federal-State fiscal arrangements may be briefly mentioned. Under the existing system, the Finance Commissions fix the amounts of grants-in-aid and the shares of various taxes that will accrue to the different States for a period of 5 years in advance. The receipts from the former are fixed in advance whereas those from the latter will vary with the yields of the shared taxes. It is inevitable that the 5-year forecasts of State revenue and expenditure and of the expected receipts from shared taxes will have a wide margin of error. To base fixed amounts of grants-in-aid for a period of 5 years on the basis of these forecasts is, to say the least, quite unrealistic.[74]

Another weakness of the present system is the uncertainty experienced by the States in relation to receipts from shared taxes. As a member of the fourth Commission pointed out, a mere terminological change can prevent the division of the receipts from a particular tax between the Federal and State Governments or can make a purely Federal tax into a divisible one. An increase in the fares on the federally owned railways designated as a tax on fare will create divisible resources whereas a similar increase designated as a higher fare will

[74] Prest, *op. cit.*, pp. 215–216.

create resources only for the Federal Government.[75] The State governments have already expressed considerable dissatisfaction about the reluctance of the Federal Government to cultivate taxes the receipts from which are shared with the States.

Finally, considerable modifications in the existing practices with regard to the service and amortization of State loans are called for. While interest on loans is charged against revenues by the State governments, practice varies among States with respect to the treatment of amortization of such loans. In the face of mounting debts it need hardly be said that efficient administration of disbursement of loans by the State governments is essential both for the solvency of the States as well as the Federal Government. Furthermore, it is a matter of equity between the States that none of them should be permitted to gain any advantage over the others through default of the loans made by the Federal Government.

VII. Proposal for Reform of Federal-State Fiscal Arrangements

After four Finance Commissions and 18 years of experience in intergovernmental financial relations under the new constitution, it is but appropriate to consider what changes need to be made in the existing Federal-State fiscal arrangements in India. In fact, the second, third, and fourth Finance Commissions felt that modifications should be made in the machinery which makes Federal-State financial adjustments.[76] Any suggestions for change in as sensitive an area as intergovernmental relations is apt to invite controversy. Nevertheless, some proposals for modifications are offered below.

In view of the fundamental importance and likely persistence of questions of Federal-State financial relations, the architects of the Indian Construction provided for a statutory body, viz, the Finance Commission, to make periodic studies and recommendations in regard to Federal-State financial arrangements. It was their intention that all important matters regarding Federal-State financial relations be subject to the deliberations of the Finance Commission. Article 282 of the Indian Constitution which enables Federal and State Governments to make grants for any public purpose, was intended only as a residual provision to meet some unforeseeable contingencies. It was never contemplated that Article 282 would have any major role in the financial arrangements between the Federal Government and the States.[77] Events have proved otherwise.

The architects of the Indian Constitution, of course, could not have foreseen the rise of the Planning Commission with enormous powers over the allocation of resources between the Federal and State Governments. The Plan grants to States, which are steadily rising in importance, are made under Article 282 of the constitution and are completely outside the purview of the Finance Commission. Thus, about 15 years after the beginning of the Federation, a major part of the total Federal financial transfers to the States have come to be determined in a manner not anticipated by the Indian Constitution.

[75] *Fourth Report*, p. 99.
[76] *Second Report*, p. 72 : Third Report, pp. 35–36 : Fourth Report, pp. 86–93 and 99.
[77] Constituent Assembly of India, *Constituent Assembly Debates, Official Report* (New Delhi, 1949), IX, Nos. 8 and 9, 303–330.

In spite of the attempt, explained earlier, to demarcate the formal roles of the Planning and Finance Commissions on the basis of Plan and non-Plan grants, the substantive part of the duplication of their roles still persists. The dichotomous division of the State budgets into Plan and non-Plan sectors for the purpose of determining Federal aid is at best a fiction since both these sectors are inextricably intertwined. Apart from this, given the dominant role of the Planning Commission, the independence and usefulness of the Finance Commission are very severely circumscribed. Indeed, the modus operandi of central planning in India precludes the Finance Commission from playing the role destined for it by the authors of the Indian Constitution. Hence, the raison d'etre of a separate statutory body, like the Finance Commission which recommends the scheme of transfer of revenues and grants-in-aid to States may be seriously questioned. Under the circumstances, it is reasonable to conclude that the Planning Commission itself is the appropriate agency to ascertain such transfers to State governments.

A related question, in this connection, is whether it is desirable to retain the rather complicated schemes of devolution of financial resources by sharing of Federal income taxes and excise levies, by distribution of estate taxes and additional excises levied by the Federal Government, by grants-in-aid of revenues, by grants under Article 282, etc. If the financial transfers from the Federal Government to the States are in an important measure subservient to the achievement of a comprehensive economic plan, a strong case may be made for the simplification and streamlining of the cumbersome means by which Federal transfers are now made to the States. Would it not be more simple and efficient to accumulate all the resources that the Federal Government can spare into a single fund from which the Planning Commission may recommend a block grant every year to each State? The effectiveness of such a procedure will depend upon the ability of the Planning Commission to insure that each State accomplishes its share of the economic development program with adequate tax effort and economy in expenditure. Such power, if given to the Planning Commission, is bound to result in some compromise of State autonomy which may not be incompatible with the highly centralized framework of the Indian Federation.

A less radical alternative will be to fix a definitive allocation of divisible taxes and excises in the constitution itself and leave grants-in-aid to be determined every year by the Planning Commission after a careful study of the State budgets.

FEDERAL-STATE FINANCIAL RELATIONS IN INDIA *

BY WILFRED PREST**

In view of current discussions of Federal-State financial relations in Australia, it is perhaps worth examining procedures and practices in other Federal countries, partly in order to understand the essential nature of our own problems, and partly in the hope that some of the solutions adopted elsewhere may be applicable here.

With these objectives in mind, the present paper attempts a review of Federal-State financial relations in India. Being a new Federation, India has been able to profit by the experience of others. The Government of India Act of 1935, and the financial arrangements made thereunder, were the products of some of the best British and Indian legal and administrative minds. More recently Independence, Partition, and the formulation of the 1950 Constitution have provided both the opportunity and the necessity to reexamine Federal-State finances in the light of actual experience. The results are of singular interest to other Federal countries, however much they may differ from India in their levels of economic development.

INDIAN FEDERALISM

Professor Wheare has described the Indian Constitution as being "quasi-Federal," principally because the President retains some of the reserve powers formerly vested in the British Viceroys.[1] Indian authorities, however, do not share this view, and point out that the President's powers to take over the government of a State, or to enable the Union Parliament to legislate on State matters, are emergency powers only, akin to "the defense power" elsewhere.[2] It may also be observed that the President is in some sense a servant of the States as well as of the Union, being elected jointly by the members of the Union Parliament and the State Legislatures, the aggregate voting power of the latter being equal to that of the former.[3]

Perhaps a more distinctive feature of the Indian Federation is that it was created primarily by a process of devolution from the center, as the Nigerian Federation is being created today, and not by a compact between preexisting sovereign States, like the original American Union or the Australian Commonwealth.[4] The devolution of powers

*Reprinted from *Economic Record*, April 1960.

**University of Melbourne.

[1] Wheare, K. C., *"Federalism"* (Oxford, 1946), p. 28.

[2] Bhargava, R. N., *"Union Finance in India"* (London, 1956), pp. 54–55. See also *"Report of States Reorganization Commission"* (New Delhi, 1955), par. 150. The President's recent action in Kerala, however, would seem to go somewhat further than this line of argument suggests.

[3] Constitution of India, art. 54 and 55. (Referred to below as I.C.).

[4] Cf. Bhargava, op. cit., p. 96. This point has also been made by Professor Hicks in *"Report of Commission on Revenue Allocation"* (Lagos, 1951), p. 26.

which created the British-Indian provinces began with Lord Mayo's scheme of decentralization in 1870, and culminated in the Government of India Act of 1935, from which the scheme of Federal-State relations embodied in the 1950 Constitution is substantially derived. It is true that after Independence, over 550 princely States were integrated in the Union, but they were in no real position to negotiate the terms on which they acceded. Thus the tradition of a strong center remains and the States derive their existence and powers not from separate charters, but from the same constitutional document as the Federal Government itself.

The position of the States in the Indian Union is well illustrated by the comparative ease with which their boundaries were reorganized in 1956 on a linguistic basis, their number reduced from 27 to 14, and the "disparate status" of Part A, Part B and Part C States abolished.[5] The Constitution gives the Union Parliament power to legislate on State areas and boundaries provided that the legislation is recommended by the President after he has "ascertained" the views of the Legislatures of the States concerned.[6] In 1956, the Congress Party still controlled every State Legislature, but subsequently it lost control of Kerala, and might in the future lose control of other States. Hence it is problematical whether the political climate will continue in the future to be favorable to such sweeping changes. Nevertheless, the purely legal obstacles to a reorganization of the States are obviously much less in India than in (say) Australia, where the Federal Parliament is empowered to legislate on such matters only "with the consent of the Parliament of a State and the approval of the majority of the electors of the State voting".[7]

A further preliminary point of some importance concerning the financial position of the Indian States is that, unlike the Australian States, they do not have the right to appoint their own Auditor Generals. There is one Comptroller and Auditor General for the whole Federation, and he is appointed by the President. Under the Constitution, however, he is required to report to the President on Union accounts, and to the respective State Governors on State accounts.[8] He cannot therefore be regarded exclusively as a servant of the Union government, and of course he holds office on a judicial tenure. The Indian States are not therefore in the position of having their accounts reviewed by a Central Government department, like British local authorities. The system would appear to combine economy in administration with adequate safeguards for the fiscal independence of the States. It has the further advantage of insuring some measure of uniformity and comparability between the accounts of all governments, since the Comptroller and Auditor General prescribes a standard classification in the *All-India List of Major and Minor Heads of Account.* In practice, differences in accounting treatment still exist.[9] Neverthe-

[5] In the 1950 Constitution as originally drafted, Part A States corresponded to the former British India Provinces, Part B States to those princely States that had survived either on their own or in union with others, and Part C States to the former Chief Commissioners' Provinces. See *"Report of States Reorganisation Commission,"* p. 6.
[6] I.C., art. 3.
[7] Commonwealth Constitution, sec. 123.
[8] I.C., art. 151.
[9] Some examples are cited by Dr. Bhargava, *op. cit.*, p. 151. See also *"Report of the Finance Commission, 1957,"* p. 70.

less, even if only a measure of standardization has been achieved, the administrative and statistical advantages must be considerable. Certainly if such standardization existed in Australia it would greatly simplify the work of the Commonwealth Grants Commission.

Finally, the borrowing powers of the Indian States are subject to certain important limitations which have the effect of giving the Central Government a monopoly of overseas borrowing, and virtual control over the terms and timing of internal borrowing. The Government of India Act of 1935 had permitted the British Indian Provinces to borrow abroad with the consent of the Central Government, but the 1950 Constitution restricts the States to "borrowing within the territory of India".[10] However, if a State has any outstanding indebtedness to the Union government, the consent of the latter is necessary before it can exercise its power of borrowing on the internal market. In fact, all States have borrowed from the Union government, particularly in recent years for purposes connected with the first and second 5-Year Plans, and their borrowing programs are therefore all subject to Federal control. It is true that in Australia also in recent years the Commonwealth has been able to limit the volume of State borrowing, but this is because State loan requirements have exceeded the amounts available from public subscriptions. It is also true that the Australia States do not issue their own securities, and that the Commonwealth borrows on their behalf, but this is done through the machinery of the Loan Council, a joint Federal-State body to which there is no parallel in India. There is a still greater contrast between the position of the Indian States and that of the American States or the Canadian Provinces, which enjoy independent and virtually unrestricted borrowing powers.

Allocation of Fiscal Powers

In Schedule VII of the Indian Constitution, fiscal powers, along with legislative powers, are exhaustively listed and allocated. The schedule lists 96 Federal powers, 66 State powers, and 47 concurrent powers. A similar degree of precision has been introduced into the constitutions of Malaya and Pakistan, but earlier Federal constitutions were much less specific. Thus the United States Constitution listed the Federal powers in only 18 short paragraphs of Section 8. and the Australian Constitution listed them in the 39 paragraphs of Section 51. In both countries, a large field of residual powers remained with the States. In India few residual powers can have escaped the net cast by Schedule VII, but such as may remain are vested in the Union.[11]

The allocation of fiscal powers in India follows no such simple rule as that which was implicit in the Canadian Constitution, and perhaps also in the Australian, whereby indirect taxation was a Federal power and direct taxation a State power. Even the almost universal principle that customs and excise duties are a Federal power is subject in India to the important exception that the States are empowered to levy excise duties on alcohol and narcotic drugs. Similarly

[10] I.C., art. 293.
[11] I.C., art. 248.

although the States (or their local authorities) enjoy the right to impose agricultural income taxes, capitation taxes, and taxes on trades and professions,[12] the important powers of taxing corporations and nonagricultural incomes rest with the Union. It should be noted that the Union's receipts from nonagricultural income tax must be, and its excise revenue may be, shared with the States, but these provisions are best regarded as methods of financial adjustment and will be discussed as such below. For the moment, we are simply concerned with the constitutional allocation of fiscal powers.

The pattern of allocation is further complicated by two constitutional provisions under which the Union government is empowered to fix the rates of certain taxes, some of which are collected and retained by the States, while the others are collected by the Union but assigned to the States without passing through the Consolidated Revenue Fund of the Union. In the first category are rates of excise duty on medicinal and toilet preparations containing alcohol and narcotics, and rates of stamp duty on most commercial documents.[13] In the second category are transportation taxes, death duties on nonagricultural property, and sales tax on newspapers, newspaper advertisements, and interstate transactions.[14]

Under the latter power an estate duty on nonagricultural property was introduced by the Union in 1953. Eleven of the States then voluntarily authorized the Union to extend this legislation to agricultural property also.[15] The States enjoy exclusive powers with respect to the taxation of agricultural property, but the Constitution empowers two or more States to request the Union Parliament to legislate for them on any State matter.[16] In the States that took advantage of this provision there is, therefore, a unified system of estate duties on both types of property, the rates being fixed and the collections made by the Union, but the proceeds being assigned to the States.

More serious complications arise in connection with the levy of sales taxes which, having been a provincial power under the Government of India Act, 1935, was continued as a State power under the 1950 Constitution. During and after the war, however, the Provinces had raised the rates of sales tax to such an extent as to create much friction and litigation.[17] The Constitution, therefore, while leaving the power to levy sales or purchase taxes with the States, prohibited any State from imposing such a tax on transactions which occurred (*a*) outside its boundaries, (*b*) in the course of international trade, (*c*) in the course of interstate trade, or (*d*) in respect of goods declared to be essential for the life of the community by the Union Parliament.[18] Moreover, as a result of an outcry against a Madras tax on newspapers and a Bombay tax on newspaper advertisements,[19] these types of sales tax were included among the taxes which Article 269

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[12] Under article 276 the latter taxes are subject to a maximum annual rate of Rs 250 per person.

[13] I.C., art. 268.

[14] I.C., art. 269.

[15] Bhargava, op. cit., p. 201.

[16] I.C., art. 252. By way of contrast the Canadian Supreme Court has ruled that neither the Federal Parliament nor a provincial legislature can delegate its powers to the other. See "Evolving Canadian Federalism" (Duke U.P., 1958), p. 117.

[17] Bhargava, op. cit., p. 225.

[18] I.C., art. 286; the Union Parliament passed an Essential Goods Act in 1952.

[19] Bhargava, p. cit., p. 80; and *Report of Taxation Enquiry Commission* (New Delhi 1955), Vol. III, p. 36.

empowers the Union to fix and collect on behalf of the States, but the Union has in fact refrained from levying such sales taxes. Subsequently, sales taxes on interstate transactions were brought within the same category by a constitutional amendment. A Federal interstate sales tax was then introduced in 1957, and in the same year the Union and the States agreed to replace the State sales taxes on three important items, viz factory-made textiles, sugar, and tobacco, by additional Union excise duties on those commodities, the net proceeds of which were to be allocated among the States.

These complicated provisions are aimed partly at securing uniformity of tax rates, partly at effecting economy in collection, and partly at preventing double taxation among the States. As for double taxation between the Union and the States, that is virtually precluded by the absence of any important field of concurrent tax powers.[20] In fact, the only concurrent tax powers listed in Schedule VII relate to stamp duties and motor taxes. As explained above, the rates of commercial stamp duties are fixed by the Union, but the duties are collected and retained by the States; only legislation about matters other than the rates of duty is a concurrent power. Again, the taxation of motor vehicles is a State power, but "the principles on which taxes on such vehicles are to be levied" is a concurrent power. With these two minor exceptions, there are no concurrent tax powers in India. Double taxation is still possible in the form of a Union excise duty and a State sales tax on the same commodity, but there are no rival jurisdictions levying the same tax on the same commodity or person, as in the United States or Canada. Moreover, this separation of tax fields is determined by the Constitution itself and not by the uncertain process of judicial interpretation, on which Australia has had to rely to exclude the States from the income tax and sales tax fields.

In a federation, intergovernmental disputes may arise not only from rival claims to jurisdiction within particular tax fields, but also from the claim of each government to immunity from taxation by the other. The Indian Constitution confers three such immunities. In the first place, it exempts both the income and the property of the States from taxation by the Union, but it gives the Union Parliament power to override the exemption in respect of State business undertakings.[21] Presumably, therefore, the Indian States or the instrumentalities could be made liable, like their Australian counterparts, to a Federal payroll tax, were one to be imposed. Secondly, the Constitution exempts the property of the Union from taxation by the States or their local authorities, but here again there is a saving clause under which the Union Parliament may legislate to waive the exemption.[22] In view of Canadian and American experience, where the exemption of Federal property from local rates is a very live issue, the saving clause would seem to be a wise one. Thirdly, the Constitution exempts the Union from State taxation on the consumption or sale of electricity.[23] The exemption applies also to Government railways, and to companies engaged in their construction or operation, but again may be waived by Act of the Union Parliament. In India electricity taxes are levied by most States,

[20] Bhargava, *op. cit.*, pp. 81, 131, and 221.
[21] I.C., art. 289.
[22] I.C., art. 285.
[23] I.C., art. 287.

but are not a significant part of State revenue except in Bombay and Bengal.[24] It may also be observed that the States are precluded, except with the consent of the President, from imposing taxes on electricity or water supplied by interstate river authorities established by the Union.[25]

Revenue and Expenditure

The practical effect of the above division of fiscal powers can be illustrated by examining the main sources from which Union and State tax revenue was actually derived in some recent year. For this purpose 1955–56 has been selected, since it is the year for which the second Finance Commission's data are available.

In 1955–56 the tax revenue of the Union government was Rs480 crores.[26] Of this sum, customs duties and income taxes accounted for over one-third each, and excise duties for slightly less than one-third. Customs duties are, traditionally, the main source of Federal revenue, but during and immediately after the last war income tax took first place. In underdeveloped countries such as India, however, income tax is a somewhat inelastic source of revenue largely because of its narrow base. Dr. Bhargava has pointed out that only one person in 700 pays income tax in India, as compared with one in every three or four in the United Kingdom or the United States.[27] In Australia the proportion is about one in two-and-a-half. In India, therefore, increasing resort has been had to excise duties, particularly since the integration of the Princely States, the existence of which had formerly made difficult any extensive use of excise duties.

In 1955–56 the total tax revenue of the States (excluding local authorities) was only Rs281 crores, *i.e.*, nearly Rs200 crores less than that of the Union. Over Rs80 crores was derived from sales taxes and about the same amount from land revenue. Traditionally, land revenue has been the chief source of State income, but being unpopular partly because of its association with the British raj, it has tended to decline relatively, despite the abolition of the zamindar (or tax farming) system in some States. Little effort has been made to supplement land revenue by agricultural income tax, which is not levied at all in five of the States. Moreover, much of the revenue that might have been derived from the potentially lucrative liquor excise has been sacrificed by the introduction of complete prohibition in Bombay and Madras, and partial prohibition in seven other States, with the result that this excise yielded only Rs44 crores in 1955–56, or little more than half the revenue derived from either sales tax or land revenue. Thus the States have had to seek new sources of revenue, and they have turned increasingly toward commodity taxation in the form of sales taxes,[28] just as the Union itself has turned increasingly toward commodity taxation in the form of excise duties.

The adequacy of the fiscal resources of the Union and State governments has to be judged by reference to their respective needs. Actual

[24] *Report of Taxation Enquiry Commission* (New Delhi, 1955), vol. III, p. 119.
[25] I.C., art. 288.
[26] Rs. 1 crore = Rs. 10 million = approximately £A1 million at the current Indian-Australian exchange rate. It would therefore seem most useful as well as least troublesome to follow the Indian practice of expressing financial data in crores of rupees.
[27] Bhargava, *op. cit.*, p. 195.
[28] *Ibid.*, p. 222.

expenditure is not, of course, a satisfactory measure of needs, any more than actual revenue is a satisfactory measure of fiscal resources, but it will suffice for the present purpose. In 1955–56 when the tax revenue of the Union exceeded that of the States by Rs200 crores, its expenditure on services fell short of that of the States by an even larger amount. The chief item of Union expenditure was defense, which accounted for nearly half its total outlay. The States' expenditure on social services, including education, was, however, nearly equal to that of the Union on defense, and in addition the States had other heavy responsibilities in respect of services such as police and civil works. The higher expenditure of the States was to some extent offset by higher revenue from nontax sources such as the earnings of Government business undertakings, which seem to be generally profitable in India.[29] Nevertheless, the net expenditure chargeable against tax revenue was Rs171 crores less for the Union than for the States. This left the Union with an excess revenue of Rs189 crores and the States with a shortfall of Rs181 crores.

The relevant figures are set out below:

1955–56	Union, rupees (crores)	States, rupees (crores)
Expenditure on services	370	597
Nontax revenue	79	135
Expenditure chargeable against tax revenue	291	462
Tax receipts	480	281
Excess (+) or deficiency (−)	+189	−181
Financial transfers	−148	+148
Surplus (+) or deficit (−)	+41	−33

Source: *Report of Finance Commission*, 1957, tables 3, 5(e) and 8(e).

Although the Indian Constitution thus gives to the Union tax resources considerably in excess of its needs, and to the States tax resources that fall far short of their needs, it does not leave this maladjustment unrecognized and unrectified. It provides specifically for its correction by the sharing with the States of the proceeds of certain Union taxes, and by the payment of grants to the States from the Union's general revenue. We shall review these provisions before examining their actual working, but it may be noted here that in 1955–56 Rs148 crores were transferred from the Union to the States, about half of the transfers being in the form of tax shares and the other half in that of Federal grants. In the aggregate the States were still left in deficit in 1955–56, but normally transfers from the Union are regarded as sufficient to cover their deficits on revenue account, excluding expenditure under the 5-Year Plan.[30]

This pattern of fiscal relationships is the outcome of a long process of constitutional development. The devolution of financial authority from the Center to the British-Indian Provinces in the latter part of the 19th century led to a system of provincial Financial Settlements,

[29] This applies even to railways, but, by contrast with Australia, the Indian railways are a Federal and not a State responsibility. The 1957 Finance Commission, however, drew attention to a deterioration in the financial results of State irrigation and electricity undertakings. *Report*, pp. 30–31.

[30] *Ibid.*, pp. 26–27.

a feature of which was certain "divided heads" of revenue. However, the actual taxes thus subject to division and the proportions in which they were divided varied in a somewhat arbitrary manner from Province to Province. In the 1920's an attempt was made to give the Provinces greater autonomy by replacing this system with one under which there was a complete separation of fiscal powers. Under the Government of India Act, 1919, excise duties, stamp duties, and irrigation receipts became exclusively provincial sources of revenue, and it was intended that income tax should be exclusively central. At the outset, this resulted in the Provinces having a surplus of revenue over needs, and for a time they were required to make contributions to the Center. However, these provincial contributions had to be abolished because provincial sources of revenue proved relatively inelastic and failed to keep pace with their expanding needs. In the meantime, a small proportion of central income tax receipts had been made available to the Provinces, under what was known as Devolution Rule 15, and the possibility of giving the Provinces a more substantial share of income tax receipts was widely canvassed by various committees prior to the enactment of the Government of India Act, 1935, which laid the foundation of the present system. The Union was thus given a surplus of tax revenues over its needs and required to make transfers to the States after it had proved impracticable either to effect a complete separation of tax resources, or to operate a system under which the Provinces enjoyed surplus revenues and made contributions to the Center.

Machinery for Financial Adjustment

Intergovernmental transfers are common enough in most federations, but generally they are extraconstitutional in the sense that the Constitution does not itself envisage or provide for large permanent transfers. This is true of the American Constitution, with the result that Federal grants-in-aid have to be given to the States under the power of Congress to make appropriations for the "general welfare." In Canada, the British North America Act did provide for certain "statutory subsidies" to the Maritime Provinces, but it specified explicitly the rates of subsidy, and secular inflation has now reduced them to a relatively unimportant place in the general scheme of financial assistance to the Provinces. The Australian Constitution provided for the payment of three-quarters of customs and excise revenue to the States, but in order to overcome the opposition of free traders these payments were limited to the first 10 years of Federation, after which time their continuation was to become a matter for the Commonwealth Parliament.[31] A similar limitation was imposed on the power to grant financial assistance to any State "on such terms and conditions as the Parliament thinks fit." [32] In the event, the Commonwealth has continued to make grants to the States, but the sharing of customs and excise revenue ceased in 1910 and it seems to have been anticipated that there would be no permanent need for the redistribution of Commonwealth revenue in favour of the States.[33]

[31] Commonwealth Constitution, sec. 87.
[32] *Ibid.*, sec. 96.
[33] Commonwealth Grants Commission, *3d Report* (1936), pp. 20–22.

The limited provisions thus made for financial transfers in other Federal Constitutions contrast sharply with the detailed arrangements set out in the Indian Constitution for tax sharing and Federal grants. The most important of the shared taxes is the Union income tax on nonagricultural incomes. The Constitution contains a mandatory article which requires the Union, before paying the net proceeds of the tax into Consolidated Revenue, to assign a percentage thereof to the States.[34] Proceeds attributable to Federal territories or Federal emoluments are excluded from this requirement, and so, too, is corporation tax.[35] Secondly, the Constitution contains a permissive power under which the Union may, if Parliament so decides, transfer to the States all or part of the proceeds of any Union excise duty.[36] These provisions differ in principle as well as in importance from those already discussed under which, as a matter of administrative convenience, the rates of certain less important taxes are fixed by the Union, although they are collected by the States or assigned to them in their entirety. The fact that the actual proportion of income tax and excise duties to be paid to the States is left to be determined according to the degree of adjustment found necessary clearly indicates that the purpose here is financial adjustment, not administrative convenience.

In respect of the above provisions the Constitution follows closely the pattern set by the Government of India Act, 1935. That Act also made provision for the sharing of a third tax, namely, the export duty on jute. However, only the jute-growing Provinces were eligible for a share of this tax, and after Partition 70 percent of the jute-growing area was lost to Pakistan. Under the Constitution the sharing of this tax was therefore terminated, but the four States of Assam, Bihar, Orissa, and West Bengal were to be compensated by special grants-in-aid for the first 10 years.[37] These grants cease in 1960, and this provision can therefore be regarded as transitional in character.

Apart from the grants in lieu of the jute export duty, the Constitution provides for two other types of grant of a more permanent and general character. The first are grants-in-aid, which correspond to the Australian special grants, and may be given to "such States as Parliament may determine to be in need of assistance, and different sums may be fixed for different States." [38] In particular, grants-in-aid must be made to Assam for the administration and development of the tribal areas in that State, and to other States for approved development schemes in respect of their scheduled tribes or areas.[39] Secondly, the Constitution gives to the Union a very wide power, reminiscent of the United States appropriation power, to make "any grants for any public purpose, notwithstanding that the purpose is not one with respect to which the Parliament may make laws." [40] A similar power is conferred on the States but in their case it seems to be nominal.

[34] I.C., art. 270.
[35] In India companies are liable to corporation tax in addition to the ordinary income tax. See *"Report of Finance Commission, 1953,"* p. 67.
[36] I.C., art. 272.
[37] I.C., art. 273.
[38] I.C., art. 275.
[39] *Ibid.,* first and second provisos.
[40] I.C., art. 282.

In the case of the Union, however, the power has been used to make a wide range of conditional grants for specific purposes, on the American pattern.

THE FINANCE COMMISSION

Although the Indian Constitution provides explicitly for this elaborate system of tax sharing and Federal grants, it does not lay down the precise sums that shall be transferred to the States under any of these provisions.[41] In this it again follows the precedent set by the Government of India Act, 1935. When that Act came into effect, the determination of actual tax shares and grants-in-aid was referred for expert examination to Sir Otto Niemeyer, whose reputation seems to stand higher in India than in Australia. With some necessary modifications after Partition, Sir Otto Niemeyer's award continued to operate until the 1950 Constitution came into effect. In the meantime, an Expert Committee on the Financial Provisions of the Union Constitution (1947) had proposed that a Finance Commission should be set up to make periodical reviews of Federal-State financial relations. This recommendation was incorporated in the Constitution, and the President is required to appoint every fifth year, or earlier if necessary, a Finance Commission of five members.[42] Parliament determines their qualifications and conditions of service, but the Constitution prescribes their terms of reference. The Commission has the duty of making recommendations to the President concerning the shares of Union taxes to be paid to the States, the allocation of those shares among the States, the principles on which grants-in-aid shall be made to the States and any other matter which the President may refer to them "in the interest of sound finance." The President is required to lay the recommendations of the Commission before Parliament,[43] but is empowered to give effect by Order to recommendations concerning income tax and grants in lieu of the jute export duty.[44] Pending provision of the necessary funds by Parliament, the President may also give effect by Order to recommendations concerning other grants-in-aid, but recommendations concerning the sharing of excise duties require parliamentary legislation.[45] It is important to observe, however, that conditional grants given by the Union under the "public purpose" power are not determined by the Commission.

It proved impossible to appoint a Finance Commission immediately the Constitution came into effect, and C. D. Deshmukh was therefore appointed to make an interim award, to replace the Niemeyer award for the first 2 years of the new era. The first Finance Commission was appointed in November 1951, with the task of reporting on the allocation of income tax, excise duties, grants-in-aid, and grants in lieu of the jute export duty. Its Final Report, which was published on December 31, 1952, gives a useful historical account of the evolution of Federal-State finances in India, and draws a number of illuminating

[41] Except that the grants-in-aid to Assam for the administration (as distinct from the development) of its tribal areas shall be equal to the net expenditure incurred for that purpose in the 2 years preceding the commencement of the Constitution.
[42] I.C., art. 280.
[43] I.C., art. 281.
[44] I.C., art. 270, (4(b)), and art. 273(3).
[45] I.S., art. 2775(2), and art. 272.

comparisons with other federations in order to establish the principles on which grants-in-aid should be based.[46] Its recommendations for the quinquennium ending March 31, 1957, were adopted in full.

The second Finance Commission was appointed in June 1956. In addition to the matters on which the first Commission had reported, it was given the task of reporting on possible modifications in debt charges on loans made by the Union to the States between 1947 and 1956, and on the allocation among the States of the estate duty on nonagricultural property, a tax on railway passenger fares, and the additional Union excise duties in lieu of State sales taxes, all of which were introduced after the report of the previous Commission.[47] It was also necessary to take account of changes arising from the reorganization of the States in 1956 and the progress of the second 5-Year Plan. The Commission's Final Report, containing its recommendations for the quinquennium ending March 31, 1962, was published on September 30, 1957.[48]

It has thus become established practice in India to leave the specific amounts and the allocations of tax shares and grants-in-aid to be determined on a nonpolitical basis. However, whereas this determination was made by a single arbitrator under the 1935 Act, it must, under the 1950 Constitution, be made at regular intervals by a Commission of five members. This innovation may owe something to the example of the Commonwealth Grants Commission, which was reported upon to the Indian Government by Mr. B. K. Nehru and Professor Adarkar in 1947. There are, however, some obvious differences.

In the first place, the Finance Commission derives its status directly from the Constitution and therefore could not be abolished or discarded without a constitutional amendment, whereas the Commonwealth Grants Commission is a purely statutory body which could be abolished simply by repealing the Act. In fact, this difference may be mainly formal, since if the Union Government wished to render the Finance Commission ineffective it could probably do so in other ways. For example, it can no doubt influence the President's choice of personnel, and in any case neither the President nor Parliament is bound to accept the Commission's recommendations, although they have hitherto done so, as the Commonwealth Parliament has accepted the Commonwealth Grants Commission's recommendations.[49]

Secondly, the functions of the Finance Commission cover a much wider field than those of the Commonwealth Grants Commission, which are limited to "special grants." In India only "public purpose" grants for specific objectives lie outside the purview of the Finance Commission, but in Australia, in addition to this type of grant being determined by the Commonwealth Government, the main category of general financial assistance to the States (i.e., tax reimbursement including supplementary grants) has hitherto been determined by political bargaining at annual Premiers' Conferences.

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[46] Government of India Press, New Delhi, 1953. (Referred to henceforth as 1st F.C.)

[47] See above, p. 194 for estate duty, and p. 195 for additional excise duties.

[48] Government of India Press, New Delhi, 1957. FD. 84/57. (Referred to henceforth as 2d F.C.)

[49] It is with these possibilities in mind that Dr. Bhargava has suggested that the Chairman of the Commission should be a Supreme Court judge, that the other members should be appointed for life, and that the Commission's recommendations should be binding on the Union Government, *Op. cit.*, p. 84.

Thirdly, the Finance Commission is required to make its general review of Federal-State finances normally only every fifth year, whereas the Commonwealth Grants Commission, in its much more limited field, makes an annual review. Some of the early Provincial Settlements in British India were also subject to quinquennial review, but the adoption of this principle in the Constitution probably owes something to the example of the postwar Canadian Tax Rental Agreements, each of which ran for 5 years, with the important difference that they were negotiated on the political level at conferences with the Provincial Premiers. The principle of regular review of the whole field of Federal-State finance at reasonably lengthy intervals obviously has much to recommend it, as compared either with the absence under the 1935 Act of any provision for regular review, or with the virtually annual reviews that have hitherto occurred at Australian Premiers' Conferences.

Finally the Indian Finance Commission, in contrast with the Commonwealth Grants Commission, suffers from a serious lack of continuity. The Commonwealth Grants Commission is in continuous existence, its three members serving 3-year terms on a part-time basis. On the other hand, the five members of the Indian Finance Commission serve fulltime for about 1 year and then disperse. The member-secretary of the first Commission became an ordinary member of the second Commission, but otherwise they had no common membership. The first Commission recommended that a small research unit should be attached to the President's Secretariat in order to continue its work and prepare material for future Commissions, but according to the second Commission this experiment was not successful.[50] They in turn therefore recommended that a nucleus staff should be retained in the Finance Ministry, and that the necessary statistical and other work should be undertaken by that department.[51] The second Commission also complained that the temporary nature of their work made it difficult to recruit staff.[52] This discontinuity in the Commission's work is of course the consequence of the system of quinquennial review and has to be set against the advantages of that system.

Tax Sharing

An important distinction needs to be drawn between tax sharing on the basis of national tax collections and tax sharing on the basis of State or Provincial tax collections. Under the first system, which is the one which operates in India, the States as a whole are assigned in one aggregate sum a proportion of the tax proceeds collected from the nation as a whole. Under the second system, which is the one which now operates in Canada, each State receives a proportion of the tax proceeds collected by the Central Government from that State's own residents or from within its own territories. Under this system, the allocation of tax shares among the States or Provinces is automatically determined, but under the first or Indian system this is not so, and the allocation of tax shares among the States has to be con-

[50] 1st F.C., p. 110.
[51] 2d F.C., p. 71.
[52] *Ibid.*, p. 4.

sidered as a separate problem. The present section will, therefore, be confined to examining the determination of the aggregate amount assigned to the States, and the question of its allocation among the States will be deferred until the next section.

As already indicated, tax sharing applies to both income tax and excise duties in India. The share of income tax payable to the States under the 1935 Act was fixed on Sir Otto Niemeyer's recommendation at 50 percent of the net proceeds. In 1952, on the recommendation of the first Finance Commission, this proportion was raised to 55 percent, with an estimated yield of about Rs56 crores per annum. In 1957, on the recommendation of the second Finance Commission, the proportion was again raised to 60 percent, with an estimated yield of about Rs67 crores per annum. The proportion of income tax receipts thus made available to the States is much higher than in other Federal countries which operate a tax-sharing system. In Central Africa, the proportion of personal income tax payable to the units is 40 percent, and in Canada it is only 13 percent, but in that country tax sharing extends also to corporation tax and estate duty.

The provisions of the 1935 Act relating to the sharing of indirect taxes were never in fact operative, except for the export duty on jute, with respect to which the Act provided that not less than 50 percent of the net proceeds should be shared with the jute-growing Provinces. Actually the proportion was fixed on Sir Otto Niemeyer's recommendation at 62½ percent, but this was reduced to 20 percent after Partition, and abolished altogether under the 1950 Constitution. On the other hand the sharing of excise duties, provision for which was retained in the Constitution, has now become a means of providing the States with additional revenue over and above their increased share of income tax. On the ground that the latter could not provide the whole of the necessary increase in State revenue, the first Finance Commission recommended that the States should receive 40 percent of the net proceeds from the excise duties on tobacco, matches, and vegetable products. These three duties, of which that on tobacco is much the most important, were selected for division with the States because they appeared to be levied on commodities of common and widespread consumption, and ones which yielded a fairly substantial and stable revenue.[53] In 1957, the second Finance Commission went somewhat further and expressed the view that income tax had ceased to be an expanding source of revenue and that any further devolution of revenue to the States by tax sharing would have to come from excise duties.[54] They therefore recommended that the number of divisible duties should be increased to eight, but that the States' share of the proceeds of each duty should be only 25 percent. In addition to tobacco, matches, and vegetable products, the divisible duties now include those on sugar, coffee, tea, paper, and vegetable oils.

It was estimated that the effect of these recommendations would be to double the amount of excise revenue payable to the States raising it from Rs16 crores to about Rs33 crores per annum. This compares with the estimated increase from Rs56 crores to Rs67 crores per annum in the amount of income tax revenue payable to the States. Thus

[53] 1st F.C., p. 82.
[54] 2d F.C., pp. 39 and 42.

whereas under the first Finance Commission's tax-sharing scheme excise revenue accounted for only about one-third of income tax revenue, it was expected to become about one-half under the second Finance Commission's scheme.[55] In fact this expectation has not been entirely fulfilled, since the amount of income tax revenue payable to the States has increased more than was expected, and in the current Budget (1959–60) it is estimated at Rs78·6 crores.

Although the second Finance Commission's recommendations resulted in doubling the amount of excise revenue payable to the States, this increase was not proportional to the even greater rise that had occurred in recent years in the Union's total excise revenue. Before the war, the Central Government levied only five excise duties, but the number had risen by 1952–53 to 13, with an annual yield of Rs83 crores, and by 1957–59 to 29, with an annual yield of about Rs260 crores. Thus whereas the first Finance Commission's award of Rs16 crores gave the States about one-fifth of total excise revenue in 1952–53, the second Finance Commission's doubled award of Rs33 crores gave the States only about one-eighth of the Union's total excise revenue in 1957–58.

The continued payment to the States of even this proportion of Union excise revenue is, however, somewhat unique. The sharing of indirect taxes in other federations has been either temporary or confined to duties on single commodities subject to special conditions. Thus the arrangement whereby the Australian States were paid three-quarters of customs and excise revenue lasted only for the first 10 years of Federation. In Australia, again, part of the revenue from customs and excise duties on petroleum products was paid to the States as road grants between 1931 and 1959. In Malaya, also, 10 percent of the revenue from the tin export duty is payable to the States under the new Malayan Constitution. Apart from examples of this type, however, tax sharing as a continuing arrangement is in other federations confined to direct taxes, if it exists at all.

In India the sharing of both income tax and excise duties takes the form, in the first instance at least, of assigning to the States a fixed and predetermined proportion of tax proceeds. This might seem to restrict the Federal Government's freedom of action in the fiscal sphere, precluding it from raising (or lowering) tax rates for its own purposes without also automatically increasing (or decreasing) the amounts payable to the States, whether or not that happened to be necessary or desirable. It was probably for this reason that the Malaya Constitutional Commission in 1957 thought it was "undesirable in principle to allocate to the States the proceeds of any particular tax or duty."[56] However that may be, tax sharing on a fixed proportionate basis not only exists in India, but its restrictive character seems to be enhanced by a constitutional provision which makes a Presidential recommendation a prior condition for the introduction of Federal legislation seeking to vary the rate of any tax in which the States are interested, or the principles on which any taxes are shared with the States, or the definition for tax purposes of "agriculture income"

[55] 2d F.C., p. 71.
[56] *Report* (H.M.S.O., London, 1957), p. 60.

(which of course affects the respective spheres of State and Union income tax).[57]

In fact, however, the Indian system is not so restrictive as it seems at first sight, as least not so far as income tax is concerned. Under the Niemeyer award the Center was permitted to retain a certain minimum amount of income tax proceeds for the first 5 years. During the war the Center again retained part of the Provinces' share of income tax, and it was not until 1950–51 that they finally received their full share. Moreover, the Constitution permits the Union, subject to the necessary legislation being introduced on the recommendation of the President, to impose an income tax surcharge for its own exclusive use.[58] This power has in fact been used to supplement ordinary tax collections by about 4 percent, or some Rs6 crores per annum, none of which is shared with the States. In this way the Union has power to vary the effective total tax rate, whilst leaving the ordinary tax rate and the State share of ordinary tax proceeds unchanged. The effect is similar to that of giving the States the proceeds of a predetermined rate of tax, in the way that the above-mentioned road grants to the Australian States were equal to the proceeds of specified rates of duty on petroleum.[59] An example of a direct tax being similarly shared on a fixed tax rate basis is the Canadian corporation tax. The Federal rate of tax is 45 cents per dollar of profits, but the provincial share is equal to the proceeds of a 9 cents per dollar tax on profits. This type of tax sharing permits a Federal Government to change its tax rates without necessarily changing its payments to the States, and substantially the same result is achieved by the Indian system of surcharges.

Even with these modifications, tax sharing differs markedly from a system of Federal grants, provided out of general revenue and determined independently of tax yields, as, for example, the Australian Tax Reimbursement Grants. Under any tax-sharing system the payments to the States fluctuate as economic conditions affect the tax yields. This means that during a period of deflation and falling tax yields the Federal Government is not in the position of having to meet guaranteed minimum payments to the States; and equally that in a period of inflation and rising tax yields the payments to the States do not lag behind the rise in Federal revenue. The latter situation has of course been the relevant one since the end of the war, and the fiscal position of the Indian States during the inflationary years 1957–58 and 1958–59 seems to have been eased considerably by this element of built-in flexibility in their revenues. By contrast the grants payable to the Australian States under the Tax Reimbursement formula lagged persistently behind their needs, and every year after 1944 the Commonwealth had to provide them with supplementary financial assistance.

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[57] I.C., art. 274.

[58] I.C., art. 271. The requirement of a Presidential recommendation is imposed by art. 274. Surcharges could also be imposed on those taxes which the Union levies and collects on behalf of the States, such as estate duties.

[59] Thus from 1956 to 1959 the road grants were equal to a duty of 8d. per gallon on both imported and locally refined petroleum, the total duty on the former being 13d. per gallon, and that on the latter being 11½d. per gallon.

Allocation Among the States

Tax sharing on the basis of national tax collections, as in India, results in an aggregate sum becoming available for allocation among the States. In India this sum was expected by the second Finance Commission to be Rs100 crores per annum, but because of the effect of inflation on income tax yields it is in fact in excess of Rs110 crores per annum. There are three alternative principles according to which this amount can be allocated among the States. They are (1) compensating for loss of preexisting sources of revenue; (2) collections of Federal tax revenue from each State, as indicating the ultimate derivation or origin of that revenue; and (3) the population of each State, as a broad and simple indication of its fiscal needs.

The first principle is that which was originally adopted for the allocation of the income tax reimbursement grants in Australia, and it also figured in the pre-1957 Canadian Tax Rental Agreements. Unlike the Australian States or Canadian Provinces, however, the British Indian Provinces never had any independent fiscal rights but merely derived their tax powers by devolution from the Center, and the question of compensation for loss of revenue therefore did not arise. The former Princely States were in a somewhat different position, but even here the integration agreements did not give them any rights to compensation in respect of either assets or revenues transferred to the Federal Government. Some questions of compensation do arise in consequence of the reorganization of the States in 1956, particularly affecting Bombay and Mysore, and also in connection with the allocation of the additional excise duties imposed by the Union in 1957 in replacement of certain State sales taxes, but both these matters lie outside the field of tax sharing proper.

The second principle would, if adopted, result in an allocation similar to that which would prevail if tax sharing operated directly on the basis of the tax revenue collected by the Federal Government within each State or Province, as in Canada. The whole point of the Indian form of tax sharing on the basis of the revenue collected from the nation as a whole, however, is that it permits the adoption of some other principle of allocation which can take account of the fiscal needs of the States. This is the virtue of the population principle, insofar as fiscal needs are proportional to population.

The conflict between the collection principle and the population principle is particularly acute with respect to the allocation of the State share of income tax. Federal income tax collections in each State naturally reflect differences in income levels. Indian National Income statistics are not available on a State basis, but there is known to be a heavy concentration of taxable income in Bombay and West Bengal, nearly three-quarters of total income tax revenue being collected in those two States. The allocation of the divisible pool of income tax on the basis of collections would therefore involve much higher per capita payments to these States than to any of the others. This is open to two objections. The first is that the high taxable income of these States is at least in part derived from or earned in other States. The second is that the per capita need for State services in Bombay and West Bengal is not necessarily higher, and could well be less than in States with lower income levels. Allocation according to the population principle is not open to these objections, however, since it would result in each State receiving an equal per capita payment.

In his award of 1935, Sir Otto Niemeyer rejected the principle of allocating the State share of income tax exclusively on the basis of collections. Instead, he considered that substantial justice would be done by basing the allocation partly on the residence of taxpayers, and thereby on collections, and partly on the population of the States. In 1952 the first Finance Commission considered and rejected arguments by West Bengal for an interpretation of the Constitution which would necessarily require income tax to be shared with the States on the basis of collections only, and by Bombay for the view that collections should be the main basis of allocation. They expressed the opinion that fiscal need should be the "main criterion of distribution," and accepted population as "a broad measure of need." They did, however, decide to give some weight to collections in view of the local origin of many small business and personal incomes. They therefore recommended that one-fifth of the divisible pool should be allocated on the basis of collections, and that the remaining four-fifths should be allocated on the basis of population.[60] In 1957, the second Finance Commission, after reviewing the conclusions of their predecessors and examining changes in the fiscal resources of the States, expressed the opinion "that the principle of collection can no longer be considered an equitable basis of distribution" and that it should be "completely abandoned in favor of population." However, in order to avoid too sudden a break with the past, they recommended that one-tenth of the State share of income tax should continue to be allocated on the basis of collections, and the remaining nine-tenths on the basis of population.[61]

The question of allocating a share of the revenue from excise duties did not arise for Sir Otto Niemeyer, but had to be faced by the two Finance Commissions. Since the divisible excise duties are levied on staple commodities in general use, their consumption is not likely to vary widely with income levels. Hence if collections reflected consumption, allocation according to the collection principle would not be seriously out of line with fiscal needs. However, an excise duty may be collected from producers in one State who derive the means to pay it from their sales to consumers in other States. Hence here also the collection principle is inferior to the population principle, but principally because it does not in this case adequately reflect the derivation of the tax revenue. The first Finance Commission recommended that in the absence of reliable statistics of consumption, the State share of excise duties should be allocated exclusively on the population basis, thereby giving each State an equal per capita share.[62] The second Finance Commission agreed that population was the best available principle of allocation, but instead of dealing with the whole of the net proceeds on this basis, as the first Commission had done, they allocated only nine-tenths of the proceeds according to population, and used the remaining one-tenth to make "adjust-

[60] 1st F.C., pp. 71–77.
[61] 2d F.C., pp. 39–40.
[62] 1st F.C., pp. 82–84.

ments," mainly at the expense of U.P. and Bombay, the two most populous States.[63]

Following the procedure adopted by Sir Otto Niemeyer, both Finance Commissions found it convenient to embody their recommendations in schedules, setting out the percentage share of each State (expressed to two places of decimals) in the divisible pool of each tax. The second Finance Commission's schedules for income tax and excise duties are set out below, together with the percentage distribution of population at the 1951 Census, which was the latest data available to the Commission and which is included for comparative purposes.

State	Population 1951 census	Allocation of income tax	Allocation of excise duties
	Percent	*Percent*	*Percent*
Andhra	8.76	8.12	9.38
Assam	2.53	2.44	3.46
Bihar	10.86	9.94	10.57
Bombay	13.52	15.97	12.17
Kerala	3.79	3.64	3.84
M.P.	7.30	6.72	7.46
Madras	8.40	8.40	7.56
Mysore	5.43	5.14	6.52
Orissa	4.10	3.73	4.46
Punjab	4.52	4.24	4.59
Rajastham	4.47	4.09	4.71
U.P.	17.71	16.36	15.94
West Bengal	7.37	10.08	7.59
Kashmir	1.24	1.13	1.75
Total	100.00	100.00	100.00

The second Finance Commission was also asked to report on the allocation of estate duty, the railway fares tax, and the additional Union excise duties in lieu of State sales taxes, which had been imposed since the report of the first Commission and the net proceeds of which are payable in their entirety to the States. In their recommendations concerning these taxes, in contrast to those concerning the State shares of income tax and excise duty, the population principle plays a minor role. They recommended that estate duty proceeds should be distinguished according as to whether they accrued from movable or immovable property. The former were to be allocated among the States on the basis of population, but the latter on the basis of the location of the property.[64] Again they recommended that the tax on railway fares, which is estimated to yield about Rs11 crores per annum, should be allocated on the basis of passenger traffic earnings in each State, as estimated from track mileage and traffic density.[65] With regard to the additional excise duties in lieu of State sales taxes, which have an annual yield of about Rs40 crores, the Commission was bound by the agreement between the Union and the States to assure to each State its previous income from the replaced sales taxes. This implied the adoption of the compensation basis, and the Commission's problem was largely the statistical one of determining actual State revenue from the replaced taxes in 1956–57. However, they also recom-

[63] 2d F.C., p. 44.
[64] *Ibid.*, pp. 51–52.
[65] *Ibid.*, pp. 64–65.

mended that if the net proceeds of the new excise duties exceeded the sum of the guaranteed amounts, the excess should be allocated among the States on the basis of estimated consumption.[66] The comparatively minor role given to the population principle or to fiscal needs in the allocation of these taxes where no sharing is involved can perhaps be taken as a further indication that they are collected by the Union on behalf of the States mainly as a matter of administrative convenience rather than as an instrument of financial adjustment.[67]

The adoption of the population principle as the chief basis for the allocation of the State shares of income tax and excise duties introduces a large element of adjustment for fiscal needs into the tax-sharing system itself. This contrasts markedly with Canada where tax sharing has to be supplemented by National Adjustment Grants to bring the combined payment to each Province up to an equal per capita level. In India tax shares are also supplemented by grants-in-aid, but since the Indian tax-sharing system itself establishes a more or less equal per capita payment for each State, the purpose of the grants-in-aid is, as we shall see, to provide additional payments for the financially weaker States. Both Finance Commissions recognized that the population principle provided only a rough-and-ready indication of fiscal needs, and did not adequately reflect the needs of States with relatively small, widely dispersed, poor or primitive populations. However, apart from the difficulty of measuring these factors statistically, they considered that a straight population basis was preferable to a complicated formula for tax-sharing purposes, and that "specialized and particular measures" would be more appropriately taken account of in the determination of grants-in-aid.[68] Thus the Indian system of allocating tax shares among the States differs not only from the Canadian, but also from the Australian tax reimbursement system, which did try to allow for factors such as sparsity of settlement and proportion of schoolchildren in its "adjusted population" formula.

GRANTS-IN-AID

Grants from the Union to the States are comparable in importance with tax sharing in the Indian system of financial adjustment. Of the several types of grants provided for in the Constitution, particular interest attaches to grants-in-aid, since with the exception of those for scheduled tribes and areas they are given for general revenue purposes on the recommendation of the Finance Commission. They are therefore determined in conjunction with the allocation of tax shares. Unlike tax shares, however, they need not be given to all States nor allocated on a uniform basis, since neither individually nor collectively are the States entitled to them as of right. They also differ from tax shares in that they are paid out of general Union revenue, and therefore instead of being tied to the yield of particular taxes the grants payable can be determined in accordance with the residual needs of the States. Since the allocation of tax shares is based predominantly on population, all "specialized and particular measures" of State needs

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[66] *Ibid.*, pp. 59–63.
[67] See above, p. 195 and p. 200. See also 2d F.C., pp. 16–17.
[68] 1st F.C., p. 75; and 2d F.C., p. 39.

are left to be covered by differential grants-in-aid. Their function is thus more clearly delineated than that of the Australian Special Grants, which are given to cover not *all* the special needs of the States, but only those which have not been embodied in the tax reimbursement grants.

In 1935, Sir Otto Niemeyer supplemented his scheme for the sharing and allocation of income tax by recommending grants-in-aid amounting in the aggregate to about Rs3 crores, to the five Provinces of Assam, Orissa, United Provinces, Sind, and the N.-W. Frontier Province. These grants were in aid of general revenue, and no conditions were attached. They were intended to give each Province a reasonable prospect of balancing its budget and meeting its residuary needs after taking account of all other forms of assistance, and of the financial resources which the Center could make available. The grant to United Provinces was for a limited period of 5 years, and various provisions for review or adjustment were attached to the grants payable to the other Provinces, but there was no arrangement for annual review, as in the case of the Australian Special Grants. They also differed somewhat in purpose, those payable to Assam and to the N.-W. Frontier Province in particular being necessary because of frontier problems which have no parallel in Australia. Subsequently, Partition accentuated such problems. The grants to Sind and the N.-W. Frontier Province lapsed with their inclusion in Pakistan, but it was found necessary to introduce new grants for the Punjab and West Bengal, both of which had suffered from Partition.

In accordance with the Constitution, the Finance Commissions are required to report on the principles which should govern grants-in-aid as well as to recommend the actual amounts to be paid. After a survey of experience in India and other countries, including Australia, the first Commission listed six principles as relevant. They were:

(1) The Budgetary Needs of a State, subject to suitable corrections to insure comparability with others;

(2) The Tax Effort of a State, allowance being made for "clear cases" of failure by a State to help itself by imposing higher taxation;

(3) Economy in Expenditure by a State, this being considered necessary to avoid introducing a premium on extravagance;

(4) Inferior Standards of Social Services, arising from special difficulties such as sparsity of population or economic backwardness;

(5) Disabilities arising from Special Obligations of National Concern, such as the consequences of Partition;

(6) Encouragement of Board Purposes of National Importance, the Commission being of the opinion that grants-in-aid should not necessarily be completely unconditional provided that the purpose was "broad but well defined." [69]

On the basis of these principles, the Commission recommended two types of grants-in-aid. The first were unconditional and general purpose grants-in-aid for seven States.[70] In addition to Assam and Orissa, which had received grants-in-aid since 1935, and the Punjab

[69] 1st F.C., pp. 96–98.
[70] *Ibid.*, pp. 101–102.

and West Bengal, which had been given grants after Partition, grants were recommended for three of the newly integrated but economically backward Princely States. These grants totaled Rs5·05 crores per annum, but taking into account the larger number of States invloved the amount of assistance provided appears to be of a similar order to that recommended by Sir Otto Neimeyer. It also seems to have been determined in the same way by estimating the residuary needs of the States after taking account of their other resources including tax shares. Whereas Sir Otto Niemeyer's recommendations had, however, included various provisions for review or adjustment, the grants now recommended were fixed for a period of 5 years commencing 1952–53. Secondly, the Commission, in line with its view that grants-in-aid could be given for broad purposes of national importance, recommended grants for fostering primary education in eight States where less than 30 percent of school-age children actually attended school. The total amount payable was to be Rs1·5 crores in 1953–54 (i.e., the second year of the quinquennium) and was to rise to Rs3 crores in 1956–57. The States were to have full discretion in utilizing these grants in the broad field for which they were intended, but it was suggested that annual reports should be submitted and that the progress achieved should be reviewed by the next Commission.[71]

Finally, it may be recalled that the four jute-growing States, each of which qualified for assistance under one or other of the above heads, were also entitled to general purpose grants-in-aid by way of compensation for their former share of the export duty on jute. On the recommendation of the Finance Commission these grants were fixed at Rs3·15 crores per annum.[72]

The second Finance Commission was required by its terms of reference to take account of (1) the requirements of the second 5-Year Plan which had come into operation in 1956; and (2) the efforts made by the States to raise additional revenue from their own resources. The first point led the Commission to extend the concept of fiscal need to cover not only the ordinary budgetary needs of the States, but also their revenue expenditure under the Plan, and for this reason they recommended substantially increased grants.[73] They even contemplated making their grants conditional on the implementation of the Plan, but refrained from doing so because the grants were not expected to provide more than one-third of the necessary finance.[74]

The second point raised the question of the interpretation of their predecessors' six principles, the second of which referred to tax effort. While regarding those principles as "unexceptionable," the Commission observed that it was difficult in practice to determine the degree of a State's tax effort, or even to be sure of "clear cases" of inadequate effort. However, they accepted as an empirical test of tax effort

[71] *Ibid.*, pp. 103–104.
[72] *Ibid.*, pp. 85–89.
[73] 2d F.C., p. 46.
[74] *Ibid.*, p. 50.

a State's record in fulfilling its promise to raise additional revenue for the Plan.[75] There appears to have been no investigation comparable to that made each year by the Commonwealth Grants Commission in calculating its adjustments for severity of State taxation in Australia. Another respect in which the second Finance Commission found it desirable to modify the application of their predecessors' principles concerned grants-in-aid for broad national purposes, such as education. While not disapproving of such grants in principle, they considered that the leveling up of social service standards in the various States was primarily a task for the Planning Commission and the National Development Council. Consequently, they did not recommend the continuance of grants-in-aid for primary education.[76]

The Commission's final recommendations provided for unconditional general purpose grants-in-aid to 11 of the 14 States. In total the grants amount to Rs36·25 crores per annum for the first 3 years of the present quinquennium, and to Rs39·5 crores per annum for the last 2 years, this increase being intended to compensate the four jute-growing States for the loss after 1960 of the grants totaling Rs3·15 crores per annum which they have received in lieu of a share in the export duty on jute. Apart from this complication, the present grants are about four times as large as those being paid at the end of the previous quinquennium. Moreover, from being little more than one-tenth they have now increased to one-third of the aggregate tax share of the States. Their true significance, however, lies not in their total amount but in their allocation among the States, and particularly in their per capita allocation.

The following table sets the grants-in-aid recommended by the second Finance Commission against the estimated tax shares for 1959–60. Whereas the grants-in-aid are nil in Bombay, U.P. and Madras, they are about equal to or greater than the tax shares in Assam, Mysore, and Kashmir. In the remaining eight States they generally amount to about half the tax share. It will also be seen that the tax shares are so allocated as to give each State about Rs3 per head (Rs2 in respect of income tax, and R1 in respect of excise duties), but the grants-in-aid range from nil to nearly Rs5 per head in Assam and Rs7 per head in Kashmir. Thus whereas the application of the population principle to tax sharing largely eliminates the effect of differential taxable capacity, the grants-in-aid introduce a differentiation in favor of the States with the greatest relative needs. That neither tax shares nor grants-in-aid amount to more than a few rupees per head is a significant commentary on India's poverty, and her numbers. By way of comparison it may be noticed that in Canada Federal payments to the Provinces amount to about $40 per head, and in Australia financial assistance and special grants to the States range from about £20 to over £40 per head.

[75] *Ibid.*, p. 24.
[76] *Ibid.*, p. 25.

State	Tax shares		Grants-in-aid		Total	
	Rupees crores	Rupees per capita	Rupees crores	Rupees per capita	Rupees crores	Rupees per capita
Andhra	9.42	3.01	4.00	1.28	13.42	4.29
Assam	3.04	3.36	[1] 4.50	4.97	7.54	8.33
Bihar	11.24	2.90	[1] 4.22	1.09	15.46	3.99
Bombay	16.50	3.42			16.50	3.42
Kerala	4.10	3.03	1.75	1.29	5.85	4.32
M.P.	7.70	2.95	3.00	1.15	10.70	4.00
Madras	9.05	3.02			9.05	3.02
Mysore	6.15	3.17	6.00	3.09	12.15	6.26
Orissa	4.37	2.98	[1] 3.40	2.32	7.77	5.30
Punjab	4.82	2.99	2.25	1.39	7.07	4.38
Rajasthan	4.74	2.97	2.50	1.57	7.24	4.53
U.P.	18.02	2.85			18.02	2.85
W. Bengal	10.39	3.95	[1] 4.78	1.82	15.17	5.77
J. & K.	1.46	3.31	3.00	6.80	4.46	10.11
Total	111.00		39.40		150.40	

[1] Including grants in lieu of export duty.

Perhaps the most remarkable feature of the Indian grants-in-aid is that they are fixed in advance of 5 years at a time. For that period the States are certain to receive them, and the Union government is committed to pay them. This rigidity contrasts with the comparative flexibility of the tax-sharing system. It also means that grants-in-aid have to be based on forward estimates rather than on a post hoc review of actual budget results such as that undertaken in Australia by the Commonwealth Grants Commission. The first Finance Commission did state that they had based their assessment "largely on the financial position of the States as disclosed by actual revenue and expenditure in recent years, corrected where necessary with reference to budget estimates for the year 1952–53 and such subsequent information as became available."[77] It is also true that both Commissions reviewed trends in State revenue and expenditure in the years prior to their appointment. Unlike the Commonwealth Grants Commission, however, they did not base their recommendations on the precise amounts found necessary to reduce the budget deficits of the weaker States to the same average per capita level as those of the stronger States, with specific "corrections" to insure comparability, and "adjustments" to allow for the degree of effort shown in the raising of revenue or the control of expenditure. It would, in fact, be unrealistic to base grants for a 5-year period on such a close examination of the audited accounts of a single past year. Regard must necessarily be had to expected future changes, and both Commissions required the States to submit forecasts of revenue and expenditure over the ensuing 5 years. Presumably it was in the light of these forecasts that the second Commission recommended grants-in-aid for most of the States despite the fact that nearly half of them had experienced surpluses during the 4 years ended 1955–56.[78] Obviously, however, such long-range forecasts cannot be firm estimates of the type which a government submits to Parliament in its annual budget. They may, in fact, prove to be seriously astray particularly in a period of rapid economic development. This is what seems to have happened in India.

[77] 1st F.C., p. 101.
[78] 2d F.C., p. 27.

"Public Purpose" Grants: Conclusion

It will be appropriate to conclude this study by examining the impact of the first and second 5-Year Plans on Federal-State finances and on the schemes propounded by the two finance Commissions. The development expenditure under the Plans has imposed heavy strains on the economy and has had fiscal consequences for the States that were not foreseen by the Finance Commissions, nor by the planners themselves. In particular, it has entailed considerable additional grants to the States, outside the schemes framed by the Finance Commissions.

To some extent these difficulties have been due to lack of coordination. The 5-year periods with which the Finance Commissions have been concerned have lagged 1 year behind the Plan periods. The first Commission was not required to have regard to the needs of the first Plan, and made no provision for its financing in its recommendations. The second Commission was required by its terms of reference to take account of the needs of the second Plan, but found difficulty in dovetailing its work with the Plan, partly because of the difference in dates and partly because the Plan does not distinguish between revenue and capital expenditure. It therefore proposed that the periods with which future Finance Commissions were concerned should coincide with Plan periods, and that the necessity of making two separate assessments of the needs of the State should be avoided.[79]

Had it not been for the requirements of the first 5-Year Plan (which ran from 1951 to 1956) the recommendations of the first Finance Commission (which covered the period 1952 to 1957) would have been "quite liberal in relation to the normal expenditure of the States and for most of them left a substantial margin".[80] The second Commission estimated that these surpluses would in the absence of the Plan have outweighed deficits to the extent of Rs66 crores. In fact, however, the requirements of the Plan imposed additional revenue expenditure of Rs333 crores on the States and converted the potential overall surplus into an overall deficit of Rs57 crores. For the rest the States raised Rs77 crores from additional taxation (although this was only about one-third of the original target assumed by the Plan), and they received Rs133 crores in the form of conditional and specific purpose grants from the Union government.[81]

These grants were given under the extremely wide "public purpose" power conferred by Article 282 of the Constitution, and lay entirely outside the scheme of the Finance Commission. In 1951–52 grants under this power amounting to nearly Rs8 crores were allocated among the States, and their main purposes were rehabilitation and the "grow more food" campaign started during the war. By 1955–56, however, "public purpose" grants amounting to Rs52 crores were allocated among the States, their main purposes being community development projects and other aspects of the Plan.[82] At this level they not only greatly exceeded the grants-in-aid, but were nearly equal to the State share of income tax.

[79] *Ibid.*, p. 13.
[80] *Ibid.*, p. 26.
[81] *Ibid.*, pp. 10, 26–29.
[82] *Ibid.*, App. XIII, tables 5 (a) and (e), and 11 (a) and (e). Further unallocated sums of Rs4 crores in 1951–52 and Rs23 crores in 1955–56 were also available for these purposes.

The second Finance Commission's recommendations in favor of higher tax shares and grants-in-aid to the States were in part an attempt to reverse this trend. The Commission assumed that in the period with which it was concerned development expenditure would be on the same scale as in the second 5-Year Plan. It estimated that the additional revenue expenditure imposed on the States would amount to Rs709 crores, which was more than double that required by the first Plan. It was also assumed that the States would be able to raise Rs206 crores by additional taxation, and that they would receive "public purpose" grants amounting to Rs275 crores over the 5-year period. The Commission hoped, however, that the remaining gap of Rs228 crores would be covered by its recommended increases in the tax shares and grants-in-aid payable to the States.[83] It estimated that these recommendations involved an annual payment of about Rs140 crores to the States as compared with an average of Rs93 crores under the first Commission's scheme.[84] Over 5 years the increase would amount to Rs235 crores which would be more than sufficient to enable the States to cover their remaining revenue expenditure under the Plan. Moreover, if "public purpose" grants were limited to Rs275 crores, i.e., to Rs55 crores per annum, they would be substantially smaller than the increased share of income tax payable to the States under the Commission's recommendations, and not so greatly in excess of the grants-in-aid as was formerly the case.

In fact, actual experience indicates that these expectations are likely to be astray in several particulars. The expenditure by the States on their normal activities outside the Plan has been greater than anticipated, thereby reducing the resources available for financing the Plan, expenditure on which has lagged substantially. The tax effort of the States has fallen short of the Plan target by about 20 percent, the shortfall being particularly serious in respect of land revenues.[85] On the other hand, the annual payments to the States from the Union are greater than expected because of higher income tax yields. Finally "public purpose" grants, so far from being stabilized, have tended to increase, and in the current Budget appear to be about Rs100 crores, although not all of this amount may be actually allocated among the States.

Included among the "public purpose" grants provided under both the first and second 5-Year Plans have been a large number of matching grants. Matching grants are, of course, quite common in the United States, and in Australia the matching principle has recently been applied to University grants and to the supplementary portion of the new Commonwealth Road Grants. In India, the second Finance Commission observed that the State governments had generally found it politically impossible to refuse such grants, even though they lacked the resources to meet their share of the expenditure without incurring larger deficits. In these circumstances, Federal tax shares and grants-in-aid might eventually have to be increased to enable the States to balance their Budgets, and the Commission commented that "if this

[83] *Ibid.*, pp. 47, 71–72.
[84] *Ibid.*, pp. 80–81.
[85] *"Appraisal and Prospects of Second Five-Year Plan"* (Planning Commission, New Delhi, 1958), pp. 13, 20.

happens the whole purpose of matching is lost." A similar comment would perhaps not be inappropriate so far as matching grants in Australia are concerned. The Commission also pointed out that matching grants designed to stimulate the States to undertake particular services had no place under an "integrated and comprehensive Plan" such as operated in India. Finally, they endorsed the more familiar argument that matching grants are inequitable, since the wealthier States are better able to take advantage of them than the poorer States. For all these reasons, the Commission expressed the opinion that "matching grants are not suitable in present conditions." [86]

Despite these criticisms conditional and specific purpose grants, often with matching conditions attached, continue to play a major role in the Indian scheme of Federal-State finance. In this particular respect Indian federalism has come to have closer affinities with the United States than with Australia or Canada, where specific purpose grants are comparatively unimportant. Such a development can hardly have been envisaged when the Constitution was framed. However, a system under which general purpose grants-in-aid are frozen for 5 yearly periods requires a certain degree of stability for its satisfactory operation. It is ironical that the 5-Year Plans, so for from increasing stability, have in fact reduced it and made prediction more difficult. It is in these circumstances that the "public purpose" grants have emerged as the most flexible element in the fiscal scheme and the channel through which additional funds are made available to the States to help them implement the Plans.

[86] 2d F.C., p. 69.

INDIA: UNION-STATE FINANCIAL RELATIONS—OUR BASIC APPROACH*

BY FINANCE COMMISSION OF INDIA

The history of the financial relations between the Central Government of India and the Governments of the constituent units is a long one; in fact, the final year of the period to be covered by the present Finance Commission will see the completion of a century since the first beginning of devolution under the scheme introduced by Lord Mayo in 1870. It is not necessary to recount the story here—there is a good historical account in the Report of the First Finance Commission—but it is worth noting that all the experiments that have up till now been made in this field proceeded from the experience of increasing gaps between the financial requirements of the functions allocated to the Provinces or States and the finances that these units could raise under their own authority. Except for the short interlude of "Provincial contributions" under the Meston Settlement of the 1920's, there has always been the need for substantial transfers of funds from the Government at the Center to the constituent units.

The trend of administrative evolution of the country has been toward the transfer of a widening range of functions—in the field of social services and, more lately, also in the field of economic development—to the Provinces or the States. There has thus been the need for maintaining the financial viability of these units at expanding levels of expenditure. One alternative method for meeting the requirements would be to divide all revenue heads into two watertight compartments—one for the Center and the other for the units—in the expectation that the finances and functions would match in every case. Another alternative would be to give concurrent taxing powers to both levels of Government. The first of these alternatives was tried in India under the Government of India Act of 1919, while the second has generally been recognized as economically unsound.

The failure of the system of a rigid division between the Central and Provincial heads of revenue introduced by the Government of India Act of 1919 could not be prevented by the Meston Award and the ultimate result was unsatisfactory both to the Center and to the units. The experience of the 1920's led, however, to the emergence of the idea that the authority most suited for discharging a particular governmental function need not necessarily be the authority most suited to raise the financial resources required to discharge the function. The taxes on income had already been recognized before 1919 as a balancing factor and it continued to be recognized as such after 1935. But it also came to be recognized that other taxes could appropriately be levied and collected by the Central Government and distributed, wholly or partly, to the Provinces or States. The Govern-

*Reprinted from: *Report of the Finance Commission* (chapter 2), 1965, India.

ment of India Act of 1935 recognized this principle and the Constitution adopted in 1950 made clear provision for (i) the assignment of the taxes raised by the Union Government under article 269 wholly to the States, (ii) for the obligatory division of the income-tax proceeds between the Union and the States, and (iii) for the division, with the approval of Parliament, of the proceeds of the Union excise duties.

The principle behind all these provisions is that in regard to some of the major revenue-yielding taxes and also in the case of some other taxes, where a countrywide uniformity of rates is desirable, the best authority for legislating and in most cases also for collecting, is the Union Government. The requirements of the Center as well as those of the component States could be met in the most equitable and efficient manner, by distributing the proceeds after these have been collected by the Central Government, rather than by dividing powers of tax collection between the Center and the States as has been done in some federations—which would not only mean high costs of decentralized collection and large scope for evasion, but also varying rates of taxation in different areas and rigidity of distribution in the face of changing requirements. Under this system, the Union Government is the agency for raising certain revenues for the benefit of both the Center and the States and for distributing the proceeds between the Center and the States and among the States themselves according to the principles and procedures set out in the Constitution.

This makes the problem of determining what part of the divisible revenues should go to the States and what should be the distribution among the States *inter se* very important. Whatever principles are laid down with regard to these two issues have, however, to be based upon the economic realities of the country and formulated within the framework of the provisions of the Constitution. It is not possible to derive much direct help from the experiences of other Federal Countries, though the course of evolution by which each federation has sought to adapt its system of financial relations to changing political and economic conditions is very instructive.

A special feature of importance in India is the introduction of 5-Year Plans and the consequent distinction that has evolved between plan and nonplan expenditure. Many States urged upon the Commission to include expenditure on the Fourth Plan in the estimates for the coming 5 years. Some States supplied detailed expenditure forecasts on new projects and also on the likely revenue components of their Fourth Plan outlays. The Commission has, however, felt it desirable to leave all such expenditure out of its consideration. This decision is based not on grounds of any Constitutional limitation of the powers of the Finance Commission but on practical considerations consequent on institutional arrangements relating to the 5-Year Plans.

When the provisions regarding the Union-State financial relations were incorporated into the Constitution, it was not possible for any one to anticipate the importance and magnitude of our successive 5-Year Plans. There was no reference to Plan expenditure as such in the terms of reference of the First Finance Commission (November 1951–December 1952) and that body did not find it necessary to draw a line of distinction between plan and nonplan expenditure. In fact, it emphasized the need for taking into account development expenditure of various types in determining the transfer of resources from the Center of the States. The Second Finance Commission (June 1956–September 1957) was, however, specifically asked to take into account both the requirements of the Second 5-Year Plan and the efforts made by States to raise additional revenues. The dimensions of Plan expenditure, however increased rapidly and it became the normal practice to make grants for plan expenditure under the discretionary provisions of article 282 instead of making statutory grants under article 275, on the basis of the predetermined plan allocations as phased and modified by the annual plan discussions. The Third Finance Commission (December 1960–December 1961) recommended grants under article 275 to cover 75 percent of the States' revenue expenditure on the Third Plan, but the Government of India did not accept this recommendation.

The terms of reference of the Fourth Finance Commission do not expressly mention plan expenditure. The fact that the Commission is to make its recommendations in the light of its estimates of revenue receipts of the States in the coming 5 years on the bases of taxation levels likely to be reached in 1965–66, takes additional taxation outside its scope. And the fact that the Commission is specifically asked to take into account the committed expenditure on the maintenance and upkeep of the completed Third Plan schemes may be taken to imply that new outlays on Fourth Plan schemes are not expected to enter into its estimates.

The Constitution does not make any distinction between plan and nonplan expenditure and it is not unconstitutional for the Finance Commission to go into the whole question of the total revenue expenditure of the States. It has been pointed out to us that the reference to "Capital and recurring sums" in the first proviso to article 275(1) of the Constitution suggests that even capital expenditure need not necessarily be outside the scope of the Finance Commission. It is, however, necessary to note that the importance of planned economic development is so great and its implementation so essential that there should not be any division of responsibility in regard to any element of plan expenditure. The Planning Commission has been specially constituted for advising the Government of India and the State Governments in this regard. It would not be appropriate for the Finance Commission to take upon itself the task of dealing with the States' new plan expenditure.

The present Finance Commission has, therefore, confined itself to nonplan revenue expenditure *vis-a-vis* the revenue receipts anticipated in the coming 5-year period on the basis of taxation levels in 1965–66. We have not, however, taken the view that the function of the Finance Commission is simply to recommend such devolution and grants-in-aid as would merely fill up the nonplan revenue deficit as reported by the States because such an approach will be extremely mechanical. We have reassessed the States' estimates in the manner detailed in a subsequent Chapter. We have not taken budgetary deficits as a criterion for distribution in the case of divisible taxes and duties.

In regard to income tax, the Constitution does not say that it should be distributed on the basis of budgetary needs. In fact, however great the budgetary needs, a State will not get a share, if, for some reason or other, the tax is not leviable in that State. And, even when there is no budgetary need in a particular case, a State cannot be denied some share in the income tax proceeds if the tax happens to be levied within that State. In the case of the Union excises also, the provisions are almost similar, though the Union Government has in this case the option of not distributing any share among the States. The estate duty on nonagricultural property is in effect a State tax collected by the Center—the receipts do not enter the Consolidated Fund of India—and here also the budgetary needs do not come in as a criterion for distribution. The additional excise duties in lieu of sales tax are again States' taxes in substance and the distribution should logically be based on the principle of compensation for loss of revenue.

The only article in the Constitution which refers to the need for financial assistance is article 275. The grants-in-aid under this article are to be made only to "such States" as are in the opinion of Parliament "in need of assistance". The obvious implication of this provision is that if any State is in need of assistance, after the taxes to be compulsory or optionally shared with the States have been distributed on the basis of the principles uniformly applicable to all States, such assistance is to be granted under article 275. Corrective action for residuary deficits can be taken only under the authority of this article.

The Third Finance Commission took "the relative financial weaknesses of the States" as one of the criteria for determining the shares of the States in the divisible pool of the Union excises. We have departed from this approach on the ground that if any State is in need of specific financial assistance because of large deficits that cannot be covered by uniformly applied principles of tax-sharing, such assistance should appear explicitly as grant, rather than being disguised as shares of taxes. If in the case of some States, our recommendations appear to involve large grants under article 275, the reason is that the required financial assistance to meet the residual deficit has in each case been shown explicitly as grants. The size of these grants could have been made smaller by devising the sharing of the Union excise receipts in such a way as to incorporate a grant element based on anticipated budget deficits into the shares going to some States. This would not have affected the total transfers from the Center to the deficit States and it would have reduced somewhat the total amount of transfers from the Center to the States. It would, however, have had the effect of concealing the fact of their financial deficits.

The States for which we have not recommended article 275 grants should have surpluses in their nonplan revenue budgets and in a few cases the surpluses are substantial. The Planning Commission will, we expect, take these surpluses into account when determining the pattern of Central assistance.

An attempt has been made in the above paragraphs to state briefly the basic principles adopted in deciding the scheme of sharing of taxes and grants.

FINANCING FEDERATION (IN AFRICA)*

BY JOHN DUE

One of the most pressing problems in any Federal Governmental system is that of the allocation of revenue sources, and particularly taxes, between the Federal and subordinate governments. Thus, the experience on this issue in the newly developed federations in Africa is of particular interest. One of the major questions is that of the extent to which the new federations have been able to avoid some of the difficulties of the older ones, difficulties arising from features which were introduced generations ago and are highly resistant to change.

Two of the eight countries have truly Federal structures—Nigeria and the Federation of Rhodesia and Nyasaland. The three countries of British East Africa—Kenya, Uganda, and Tanganyika—have no Central Federal Government but do have a number of features of a Federal structure, so far as taxation is concerned. Nigeria, Rhodesia, and East Africa have certain characteristics in common—a small number (three) of subordinate units, a relatively early stage of economic development, with heavy reliance on primitive agriculture, a common language, British traditions and institutions of government, and formation as a Federal State within the last three decades.

THE FEDERATION OF RHODESIA AND NYASALAND

The Federation of Rhodesia and Nyasaland, often referred to as the "Central African Federation," and in southern Africa generally as the "Federation," consists of three previously separate territories: Nyasaland, Northern Rhodesia, and Southern Rhodesia. The backgrounds of the three are very different. Nyasaland is small in area but with a population comparable to that of the others, about 2.85 million people, of whom only 9,000 are Europeans. Once thinly settled, it has grown rapidly in population since 1900, largely by emigration from Portuguese East Africa, and is now relatively overpopulated. Nyasaland was made a British protectorate in 1892, largely to keep out the Portuguese. A beautiful country of mountains, rivers, and lakes, it has relatively few resources and by far the lowest per capita income in the Federation.

Northern Rhodesia, vast in area but in large measure consisting of uninhabitable desert, has about 2.5 million people, of whom about 80,000 are Europeans—mostly farmers along the railway line, and miners in the north. While much of Northern Rhodesia is poor, its wealth in copper ore is of great importance to the country as a whole, and it provides most of the foreign exchange. Northern Rhodesia was

*Reprinted from *Taxation and Economic Development in Tropical Africa*, Cambridge; M.I.T. Press, 1963.

ruled by the British South Africa Company until 1924; in that year it became a protectorate, with a legislative council controlled by the appointed Government officials and thus by the Colonial Office. The white settler element long sought greater control of the country.

Southern Rhodesia, with 3.1 million persons, is the most populous of the three territories and contains the two major cities, Salisbury and Bulawayo. With 225,000 Europeans, Southern Rhodesia has the largest white population of any African country between South Africa and the Sahara. The area came under control of the South Africa Company largely by virtue of conquest of the Matabele and the Mashona in the 1890's. Political power gradually passed into the hands of the settlers, and in 1923, Southern Rhodesia was formally annexed to the Crown as a self-governing colony, almost, but not quite, with dominion status. Industrial development in Southern Rhodesia has been rapid, together with expansion of tobacco and other agricultural production. Economically, the two Rhodesias were tied together by the railway that was built northward from a connection with the South African system, through Bechuanaland to Bulawayo and on to the copper country, completed in 1909. Nyasaland, however, is separated from the Rhodesias in its populous southern part by Mozambique, and the only rail connection is the long route via Dondo and Umtali.

Thus the Federation has a total of about 8 million people, some 300,000 of whom are European, plus about 25,000 Asians (largely from India). Per capita income of the Europeans is one of the highest in the world—about £580 per capita, or £2,320 per family (about $6,500 a year per family). On the other hand, the African per capita income is estimated at £24, less than that of Uganda (£26), for example.

ESTABLISHMENT OF THE FEDERATION

Thought had been given to possible federation or amalgamation for a number of years, and in 1938, a Royal Commission was appointed to investigate the question. The Commission recommended against such action because of the divergencies among the territories and African opposition in the two northern territories to closer ties, but sought the establishment of a council to attain coordination of various services. This recommendation was accepted in 1945. In 1950, the British Government again raised the question of some form of union among the three territories. Various conferences were held on the question, and despite substantial African opposition, a Federation was brought into force in September 1953. While the change had considerable support in the country, mainly on the part of the Europeans, the impetus came from the British Government, not from any strong pressure from the population of the territories as a whole.

Significant powers were transferred to the Federation Government thus necessitating the provision of substantial revenues. The task of drafting a revenue proposal was given to a Fiscal Commission established for the purpose, headed by Sir Jeremy Raisman (who has subsequently headed somewhat similar Commissions in East Africa and Nigeria), but made up primarily of civil servants, not of experts in the field of public finance. The terms of reference, so far as taxation was concerned, required that the Commission consider how the revenues available could best be collected and distributed to the four Governments, in view of the need for (1) autonomy of the constituent territories, and (2) insuring that revenues were employed for the benefit of the Federation as a whole. The terms of reference included the question of the best form of income taxation to insure uniformity throughout the area, and the establishment of a customs union. The Commission's basic approach was to estimate the expenditures by each Government and then ascertain the pattern of allocation of revenue which would cover the expenditures, consistent with the other requirements. Out of the recommendations of the Commission came the system still in operation (with minor changes) until the end of 1963.

ALLOCATION OF TAXING POWERS

In general, the system involved the establishment of a very high degree of centralization of taxation in the hands of the Federation—much more than is typical in non-African Federal Government structures. The major elements are as follows:

1. *Customs and excises.*—The establishment of a customs union and thus a common market was regarded as essential and, in fact, a major advantage of federation. Previously, each territory had its own customs system. The tariff in Nyasaland and that for a portion of Northern Rhodesia had no Commonwealth preference because of the terms of the Congo Basin Treaty. The Southern Rhodesia tariff was based on that of South Africa; in fact, the two countries were close to a customs union. For the Federation, a single customs system similar to that of Southern Rhodesia was recommended and accepted. All customs and excise revenue was assigned to the Federation Government, with one exception. The duty on motor fuel (or an alternative tax on the sale), though administered by the Federation, is subject to the jurisdiction of the territories so far as rates are concerned, and the revenue accrues to them. The main reason for this exception was that the tax in Southern Rhodesia was high and yielded substantial revenue, while there was great opposition in Northern Rhodesia to raising its rate to a similar level.

2. *Income tax.*—Substantial importance was attached to the need for a single national income tax, uniform in structure throughout the country, the prevention of any form of double taxation by the territories, and the avoidance of nuisance for the taxpayer and of duplicating administration. Yet the territories obviously required revenue from this tax. Thus several features were provided:

(*a*) A single unified income tax structure, with assessment and collection of the tax by the Federal Government.

(*b*) The distribution of the revenue among the four Governments, on the basis of a formula derived from an estimate of expenditure needs and revenues from other sources. The Federal Government was assigned 60 percent, Southern and Northern Rhodesia each 17 percent, and Nyasaland 6 percent. It was recognized that the formula would not be suitable indefinitely, and provision for reconsideration was included in the recommendations.

(*c*) The privilege for the territories to add a surcharge to the Federation tax, up to the amount of 20 percent, in order to give more autonomy and flexibility to the territories. Liability for the surcharge is based on residence for individuals, and territory of origin of the income of companies.

(*d*) Substantial progression in the income tax structure. The use of the tax structure of the Southern Rhodesian levy (which had been based on the South African tax) was recommended and adopted; there was little progression in the Northern Rhodesia tax.

The net effect of the acceptance of these provisions was to give to the Federation power over income taxation far greater than is typical in other federations—Nigeria, Canada, the United States, and Switzerland, for example—and thus to restrict the taxing powers of the regions materially.

3. *Export duties.*—These had been used only by Nyasaland, and it was assumed that they would not be used by the Federation. But the Commission recognized that they could be used to undercut the income tax. If imposed on exports whose prices are determined in world markets, they reduce the net taxable incomes of the producers. Thus the Commission recommended that any revenues from this source be allocated on the same formula as the income tax.

4. *Sales tax.*—The Commission noted the potential effects of sales taxes on excise and income tax revenue, and the dangers of their interfering with trade across territorial lines. Thus, it recommended that they be exclusively under Federal jurisdiction, with revenue allocated on a formula basis, the Federation not to receive more than one-third.

OPERATION OF THE SYSTEM

The single unified customs tariff and income tax law were brought into effect.[1] However, motor fuel levies of the three territories vary widely. The three territories all levied surcharges up to the maximum 20 percent on income tax with one exception: Northern Rhodesia does not impose a surcharge on the personal income tax. There are several reasons: the high yield of the company tax surcharge, the widespread discontent in Northern Rhodesia with federation, and the desire to attract outside investment.

No sales tax has been introduced, largely because of the fears of collection difficulties at the retail level, and the obvious disadvantages of the other possible levels.

As the system operated in the 1961–62 fiscal year, the Federation collected £43 million for its own use, and an additional £28 million for the territories, whereas the latter themselves collected only £8.7 million of tax revenue. The revenues are shown in table 8.1.

[1] In 1957, the allocation figures were changed to give the Federation 62 percent, Southern Rhodesia 14 percent, Northern Rhodesia 18 percent, and Nyasaland 6 percent.

TABLE 8.1.—*Tax revenues, Federation of Rhodesia and Nyasaland, budget estimates, 1961–62*

[In thousands of pounds]

Tax	Nyasaland	Southern Rhodesia	Northern Rhodesia	Territories total	Federation	Total
Centrally collected:						
Income tax	2,480	5,753	7,377	15,610	26,089	48,953
Income tax, surcharge	200	3,000	4,054	7,254		
Customs and excise	241	4,800	225	5,266	17,225	22,491
Total	2,921	13,553	11,656	28,130	43,314	71,444
Collected by territories:						
Personal tax	1,055	2,500	345	3,900		3,900
Other	195	3,892	730	4,817		4,817
Total	1,250	6,392	1,075	8,717		8,717
Grand total	4,171	19,945	12,731	36,847	43,314	80,161

Thus the income tax, including the territorial surcharge, is by far the most important element in the tax structure, yielding 60 percent of the overall revenues—a most unusual situation in a developing economy. Since the Federation collects both income taxes and customs and excise, it collects, in total, 76 percent of the territorial revenues and 89 percent of the total revenue of all four Governments. The personal tax and motor vehicle and other license taxes are the principal levies collected by the territories.

MERITS AND COMPLAINTS

The system obviously has important advantages, which can easily be overlooked. Discriminatory double taxation of interterritorial income is completely avoided, as well as nuisance for taxpayers of varying territorial tax structures and the need for filing duplicating tax returns. In fact, complete uniformity of income taxation is attained, except for the absence of a surtax on individual incomes in Northern Rhodesia. The Federation Government has, in effect, complete control over most of the total tax revenue and thus is placed in a particularly good position to adjust taxation for purposes of attaining greater economic stability. Nuisance features of differing commodity taxation in the various jurisdictions are avoided (except on motor fuel). Allocation to the territories of much of the revenue by a prearranged formula gives some recognition to varying revenue needs and avoids the problem of ascertaining origin of the revenue.

However, this efficiency in operation has been attained at the price of substantial loss of fiscal autonomy on the part of the territories, and, particularly in Nyasaland and Southern Rhodesia, there is a strong feeling on the part of the territorial governments that they have inadequate total revenues to finance the functions assigned to them. The major source, the income tax, is dependent in its yield strictly on Federation policy, completely so far as the shared portion is concerned, and actually with the surcharges as well, since the latter have, with the exception noted, been held at the maximum. Adjustments in the Federation income tax automatically produce changes in the major revenues of the territories, and these adjustments are apparently made with little consultation with the territories; the Federation determines its tax policy largely on its own. The territories are left with only minor autonomous revenues, and one of these, the motor fuel tax, is administered by the Federation. In Southern Rhodesia, there has been a tendency to use the motor fuel tax as the balancing item in the budget, whereas under usual principles of taxation this levy is particularly unsuited for the purpose. The territories are of course permitted to levy personal or poll taxes, and all three do so. But these taxes cannot raise significant sums of revenue without violating usual standards of equity unless they are graduated, and in the past the territories have concluded that graduation would render the taxes invalid by giving them the form of income taxes, which are within the Federation's sphere. In 1961, however, Southern Rhodesia introduced limited graduation into its tax. But at best these can only be minor revenue sources.

Northern Rhodesia's principal criticism is of a slightly different nature. With the large profits of the mining industry in the territory, Northern Rhodesia, in a sense, subsidizes the other two territories by paying a disproportionate share of Federation tax, although, on the whole, Southern Rhodesia is much the wealthier area.

There is also criticism, especially in Nyasaland, of the high exemptions under the personal income tax, which are attributed to the desire of the Federation Government to attract European immigrants.

THE MONCKTON RECOMMENDATIONS

In 1960, a complete review of the Constitution of the Federation was undertaken by a group generally known from the name of its Chairman as the Monckton Commission. The Commission recommended a substantial redistribution of governmental functions, and the establishment of a Fiscal Commission to reallocate the proceeds of taxation among the four Governments. Two general principles were emphasized, so far as taxation is concerned: the range of taxes under the control of the territories should be as wide as possible, yet the Federation Government should be able to exercise broad fiscal policy to aid in stabilization of the economy. It was recognized, of course, that these two goals were somewhat contradictory. The principal change recommended was the allocation of customs duties on the basis of a prescribed formula, in order to increase the revenues of the territories in conformity with their enlarged functions. No basic changes in the income tax were suggested, except that the maximum of the surcharge be stated in terms of tax rate rather than a percentage of the Federation tax, so that the territorial yield would not move automatically with changes in the Federation levy. In addition, authorization for the territories to institute graduated poll taxes (but with no overlap of liability for poll and income tax) was recommended.

The Monckton Commission also reviewed the question of whether the power for determining income tax rates should rest with the Federation or territorial governments, and offered two alternatives: (1) that the present system continue; and (2) that the territories be permitted to fix the rates of the personal income tax, subject to Federation regulation and collection. The basic company tax would remain a Federation tax. No formal preference for either of these was indicated.

Thus, on the whole, the recommended changes would not have drastically altered the present system so far as the levying and collection of taxes were concerned, the main change being allocation among the four Governments of the proceeds of the customs duties. Administration and determination of customs and income tax structures would remain Federation functions, as well as rate determination, except for the surcharges, unless the second alternative noted in the previous paragraph was accepted.

THE FUTURE

The recommendations of the Monckton report were not implemented. When Nyasaland and Northern Rhodesia gained African Governments in 1962 and 1963, they sought the right to withdraw Rhodesia. This right was granted by Great Britain in 1963, and a from the Federation because of its domination by "white" Southern conference at Victoria Falls resolved the major issues relating to dissolution. The Federation is scheduled to end on December 31, 1963. Whether or not a customs union and any sort of joint tax administration will continue has not been resolved as of September, 1963. Meanwhile, 10 years of experience with a highly centralized tax system demonstrated its technical efficiency on the one hand and its effects on territorial autonomy on the other.

NIGERIA

Unlike the Central African Federation, Nigeria assumed Federal status from a unitary state. The transition was made in order to increase the chances of the country remaining intact after independence. The divergent interests among the three regions were so great that a unitary state appeared almost certain to disintegrate.

THE NATURE OF THE COUNTRY

Nigeria, like other African countries, did not exist as a unit prior to the coming of the British. British rule was gradually extended northward, and control was completed in 1903. Not until 1914, however, were the northern and southern protectorates united to form the Colony and Protectorate of Nigeria. Self-government came slowly until after World War II, when the movement speeded up rapidly. The 1946 and 1951 constitutions both provided for a unitary state. But quarrels between the North and the South brought a near breakdown in Government, and the result was a new constitution in 1953 providing for a Federal structure. On the basis of this new constitution Nigeria became independent on October 1, 1960.

The country consists of the Federal district of Lagos (following the United States-Australian pattern), and Eastern, Western, and Northern Nigeria. The North has slightly more than half of the population, the East slightly more than the West. The East and West have some characteristics in common, such as heavily wooded terrain, but also significant differences. The West, dominated by the Yoruba, is characterized by village and city dwelling, and contains some of the oldest African cities—Ibadan, Abeokuta, Ife, and Benin. Tribal rule was typically hereditary. Economically, this area is comparable to Ghana, with its heavy reliance on cocoa. The East, whose relatively small cities are mainly European creations, is a thickly settled land of village and farm dwellings, with production concentrated on palm oil. The dominant tribe is the Ibo, one of the most important democratic tribes of Africa, with no tradition of chiefs or central authority.

The North is a very different type of country, in terms of physical environment, culture, government, religion, and virtually every aspect of life. It is a land of vast semiarid plains, of mud-walled cities dating back to A.D. 1000 (Kano, Zaria, and Katsina are the chief examples), of predominantly Moslem culture, of autocratic governments of Emirs and Sultans (but now with a substantial element of democracy), of primitive agricultural methods, but extensive production for market. There were no indigenous ties with the South at all; those which exist, such as the railway lines, were creations of the British.

So far as taxation is concerned, prior to 1952 the regions had no taxing powers of their own, but were assigned arbitrarily allocated shares of Federal revenue. In 1951, some taxing powers were given to the regions, and in the 1954 constitution these were extended, on the basis of the recommendations of Sir Louis Chick, who had served as Revenue Commissioner. Under the 1954 system, revenues of import, excise, and export duties were assigned to the regions on the basis of derivation or by fixed percentage (general customs revenue). Federally collected income tax revenues on companies and on non-Africans were returned to the regions, as were mining royalties. Various produce sales taxes were also used by the regions; purchase taxes on motor fuel, beer, and spirits in the East and taxes on personal income in the Eastern and Western regions.

THE RAISMAN REPORT

Dissatisfaction with the system led to the appointment of a Fiscal Commission in 1957, consisting of Sir Jeremy Raisman (Chairman) and R. C. Tress. This Commission reviewed the whole question of fiscal arrangements and made a number of suggestions, almost all of which were accepted, and which form the basis of the present tax arrangements. Most of the criticisms of the old system centered around the lack of sufficient autonomous revenues for the regions, the difficulties in the ascertainment of the origin of the revenues from various regions, particularly import duties, and failure to recognize the lack of correlation between the needs of a region and its revenues. The Commission sought to attain an effective compromise between maximum fiscal autonomy on the part of the regions and attainment of administrative effectiveness, free interregional trade (regarded as of utmost importance), and unified national policy, particularly financial stability of the Federal Government.

The system developed on the basis of the Raisman report contains the following major elements:

1. Exclusive jurisdiction is given to the Federal Government over—
   (*a*) Customs, excise, and export duties.

(*b*) Sales and purchase taxes, except those on produce (other than tobacco), hides and skins, motor fuel.
(*c*) Taxes on the income and profits of companies.
(*d*) Mining royalties and rents.
(*e*) Taxes on incomes of persons resident in Lagos.

2. The regional governments and their subdivisions, therefore, have the power over—
(*a*) Personal income taxes, subject to the requirements noted below.
(*b*) Taxes on the sale of the items enumerated in 1(*b*) above.
(*c*) Poll or graduated personal taxes.
(*d*) Taxes on wealth and property, including real property, livestock, and other possessions.
(*e*) License taxes.

3. Since this allocation provided entirely inadequate funds to the regional governments, yet no additional transfer of taxing powers was considered consistent with the need for free inter-regional trade and administrative feasibility, provision was made for allocation of certain Federal revenues to the regions.

The allocations are based upon two principles: derivation (that is, where the tax revenue was generated) and need for funds. In terms of these criteria, the allocation system was set up as follows:

(*a*) Exclusively to the regions of origin:
(1) Import duties on motor fuel.
(2) Import and excise duties on tobacco.
(3) Export duties on produce, hides, and skins.

(*b*) Exclusively to the Federal Government:
(1) Import duties on beer, wine, and liquor.
(2) Excise duty on beer.

(*c*) Allocated to distributable pool:
(1) 30 percent of all import duties other than those listed above, the other 70 percent retained by the Federal government.
(2) 30 percent of mining rents and royalties; 50 percent of the revenues go to the region of origin; 20 percent to the Federal Government.

In addition, the company tax and the Lagos personal income tax yields go exclusively to the Federal Government.

The distributable pool is allocated as follows: 40–95 to the North; 24–95 to the West; 31–95 to the East.

The allocation system is written into the constitution, and cannot be altered except by action of the legislatures of two regions and Parliament. The constitution also provides that from time to time the Federal Government shall appoint a Commission to review the allocation, but this has not yet been done.

INCOME TAX

The Raisman Commission was eager to insure that, while the setting of personal income tax rates and allowances should rest within the jurisdiction of the regions, at the same time multiple taxation should be avoided. The decision to keep the tax at the regional level, in contrast to the policy in other new federations, was based upon several considerations, in addition to the desire to give the regions as many autonomous revenue sources as possible: the traditional use of direct personal tax by the regions, the need for adapting the tax to local conditions, the importance of direct tax systems in the tax structure of the Native Authorities in the North, and the existing use of income taxation in the East and the West.

To insure satisfactory operation of the tax system, however, the Federation was given power to enact legislation affecting tax on individual incomes, for the purposes of—

1. Implementing double taxation treaties with other countries.
2. Securing uniform treatment of international income.
3. Prevention of double taxation of the same income by more than one region.
4. Attainment of uniformity in the computation of taxable income, the treatment of losses, depreciation, and contributions to pension systems.
5. Facilitating arrangements between the regions and the Federal Government relating to exemption of certain incomes.
6. Facilitating exchange of information on the income tax by various taxing jurisdictions.
7. Establishment, by cooperation of the various governments, of authorities designed to increase the uniformity of taxation.

However, the Federal Government was denied the power to establish tax rates, personal allowances, or reliefs, which were left specifically to the regions. Thus a framework was provided to prevent double taxation and insure uniformity in the calculation of income, yet to insure autonomy to the regions so far as level of the tax and treatment of dependents were concerned.

Pursuant to this provision, the Federal Government, after consultation with the three regional governments, enacted the Income Tax Management Act in 1961. The Act seeks to prevent double taxation by giving exclusive jurisdiction to the region of residence of the person for the year. The Act also defines income in some detail and specifies the treatment of partnership income, dividends and interest, deductions for calculating taxable income (other than allowances for dependents), losses, depreciation, and the like. Residence is defined in great detail. A Joint Tax Board was established to handle questions of interpretation under the Act, and related matters.

It is by no means clear how far the Federal Government can go, constitutionally, in the direction taken in the Income Tax Management Act, and to what extent the Act is actually binding on the regions, since this is a field of concurrent taxing powers. The source of doubt is the fact that, while the Federation is given various powers in the field, at the same time, the constitution guarantees the autonomy of the regions. It would appear that there is no doubt on issues on which the constitution is specific, such as the prevention of double taxation. There is doubt, however, on the question of various deductions authorized by the Act. Must the regions adjust their laws to provide these, or can they fail to grant some allowances provided in the Federal Act? Can they provide additional allowances not given in the Federal Act? The most common answer is that they must provide the allowances mentioned, but may give others. The unofficial reaction in Western Nigeria, however, is that the Act is much less binding on the regions than is usually thought.[2]

[2] This point of view may reflect primarily the fact that the political party in power in Western Nigeria constitutes the Opposition in the Federal Parliament.

Apart from the question of the exact scope of Federal powers over income taxation, there are certain other questions of interpretation that the courts must decide. One is the concept of "produce"; the regions are entitled to apply sales taxes to produce (and a few other items). Does the term include articles manufactured from products grown in the area, or only those in the form of unprocessed or partially processed agricultural goods?

THE REVENUE PICTURE

The 1961–62 Budget Estimates give a general picture of the actual revenue sources under the Federal system as it operates. Lagos is included in the Federal figures.

A few general comments can be made about table 8.2. The Federal Government collects about £85 million in tax revenue annually, the regions about £11 million. However, the Federal Government retains only about half of the total, or roughly £44 million. The remainder (£41 million) is transmitted to the regions, which thus get 79 percent of their total of £52 million of tax revenue from the Federal Government. The expenditures from tax revenue of the Federal Government and those of the regions, in total, are comparable (£47 million versus £52 million), but the Federal Government is the chief tax collector, and the financial autonomy of the regions—despite their freedom to impose personal income taxes—is not actually very great. This situation results in large part from the fact that, given the general nature of the economy, much of the revenue must come from customs duties, which of necessity must be determined and administered by the Federation. The customs revenues, unlike those of Rhodesia, are shared with the regions.

TABLE 8.2.—*Tax revenues by level of government, Nigeria, 1961–62 budget estimates in millions of pounds*

Collected by	Western Nigeria	Northern Nigeria	Eastern Nigeria	Total regions	Federal	Total
Federal:						
Company tax					4.6	4.6
Customs and excise:						
Tobacco	2.7	1.9	1.9	6.5		6.5
Motor fuel	2.3	1.9	1.6	5.8		5.8
Distributable pool	3.5	5.6	4.1	13.2	33.6	46.8
Export taxes	6.6	4.4	2.1	13.1		13.1
Mining royalties	.9	.6	1.0	2.5	1.6	4.1
Miscellaneous					3.9	3.9
Total	16.0	14.4	10.7	41.1	43.7	84.8
Regions: [1]						
Personal income tax	1.0	.5	3.5	5.0	2.4	7.4
Personal tax		1.3		1.3		1.3
Produce sales taxes	.8	.7	.8	2.3		2.3
Motor fuel taxes			.3	.3		.3
License taxes	.7	.7	.6	2.0	.8	2.8
Miscellaneous						
Total	2.5	3.2	5.2	10.9	3.2	14.1
Grand total	18.5	17.6	15.9	52.0	46.9	98.9

[1] Including taxes collected by the Federation for Lagos only.

The only regional levies of any magnitude are the personal income taxes (plus the personal tax and the jangali, or cattle tax, in Northern Nigeria); the produce sales taxes, collected through the marketing boards; the motor vehicle and other licenses, which in general are kept uniform among the regions; an entertainment tax, which produces little revenue; and in the East, a motor fuel tax. The regions are permitted to impose motor fuel levies in addition to the Federal customs and excises, but only Eastern Nigeria does so. The regional personal income taxes are by no means uniform, differing in rates and, particularly, in the personal allowance systems.

PREVAILING ATTITUDES

The attitude of the regional governments on the question of taxes is that of States in most Federal systems: they argue that they have inadequate revenue sources compared to their functions. This feeling is particularly strong in the West—again, perhaps, reflecting political differences. The heavy reliance on customs, excises, and export duties, with revenue subject to frequent change as economic conditions vary and with rates set by the Federal Government, makes regional budgeting difficult. There is little elasticity in the regional budgets, with no place to turn in a fiscal emergency except to the Federal Government.

The general argument is made that the Federal Government has relatively far too much money at its disposal, while the regions have not nearly enough, with consequent unbalance in relative expenditures on the respective functions of the various levels of government. Given the overall revenue structure, about the only significant avenue of reform is to increase the size of the distributable pool, so as to assign more federally collected revenue to the regions.

From a longer range standpoint, certain other problems confront the regions. As domestic manufacturing increases, a smaller percentage of basic produce is exported, and thus export duties fall. As individual enterprises grow and become companies, the revenue goes to the Federal Government instead of the regions. On the other hand, as income rises the personal income tax will be increasingly productive of revenue. Typically, as countries have developed economically, the income tax has grown in importance relative to the indirect taxes, and this trend almost certainly will occur in Nigeria. At the same time, taxes on property, which fall within the scope of the regions and their local governments, can be expanded over time and can lessen the reliance of the regions on sums allocated by the Federal Government.

EAST AFRICA

The three mainland East African countries—Uganda, Kenya, and Tanganyika—while not comprising a federation in the usual sense of that term, have certain elements of federalism, and a very high degree of uniformity and common administration of their tax systems. The cooperation among them provides a significant illustration of how coordination can be attained among countries that are not technically federated.

THE COUNTRIES

A brief word on the three countries is desirable as an introduction. In regard to population, Tanganyika, with 9 million people, is the largest, Kenya and Uganda each having about 6.5 million inhabitants. Uganda, one of the last sections of Africa to come under European domination, became a British protectorate in 1894, and gained its independence in October 1962. It has certain Federal elements in its own governmental structure, which will be described later in the chapter. There are relatively few Europeans in Uganda. Most of the merchants and a few plantation owners are Indian, but primarily Uganda is a purely African country; coffee is the major crop, and most people live on their individual farms rather than in towns or villages.

Kenya, on the other hand, has a large number of Europeans; the white highlands are farmed by Europeans who settled in the country shortly after 1900, and Nairobi is basically a European-Indian city. Much of Kenya outside the coastal strip was wilderness, largely uninhabited, when the British made Uganda a protectorate, and control of the country was taken by the British largely to protect the rail route to Uganda and to keep the Germans out. The white settlers of Kenya long sought self-governing status but never received it; after substantial violence during the Mau Mau uprising of the early fifties, peace was gradually restored, and a constitution agreed upon early in 1962, so that the country will become independent on December 12, 1963.

Tanganyika is by far the largest of the three in area, with a widely scattered population, much desert country, an inadequate transportation system, and low per capita income. Taken over by the Germans in the 1890's, it passed into British trusteeship after World War I, and was granted independence in 1961.

A fourth East African country, one which participates in some of the common services, is Zanzibar, with a population of only 300,000. Zanzibar, long ruled by a Sultan whose ancestors moved from Oman, became a British protectorate in 1891. Independence, delayed by the inability of the Arab and African groups to agree on a constitution, will become effective December 10, 1963.

DEVELOPMENT OF TAX COORDINATION

The idea of cooperation among the territories dates back to the period immediately after World War I. But the path to closer ties was a slow and rugged one, largely because of the fear of the Africans in Uganda and Tanganyika of a "white" Kenya dominating the entire area. Some cooperation developed in the thirties, and this was replaced in the forties by a more formal organization, with the establishment in 1947 of the East Africa High Commission (now East Africa Common Services Organization) and a Central Legislative Assembly. So far as taxation is concerned, it was originally intended that the Central Legislative Assembly should have the power to set customs and excise tax rates, but this plan was abandoned.

Coordination of the tax structures and administration of the three territories had actually begun long before a formal organization was set up. In 1917, internal free trade and a common customs system were established by Kenya and Uganda, and joint administration was established. The Tanganyika tariff was merged with the others in a series of steps, and the customs department joined in 1949. The administration of customs and excise became a High Commission service in 1948. Subsequently, in 1952, the Central Legislative Assembly enacted a Customs Management Act and an Excise Tax Management Act. The rates of duties, however, are technically set by the legislatures of each territory. Income taxation was first introduced in Kenya; when the other two countries levied it in 1940, uniformly and joint administration were established. The power over the income tax structure was ultimately given to the Central Legislative Assembly, which enacted an Income Tax Management Act in 1952 (replaced by a new act in 1958). Thus the income tax structures are of necessity uniform, but the rates and personal allowances are set by the territorial legislatures, and may vary.

Despite the fact that the power to set customs and excise and income tax rates rests with the territorial legislatures, a very high degree of uniformity is attained. Tariff changes are discussed and agreed upon in advance by a committee made up of the Permanent Secretaries of Finance and Commerce and Industry of the three countries, with technical advice from the Commissioner of Customs. The changes are then enacted by the legislatures. There have been only a very few cases in which agreement has been impossible, with consequent slight differences in the tariffs. There are no tariff barriers within the territory covered by the three countries. The allocation of customs and excise revenue is made on the basis of the destination of the goods. When goods are imported for use in a particular territory and used in that territory, no complications arise. When, however, subsequent transshipment to another territory occurs, the shipper is required to fill out a transfer form indicating the territory of final destination. No additional duty is payable.

In the income tax field, likewise, despite the setting of rates by the territories, almost complete uniformity is attained. Although the rates have at times varied slightly, they are now entirely uniform. There are minor differences in personal allowances in Zanzibar, which is a party to the common income tax but not customs duties, and Kenya provides an additional allowance for old people that the others do not. Income tax rate changes are discussed in advance by the Finance Ministers of the three territories and announced in the budget messages at the same time. The Income Tax Management Act provides a very detailed statement of the income tax structure (apart from tax rates and personal allowances), dealing with the concept of income, the treatment of special forms of income, deductions, tax returns, assessments, appeals collections, depreciation, and allocation of income by territory. Thus, in fact, a much greater coordination of personal income tax is found than in Nigeria, despite the fact that the latter is a single country and East Africa is not.

THE REVENUE SITUATION

As shown in table 8.3, the great bulk of the revenues of the three territories comes from the common taxes. Thus 76 percent of Uganda's tax revenue, 88 percent of Tanganyika's, and 85 percent of Kenya's are collected by the joint administration. The major taxes operated individually by the countries are the personal taxes, license taxes (primarily on motor vehicles), and, in Uganda, export taxes.

TABLE 8.3.—*East African territorial revenue, 1961–62 budget estimates in thousands of pounds*

Revenue	Uganda	Tanganyika	Kenya	Total
Common administration:				
Income tax	3,300	4,100	10,000	
Customs duties	6,350	8,176	9,100	
Excise taxes	2,770	2,474	3,200	
Total	12,420	14,750	22,300	49,470
Separate administration:				
Personal tax	[1] 628	950	1,700	
Export duties	2,440	45	0	
License, stamp, and miscellaneous	891	955	2,352	
Total	3,959	1,950	4,052	9,961
Total	16,379	16,700	26,352	59,431

[1] Expired in 1962.

MERITS AND DIFFICULTIES

The East African system has worked very well in many respects. The uniform tariff, with no duties for shipments among the three countries, has provided a common market of more than 23 million people, one of the largest in Africa, and has, without question, stimulated the economic development of the area, particularly of industry, and is likely to do so even more in the future. The lack of internal tariffs and the joint customs administration have materially reduced manpower needs and expenses of collection. Also, a single uniform income tax structure has greatly simplified the task of administration, allowed more specialization in administrative personnel, aided taxpayer compliance, and facilitated economic development of the region as a whole. And, at least theoretically, the autonomy of the three territories over tax rates and allowances has been maintained.

On the other hand, the system has given rise to certain difficulties, which were responsible for the appointment of the Raisman Commission, whose report was made in 1961. These can be summarized briefly:

1. The most widespread discontent has been over tariff policy: Kenya, which has been in the best position to develop industry, has sought extensive protection, which the other two territories opposed, since, as a consequence of higher duties, they had to pay higher prices for goods consumed. To aggravate the problem, as protected Kenya industry developed, the other territories lost their customs revenue, while Kenya gained the income tax revenue from the new enterprises. Furthermore, the Kenya marketing boards would often sell Kenya goods on the foreign market more cheaply than in Uganda and Tanganyika, where the tariff protected the boards from foreign competition. Kenya and, to a limited extent, the others have

at times interfered with the completely free flow of farm products by marketing board controls.

2. There have been some complaints about the operation of the customs systems. When goods are imported into Kenya, and then subsequently transferred to one of the other countries, Kenya receives the customs revenue unless a transfer form is supplied. With shipments by rail, air, or post, there is no leakage, because the form must be filed before the shipment will be accepted by the carrier. But with motor transport, there is no such assurance. Concern over the question by Uganda led to systematic road checks, which indicated that the leakage was not of significant volume.

The other operational question is that of the appropriate value figure to use on goods no longer identifiable in reference to the original import because of processing, breaking bulk, etc. In practice, a 0.7 factor is used to reduce the figure to the imported price. While this is an arbitarary approach, it has produced relatively good results.

3. The income tax operation gave rise to two major complaints, both of which have, in part at least, been remedied as a result of recommendations of the Raisman Commission. One related to the allocation of individual income earned in one territory by the residents of another. The original formula assigned one-half of such income to each of the two territories; this has been changed to give it all to the territory of origin.

The second complaint was a longstanding charge that Kenya received a disproportionate share of company tax because no reference was made in the formula to the sales made from Kenya into the other territories, when there was no actual place of business in the destination territories. The solution to this problem was the distributable pool approach, noted below. There have also been complaints about the allocation of tax on incomes of Common Services Organization employees, a high percentage of whom live in Kenya.

4. A more fundamental difficulty has been the inflexibility of the revenues of each of the territories. So long as the territories accept the principle that customs, excises, and income taxes must be uniform or nearly so, no government can vary its revenue from these sources without agreement of the others, and this is not always forthcoming. As noted, the revenues other than the common ones are of minor significance. This problem has been less serious than it might have been, because the revenue needs of the three territories have not differed fundamentally from the yield of the taxes at the agreed-upon rates. However, particularly Uganda and Tanganyika are somewhat concerned about the general inflexibility and potential inadequacy.

5. The methods of determining income tax and customs duty rates have been subjected to some criticism. It is maintained that frequently decisions are made largely on the basis of horse trading and the strength of personality and bargaining skill of the representatives of particular countries. Yet on the whole the decisions have been made without serious conflict.

6. Finally, in somewhat broader terms, there exists a fundamental deficiency, relative to the usual Federal structure. Normally, when

several territories are willing to accept common customs and taxes despite substantial variations in per capita income and economic growth, they do so in part because the common taxes are accompanied by grants or expenditure programs which transfer money from the richer to the poorer areas of the Federal system. But in East Africa, with no Central Government in the true sense of that term, there has been no system for transfers by grants. This deficiency led the Raisman Commission to recommend the distributable pool system described below.

SOLUTIONS TO THE PROBLEMS

Apart from minor adjustments to improve the system made from time to time, a major change was made in 1961, following the recommendations of the Raisman Commission.

So far as taxation is concerned, the major recommendation of the Raisman Commission was the establishment of a distributable pool, a recommendation which the territories accepted, although, in the case of Tanganyika, for a 2-year period only. The primary aims were to provide some redistribution of revenue from Kenya, which gains greater benefits from the Common Market than the others, to the other two territories, as well as to lessen the complaints that Kenya receives an unfairly large sum of company tax revenue. Specifically, there is allocated to the pool 40 percent of the revenues of customs and excise duties. One-half of the revenue is used to finance various services of the Common Services Organization, and the other half is distributed in equal shares to the three territories. Costs of administration of the taxes were made a first charge against the revenues. While Tanganyika felt that the change did not go far enough, there was general agreement that this represented a step in the right direction.

As the three countries gain their independence, there has been speculation about more drastic changes. There had been some fear that the whole joint services operation might break up, with elimination of the Common Market and establishment of separate customs and tax administrations. Such a change was opposed by the World Bank report on Tanganyika and the Raisman Commission, the three Governments appear today to accept the position that the advantages of the Common Market and common administration are such that they should be retained. It is a question in which African politicians have shown little interest; whether the new Governments can coordinate their efforts as well in attaining mutually acceptable conclusions remains to be seen. But the three countries, while not without rivalries, have many common interests, and with Kenya an "African" instead of a "white" country, there are no significant traditional hostilities, and continued cooperation should be a very real possibility.

The other possibility is that of the move toward actual federation on the Nigerian pattern, a move originally sponsored by Tanganyika's President Nyerere. Initially, the plan found little support in Uganda, largely because of the fear that the Federation would be dominated by a "white" Kenya. With this fear eliminated, there is less opposition in Uganda, but some fear on the part of Buganda that, while it can probably control Uganda, it could not control the entire Federation. In 1963 there has been increased support for the move toward federation.

THE UGANDA AND KENYA INTERNAL PROBLEM

The establishment of a constitution in Uganda was delayed by the demands of Buganda, by far the largest and wealthiest unit of the country, for a high degree of autonomy. Actually, there was substantial support in Buganda for separate independence. Thus it was necessary to grant Buganda essentially the position of a State in a Federal system; agreement on this point was reached in 1961, but without agreement on financial aspects. In part, to aid in a solution to this problem, a Fiscal Commission was appointed by the Uganda Government in 1962, which rendered its report in May of that year. In its memorandum to the Fiscal Commission, the Buganda Government argued that it had rights to all taxation arising out of the land of the Kingdom, activities connected with the use of the land, and the people residing on it—thus to all personal and income taxation, land taxes, export duties, and excise duties on goods produced in Uganda. There would be left to Uganda only the customs duties and company taxation. On the other hand, existing grants by Uganda to Buganda would cease. The Fiscal Commission was unwilling to accept this request and suggested only minor increases in the taxing powers of Buganda.

Attention has also been given in Kenya in the last 2 years to the question of allocation of functions and tax revenue among the central, regional, and local governments. A Fiscal Commission studied the issues and made recommendations.

CONCLUDING OBSERVATIONS

In these three instances of Federal finance, great stress was placed on the development or reform of the tax systems, upon the need for uniformity of customs duties, excises, and income taxes, as well as upon unified administration. Several factors played a part in this emphasis. One was the urgent need for maximum efficiency in administration of the taxes, given the general shortage of personnel in these countries. A second factor was the desire to minimize nuisance for the taxpayer in the form of duplicating returns and varying rules for calculation of income. A third was the strong desire to avoid discriminatory double taxation by more than one territory. Finally, great attention was paid, in the interests of economic development, to the need to insure the internal free flow of trade and avoidance of tax differentials—particularly of company taxes.

On the other hand, some attention was paid to the need for the fiscal autonomy of the territories and the desire to insure them some independent revenues and some influence in the setting of the tax rates. In addition, in the allocation of the yield of various taxes, recognition was given to the total expenditure needs of the territories. However, while the autonomy argument was stressed, it actually played a very subordinate role to that of efficiency and uniformity.

As a consequence, a high percentage of all tax revenue is collected by the central administration: in Rhodesia, 76 percent of the territorial revenues and 89 percent of the tax revenue of all governments; in Nigeria 79 percent of the regional government revenues and 86 percent of the tax revenues of all governments; and in East Africa 83 percent of the territorial revenues. With a portion of this revenue the rates are technically subject to control of the territories, but in fact this power is effective in only a few instances—the motor fuel taxes in Rhodesia, for example. While the territories can vary their surcharges on income tax in Rhodesia, in fact they do not, with one exception.

More specifically, the tax systems which have developed have the following major characteristics:

1. In all three instances there is a single uniform customs and excise system with common administration and uniform rates (with minor rate exceptions in East Africa), and complete free trade within the federations. The rates are set by the Central Government in Nigeria and Rhodesia, and technically by the territories in East Africa. In all instances the basic structure (apart from rates) is established by the central legislative body.

2. All three have uniform, centrally administered company income taxes; uniformity in this field is regarded as essential for economic development and effective enforcement.

3. In the personal income tax field, common structural legislation (excluding rates and personal allowances) is found in all three areas. In Rhodesia, the rates are set by the Federation except for the territorial surcharges. In East Africa, the rates and allowances, while technically set by each territory, are in fact uniform (with minor exceptions). Only in Nigeria do the rates and allowances differ, and each region has its own administration.

4. The territorial governments are confined, except for Nigeria, to relatively minor taxes, the most important of which are the graduated personal taxes, export duties (Nigeria and Uganda only, centrally administered in the former), motor vehicle and other licenses, produce sales taxes (Nigeria), and, for the cities, property rates.

Since the revenues from the taxes left to the territories are grossly inadequate, a portion of the centrally collected taxes is returned to the territories. There are two basic rules of distribution:

1. The "origin" rule—that is, allocation on the basis of where the activity that gave rise to the tax took place—is used in several instances:

(*a*) Export duties—Nigeria.

(*b*) Motor fuel taxes—Nigeria, Rhodesia.

(*c*) Customs and excise (less 6 percent)—East Africa.

(*d*) Personal and company income taxes (except 40 percent of the proceeds of the latter from manufacturing and financial firms, in East Africa).

(*e*) The territorial surcharge on income tax—Rhodesia.

(*f*) Tobacco duties and excises—Nigeria.

(*g*) A portion of mining royalties—Nigeria.

2. The distributable pool, whereby revenues are allocated on the basis of a formula indicating need, is used to some extent in all three jurisdictions:

(*a*) Income tax, Rhodesia, on the basis of preset percentages derived from comparison of expenditure needs and other revenues.

(*b*) A total of 40 percent of the company tax revenues from manufacturing and financial establishments, and 6 percent of customs duty, East Africa. Half of the pool funds is used to finance the Common Services Organization expenditure; the other half is divided among the territories in equal shares.

(c) In Nigeria, a portion of import duties and mining rents and royalties.

The emphasis on Central Government control and administration has, on the whole, resulted in a high degree of efficiency of operation, and minimization of double taxation, multiplicity of returns, and other nuisances. But at the same time it has produced the inevitable complaint of lack of flexibility and real financial autonomy on the part of the territories, and frequently a general complaint of inadequate territorial funds relative to expenditure needs. Some of the intended fiscal autonomy has proved nominal; all three territories in Rhodesia have found it necessary to use the maximum figure of the permitted surcharges on income (with one exception). The East African countries have considered uniformity of duties and income taxes to be imperative. The revenue inadequacies have led to demands for greater allocations, particularly of customs duties, into the distributable pools.

Thus, the experience of these new federations suggests that it is, in fact, possible to avoid many of the major evils of tax aspects of federalism found in older countries. But to do so requires a degree of centralization of taxation which reduces the fiscal autonomy of the subordinate units beyond the levels regarded as tolerable in the older federations. The optimum balance between uniformity and efficiency, on the one hand, and territorial fiscal autonomy, on the other, cannot be defined in any scientific way, but it is obvious that the optimum is not likely to be the same under all conditions. Newly developing economies must of necessity rely heavily on customs duties, which must be federally administered; thus, almost of necessity the optimum balance in new federations requires more centralization than in old. The urgency of economic development may make uniformity of income taxation more important than it is in established economies. But in the older, long-established federations, the division of taxing powers was often made with little thought of uniformity and efficiency considerations, and some readjustment toward greater centralization might well be justified. But once various taxing powers are strongly implanted in the subordinate units, considerations of prestige and "states' rights" may make readjustment very difficult. The new federations may well move gradually away from such great centralization as they now have—but this move may be considerably less difficult than the reverse moves with the countries that started their Federal existence centuries ago with complete emphasis on the need for fiscal autonomy, and complete neglect of economic considerations.

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FEDERAL-STATE FINANCIAL RELATIONS IN AUSTRALIA*

BY ERIC J. HANSON

The Commonwealth of Australia is a Federation with an area of nearly 3 million square miles and almost 11 million people. There are six States and two territories. Three States, New South Wales, Victoria, and Queensland, occupy one-third of the area but have almost four-fifths of the population. The other three, South Australia, Western Australia, and Tasmania, cover almost half the area but have only one-fifth of the population. More than three-quarters of the population of Australia live in the cities and large towns of the fertile coastal regions. The national income is one of the highest in the world. While most of the population is urban and the value of manufacturing output exceeds that of agriculture, more than three-quarters of the value of exports consists of agricultural products, especially wool, meats, sugar, hides, flour, and fruits. Thus Australia, like Canada, is a vast country with a major transportation problem; like Canada, too, it is highly dependent upon foreign trade. Unlike Canada, however, it has no immediate neighbor of the size and importance of the United States to influence its economic and social development.

Like any other federation, Australia has had its share of intergovernmental financial problems. The ways in which some of these have been met may be instructive and pertinent for Canadians. The work of the Australian Commonwealth Grants Commission should be of particular interest and, after providing a brief chronological sketch of the fiscal evolution of Australia, we shall examine this body in some detail.

The Australian Constitution was ratified by the British Parliament in 1900 and become effective January 1, 1901. The Federal Government was given certain enumerated powers, leaving the States with residual powers. This, of course, is a contrast to the principle adopted in Canada in 1867. The States also have concurrent jurisdiction with the Federal Government in the enumerated functions, except on certain specified matters such as defense, currency, and external trade.

The Commonwealth Government is solely responsible for all matters pertaining to defense, external trade, immigration, international policies, and the administration of the territories. The States provide internal justice, police protection, and public safety measures; they have delegated very few of these to the local governments.

As to the social services, the Commonwealth is responsible for invalid and old-age pensions, maternity allowances, widows' pensions,

*Reprinted from *Canadian Public Administration*, March 1962, vol. V, No. 1
This paper was presented to the 13th Annual Conference of the Institute of Public Administration of Canada, Sept. 6 to 9, 1961, Ste. Fow, Quebec.

child endowments, sickness and hospital benefits, unemployment benefits, and veterans' pensions. Some of these, particularly provision for the unemployed, were transferred from the States as late as 1946 by a constitutional amendment. The State governments provide for education, public health, and hospitals. The local governments participate in the public health sphere (e.g., garbage and sewage disposal) and in hospital operation. A notable feature is the lack of local jurisdiction over schools. Since the end of World War II the Commonwealth Government has provided for an increasing number of educational functions such as technical and vocational training, university education, and research.

Economic functions are divided in various ways. The Commonwealth regulates banking and currency, takes the national census, regulates weights and measures and copyrights, conciliates and arbitrates interstate industrial disputes, provides bounties to industries, and relief to primary producers. The States are responsible for much of the road construction and maintenance; they regulate land transfers and provide agriculture and forestry services, and they undertake various public works. The local governments are usually responsible for local roads and streets.

Among commercial and semicommercial activities, the Commonwealth operates the post office, telegraphs, and some railways. The States have major railway commitments and share heavily with their local governments in the operation of tramways, electric light and power utilities, gasworks, and other utilities.

Under section 51 of the Constitution Act of 1901, the Commonwealth Parliament was empowered to make laws with respect to taxation "but so as not to discriminate between States or parts of States." Sections 86 and 90 granted the Commonwealth exclusive power over the imposition of customs and excise duties. Thus the taxation powers of the Commonwealth were made unlimited (except that it must not discriminate among the States) ; on the other hand, the States were also given wide taxation powers (except for customs and excise duties).

At the time of Federation, the expenditures on the functions taken over by the Commonwealth were not large while the potential revenue from customs duties and excises appeared more than ample. The States insisted that a large part of the customs revenue should be paid to them and, after many negotiations in 1899, section 87 (the Braddon clause) emerged; this provided that three-fourths of the net revenue from customs duties and excises were to be distributed to the States or "applied toward the payment of interest on debts of the several States" for the period 1901–10 and in subsequent periods until the Commonwealth Parliament provided otherwise. Another section stipulated that after 5 years from the imposition of uniform customs duties, the Parliament might provide for the monthly payments to the States of all surplus revenue of the Commonwealth. Under section 96 the Commonwealth was empowered to grant financial assistance to States which might be in need of revenue. Section 105 enabled the Commonwealth to make agreements with the States pertaining to their public debts, including the taking over of such debts, the management of them, and regulations governing future borrowing by the States.

The States sought to perpetuate the Braddon clause beyond 1910, and failing this, suggested per capita grants. A referendum on such grants was defeated by the electors, but the Commonwealth Parliament enacted the substance of the proposed constitutional amendment as the Surplus Revenue Act in 1910, providing for per capita payments to the States for 10 years, subject to renewal by Parliament. These grants were continued until 1927. Between 1910 and 1927, the Commonwealth Government paid in grants to the States about half of what it collected in customs duties and excises. In addition, special grants were paid to Western Australia and Tasmania. Payments to the States of all the surplus revenue of the Commonwealth ceased when it began to pay old-age pensions and in 1907 the Commonwealth began to appropriate all surplus revenue to a trust account as a reserve for the pensions. The High Court of Australia upheld the Commonwealth in this procedure. In any event, the payment of old-age pensions by the Commonwealth relieved three States from payments they had been making, and the other three were relieved of a potential expenditure.

Commonwealth expenditures rose markedly during World War I and they remained high after the war to provide veterans' pensions and to pay interest on the public debt. As a result the Federal Government began to levy substantial direct taxes, a move that was at times resisted by the States who were not only having difficulties in balancing their budgets on current account but were also borrowing heavily on capital account to finance a variety of projects deemed to promote economic development. After various proposals and negotiations, a new scheme was worked out and agreed upon, the Financial Agreement of 1927.

Under this the Commonwealth agreed to take over the whole of the public debts of the States, to apply £7.6 million (the amount of the per capita payments in fiscal 1926–27) toward payment of interest charges, to make substantial contributions to sinking funds established in respect of existing and future State debts, to establish an Australian Loan Council to manage debt and future borrowing, and to make final settlement with respect to properties transferred to the Commonwealth at the time of Federation. A referendum was passed in 1928 to amend the constitution and legalize the agreement.

In 1926–27, too, the Federal Aid Roads Grant began to be made to the States, three-fifths on the basis of population and two-fifths on area. The States were required to spend 15 shillings on roads for each £1 granted by the Federal Government which recouped much of the grant from taxes on gasoline.

The depression struck Australia hard and it reduced the customs revenue of the Federal Government greatly. That Government responded by imposing a special tax on property income, duties on imports, and sales taxes. The States were faced with deficits while recourse to indirect taxes was not open to them.

While the overall Federal-State financial balance was disturbed by the depression, it was practically destroyed in the case of the three "marginal" States. The claims of these States, particularly of Western Australia, had been recognized from the beginning of Federation. In 1901, Western Australia was permitted to levy customs duties on goods imported from other States for 5 years. In 1910 the Commonwealth began to pay special grants to Western Australia. During the 1920's and into the 1930's the Commonwealth increased customs duties successively, as it pursued a high tariff policy to encourage the development of domestic manufacturing. Western Australians began to feel that the national tariff policy was undermining the development of their State. Tasmania and South Australia also began to become restive and began to press for special assistance. The Commonwealth appointed committees to investigate the position of the claimant States. It also increased the special grants to Western Australia and Tasmania and in 1929 it began to pay a special grant to South Australia.

As the finances of the States deteriorated and the depression persisted to its low point, the Commonwealth Parliament passed the Commonwealth Grants Commission Act, No. 3 of 1933, empowering the Federal Government to set up a Commission to sit for 3 years to deal with applications for financial assistance by any State. In July 1933, Prime Minister Lyons appointed a Grants Commission consisting of three members, the Hon. F. W. Eggleston (chairman), Prof. L. F. Giblin, and Mr. J. W. Sanford. In the meantime, in May 1933, Western Australia had voted in favor of secession by 2 to 1 on a referendum put to the people. The new Commission set about gathering statistical data during the latter part of 1933 while the three claimant States prepared their cases. Hearings were held in early 1934 and in July of the same year the Commission presented its first report.

The Commission held hearings on the basis of judicial procedure. Witnesses gave evidence on oath and were subject to cross-examination by the Commissioners and representatives of the Commonwealth and States. However, the procedure was far short of the formal methods of litigation. The fundamental aim was to get at the questions of fact, and while questions of law had to be considered, they were not permitted to ener into the proceedings in such a way as to break down witnesses; the Commission stated that "it would have militated against the necessary respect for our impartiality and judgment if witnesses had been examined from a hostile standpoint, or attempts had been made to break them down." Over 100 witnesses were sworn and examined. Most of these were Federal and State public servants, but there were also professors of economics, chartered accountants, journalists, and members of Parliament. The Commission also held a number of informal conferences with representatives of the States and a roundtable conference in which the Commonwealth and States both took part was held. The States were requested to prepare statistical material on a uniform basis and in such a way as to illustrate various quantitative concepts in public finance. The Commission itself did independent research and attempted to work out principles relevant to its task.

The main problem facing the Commission was the claim by Western Australia, Southern Australia, and Tasmania that they suffered from disabilities by virtue of being members of the Australian Federation. In particular, they argued that their Government finances and economic development had been affected adversely by the Commonwealth policy on tariff and related matters.

The Commission began by tracing the financial adjustments made since Federation. It observed that "some adjustment may have to be made in the form of a redistribution of revenue from the more favored to the less fortunate member or members of the union." The Commission concluded that the claimant States were in financial difficulties mainly because of "development policy," the making of loans for railway construction, land settlement, and a variety of public works. The problems of the claimant States arose because of their physical nature and their sparse population. They had large marginal areas which constantly invited development requiring public works, transportation facilities and water supply before settlement could proceed. The States, through subsidies and loans, encouraged settlement of new lands before World War I; this policy of "protection to rural production" was intensified after the war with a number of unfortunate results. In the end, however, there was a lack of coordination between Federal tariff policy to foster secondary industry and State development policy to encourage primary industry; the latter was often affected adversely by the former.

The three Commissioners hesitated in promulgating definite principles in their first report but they gave an indication that they favored the principle of compensation and they did make computations stipulating the size of special grants for the ensuing fiscal year. The Commission clung to adverse effects of Federal policy, particularly tariff policy, as the justification for special grants. But it had to conclude that "experts agree that the excess cost of the tariff, which is the chief example of this type of disability is not measurable at present," but that "such burden must be reflected in the financial condition of the State." It decided that it must turn to the surface manifestations, State budgets, to find measures of the net effects of all disabilities.

The first step of the Commission was to compare the budget deficits of the States on a per capita basis. As a standard, it calculated the average deficit per capita of the three nonclaimant States, which all had deficits. This worked out to be £1.15 per capita and this was taken as a measure of "normalcy." Thus a claimant State with a deficit greater than this (and all of them qualified) would receive a special grant to "normalize" its deficit. Various adjustments had to be made to allow for omissions from budgets, differences in financial policy and standards, maintenance allowances for railways, the scale of social services, and the severity of taxation. A description of the actual adjustments made cannot be made within the scope of a paper.

No sooner had the grants recommended by the Commission been approved than the claimant States applied for greatly increased special grants. The Commission again held hearings, but the time expanded for this purpose was considerably less than in the previous year. The submissions of the claimant States again stressed the disabilities of federation.

This time in its second report (1935), the Commission stated its conviction that "the relative financial position of the States, when analyzed with sufficient care and understanding, must be the basis on which any grant is made" but that this did not necessarily mean that "States should be put in an equal financial position by the payment of grants for the principle must be applied with some austerity to prevent abuse." This was a definite statement of principle in contrast to the tentative conclusions of the first report and was the result of additional time and thought devoted to the whole question. The Commission rejected any reallocation of functions and revenue sources because the Commonwealth could raise revenue "more easily" than the States; therefore special grants were needed. Special grants should be regarded as a more or less permanent fixture of federation, a device required "to complete the work begun by other transfers" of central revenues to the States and "to reduce the financial inequality of the States sufficient for the harmonious and effective working of Federal Government."

This, however, was not the apparent approach of the claimant States who kept insisting upon specific disabilities arising from Federal policy and who requested compensation accordingly. The Commission argued that any legislation was likely to benefit some members of the community and to harm others but that it was passed by reference to the effect upon the whole jurisdiction; to compensate those harmed might hamper the policy intended by the legislation. If special compensation was required, the legislature should look to this by passing special measures in connection with each general statute passed. The Commission stated that there were benefits as well as disabilities attaching to Federal policies. It was entirely likely that any given State would have been considerably worse off as a unitary country than as part of a federation. The Commission pointed out that protective policy was the only part of Federal policy which seemed to impose serious disabilities on the claimant States; there was little evidence of great disabilities arising from other policies and, on balance, it appeared that "the net effects of all the rest of Federal policy are more likely to be favorable than unfavorable to the claimant States." By comparing offsetting advantages, a judgment on net effects could be made.

The Commission asserted that the inferior financial position of the claimant States arose mainly from factors outside the actual operation of federation, such as adverse price changes, past loan expenditure commitments, and depletion of natural resources. Only in minor degree could federation be blamed for the inferiority. In any event, even if total net disabilities of federation could be measured they could not be the basis for special grants. The Commission pointed out that a distinction must be made between compensating the people of a State and compensating the government of a State. People can move from one State to another if they find economic conditions unsatisfactory in the former. Governments of States, however, cannot move to other States. The Federal Government has a responsibility to keep them functioning and to assist in carrying out this responsibility, the comparative financial positions of the States must be examined carefully.

The only basis, then, in the eyes of the Commission, for special grants is the need of a State government to carry on. The adverse net effects of Federal policy are not sufficient grounds for such grants. "Federation would be meaningless on a strict bookkeeping system." Two alternatives to special grants to meet fiscal need were suggested by the Commission. One was to exclude a State from the Federation by a constitutional amendment; this would still leave the Commonwealth responsible for the State's debts. The other was to take over the government of a State and administer it as a territory. The Commission stated that these were not to be "disregarded" but the possibilities of it happening seemed "remote." Finally, it opposed the idea (put forward by the States) that long-term grants be provided, because of the variability of economic conditions and because it felt it was still feeling its way in making even short-term grants. The Commission also dealt at length with the Federal problem. A federation has only two alternatives, grants or unification. Unification would not check the centralization of economic activity in the more highly developed States and the question of providing assistance to the "outer parts" would still remain. These outer parts, however, would not then have "the organization and the leadership they have under federation, and centralization would possibly defeat a healthy all-round development. Under federation with grants of assistance the States being independently organized can express and enforce their views. Disharmonies of this kind are incident to and inevitable in all Federal groupings."

The Commission turned to an examination of the financial position of the States. In determining the standards for comparison it took the simple average of deficits per capita, severity of taxation, and the expenditure per capita for social services and other functions in two States, Victoria and Queensland. New South Wales was excluded because it was felt to have "so many abnormal features" with respect to social services and the general scale of government. Victoria had a long-established policy of economy of administration and low taxes; Queensland was providing services at a relatively high level with high taxation. Together they were regarded as a "fairly balanced pair."

In determining the "minimum" standard at which a State would be expected to function, adjustments of various kinds were made. Thus the minimum effort required of a claimant State with respect to social services was a standard of not more than 10 percent below normal. Similarly, the taxation "penalty should not be more than 10 percent above the normal." In brief, a claimant State might cut its social services a little and be willing to increase its taxation somewhat above the normal. The Commission made special studies of the cost of administration and the scale of social services and made adjustments accordingly. To measure the severity of taxation several indexes embracing incomes and State and local taxation per capita were worked out and weighted rather arbitrarily. It is not feasible to describe their techniques at length here.

The third report consolidated much of the thinking and most of the procedures followed previously. It recapitulated much of the material in the first two reports and in some instances statements of principles and methods were more definite than before. The Commission had acquired sufficient data and experience to make firm observations. Its findings were also accepted by the States and the Commonwealth. Its term was renewed, and in fact it has continued to operate until today with changing personnel from time to time. It has become an institution in Australia. In subsequent prewar years, the Commission continued to follow the precedents and procedures established. Some modifications became necessary during the war years when, for example, State income taxes ceased to be levied and the Commonwealth Government imposed uniform income taxes and reimbursed the States according to an agreed formula.

The postwar years brought new problems and conditions. The inflationary trend imposed strains on State budgets and revenue deficits began to appear again after the surpluses of the war years. The Commission adhered to the basic principle of fiscal need. One change made in 1949 was to split calculations into two parts, a first part with a retroactive adjustment and a second part providing estimated need for the current fiscal year.

Over the years a procedural pattern has developed. The claimant States make application for special grants before the end of September in each year. These applications are supported by official "Cases" which set out the grounds of claims, criticism of principles and methods used by the Commission, and proposed alternatives. The Commission examines each "Case" and conducts such investigations as may be deemed necessary. Beginning in October, the Commission visits the claimant States to take evidence. The government of each State is represented by a committee which conducts the main "Case." Evidence is also taken from other witnesses, including representatives of State departments and enterprises. Copies of the transcript of evidence taken in each State are supplied to the Commonwealth Treasury. The latter also makes a submission each year. This usually contains observations upon the claims submitted, the points raised by the States or the methods employed in estimating special grants. A special hearing, known as the Commonwealth hearing, is held at Canberra or Melbourne in March or April to examine the Treasury submission. This annual hearing is attended by representatives of the claimant States. About the end of July the claimant States present preliminary estimates of revenue and expenditure. These are discussed with representatives of each claimant State and are treated confidentially. On the basis of this information the Commission makes its recommendations of the second part. In recent years the Commonwealth Treasury has requested representation at these in camera meetings, but the Commission has not acceded to this request.

In recent years there has been considerable discussion about the desirability of abolishing special grants. This is a result of the steady improvement of economic conditions in South Australia and Western Australia. Indeed, during the 1950's a remarkable degree of equality of income per capita developed among the Australian States. In 1959 South Australia was in fact transferred to the category of non-claimant State.

A summary of the overall development in Commonwealth payments to the States is now in order. After the war agreement was reached to continue uniformity of income taxation with the Commonwealth levying income taxes and reimbursing the States. This is similar to the Canadian arrangement of tax rental agreements. The payments were distributed among the States partly on the basis of population adjusted for numbers of children between the ages of 5 and 15 years, and partly on the basis of sparsity of population. This formula has been revised successively. In 1959 it was changed so as to base the grant for a given fiscal year on the estimated population of a State on June 30 of the preceding year. In addition, an adjustment is to be made each year for the percentage increase in average wages for Australia as a whole for the most recent year.

Under the new formula the grants (termed Financial Assistance Grants and to run for 6 years) were increased from £205 million in 1958–59 to almost £245 million in 1959–60. The total was arrived at by negotiations and accepted at the Premiers' Conference in June 1959. On a per capita basis, the grants for 1959–60 exceeded those of the previous year in every State but in varying degree. For example, in 1956–57 the grants varied from a low of £17 1/2 for Victoria to a high of £20 for Western Australia. Under the new scheme of things in 1959–60 the per capita grants varied from £22 for New South Wales to £35 for Western Australia.

Under the Financial Agreement of 1927 the Commonwealth contributes about £13 per capita to all the States (with variations around this average). This agreement is to run until 1985 (a 58-year term set in 1927). A number of other payments are made to the States for special purposes, such as roads, public hospitals, welfare, universities, subsidies, and emergencies. These exceeded £5 per capita in 1958–59. A 5-year grants program for highway construction, reconstruction, maintenance, and repairs was introduced in 1959 since the quality of highways (largely under State jurisdiction) was deteriorating. Under this program the Commonwealth will pay up to £250 million to the States, beginning with £42 million in 1959–60 and ending up with £58 million in 1963–64. Out of the total, £220 million will be paid as basic grants and £30 million as matching grants. The basic portion is to be distributed as follows: Tasmania, 5 percent; of the rest, one-third according to total population, one-third according to land areas, and one-third according to motor vehicle registrations. Grants to States for universities, hospitals, and other special purposes were increased in most cases in 1959.

Related to the new arrangements were proposals to reduce the number of States depending upon special grants to two and to reduce the dependence of these two on special grants. Agreement was reached on the proposition that in the future Western Australia and Tasmania would be the only continuing claimant States. It was suggested that Queensland and South Australia should have the right to apply to the Commonwealth Grants Commission for special grants, if necessary. The Premiers of these two States agreed that "their States would exercise this privilege only in special or unexpected circumstances which endangered their budgetary position relative to that of other States."

In 1958–59 special grants averaged £2 per capita for all the States. For the recipient States they were significantly large: about £6 per capita for South Australia, £14 for Tasmania, and £17 for Western Australia. Under the new arrangements, special grants amounted to less than £1 per capita for Australia, with about £5 per capita for Western Australia, and £11 for Tasmania.

The trend in the Australian Commonwealth is toward increasing Federal grants. There is a growing dependence of the States upon the Federal Government for their revenues, despite the diminishing role of special grants. The new financial assistance grants provide higher per capita payments to the actual and potential claimant States than to the nonclaimant States. It is doubtful that special grants will disappear altogether because Tasmania has chronic economic problems which have not been solved by the prosperity of the postwar period and because there are fluctuations in the volume of export trade, which can have substantial adverse effects on some of the States.

A major problem of Federal finance is the great dependence of the States on the Commonwealth Government. For example, in 1956–57, before the new financial agreement, Commonwealth grants equaled 54 percent of the revenue of the Australian States, varying from 50 percent in New South Wales to 66 percent in Western Australia. Special grants accounted for 5 percent of the total for the States, varying from 14 percent in South Australia to 26 percent in Western Australia. Currently the overall ratio has risen above 54 percent with increases in Commonwealth payments; special grants have diminished in importance.

There are several reasons for the heavy dependence of the States upon Commonwealth grants. There is the underdeveloped condition of local government which pushes additional tasks on the States. There is the restriction upon their taxing power through the principle of imposing uniform taxation by the Commonwealth. And the States are saddled with railway operations which incur large deficits.

The issue is causing concern and is debated continuously. Some observers predict that Australia will eventually become a unitary state, that federalism there is becoming obsolete. Others feel that federalism will survive because the States have preserved their identities through a century, they have a number of special regional interests, and the Commonwealth Government has not expressed interest in taking over responsibility for State functions, for example, schools and railways. The major extensions in Federal power came during the two great wars; the States have managed to adjust and grow during times of peace. It is likely that they will continue to be strong functioning units for some time to come.

Two intergovernmental institutions should be of interest to Canadians. One is the Australian Loan Council; the other is the Commonwealth Grants Commission. The Loan Council was set up in 1927. It consists of one representative of the Commonwealth who is chairman, and a representative from each State. The chairman has two votes and an additional vote in case of a tie. The function of the Council is to decide upon how much money is to be borrowed each year by the Commonwealth (except for defense) and the States; it also allocates the funds. In effect, the Commonwealth Government dominates the Council because it raises the funds either by borrowing in the market or by drawing on its own surplus funds (as has been the case during the postwar years). The Central Government, too, by its control over monetary, fiscal, and international trade policies affects the capital market and hence the availability of funds.

The existence of the Council enables the Commonwealth to coordinate more effectively policies designed to offset recessions or inflation. At the same time it reduces the autonomy of the States. In Canada, provincial and municipal governments can counteract Federal fiscal and monetary policies in considerable degree, particularly by borrowing in the United States. Indeed, Mr. Coyne raised this issue in his speeches of yesteryear. It would be useful from a countercyclical point of view to have a Loan Council; on the other hand, it is difficult to envisage consent among the Provinces to such a proposal. The issue may become urgent in the future as our need for schools, hospitals, roads, health services, and housing increases. Provinces and municipalities do have difficulties in obtaining funds, particularly in Canada.

The Australian Commonwealth Grants Commission has made a great contribution in Federal-State relationships through its research studies and its impartial examination of issues. It has provided an agency through which controversial questions have been studied and discussed in public and by the use of factfinding techniques. It has become something of an institution.

Would such a Commission be useful in Canada? Perhaps in the first place it has been made possible only in the Australian environment. There the claimant States have been identified definitely; they have been recognized as such either tacitly or explicitly by the nonclaimant States and by the Commonwealth. They have had a relatively small fraction of the population (one-fifth). Professor Ratchford in his study of expenditures in Australia has pointed out that there special interests and groups are not shy about asking the Government for protection. "Once a group has gained one of these concessions it wants the terms 'spelled out' in detail, written into law, and a board or commission appointed to administer them." [1]

In Canada, where Federal-Provincial financial relations have always been subject mainly to the influence of political factors, it might be salutary to have a "special grants" commission. The need for public services and social capital will be growing continuously and relentlessly in the future. There will continue to be variations in the ability of Provinces to find the funds to provide a minimum national standard of services. It has been recognized that the Atlantic Provinces have a lower fiscal capacity than the rest of Canada, and special grants are paid to them. The amounts, however, have been determined almost by the process of taking a figure out of a hat. There are also other Provinces, such as Manitoba and Saskatchewan, who could make good cases for special grants.

There would be a basic tax agreement of some kind and worked out every 5 years or so as at present, providing for payments to all the Provinces. Grants-in-aid for special services such as vocational education and health services would continue. A special grants commission, as in Australia, would determine "residual" payments by the Federal Government to Provinces with special needs. It would also build up a fund of useful information about the fiscal condition of the various Provinces. A drawback of the scheme is that since the initiative would be in the hands of Provinces to apply for special grants, they might become unduly aggressive and persistent in presenting their cases. To meet this the Federal Treasury would have to make firm representations to the Commission.

The Australian experience suggests that the problem of providing for minimum national public service standards can be dealt with pragmatically and satisfactorily. There are large differences in the fiscal capacities of the Canadian Provinces which create substantial variations in the level of public services provided. Perhaps this problem is

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[1] B. V. Ratchford, *"Public Expenditures in Australia,"* Durham, N.C.: Duke University Press, 1959, p. 77.

not so serious as it was at one time; on the other hand, all the signs point to a need for increased spending on provincial and municipal services in the future. How are the Provinces with fiscal capacities below the national average to cope with the demands upon them? The suggestion here is that some kind of scheme which reviews their needs continuously is worth considering. The Australian solution is one which deserves study. The need for special grants has diminished greatly in recent years because the claimant States have shared in very large measure in the general postwar prosperity. The system has been flexible enough to permit the reclassification of claimant States to nonclaimant States. This, of course, has been done subject to adjustments under the basic tax arrangements. In Canada, postwar economic development has proceeded at uneven rates in different Provinces and income differentials among them have persisted.

PATTERNS OF FEDERAL FINANCE IN THE NEWER FEDERATIONS*

BY PETER ROBSON

Since the war a number of newly independent countries in the underdeveloped areas have adopted federal or quasi-federal constitutions. In others, federal arrangements are nascent or in prospect. A comparative discussion of the fiscal arrangements employed in these countries and of the way in which they have operated is of interest not only to students of public finance but also, at a more practical level, to those concerned with operating such arrangements, or, as in East Africa and elsewhere, to those who are actively thinking about the form which a future federal scheme might take. This article has the strictly limited purpose of discussing, descriptively and statistically, the patterns of finance which are found in these federations, in a fuller form than is otherwise available. Particular attention is focussed upon the tax sharing and grant arrangements employed. The discussion will throw light on the ways in which the classical problems of federation are being handled, and will also indicate some of the special problems with which these federations are confronted. The countries on which the discussion centers are India, Libya, Malaya, Nigeria, Pakistan, Rhodesia and Nyasaland and the West Indies.

1. THE OVERALL PATTERN OF FEDERAL-STATE FINANCES

One of the most important ways in which federations differ from one another is in the range of functions allotted to the different layers of government. From our present standpoint the importance of this factor lies in its implications for revenue allocation since the larger is the volume of services performed by a layer of government, the larger will be the amount of revenue which it will require to enable it to perform its functions. On grounds of purely financial administration there is undoubtedly much to be said for providing the different layers with sufficient jurisdiction over an appropriate range of independent sources of revenues so that intergovernmental financial transfers can be minimized. There are, however, other considerations of an economic, political, and administrative nature to be taken into account in deciding on the appropriate pattern of revenue jurisdiction. For instance, most modern federal states have assumed a wide range of responsibilities in the economic field, with particular reference to the promotion of growth, stability, and external balance. To achieve these objectives calls for a wide range of fiscal powers and argues generally for giving the federal government jurisdiction over all the major revenue producing taxes in the modern state, including income and profits

*Reprinted from *Finanzarchiv*, J. C. B. Mohr (Paul Sieback) Tubingen, 1961, Germany.

taxes, customs and excise, and, generally, export taxes. Administrative considerations often point in the same direction. In addition, where, as is often the case, political considerations argue in favor of limiting unbalanced economic and social development within the federation, a powerful additional ground presents itself for giving the federal government revenue even in excess of its own requirements so as to enable it to make redistributory grants to the states. The extent to which all these considerations[1] are taken into account will clearly depend on the nature of the federation and the strength of the political and economic factors from which it derives.

In the countries under review, income and company taxes are federal (although some part may be shared—see section 2 below), except in Libya, where the Provinces levy their own income and profits taxes, and in Nigeria, where the regional governments have sole power to levy personal income taxes, and in the West Indies, where this power resides with the island governments. In Rhodesia, however, the territories may levy a limited surcharge on the federal tax. In India and Pakistan, agricultural income tax is a state tax. So far as customs and excise are concerned, these again are generally federal except in the West Indies, in Nigeria where certain important regional sales taxes are levied in substitution for federal export taxes, in Rhodesia, where the territories levy a petrol excise, and Libya, where, surprisingly, excises (though not customs) are a matter for the Provinces.

This pattern of fiscal jurisdiction taken with the range of functions assigned to the different layers produces varying degrees of financial balance; hence the need of and scope for intergovernmental financial transfers of varying kinds and importance. The picture for the federations under discussion is shown in table 1, page 550, which gives state revenues and expenditures as a proportion of total public revenues and expenditures for a selected year.

This table indicates very clearly that the countries under discussion embrace very different kinds of "federation." At one extreme we have the West Indies, which is hardly deserving of the term federation in any of the senses in which recent students of politics have used the term. The federal government in the West Indies controls a neligible proportion of total public revenues and has no resources available for interterritorial transfers. There is at present no customs union nor even free movement of labor. Recent developments place the whole future of this federation in question. At the other end of the spectrum we have the case of Malaya. Here the states control a relatively small proportion of public revenues and are responsible for a slightly larger, but still small proportion of public expenditures. Between these two extremes of the extremely weak and decentralized federation, and the strong centralized federation, which in fact, if not in form is a close approximation to a unitary state, we have the other new federations in which the states have jurisdiction over an appreciable proportion of public revenues (one-third or more), and which have jurisdiction over functions involving a fairly high proportion of public expenditures

[1] A valuable discussion of the way in which considerations of national policy affect the scope for regional fiscal autonomy can be found in Nigeria: *Report to the Fiscal Commission,* Cmnd. 481 of 1958, London, H. M. S. O.

(more than one-half, except in the case of Rhodesia). In all of these intermediate cases a need arises for intergovernmental transfers on a substantial scale.

2. Intergovernmental Fiscal Adjustments

In the light of the situation of financial unbalance in most of the newer federations, which is indicated by the fact that the proportion of total revenues controlled by the states is smaller than the proportion of total public expenditures for which they are responsible, financial adjustments are called for between the center and the regions. Such fiscal adjustments might take the form either of *arbitrary grants* from the federal government or alternatively, of *grants made according to some accepted principles.* Although arbitrary grants may have a limited role to play in the fiscal arrangements of a federation, for practical purposes they will have to be allocated, at least so far as concerns tax revenues, according to agreed principles. If this is not done, the state governments become, in effect, nothing more than agents of the center, and we are no longer dealing with a truly federal situation.

In practice there are *two main principles* by reference to which grants are made. The first is that of *derivation.* According to this principle, regional governments receive from the federation the whole, or a share of certain taxes deemed to have been paid by their members. The other principle is that of *national interest* or one of its variants, such as the *even development principle.* When grants are made according to this principle they are determined in such a way as to encourage expenditure of national importance, while at the same time distributing the money in such a way as to be equitable to different individuals, no matter in which state or region they may happen to reside. According to *J. R. Hicks,*[2] the principle of derivation is appropriate to customs union, while the national interest principle is appropriate to a unitary state. Actual federations generally lie between these extremes, and in practice utilize both principles to a varying extent. This is not unreasonable, since although from one standpoint a federation has affinities with a unitary state and should to that extent make grants according to the principle of national interest, from another point of view it is to be regarded as a group of regions cooperating for certain limited purposes, so that the principle of derivation is also relevant.

In this section we consider briefly the ways in which fiscal adjustments are made in these federations. It is as well to point out at the outset, however, that apart from using grants, it is also possible for the federal government to promote regional development for national purposes in ways other than by fiscal adjustments. In the first place, *extrabudgetary operations* provide an important means by which alterations in the institutional framework can be effected which will have an influence on the regional balance of economic and social development. Regional development may also be influenced by the federal government's ability to spend money in pursuit of its own responsibilities on a nonuniform basis in the states or regions. Finally,

[2] See J. R. Hicks: A Chapter in Federal Finance, in *"Essays in World Economics"* Oxford, for an elegant discussion of this question.

loan control provides an important way in which, in many instances, development patterns can be influenced. These considerations should be borne in mind in considering the adjustments discussed below, although it will be possible to take them into account only to a limited extent in the discussion.

In *India* the position is that the Federal income tax is shared and in addition there is a permissive provision enabling the Union to assign to the States all or part of the proceeds of any union excise. In addition the constitution contains provision for two kinds of grants of a general character. The first is grants-in-aid which may be given to any State deemed to be in need of fiscal assistance. The second is grants made for a wide range of public purposes. The States' overall share of these taxes and their subsequent allocation amongst the different States are not fixed in the Constitution but (with the exception of public purpose grants) are left to be determined by a statutory Finance Commission. In order to allow the Central Government to vary tax rates for its own purposes without correspondingly varying the amounts payable to the States, the Union is permitted to levy an income tax surcharge for its own exclusive use.

The principle of derivation is given little weight in allocating these tax shares. Since 1952 the little weight attached to it has been reduced, and the Report of the Second Finance Commission has declared that the aim should be to reduce it still more. In its place, major weight is given to population, which the Finance Commission regards as a broad and simple indicator of fiscal need. Thus, during the current quinquennium, income tax is allocated as to one-tenth on the basis of collection and nine-tenths on the basis of population, and the Commission has recommended that the collection principle should be abandoned in the future altogether. Excise taxes are distributed to the extent of nine-tenths according to population, leaving one-tenth for adjustments.

The use of population as the main basis for allocating State shares of these taxes [3] means of course that a substantial element of adjustment for fiscal need takes place within the tax allocation system itself. This practice contrasts sharply with that in Nigeria for instance, where all adjustments required on account of fiscal need are effected through the distributable pool.

The tax shares discussed above are supplemented by grants-in-aid designed to provide additional help for the financially weaker States. These grants are paid by reference to such factors as financial need, tax effort, standards of expenditure and, since the Report of the Second Finance Commission, to the financial burdens imposed by the Second 5 Year Plan. At the end of the first quinquennium, these grants amounted to one-third of the tax shares of the benefiting States. The public purpose grants mentioned above fall outside the scope of the Finance Commission's recommendations. These grants became very important during the first quinquennium, mainly as a result of the requirements of the First 5 Year Plan which imposed substantial additional revenue expenditures on the States. At the end of the period they exceeded States' grants-in-aid and nearly equaled their share of

[3] The States' share of income tax is currently 60 percent and of the union excises, 25 percent.

income tax. To reduce States' dependence on this form of grant the Second Finance Commission recommended increased tax shares and grants-in-aid. These recommendations were accepted. If the Commission's expenditure forecasts are accurate, this form of grant should not, during the second quinquennium, exceed the aggregate of grants-in-aid. These public purpose grants, many of which are matching, conditional and specific, represent at present the most flexible element in the adjustment system and the channel through which additional funds are made available to facilitate plan implementation. As a result of the important role recently played by these grants, Indian Federal finance has come, as *W. Prest* remarks,[4] to have a closer affinity with the arrangements of the United States, than with Canada or Australia, where specific purpose grants are comparatively unimportant.

We next consider *Libya*. The Federal financial arrangements found here are unique. There are no shared taxes. The Provincial governments, of which there are three, thus have to rely on grants-in-aid from the center, and these cover nearly half their expenditures. The Constitution requires that these grants shall be determined by Federal law in such a way as to guarantee to the Provinces grants increasing in proportion to the growth of Federal revenue and such as to guarantee them a constant economic progress. It is of course difficult to justify the principle that state grants-in-aid should be increased in proportion to Federal revenues and quite impossible to guarantee to the Provinces by grants a constant economic progress because that depends on factors outside the control of any federal government. To date, however, this provision has remained in abeyance. Grants are unconditional; no set principles are followed in determining their amounts, and the Federal Government appears to exercise no control over the way in which they are spent. This state of affairs is obviously unsatisfactory. Although proposals were put to the Federal Government some years ago for a law on grants-in-aid, no action was taken. The recent Mission of the International Bank has added its weight to the case for reform and recommended that immediate attention should be given to this issue. In the view of the Mission, it would be appropriate for these grants to be allocated on the basis of the financial needs of the Provinces. These would be left to be determined by the establishment of a Finance Commission on the lines of those found elsewhere.

In *Malaya* too, shared taxes are of negligible importance. Since 1958 they are represented only by the proportion of the export duty on tin which the 1957 Constitutional Commission recommended should be allocated to producing States. Currently this item contributes only about 4 percent of the aggregate receipts of the States from central grants. Most of the rest comes from two grants; namely, the general capitation grant, made on a population basis, and the grant for the maintenance of State roads which in 1958 replaced the allocation of a share of the import duty on petrol to the States. These two grants represent in 1960 55 percent and 24 percent of grant revenue respectively. The balance of the grants consists of various conditional grants for drainage, irrigation or development. Expenditure on these services is closely supervised by the Federal Government. Until 1958 the States were

[4] W. Prest: Indian Federal Finance, *"Economic Record"*, April 1960, p. 218.

even more dependent upon grant aid than they are now. The apparent increase in their financial independence since that date is not due to an increased command over independent revenues, but to a substantial reduction in their administrative responsibilities. In that year their responsibilities for educational and medical services were assumed by the Federal Government, and with this, the 100 percent grants for these services which accounted for a large part of the States' grant income.[5]

The division of revenue between the various parts of *Nigeria* has been a recurrent problem since 1914. Major developments have occurred in the last decade or so, and have accompanied the progress of the country from a quasi-federal state to a federal state of classical form. The financial counterpart of these changes has been the marked expansion of the independent revenues of the regions and a move away from the principle of derivation of shared taxes. The current arrangements are based on the recommendations of the Fiscal Review Commission which reported in 1958.

Under this system, fiscal adjustments are made in part by allocating to the regions the proceeds of certain taxes on the basis of derivation, and in part by making grants from a distributable pool. The duties distributed to the regional governments on the basis of attribution are the federal import duties on motor spirit and diesel oil and the import and excise duties on tobacco. The distributable pool is fed by 30 percent of the the revenue from rents and royalties from mining and minerals and from general import duties other than those on motor spirit, diesel oil, tobacco and liquor.

These arrangements have two strong merits. First, the distributable pool contains elements of growth which should help it to keep pace with the expanding needs of the regions. Second, they leave the Federal Government, like the regions, with some sources of independent revenue; namely, the direct tax on companies and the indirect taxes on wines and spirits. One effect of the revised arrangements, however, is that they render regional revenues somewhat sensitive to fluctuations in certain raw material prices; namely, cotton, cocoa, and oilseeds, on which the regional produce taxes are levied. No doubt it is partly to overcome this instability that the Eastern and Western Regions have been seeking to expand their revenues from the graduated personal tax. So far, however, the success achieved has been rather limited.

The current tax sharing and grant arrangements in *Pakistan* follow the recommendations of the *Raisman* Commission of 1952, which itself built upon the provisions of the Government of India Act of 1935 and the *Niemayer* formula. Currently the yield from customs and excise is exclusively Federal, save that East Pakistan is entitled to a share of the jute export duty to the extent of 62½ percent of the basic duty and 10 percent of any additional duty, and the two Provinces are entitled to 50 percent of the duties on tobacco and tea. Corporation income tax and the central income tax surcharge are exclusively Federal, but the Provinces get 50 percent of the proceeds of the basic income tax. The proceeds from the sales tax are also shared. Of the

[5] Provision for review of these arrangements is provided by the requirement that the National Finance Council which meets annually, must be consulted concerning grants to States, assignment of Federal taxes, etc.

Provincial share of income tax, East Pakistan gets 46.23 percent and West Pakistan 53.74 percent sales tax, and the tobacco and tea duties are allocated on an attribution basis. Each Province get 50 percent of the collection in its areas subject only to a minimum payment in East Pakistan, and a small adjustment to allow for collection in the Federal capital in West Pakistan. The basis of sharing the nonattributed taxes seems to give weight both to population and to collection.

Under the 1956 Constitution, the National Finance Commission was to have been constituted at intervals of not more than 5 years for the purpose of making recommendations regarding the sharing of taxes, grants-in-aid, public borrowing and any other matter referred to it by the President. This Commission was never convened, however, and the *Raisman* Award remains the basis of the present Federal-Provincial financial relationships. There are, however, strong indications that current fiscal pressures are likely to lead to a revision of this award in the near future. These financial pressures arise, as in the case of India, from the problems of implementing the Five Year Plans, coupled with the fact that the central basis of the original award was recurrent liabilities, not developmental expenditures. During the period of the Second Five Year Plan it is anticipated that special arrangements will have to be made to transfer 500 mn. rupees to East Pakistan and 200 mn. rs. to West Pakistan to cover their nondevelopment liability on revenue account, that is to say, to meet their additional recurrent liabilities arising out of past development expenditures. Added to this, a high proportion of the development expenditures of the two Provinces is dependent on central finance, either by way of grant or loan. Evidently this situation may seriously restrict the flexibility and autonomy of Provincial budgeting. The Planning Commission [6] therefore sees these considerations as strong arguments for revising the *Raisman* Award in the light of the requirements of the Provinces for both developmental and nondevelopmental expenditures.

Of the "effective" federations, *Rhodesia and Nyasaland* is unique inasmuch as there is no general grant-in-aid of territorial revenues nor grants for particular services falling within the responsibilities of the territorial governments. The territories derive their revenues additional to those they themselves levy, from a share of the basic income tax imposed by the Federal Government. These shares were: Southern Rhodesia, 13 percent; North Rhodesia, 17 percent; and Nyasaland, 6 percent. These shares appear to take into account the fiscal needs of the territories, but there was no explicit statement in the report of the Fiscal Commission on whose recommendations these proportions were based, on exactly how this was done. One interesting fiscal provision in the case of Rhodesia requires the Federal Government, if it should levy an expert duty, to pay to the territorial governments a share equal to their share of the basic income tax. This prevents the Federal Government from imposing an export tax and attracting to itself additional revenues at the inevitable expense of the distributable pool of income tax. The tax shares are constitutionally reviewed by a Fiscal Commission once every 3 or 4 years. Following the report of the latest review [7] these proportions are currently 14, 18 and 6 percent

[6] *The Second Five Year Plan*, 1960–65, pp. 42/44.
[7] (C Fed. 56).

respectively. External loans have to be allocated to territorial governments in proportions agreed by a Loans Council or, failing that, in proportions laid down. Currently these proportions are 16, 7 and 6 percent respectively.

In the *West Indies*, under the 1954 constitution, the island territories receive no tax shares or grants from the Federal Government, save that Colonial Development and Welfare grants are administered by the Federal Government. The Federal Government derives its revenue from consumption taxes on a limited number of commodities at rates initially fixed to yield a revenue adequate to meet the very limited Federal obligations. At the Intergovernmental Conference in 1961 it was agreed that, on independence, the Federal Government should be financed by the proceeds of certain customs duties which are expected to provide about £6 mn. in each of the first 3 years of independence. Subsequently the Federal Government was to be empowered to levy a surcharge on other customs duties to the extent of 5 percent of their yields. The whole future of this very weak federation in now in doubt as a result of the Jamaican referendum result which favored secession. Without Jamaica, it is difficult to see much of a future for the grouping, for the other major territory, Trinidad, is unlikely to participate without Jamaica, and the viability of the other territories is then very questionable.

By way of footnote, the case of *East Africa* may be mentioned briefly, although this grouping does not constitute a federation. East Africa comprises the three territories of Kenya, Uganda, and Tanganyika. They form a customs union in which income tax and, with minor exceptions, excises, are levied on a uniform basis. Certain services, including tax collection, are performed, on an agency basis by the East Africa High Commission. These and other links are similar to those which exist in formally constituted federations. There is, however, no common exchequer, no agreed economic policy or overall fiscal policy. In recent years, many economic and budgetary strains have arisen in the Common Market, in part on account of the unequal distribution of the benefits which the three territories derive from it. In a properly constituted federation these strains would be offset to some degree by means of interbudgetary transfers of the kind discussed above. Recently, in order to ward off the danger that the market might break up, the *Raisman* Commission recommended that also an interterritorial redistribution of income should be made to offset the inequalities in the benefits. This was to be done by means of a distributable pool of revenue fed from two sources: (i) 40 percent of the yield from the income tax charged to companies on profits arising from manufacturing and finance in the three territories; and (ii) 6 percent of the annual revenue collected in the territories by means of customs and excise duties. These recommendations have been accepted by the governments concerned as a "package deal" and they should go some way toward alleviating the economic and financial difficulties now arising. Financially, the effect of the recommendations is to bring about a redistribution of income from Kenya to the other two territories. In 1961–62 Tanganyika will benefit to the extent of £310,000 and Uganda to the extent of £245,000. These adjustments compare with total tax revenues of £14½ mn. and £11½ mn. respectively.

Table 2 indicates the relative importance and the composition of the intergovernmental fiscal transfers in the federations discussed above.

Aside from the West Indies, where transfers are of negligible importance, the table shows the intergovernmental adjustments in the latest year included account for about one-third of total revenues in most cases, except in Libya where the proportion is one-half. Revenues based on tax shares account for the whole of the adjustment in the case of the Federation of Rhodesia and Nyasaland, and make up a diminishing proportion as one moves from Pakistan to Libya, where this form of revenue is unrepresented. The inverse situation obtains in the case of revenues from grants in aid. These grants are commonly unconditional, except in India where in the year 1955–66 conditional grants outweighed unconditional grants, and Malaya where conditional grants represented about 14 percent of total revenues.

It is a notable feature of the older federations that the states have, over long periods, tended to become increasingly dependent upon federal subventions. The period covered by this table is of course very short, but at the same time, for most of the countries concerned, the years were ones of rapid economic and social development. No such overall trend is manifested in these figures. In India an increase in transfers has certainly come about, almost wholly as a result of the large increase in grants paid outside the Finance Commission's recommendations. In Malaya and Nigeria, on the contrary, there has been a marked reduction over the period. In Nigeria this is the reflection of a genuinely increased fiscal independence over the period. In Malaya, as already remarked, this is a reflection of the reduced administrative jurisdiction of the states. Elsewhere the grant proportion has not increased and has if anything a tendency to fall.

3. Standards of Expenditure in the States and Regions

In the light of this discussion of tax sharing and grant arrangements it is of interest to look at indicators of standards of expenditures in the states or regions of these different federations. The object of making such an examination is to try to throw some light on the disparate levels of social and economic development. On certain assumptions about social needs and costs of provision and the opportunities for economic development, these may be taken in any year as giving a crude indication of the need for fiscal adjustments. Similarily, changes in standards over a period may indicate the extent to which changes in the direction of equalization have occurred. Equalization to some extent is an in-built objective of most of these federations. Of course, financial indicators are at best only a crude guide to the factors in which we are interested, even when they are computed for individual economic and social services, but they may provide, if used with caution, a perspective into which the financial arrangements discussed can be fitted.

The financial transfers we have been discussing, and which to an extent support the levels of expenditures now to be discussed, take place in all cases within the context of economies which are growing. This growth tends, as experience shows, to reinforce disparities to the extent that dualistic forces are present. Unless the regional economies stand in a particularly favorable economic relationship to each other or are otherwise well balanced in their individual natural resource endowments, strong neutral measures may be required if the operation of these natural forces is to be limited. The sources of fiscal adjustment already discussed will certainly reflect the general growth of the economy, but the tax shares and the redistribution of revenue are unlikely to compensate the local budgets adequately for the diverse rates of economic growth likely to be experienced in the various states or regions.

In some of the federations now considered, this issue is to a degree irrelevant to the problem of intergovernmental financial relationships. This is so, for instance in Malaya, where over a large part of of the field, expenditures are financed centrally, and the standard of services is determined centrally. In the West Indies likewise, there is no scope for equalization, but the figures are nonetheless interesting as an indicator of the nature of the problem, and the extent to which it is changing. Moreover, figures over a sufficiently long period to make a comparison of great value are not yet available. In the cases of India, Nigeria, Pakistan and Rhodesia, however, such a comparison may be of considerable interest, for these are the effective federations.

Table 3 contains some data bearing on this problem. It shows, where available, average expenditure per head for ordinary and developmental purposes for each of the federations as a whole, for selected years and also indicates the range of expenditures per head in the states between those enjoying high standards and those enjoying lower standards. The figures should be used with caution, and with due regard for the limitations of the range as a statistical indicator.

The table reveals no very uniform picture. In the West Indies, where no equalization takes place through the federal finances, there seems no doubt that the range of expenditures has widened in recent years, both in absolute terms and in relation to the level of expenditures recorded. In Nigeria, the range of per head expenditures on both current and development account appears to have widened, in relation to the average levels of expenditures. In Pakistan, the range of expenditures on current account have remained about the same in relation to levels of expenditure, but have narrowed on capital account. In Rhodesia, the current ranges have not significantly altered. In India, the range appears to have widened slightly. It must be borne in mind that in Rhodesia, some leveling up may have been produced by differential expenditures in the territories on services which are the responsibility of the Federal Government. The picture here presented may well change sharply in some of the federations as the recurrent expenditure implications of development programs increasingly make their impact felt on the ordinary expenditures of the states and regions.

Conclusions

This paper has been mainly concerned with discussing in broad financial terms the ways in which some of the newer federations have tackled the financial problems which they share with the older federations, with particular reference to tax sharing and grant arrangements. The newer federations, however, are confronted with other problems which the older federations did not have to tackle at the time of their establishment, and which, on account of their much more advanced economic structures, they have since escaped to some extent. Moreover, their problems have to be resolved in the context of an extremely rapid pace of change—political, social and economic.

Foremost amongst the additional problems confronted by the newer federations are the implications raised by the major role now played by many of the federal governments in economic development, and the importance attached to economic planning. Generally speaking, the irtergovernmental fiscal relationships we have been discussing were designed at their inception to deal with the allocation of existing tax resources in such a way as to preserve continuity, and with some provision made for leveling grants on a usually limited scale. The appearance of large-scale development programs in the economic and social field which are designed to carry these countries at least into the take-off stage, and perhaps to the point of self-sustaining growth puts intergovernmental financial relationships into a rather different context. In most cases, development expenditures are financed only to a very limited extent out of taxation, and for the most part depend on loans, grants from abroad, or to some extent, credit creation. Access to these sources is in most cases confined to the federal government. By drawing on them the federal government is able to make available to the states finance which falls outside the framework of revenue allocation.[8] To the extent that central planning is important, this is done in accordance with a laid down scheme of national priorities. Development expenditures financed in this way, however, will have eventually, implications for the recurrent budget, and if capital installations are to be utilized, finance will have to be provided, in one way or another, to meet the running costs. No doubt, to some extent, growth will give rise to uncommitted revenues, but where these are insufficient it would be illogical not to take action to insure that finance is available to meet the commitments.

In the light of this situation it might perhaps appear to be logical that the body charged with planning should also consider the requisite financial adjustments. This happens only in the case of Malaya in the federations under discussion however. Elsewhere, separate bodies are responsible for planning and for financial adjustment. Where this is the case and where at the same time planning decisions have a large impact on the public finances it seems inevitable that the role of financial adjustments will to a degree be subordinated to the investment decisions and priorities decided at the federal planning level. No longer do the financial adjustments determine the scope of the regional and state developments, but, within limits, it is the priorities which set the pattern of financial adjustments. Under these circumstances, the role of the finance commission seems likely to be directed toward ascertaining standards of financial administration and the extent to which states are adequately exploiting their own tax resources and matters of this sort. The real center of interest in federal-state relationships then shifts away from the purely financial considerations to an analysis of the standards and criteria and administrative procedures by which the national development plan is formulated.

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[8] It may be that just as the development of the social services was, in the past, one of the major influences remolding federal-state financial relations in the older federations, so in the newer federations, *reliance upon external aid* may turn out to be an equally important influence—at least in the short run. Where the central government retains control over access to external aid, and where this is a major source of finance of development, the independence of the states may be subjected to a considerable eroding influence. On the other hand, donors of external aid themselves are in a position, through their standards of eligibility, and procedures, to influence to a degree the future pattern of finance in these federations.

TABLE 1.—*State revenues and expenditures as a percent of total public revenues and expenditures (current account)* [1]

Year	Federation	State revenues as percent of total public revenues	State expenditures as percent of total public expenditures
1955–6	India	43	62
1957–8	Libya	30	69
1959	Malaya	12	17
1959–60	Nigeria	33	54
1960–1	Pakistan	31	56
1960–1	Rhodesia	34	43
1955–6	West Indies	95	95

[1] Revenues of are net of interauthority transfers by way of grants, tax-sharing or loans.

Sources: Annual budget statements and explanatory memorandums on the budgets. Libya, the Economic Development of Libya.

TABLE 2.—*Derived revenues (including shared taxes) and grants as a proportion of State revenues*

Country	Year	Derived revenues	Unconditional	Grants conditional	Total	Total grants and derived revenues
India	1951–52	13	4	4	8	21
	1955–56	13	4	14	18	31
Libya	1957–58	----------	50	----------	50	50
Malaya	1952	----------	----------	----------	----------	61
	1958	----------	23	14	37	37
Nigeria	1951–52	----------	----------	----------	----------	84
	1959–60	18	19	----------	19	37
Pakistan	1951–52	27	4	----------	4	31
	1960–61	25	2	----------	2	27
Rhodesia	1954–55	41	----------	----------	----------	[1] 41
	1960–61	32	----------	----------	----------	[1] 32
West Indies	----------	----------	----------	5	----------	[2] 5

[1] This excludes appropriations-in-aid for work carried out in territories on behalf of the Federal Government.
[2] This is derived from C.D. & W. grants.

TABLE 3.—*State expenditures for ordinary and developmental purposes*

Federation	Unit	Year	Ordinary: Average per head	Ordinary: Range	Developmental: Average per head	Developmental: Range
India [1]	Rupee	1951–52	3.3	3.8	(2)	(2)
		1955–56	5.2	6.7	(2)	(2)
Libya	Libyan pound	1957–58	7.3	4.5	(2)	(2)
Nigeria	Pound	1951–52	.3	.2	.1	.05
		1961–62	1.5	1.8	.7	[3] .9
Pakistan	Rupee	1951–52	8.0	6.1	2.7	3.2
		1955–56	9.8	7.2	5.6	11.0
		1960–61	17.3	12.6	5.5	4.0
Rhodesia	Pound	1954–55	4.3	5.2	(2)	(2)
		1960–61	6.8	8.3	(2)	(2)
West Indies [4]	West Indies dollar	1953–54	59.3	55.8	-------	-------
		1958–59	106.9	140.9	-------	-------

[1] India: expenditure on social services only.
[2] Not available.
[3] Capital expenditures for 1959–60.
[4] West Indies: figures include both current and developmental expenditures.

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THE IMPACT OF ECONOMIC DEVELOPMENT ON FISCAL FEDERALISM: THE NIGERIAN EXPERIENCE

BY HARLEY H. HINRICHS*

ISSUES: THE STRUGGLE FOR FEDERAL REVENUES BY UNEVENLY-GROWING REGIONS[1]

Decentralization of functions and powers within a government unit, such as the Federal Republic of Nigeria, inevitably presents certain problems and issues of intergovernmental fiscal relations. These may be both of the "vertical" (federal-regional-local) and "horizontal" (among regions and among local governments within any region) nature. These problems may be summarized as (1) lack of correlation between expenditure and revenue sources, i.e., the criteria that best determine the government unit most able to carry out certain functions (make expenditures) are not the same as the criteria that best determine the government unit most able to generate the revenues to finance these functions; (2) lack of correlation (unequal tax capacity) among government units at the same (horizontal) level which may have similar functions and needs; (3) overlapping (concurrent) tax sources allocated to different government units; and (4) fiscal equity[2] in that the "fiscal residuum" (public benefits or services less their tax or fee cost) may vary among individuals and enterprises within a country

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*Faculty of Economics, University of Maryland; this paper is partly based on the author's experience on a World Bank fiscal mission to Nigeria in 1965, as well as participation in the U.S. State Department/AID summer research project on Nigeria in 1966; the views expressed here do not necessarily reflect those of either of these two groups; portions of this paper were presented at a Conference on Nigerian Integration and Disintegration, Africa House, Northwestern University, on April 1, 1967.

[1] Because of the extensive literature on intergovernmental fiscal relations and especially the historical development of these relationships in Nigeria and because of the intrinsic and primary political determinants (which are outside the scope of this paper) of how these relationships have been and should be resolved in Nigeria, this paper only touches briefly on this subject; see Hicks, United Kingdom, et al., *Federalism and Economic Growth* (London: George Allen and Unwin, 1961); National Bureau of Economic Research, *Public Finances—Needs, Sources and Utilization*, (Princeton: Princeton University Press, 1961, pp. 79–274); B. P. Adarkar, *The Principles and Problems of Federal Finance* (London: P. S. King and Sons, 1933; James S. Coleman, *Nigeria: Background to Nationalism* (University of California, Berkeley and Los Angeles, 1960); John P. Mackintosh, "Federalism in Nigeria," *Political Studies*, vol. X, No. 3, (October 1962), pp. 223–247; Eme O. Awa, *Federal Government in Nigeria* (Berkeley and Los Angeles: University of California Press, 1964); and the various commissions that have studied the problem: Nigeria (S. Phillipson), *Administrative and Financial Procedure under the New Constitution: Financial Relations between the Governments of Nigeria and the Native Administrations*, Report by S. Phillipson (Lagos: Government Printer, 1946); Nigeria (J. R. Hicks and Sir Sidney Phillipson), *Report of the Commission on Revenue Allocation* (Lagos, Government Printer, 1951); Nigeria (Sir Louis Chick), *Report of the Fiscal Commission on the Financial Effects of the Proposed New Constitutional Arrangements* (Cmnd. 9026); H.M.S.O., London, 1954); Nigeria (Jeremy Raisman), *Report of the Fiscal Commissioner* (Cmnd. 481, H.M.S.O. London, 1958); and Nigeria (K. J. Binns), *Report of the Fiscal Review Commission* (Lagos: Federal Ministry of Information, 1964). See especially P. N. C. Okigbo, *Nigerian Public Finance* (Northwestern University Press, 1965); Gerald K. Helleiner, *Peasant Agriculture, Government, and Economic Growth in Nigeria* (Irwin, 1966), and John Due, *Taxation and Economic Development in Tropical Africa* (M.I.T. Press, 1963).

[2] See J. M. Buchanan, "Federalism and Fiscal Equity," *American Economic Review*, vol. XL, No. 4 (September 1950).

(thus leading to fiscal pressure on the location and mobility of labor and capital within the country that may not be optimal from a resource allocation viewpoint).

For a developing country such as Nigeria, intergovernmental fiscal relationships take on particular importance as it is not only the size of revenue (and expenditure) sources but also their growth during the process of development that present continually changing problems and issues (these have been treated to some extent by the series of Nigerian fiscal review commissions in 1946, 1951, 1954, 1958, and 1964, as cited in the earlier footnote).

In the process of development and social mobilization the scope and function of government evolve so that there is typically a shift of both power and functions to the more centralized units of government (federal government) and away from local and regional units. Thus pressure naturally exists to reallocate decentralized revenue sources to the centralized unit of government to finance these greater functions. For Nigeria this transition has had the interesting development (since 1951) of the interposition of regional governments between the earlier (since 1900) local government units and a centralized authority (the British "Colony and Protectorate of Nigeria", though divided into the Colony of Lagos and the protectorates of Southern and Northern Nigeria). The earlier traditional system of revenue generation primarily at the local level (with partial transfers to the centralized authorities under the system of "indirect rule") evolved with greater revenue generating capacity flowing to the centralized authority (and partial transfers to decentralized units). However, the creation of constitutionally autonomous regions then shifted most of the revenue back from a Federal to a less centralized (regional) orientation.

The tax structure change during development has meant the predominance of external indirect taxation (foreign trade taxation) over the earlier localized traditional direct taxes making the Federal (centralized) government the chief revenue collector.[3] However, the regions—by legally capturing a growing share of these revenues—have become the chief disposers of most revenues generated in Nigeria. Thus the pattern of transfers has been altered to one wherein the Regions (especially the Eastern Region) have been making the major transfers to local government units (by direct block grants as in the East or by shares of the Regional Income Tax as in the West and Midwest) while the Federal Government has been collecting more than two-thirds of the revenues which make up the regional budgets, these revenues being allocated by statute.

The recent (January 1966) fiscal dilemma then—as evidenced by the papers submitted to the recent Binns Commission—has been a tug of war between the regions and the Federal Government for a greater share of the revenue base (as well as among the regions themselves in their share of the "distributable pool" whereby most revenues are secured). In this contest for revenues the Federal Government would have predominated (if the federation had remained intact) development. The growth of industrialization, domestic production

[3] This is consistent with the model developed in my book, *A General Theory of Tax Structure Change During Economic Development* (Cambridge: Harvard Law School International Tax Program, 1966).

development. The growth of industrializations, domestic production (particularly petroleum), and import-substitution with the concomitant rise in revenues thereon (by way of general excises, excises on petrol, company income tax, and the petroleum profits tax—none of which are constitutionally earmarked for regional sharing) will over time strengthen the fiscal hand of the Federal Government. (The Federal Government, however, has so far adopted the policy of making nonstatutory allocations of part of these new and rising revenues to the regions in keeping with the older pattern; the Binns Report would prefer instead a fixed grant to the regions at least for general excises.)

In terms of existing fiscal equity—as defined earlier—the differentials of public benefits less tax costs appear to be relatively significant, not only between regions, but among individuals (especially farmers producing for different export crops) within the regions. The level of the public services appears to be highest in the Eastern Region (especially education) and lowest in the less-developed North; personal and income taxation of lower income groups appears to be highest in the Western Region but with a substantial degree of "horizontal inequity" (tax evasion). The differences between low-income farmers (subject to fairly high export and personal taxation but with few educational and health facilities) and city-dwellers, urban property owners, and middle-income entrepreneurs (often able to evade personal, property and income taxation yet the beneficiaries of government-provided urban services) appears to be fairly sharp. These will be issues and problems that will continue for some time; partial resolution of them may be in lower export taxation and greater internal indirect taxation.

PRESENT STRUCTURE

The Nigerian constitution (1960) establishes two layers of government, Federal and Regional (local governments subsist under the legal prerogatives of their respective regions and have no intrinsic powers as such). The Federal Government is granted certain "exclusive" revenue powers and share with the regions "concurrent" jurisdiction over others; the Regions retain residual power in those areas not enumerated under the above "exclusive" and "concurrent" areas.

The Regions have experienced a substantial growth in their statutory share of tax revenues collected by the Federal Government; this statutory Regional share of Federal tax revenues has grown from 6 percent (1951) to 52 percent (1961–62) in the past decade (using a constant 1960–61 revenue base). Of total Federal current revenues (except reimbursements, foreign and domestic grants) the Regional share has grown from 9 to 43 percent in the same period in terms of actual transfers (and a changing revenue base). In recent years the share of the Regional current revenues made up by these statutory transfers has been 60 percent (Eastern Region), and 80 percent (for both the Northern and Western Regions, including the Midwestern Region). The Northern Region has been the major beneficiary of the several fiscal reallocations in this period with its "federally collected" share of total Northern Regional Current Revenues rising from 63 percent in 1952–53 to 79 percent in 1961–62, while the same share for the Eastern Region fell from 75 percent to 62 percent in the same period (with the Western Regional share remaining roughly constant).

The present (1966) statutory allocation of Nigerian revenues by revenue component, by the government unit that establishes tax rates and collects the taxes, the government units which share in the proceeds of those tax collections, and the basis for determining the share is best presented in outline form as follows: (the notes indicate where the sharing has been nonstatutory and thus changeable by Federal policy without constitutional revision).

Nigeria—Separation and sharing of tax sources, 1964–65

Revenue components	Rate setting and collection by—	Assignment of revenue	Basis of assignment
Direct taxes:			
Income taxes:			
Individual	Federal (Lagos) Regions	Federal Regions	Residence. Do.
Company (including petrol profits tax).	Federal	Federal	
Personal taxes, rates, and property taxes.	Local [1]	Local [1]	Local.[1]
Foreign trade taxes:			
Import taxes:			
General	Federal	70 percent Federal; 30 percent region (pool).	Pool share.[2]
Petrol [3] [4]	do	Regions	Consumption.[5]
Tobacco	do	do	Do.[5]
Beer, wine, liquor	do	Federal	
Export taxation:			
Produce, hides, skin	do	Regions	Derivation.[6]
Other	do	Federal [7]	
Produce sales [8]	Regions	Regions	
Marketing board trading profits.	Regions (marketing board.)	Regions (marketing board.)	
Internal indirect:			
Excises:			
General [9]	Federal	70 percent Federal; 30 percent region (pool).	Pool share.[2]
Tobacco	do	Regions	Consumption.[5]
Beer, wine, liquor	do	Federal	
Produce sales [8]	Regions	Regions	
Additional petrol [4]	do	do	
Miscellaneous:			
Stamps, licenses, fees, rentals	Each government	Each government	
Income from property: Mining rents/royalties.[10]	Federal	20 percent Federal, 50 percent region (where located). 30 percent regions (pool.)	Derivation. Pool share.[2]

[1] Traditional direct personal taxes, rates, and property taxes are levied and collected by local governments (but often subject to limits set by regional governments, especially in the eastern region); 12.5 percent of the northern region "community and cattle" taxes levied and collected by local government units are assigned to the regional government; in the western and midwestern regions the "personal" tax element of the regional income tax (N£3 per head) is collected and retained by local government units, as well as other income taxes on incomes up to N£300 (part of which is collected under the regional PAYE system).

[2] Pool share; Northern region 40/95; eastern region 31/95; western region 18/95; midwestern region 6/95.

[3] The proposed equivalent excise on the forthcoming domestic production and refining of petrol is to be treated in the same manner by a nonstatutory grant of the Federal Government.

[4] Regions may levy an additional excise on petrol; so far only the eastern region has done so.

[5] By location of consumption in previous quarter of year; Lagos is considered for this purpose to be part of the western region.

[6] By area of purchase for export in previous quarter or previous 12 months.

[7] "Other" has so far included animals, birds, and reptiles; these revenues have been assigned to the region of derivation as a nonstatutory grant of the Federal Government.

[8] Regional produce purchase and/or sales taxes are primarily on export commodities (and paid either by producer or marketing board) and may be considered to be either internal indirect taxes or equivalent to export taxes.

[9] General excises (other than petrol, beer, wine, liquor, tobacco) are assigned in this fashion (30 percent to the regional pool) by policy and nonstatutory grant of the Federal Government.

[10] May also be considered a part of foreign trade taxation.

THE NEW SYSTEM OF REVENUE ALLOCATION TO STATES AND SETTLEMENTS IN THE FEDERATION OF MALAYA*

BY HUAN TZU HONG**

Under the old system of revenue allocation in the Federation of Malaya, the States and Settlements had some sources of revenue of their own from which to meet part of their expenditure. These sources of revenue consisted mainly of entertainments duty; certain excise duties; revenue from lands, mines (excluding export duties on mineral products) and forests; licenses, fees and other charges; revenues of local authorities other than municipalities; and the profits distributed by the Board of Currency Commissioners. The remaining portion of their expenditure was met from lump-sum Federal grants, which formed nearly two-thirds of their respective total revenue. These grants, made annually, were apportioned on the basis of rule of thumb rather than on agreed principles. Consequently, the amount allocated to each State and Settlement for the ensuing year was a matter for annual discussion. The amount of the preceding year was of course taken into consideration, but the Federal Government's financial prospects and commitments for the next year had a marked influence in determining the amount that could be allocated. Any excess of State and Settlement revenue over expenditure at the end of the financial year had to be returned to the Federal Government. This system of revenue allocation was found to be unsatisfactory both to the Federal and to the State and Settlement Governments.

Substantial changes were made accordingly, and a new system of revenue allocation came into existence on January 1, 1956.[1] This system aims at providing the States and Settlements with their own revenues as before, but with allocations from the revenues of the Federal Government on an entirely new basis. Their total revenues in the future are to be derived from the following channels:

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*Reprinted from: *The Malayan Economic Review*, vol. 11, No. 1, April 1957, University of Malaya, Singapore.

**Mr. Huan Tzu Hong is at present an honors student at the University of Malaya (editor).

[1] I am greatly indebted to Mr. Chan Thye King for his permission to use as a basis for this article his unpublished Honors Thesis, *A Study of the Allocation of Revenues to the States and Settlements of the Federation of Malaya from 1948 to 1956* (Singapore: University of Malaya, 1956). For further details in published documents, see International Bank Mission *Report on the Economic Development of Malaya* (Singapore: Government Printer, 1955), the *Report* of the Committee appointed to review the Financial Provisions of the Federation of Malaya Agreement of 1948 (Kuala Lumpur: Government Printer, 1955), and *The Federation of Malaya Agreement (Amendment) Ordinance, No.39 of 1955*, published in the Federation of Malaya Government Gazette (Kuala Lumpur: Government Printer, 1955), pp. 1135–1146.

(1) Independent revenues. These consist of the same sources of revenue as had been prescribed for the States and Settlements in the former system.

(2) Petrol duty; 30 percent of the proceeds of the import duty on petrol is to be shared between the States and Settlements in proportion to the amount of petrol used in their areas. This percentage is fixed for an indefinite period.

(3) Annual per capita grant (or Capitation Grant). This is to be based on the adult population of 20 years of age or above, according to the latest census figures. The amount is to be decided after consultations between the Federal and the State and Settlement Governments, but there is to be no downward variation from the grant made in the preceding year by an amount exceeding 10 percent of the basic 1956 grant.

(4) Special allocations. The responsibility for financing expenditure on certain subjects of national interest, i.e. on education, on medical and health services, and on capital works for drainage and irrigation, is to rest with the Federal Government, which will make special allocations to the State and Settlement Governments to meet the vast cost of these services.

(5) In addition, Development Grants are to be made to four States; namely, Kelantan, Pahang, Perlis, and Trengganu, since they need special assistance to raise their standard of development. The amounts of such grants are to be determined by the High Commissioner-in-Council, though the architects of the present system had suggested that they should be on a per capita basis and equal to about 25 percent of the Capitation Grant.

(6) The new system also provides for Special Transitional Grants to territories which have no excess of revenue over expenditure, Kedah, Negri Sembilan, Pahang, and Perlis are to receive these special grants (based on $2 per capita, up to a maximum of $500,000), which are to continue until such times when these States can balance their budgets.

Furthermore, supplementary allocations will be considered by the Federal Legislative Council in exceptional circumstances.

The new system no longer requires all the State and Settlement Governments to transmit their annual estimates to the Federal Government, except those items which relate to education, to medical and health services and to drainage and irrigation. Those States, however, which receive Special Transitional Grants will still have to transmit their estimates for approval. Another important change is that the States and Settlements will now be able to retain any surplus of revenue at the end of a year and thus to build up budgetary reserves.

Although these allocations are "based on fixed and determined principles," guaranteeing the States and Settlements "revenues of a stable and continuing character,"[2] yet the principles involved are not stated.

[2] *Report* of the Committee appointed to review the Financial Provisions of the Federation of Malaya Agreement of 1948, *op. cit.*, p. 2.

A careful study of this new system, however, indicates that it is based on the following principles:

(1) The principle of independent revenues, which states that it is desirable from the standpoint of financial independence that the State Governments should have an independent tax revenue of their own, over which they have full control. This has been an accepted practice in federal finance.

(2) The principle of derivation, which lays down that an area is admitted to have an inherent claim on revenue collected within its jurisdiction, notwithstanding the fact that the tax lies wholly within the competence of the Federal Government. In other words, the proceeds of some taxes at least should be divided among the States in the proportion in which the people of those States have contributed to the taxes in question, as far as these proportions can be ascertained. Experience has shown that this principle can be applied to only a limited number of taxes and that the use of this method is confined to those taxes which can be allocated efficiently by means of a relatively simple formula. In the new system in the Federation, this principle is applied to the important duty on petrol, which is a good choice as the distribution of all petrol requirements in Malaya is undertaken by two major oil companies and the necessary statistics can be obtained from them without difficulty.

(3) The principle of needs. In order to insure a fair distribution among the people of the Federation of Malaya, part of the Federal revenue is allocated to the States and Settlements on the basis of the needs (e.g. the Capitation Grant, Development Grant and Special Transitional Grant).

(4) The principle of national unity. Notwithstanding the desirability of a large degree of autonomy, the assumption of underlying national unity, which is the ground for distribution according to needs, may also be made a ground for the distribution of funds to provide for certain kinds of expenditure which it is in the national interest to encourage and support. The main fields for the operation of this principle are education, health, drainage, and irrigation.

These principles have been generally accepted as applicable to federal finance, and they are used as a basis for revenue allocation in a number of federal countries with problems similar to those encountered in Malaya (e.g. Nigeria and India). In effect, the new system of revenue allocation involves the use of independent revenues, shared taxes, unconditional grants and conditional grants, the four possible solutions to the problems of revenue allocation in federal countries. That it involves four different principles is the logical result of the impracticability of rigidly applying one simple formula in federal finance. Moreover, the combination of the four principles will, in practice, insure a careful system of balanced allocations in which the frequently conflicting interests of the Federal and the State and Settlement Governments are happily reconciled.

Under this system, the Federal Government can plan and coordinate the expansion and improvement of economic and social services, and control the expenditure of federal funds on them more effectively. The Federal Government's control of the State and Settlement budgets will be virtually confined to a reduction, or an increase, in the Capitation Grant and in the expenditures on education, medical and health services and on capital works in drainage and irrigation, which should be under Federal control in the interest of national unity. If the Federal Government feels that the States and Settlements are spending too much in relation to public revenues, it can reduce the Capitation Grant, but by not more than 10 percent of the original grant of $12 per capita for 1956. Therefore, the States and Settlements will know in advance that their revenues can be varied to a limited extent only, and not at the whim of the Federal Treasury. Furthermore, they can now budget in the knowledge that the Federal Government will pay for education, medical and health services and capital expenditure on drainage and irrigation, the cost of which amounts to about half their total expenditure. Revenue to cover about one-third of the remaining half can be varied by the Federal Government, but the other two-thirds of this half will be subjected to the ordinary fluctuations of revenue collections. Thus this system will give the States and Settlements considerably greater financial autonomy and stability than under the old system.

As mentioned above, it is advisable that certain subjects of national interest should be the direct financial responsibility of the Federal Government, but in practice this may give rise to many difficulties. The State and Settlement Governments may submit inflated budgets for these items, since the expenditure on them is not borne by themselves. On the other hand, the Federal Government as paymaster may feel that these estimates are unduly large and therefore need to be reduced. It is also possible that the Federal Government, in anticipation of lower revenues, may pay the States and Settlements less than they justly ask for. In addition, there is the likelihood that the former, in its desire to insure uniform levels of services for the Federation as a whole, may not pay adequate attention to the differences prevailing in the latter. These difficulties may mar the smooth operation of the system, but they are to a large extent unavoidable. As they are inherent in the very nature of federalism, showing that no solution can be perfect in federal finance, it is only hoped that when they do arise, the various parties will compromise in the interest of national unity.

A serious weakness of the previous system was that the unspent portions of the grants had to be returned to the Federal Treasury at the end of each year. This meant that the States and Settlements were not inclined to practice economy; instead they would rush to spend any surplus which might have accrued toward the end of the financial year. The new system allows the States and Settlements to retain any such surplus. This is particularly important, for under this system it is expected that most of them would have surpluses in their budgets. It is obvious that with such surpluses they will be able to build up their resources and to plan intelligently and constructively for their own development. As reserves can now be built up, they need no longer fear any interruption in their planning programmes. They will also be encouraged to develop a proper attitude to economy and thereby to increase the efficiency of their administrations. Since any savings will be kept by the States and Settlements, this system will be more conducive to the better exploitation and fuller developments of the sources of revenue under their control. In this way, financial responsibility on the part of the States and Settlements will be insured; they will no longer be passive, but will make efforts, to help themselves.

However, the Committee which drew up this new system may have laid too much emphasis on surplus or balanced budgets for the States and Settlements. While the trend of prices and therefore of revenues can be said to be increasing in the long run, reductions in revenues resulting from the fluctuations in Malaya's export markets are by no means to be ruled out, and under such circumstances it is economically unsound and socially undesirable to practice balanced budgets. The fallacy of favoring balanced budgets at all times is obvious enough from economic literature. Thus, in bad years the States and Settlements should budget for a deficit, by drawing on reserves or by raising internal loans or by doing both. But the power to raise loans is still the privilege of the Federal Government only, despite the fact that the Committee had proposed that a Loan Committee be established to enable consultation and coordination to take place in these matters. It is difficult to find the reason why this recommendation was not adopted.

The Committee, in its deliberations for an equitable basis of distribution applying to all the States and Settlements, took into consideration not only general needs, as measured for instance by population (i.e. the Capitation Grants), but also the special needs of those States which required additional assistance for the purpose of economic development or of balancing their budgets (i.e. the Development Grants and the Special Transitional Grants). The total allocations, therefore, benefit the poorer States relatively more than the richer ones, whilst on the other hand the latter contribute much more revenue per capita than the former. It may be argued that those States which pay the highest per capita taxation should receive better treatment. But if the aim of federal public finance is the integrated development of the Federation as a whole, then this argument loses much of its importance. It is only by reducing economic inequalities that lasting national unity can be established.

The changes introduced by this scheme are expected to increase the State and Settlement revenues significantly. For instance, the total allocations to the States and Settlements for 1956, estimated at $189 million, showed an increase of $26 million over the previous year, though admittedly this was partly the result of the overall increase in estimated total federal revenue between these two years.

With regard to the sources of State revenue, it is well to remember that the proceeds of 30 percent of the import duty on petrol and the Capitation Grant have been given constitutional guarantees, in consequence of which the States and Settlements have an independent claim to them. Together with the special aid to the poor and backward States, these measures attempt to give elasticity to the finances of the States, and under this system the former rigidity of revenue allocation is eased for the first time. Furthermore, the onerous responsibilities of financing certain services, such as education and health, have, as mentioned before, been lifted from the States and Settlements.

Though no financial arrangements can be said to be satisfactory unless it has worked well in practice, it is evident that this new system has many advantages not found in the previous one. As its basis it has principles which will insure financial responsibility on the part of the State and Settlement Governments, without prejudicing the necessary requisites of financial autonomy which are such an important advantage of federalism. The essentials of federalism will therefore be preserved, and in as far as they are compromised at all, this is done in the national interest. In this way, sound balance is achieved between the forces of centralization and decentralization, which is the essence of any real federal system and the basis on which Malayan national unity can be built.

LESSONS OF THE ARGENTINE REVENUE SHARING EXPERIENCE

BY HARLEY H. HINRICHS*

I. INTRODUCTION AND SUMMARY: REVENUE SHARING LESSONS

It is highly misleading, dangerous and foolhardy to attempt to transfer fiscal lessons from one socioeconomic milieu to another; however, to ignore international fiscal experience may be even more risky. History is no virgin; one is never quite certain who might use it to derive different experiences and gain different insights; but if one can't use history, what else is there?

With these caveats aside, what lessons, if any, can be drawn from the Argentine experience of fiscal federalism? These lessons, of course, may or may not be relevant to the United States; but these lessons, nevertheless, deserve to be recorded so that others may judge their value, if any.

In summary, the lessons of the Argentine experience of 1935–64—and their implications, if any, for the North American fiscal systems—can be briefly stated:

1. *The socio-politico-economic milieu.*—Argentina is a developing, Latin American constitutional federal republic only in freshman textbooks; in fact, it has been undeveloping, is European in every way but geographically, and is a constitutional federal republic only in the offseason. Argentina has a glorious history, a magnificent prospect for the future, but seems to be always temporarily indisposed at any given present moment. It is important to understand this initial stage-setting in order to view the drama of Argentina's experience with fiscal federalism.

2. *Revenue sharing has been associated with a declining public sector.*—The growth of revenue sharing in Argentina—the share of centrally collected revenues distributed to provinces and municipalities has increased from about one-fourth to nearly one-half in the past two decades—has been associated with a decline in the size of the public sector. Local and provincial tax sources have become eroded and/or under-utilized as decentralized government units have found it easier to seek revenues through a greater federal share than through a determined nurturing of local revenue sources. This historical denouement casts doubt on the common assumption that revenue sharing may automatically increase the size of the public sector.

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*Faculty of Economics, University of Maryland; this article is based partly on the author's experience on World Bank missions to Argentina in 1964 and 1966, however, the views expressed here are not necessarily those of the IBRD. Deep gratitude for constructive criticisms of this paper are herewith rendered to Murray Ross of the IBRD; Hans Wyss and Frederico J. Herschel were also invaluable sources of data and suggestions.

3. *Revenue sharing has been associated with a weakening of provincial and local government units.*—As decentralized governmental units have found themselves more and more reliant on the central purse for budgetary revenues, their own vitality and independence have tended to decrease. This Argentine result casts doubt on the common assumption that revenue sharing—in and of itself—is a sufficient force for shifting power within a federal system to state and local governments.

II. Public Sector Saving

A. DETERIORATION OF SAVINGS IN RECENT YEARS

Public sector saving in Argentina has sharply deteriorated in recent years, becoming negative (M$N10 billion) in 1964. For 6 of the 8 years from 1950–57 public sector saving was about 5 percent of GNP; since then there has been a sharp secular decline in saving with the 3 years of zero or negative savings (1958, 1962, 1964), 2 years of meager savings at about 2 percent (1959 and 1963), and 2 years of saving at 4 percent (1960, 1961), years of economic resurgence coupled with improved tax administration. (See tables A 1–4 and accompanying charts.)[1] (The public sector is defined to include the Federal Government, its decentralized organizations, the social security system, the federal district (Buenos Aires), provincial and municipal governments, and public enterprises. All except the public enterprises comprise "general government".)

TABLE A–1.—*Gross saving and investment in the public sector*

[In billions of current pesos]

	1959	1960	1961	1962	1963	Estimate, 1964
National Government:						
Current receipts (less tax share to Provinces)[1]	89	130	167	164	213	238
Current expenditures and transfers	92	111	137	177	201	266
Consumption expenditures[1]	41	57	70	90	99	139
Transfers	27	37	51	61	77	95
Social security	23	32	46	52	66	81
Interest on public debt	1	2	3	4	6	9
Private sector	3	3	3	4	5	5
Subsidies (net) State:						
Enterprises	20	13	13	20	18	19
Subsidies and financial transfers	23	18	21	30	32	38
Profits	3	5	9	10	14	19
Transfers to Provinces and municipalities	5	3	4	7	7	13
Current account saving	−3	+19	+30	−14	+12	−28
Provincial and municipal: Gross saving[2]	+8	+20	+19	+14	+27	+18
Public sector saving (gross)	+5	+39	+49	−0	+39	−10
Investment (gross)	34	54	75	74	98	135
"Real" investment[3]	32	50	66	69	94	131
National Government	6	13	14	15	17	95
Public enterprises	18	23	28	29	49	
Provinces and municipalities[2]	8	14	24	26	28	36
Financial investment	3	4	9	4	4	4
Savings less investment (gross)	−30	−15	−28	−74	−59	−145
GNP (at current market prices)	751	981	1,176	1,418	1,724	[4] 2,395

[1] For comparability with earlier years, excludes accounts of certain decentralized organizations.
[2] Rough estimates for years after 1961.
[3] Disbursements on investment account.
[4] GDP.

NOTE.—Details may not add to totals due to rounding.

Source: CONADE—Provincial and municipal data for 1961 and later are rough estimates.

[1] Based on CONADE preliminary data: later data revisions result in no significant changes in trends and magnitudes.

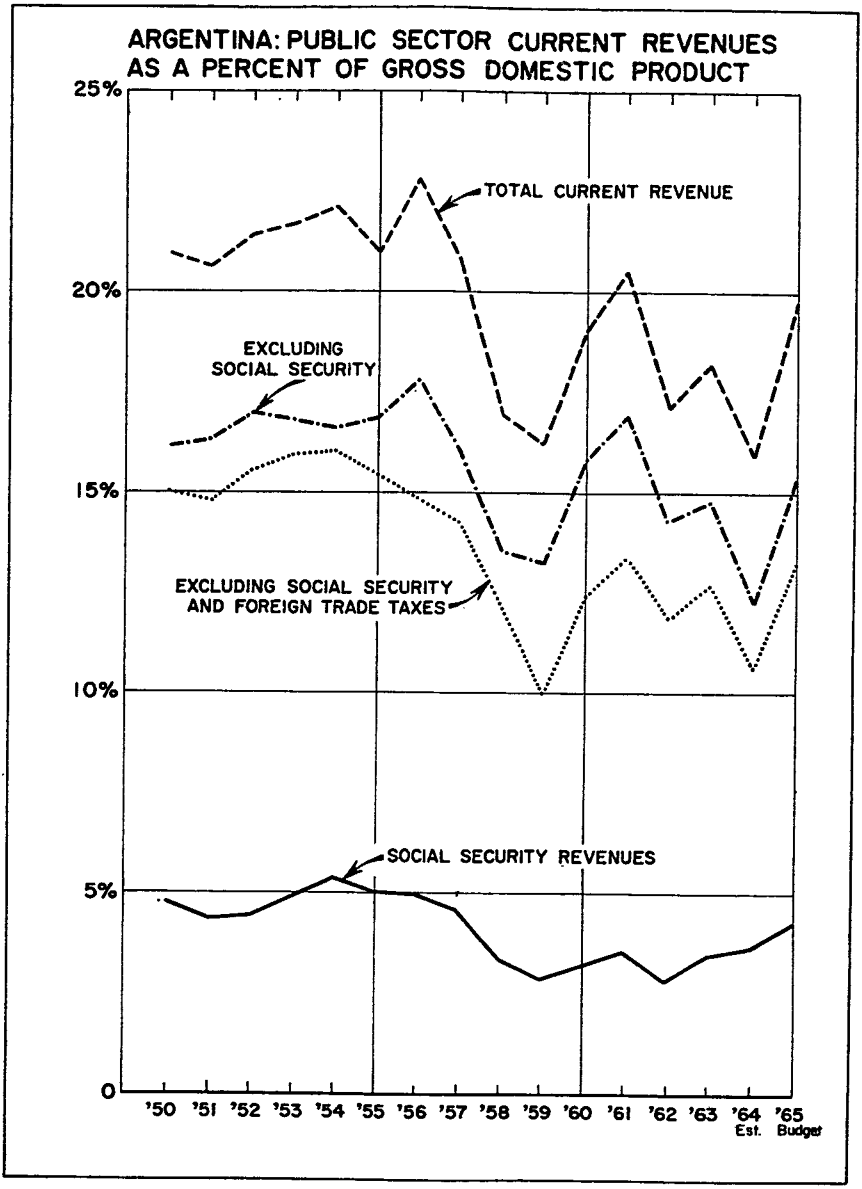
TABLE A–2.—*Public sector saving, 1950–65 (as percent of GNP)*

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	Estimate, 1964
Current revenue	20.9	20.8	21.4	21.7	22.1	20.8	22.7	20.9	16.7	15.8	18.0	19.5	16.4	17.2	15.0
Transfers	5.8	6.2	6.5	7.3	9.7	8.8	7.7	8.0	8.0	7.6	6.4	7.2	7.3	7.2	7.2
Consumption expenditure	10.6	9.6	10.4	10.6	10.8	10.7	10.4	9.3	9.5	8.4	8.6	9.8	9.9	8.9	9.6
Total outlays	16.5	15.8	17.0	17.9	20.6	19.5	18.1	17.3	17.5	16.0	15.0	17.0	17.2	16.1	16.8
Gross savings of General Government	4.4	5.0	4.5	3.8	1.5	1.3	4.6	3.6	−.9	−.2	3.1	2.5	−.8	1.1	−1.8
Net profits of State enterprises	.9	1.2	.9	.9	1.0	1.0	1.3	1.5	.5	1.6	1.2	1.2	1.0	.9	.8
Gross saving of public sector	5.3	6.1	5.4	4.7	2.5	2.3	5.8	5.1	−.4	1.5	4.3	3.7	.1	2.0	−1.0
Investment	6.7	6.4	5.8	5.9	5.4	4.2	3.7	4.0	5.7	4.3	5.3	5.7	4.6	5.1	5.5
Gross saving less investment	−1.3	−.3	−.4	−1.2	−2.9	−1.8	2.1	1.1	−6.1	−2.8	−1.1	−2.0	−4.5	−3.2	−6.5
Gross national product [1]	69.5	99.5	114.6	129.9	144.4	172.5	217.1	234.1	395.5	750.8	980.7	1,175.5	1,417.9	1,724.2	[2] 2,395.0

[1] Billions of current pesos.
[2] Revised GDP.

NOTE.—1956 and before are calendar years; 1957 is Jan. 1–Oct. 31; 1958 and after is fiscal year Nov. 1–Oct. 31.

Source: CONADE; there are minor differences between this table and a similar one in the preliminary 5-year plan where GDP rather than GNP was used as the base. See the plan table No. 54 for comparison.


ARGENTINA: PUBLIC SECTOR CURRENT REVENUES AS A PERCENT OF GROSS DOMESTIC PRODUCT
25%
20%
15%
10%
5%
0
TOTAL CURRENT REVENUE
EXCLUDING SOCIAL SECURITY
EXCLUDING SOCIAL SECURITY AND FOREIGN TRADE TAXES
SOCIAL SECURITY REVENUES
'50 '51 '52 '53 '54 '55 '56 '57 '58 '59 '60 '61 '62 '63 '64 '65
Est. Budget

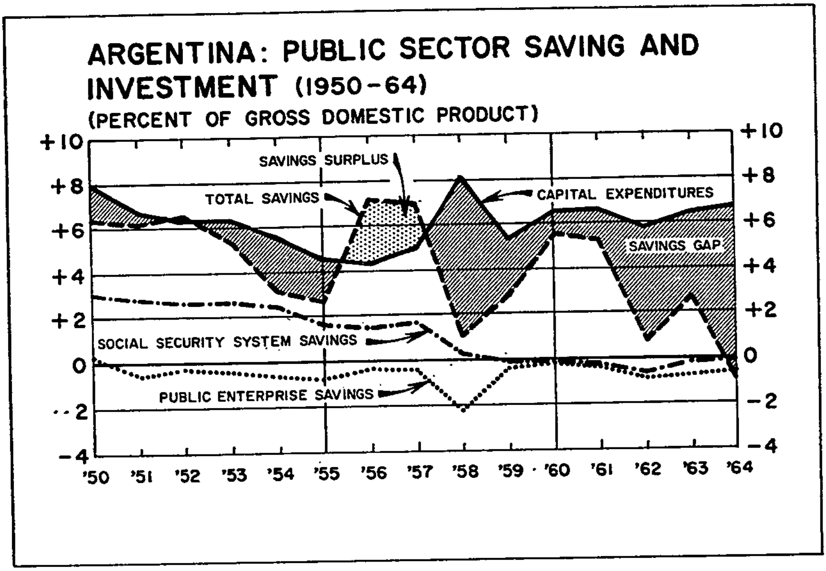


TABLE A-3.—*National Government (fiscal year Nov. 1–Oct. 31)*

[In billions of current pesos]

	1961	1962	1963	Estimate, 1964
Current revenues: [1]				
Tax revenues	145	139	170	176
Income taxes	39	34	43	40
Wealth taxes	5	6	5	5
Production-consumption-transfer taxes	60	64	87	94
Foreign trade taxes	41	35	35	37
Nontax revenue [2]	12	17	23	25
Social security contributions	42	41	60	81
Total current revenues	200	198	253	282
Current expenditures and transfers:				
Consumption [2]	70	90	99	139
Wages and salaries	47	63	71	100
Purchases	23	27	29	40
Transfers	101	122	143	171
Social security	46	52	66	81
Provinces and municipalities, of which	36	40	47	57
Shared taxes	(32)	(34)	(40)	(44)
Subsidies to public enterprises	21	30	32	38
Less profits of public enterprises	9	10	14	19
Private sector	3	4	5	5
Interest on debt	3	4	6	9
Total current expenditures and transfers	171	212	242	310
Current account surplus	+30	−14	+12	−28
Capital expenditures	49	47	71	99
Deficit	19	61	59	127

[1] Including taxes shared with provinces and municipalities.
[2] For comparability with earlier years, excludes accounts of certain decentralized government organizations.

NOTE.—Details may not add due to rounding.

TABLE A-4.—*National Government*

[In billions of pesos in 1961 prices]

	1961	1962	1963	Estimate, 1964
Current revenues: [1]				
Tax revenues	145	111	102	88
Income taxes	39	27	26	20
Wealth taxes	5	5	3	3
Production consumption transfer taxes	60	51	52	47
Foreign trade taxes	41	28	21	18
Nontax revenue [2]	12	14	14	12
Social security contributions	43	33	36	40
Total current revenues	200	158	152	141
Current expenditures and transfers:				
Consumption [2]	70	72	60	70
Wages and salaries	47	50	43	50
Purchases	23	22	17	20
Transfers, of which	101	98	86	85
Social security	46	42	40	40
Provinces and municipalities, of which	36	32	28	28
Shared taxes	(32)	(27)	(24)	(22)
Subsidies to public enterprises	21	24	19	19
Less profits of public enterprises	9	8	8	9
Private sector	3	3	3	3
Interest on debt	3	3	4	4
Total current expenditures and transfers	171	170	145	155
Current account surplus	+30	−11	+7	−14
Capital expenditures	49	38	43	50
Deficit	19	49	35	64

[1] Including taxes shared with provinces and municipalities.
[2] For comparability with earlier years, excludes accounts of certain decentralized government organizations.

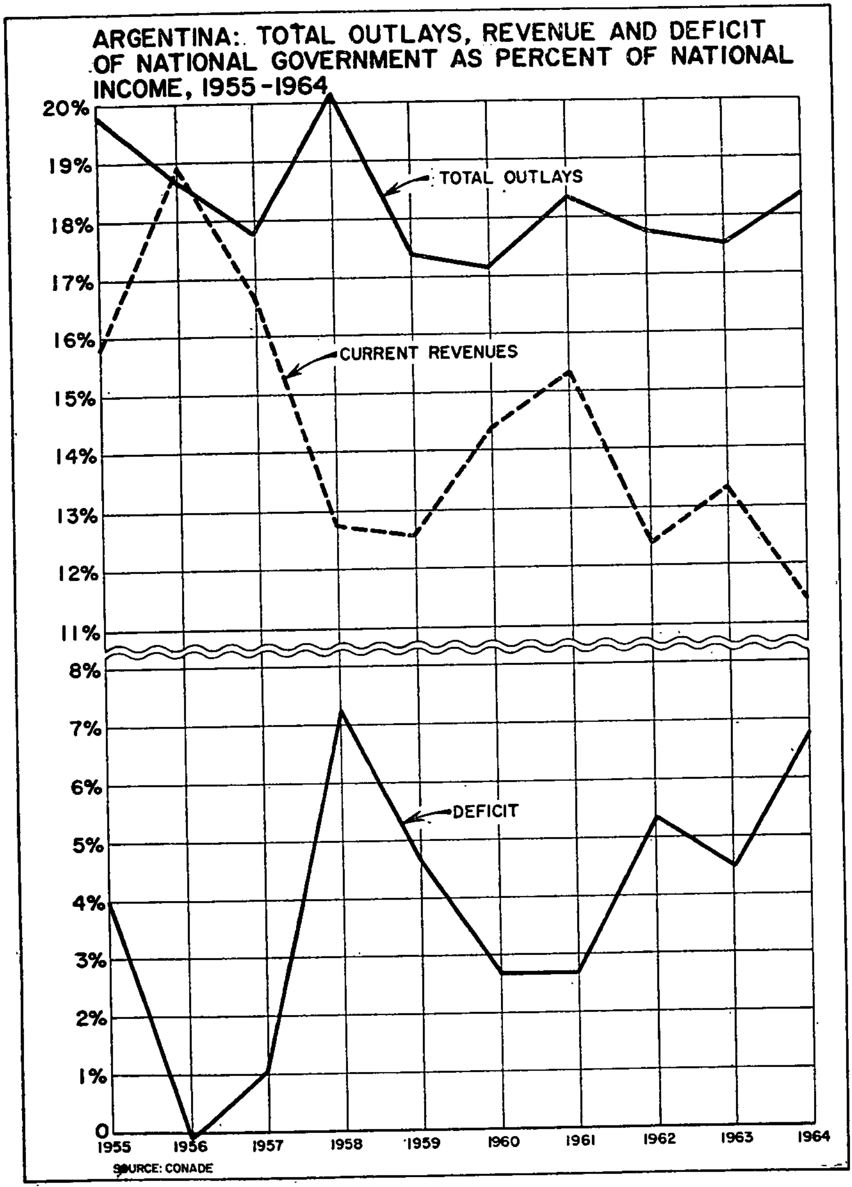
NOTE.—Details may not add due to rounding.

Public sector investment has been maintained at the rate of about 5 percent of GNP per year. (During 1961–63 real investment was probably higher as official data exclude investment financed by foreign credits.) Thus the elimination of any gross savings in the public sector has resulted in financing investment by sizable deficits of the National Treasury. In 1964 this has meant a savings gap (gross investment less gross savings) of roughly M$N140 billion, or about 6 percent of GNP (about M$N2,400 billion), most of which fell upon the National Treasury to finance. (See table A–1 and accompanying chart.)

B. DETERMINANTS OF THE DETERIORATION

This decline in public sector savings has resulted from government consumption expenditures and transfers remaining either constant (or slightly increasing) in real terms and as a share of GNP while current revenues have fallen by one-fourth. (See table A–2 and accompanying charts.) This deterioration is most obvious since the 1960–61 prosperity but is also true since the 1950–57 period.[2] The roots of this decline cannot be explained simply in terms of the cyclical downturn of 1962–63 but is tied to a series of interrelated structural factors: weak government, inelastic tax system, inefficient public enterprises, increased rate

[2] Some of this deterioration (about 1 percent of GNP) can be explained by the change in the fiscal year in 1957 which distorted future statistical data for comparative purposes. See later discussions.



of inflation (relative to 1952–57), inadequate tax administration, slow and uneven rate of economic growth, a fall in the money/GNP ratio in the past 6 years, the turnabout in the savings performance of the social security system, and the tendency toward peso overvaluation.

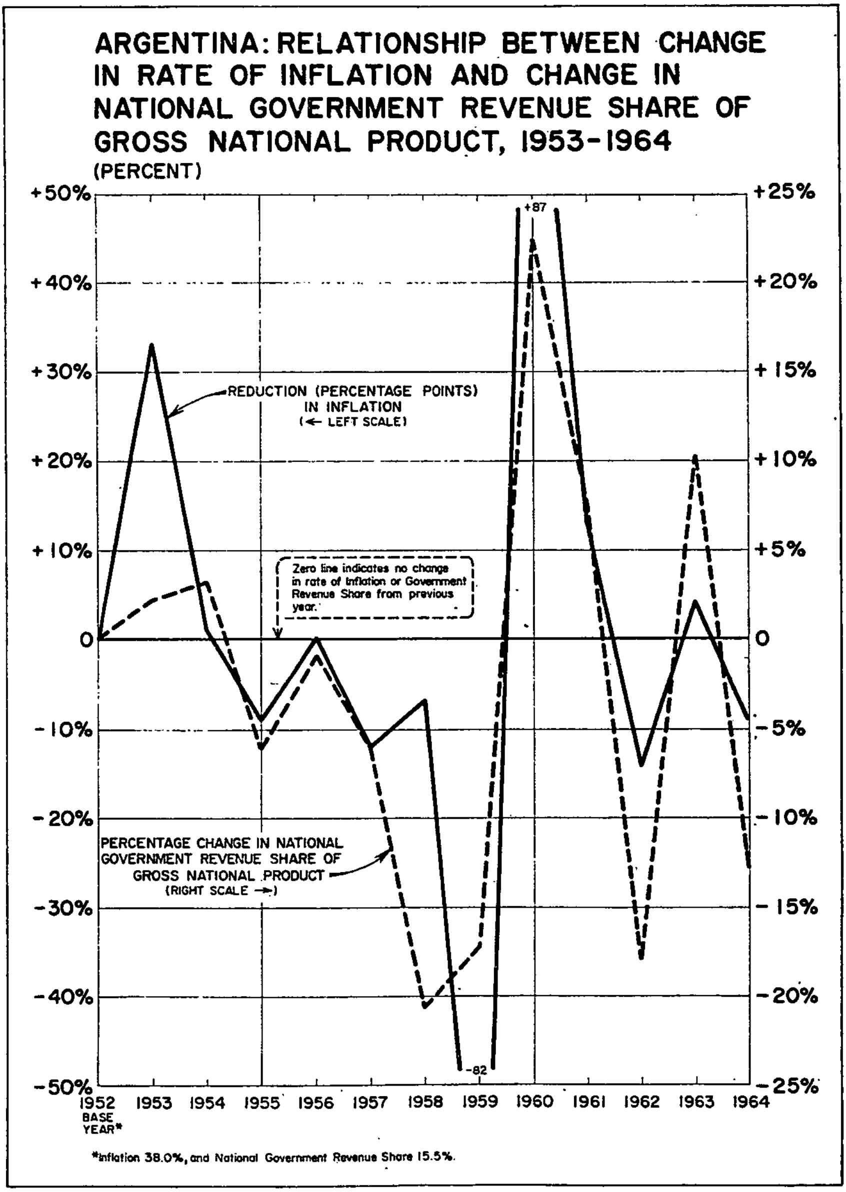
Weak government.—Frequent and destabilizing changes in government in the last 10 years have resulted in weak and uncertain efforts to deal with the deeply embedded problems of tax reform and administration, inefficient public enterprises (chiefly the railways), as well as to provide stable economic policy needed as a framework to promote economic growth and restrain inflationary pressures. During years of government transition (1955, 1958, 1962, and 1964, the first full year of administration of a new minority government), the government revenue share (current revenues as a percent of GNP) fell by 10 to 20 percent. Furthermore, weakness of the Central Government has meant serious inroads into the National Treasury by pressures from the public enterprises, Provinces, municipalities, and the social security system. By failing to coordinate policies within the national economy the Central Government has at times been forced to come to the rescue of semi-independent government units, many of which have tended to overspend and undertax or undercharge for services and then fall back on the National Treasury for financing. Since 1961, for example, while public sector revenues declined in real terms by one-fourth, revenues remaining to the National Treasury fell by one-half. The Provinces and municipalities in this period had increased their participation in shared revenue sources from 33 to 40 percent rather than updating property tax assessments or raising their gross receipts tax of slightly less than 1 percent.

Inelastic tax system.—The Argentine tax system has been inelastic relative to changes in money income not only because of the other determinants, such as poor tax administration, but also because of its basic structure. Compared to similar countries, Argentina's tax system places a greater reliance on direct taxation (including social security payments) than on internal indirect and foreign trade taxes. In comparable countries direct taxes have tended in the last decade to be decidedly less income-elastic than indirect taxes, mostly due to the latter's greater ease of administration. Argentine National Government revenues have been divided about evenly between direct and indirect taxes while comparable countries generally have a direct/indirect tax ratio of about one-half, if adjustments are made for income tax revenues on exports of large (chiefly foreign) extractive corporations.

A second structural feature of the Argentine tax system is the critical lag between the tax base, tax assessments, and payments as well as the lag in increasing specific tax rates and charges (as contrasted to an "automatic" *ad valorem* indirect tax structure). The taxes on income and sales are estimated generally on the previous year's tax base, are payable in the current year, but often collected in the following year. Thus it is not unexpected that changes in the revenue from these taxes are related to changes in the previous year's tax base. This lack of flexibility often results in perverse fiscal effects.

A further disturbing feature that has heightened the disadvantage of the noncurrent payment of important taxes is the increased rate of inflation. With prices increasing about 25 percent per year, this results in a loss in real tax revenues of the same percent when they are actually collected. In addition in recent years frequent oscillations between boom and bust have meant that in good years taxes could be paid but are not due while in bad years high tax payments based on earlier years cannot be paid because of a current recession or lack of liquidity.

Increased rate of inflation.—Due to these structural characteristics of the Argentine tax system, revenues have been price inelastic. The average annual rate of inflation of 33 percent in the 1958–64 period has been double that of the average for the 1950–57 period, resulting in a greater tax erosion from inflation. Furthermore, every year since 1950 that the rate of inflation has *increased,* the Government tax share has declined (see following chart). Inflation not only has made the



noncurrent payment of many taxes a more important factor but also has undercut the real value of specific (rather than *ad valorem*) consumption taxes, public enterprise charges, property tax assessments, and tax penalties. In the latter instance, a low interest rate charge (previously from 1 to 2 percent per month) on unpaid taxes had reduced the penalty to one of a no-interest loan when inflation was 25 to 30 percent per year. It also became cheaper to borrow from the Government by nonpayment of taxes than to go to the market for funds at interest rates up to 4 percent per month.

Inadequate tax administration.—Government revenues have also been limited by frequent changes in tax administrations, changing emphasis on tax collections, tax moratoriums or concessions lowering back liabilities to increase shortrun revenues (but which thus tended to subvert future tax payments in hopes of future tax moratoriums), and at times inept, lenient, and even, on occasion, corrupt tax administration. Evasion has been rampant but at least as important has been the noncollection of reported tax liabilities. Corporations have often not only failed to remit their own social security payments (15 percent of wages) but also at times failed to forward social security payments collected from employees (11 percent of wages). Many companies have recorded current tax obligations as long-term liabilities and at the same time have paid stock dividends, the shares thus received being then sold by stockholders with no capital gains tax on such sales. The nonpayment of acknowledged taxes (including social security contributions) has been estimated at about one-third of total National Government revenues in the past few years. During and following the period of recession, political turmoil, and uncertainty in 1962–63, much of the energy of the tax administration was shifted to arranging financial payment plans for tardy taxpayers (some payments were scheduled up to 1970) rather than in a rigorous collection of tax revenues. There has been little recourse to prosecution of tax nonpayment or outright evasion. Companies and individuals have been given financing, discounts, and/or concessions in hope of future payment rather than meaningful penalties; bankruptcy and prosecution have not been used as instruments of enforcement.

Slow and uneven rate of economic growth.—The earlier period of 1951–57 with significant (5 percent) public sector saving showed increases in real GNP in 6 out of 7 years while the period 1958–64 showed increases in only 4 of 7 years thus serving as a drag on revenue collections. This was due to the combined effect of a drop in real income and liquidity, which as we have noted, resulted in the private sector using the nonpayment of taxes as means of finance.

Furthermore, much of the economic resurgence in late 1963 and 1964 was based on 2 years of good harvests and agricultural prices resulting in sharp increases in agricultural income but in income that was little taxed, mostly due to generous exemptions for investment. In one survey by the Treasury, the average tax rate on agricultural income was only about 3 percent as contrasted to fairly high rates in the industrial sector (10 percent value-added tax, 26 percent tax on wages for social security, 38 percent on corporate profits).

Fall in liquidity.—During the past 6 years the fall in the ratio of money supply to GNP from 37 percent to 18 percent has aggravated the public finance dilemma.[3] The other determinants already mentioned were serious problems already but the diminution in the means of tax payment undercut much of the tax collection system. Evasion has always been a serious problem in Argentina as elsewhere throughout Latin America. But the shortage of finance contributed to nearly half the deficit in 1964 being due to unpaid but acknowledged back taxes. Without any meaningful penalties to enforce tax collections, especially in a milieu of weak Government and 2 previous years of recession, the amounts of back taxes have mounted as a means of finance for the economy. This has also had adverse effects in terms of any rationalization of the industrial economy: efficient firms pay fairly high taxes while inefficient high-cost firms are kept afloat by paying no taxes, and in cases even "borrowing" the social security contributions of employees rather than remitting them to the Government.

This financial impasse has coincided with two other important features of the Argentine system of public finance: massive debts of the Government to the private sector (M$N70 billion) aggravating the illiquidity of the private sector; and the increased use of tax debt cancellation certificates as means of payment by the Government. These certificates can be used to pay present taxes and are sometimes discounted by their recipients for immediate cash. Recently about 30 percent of Treasury revenues have consisted of these certificates with the corresponding problem of the Treasury to remit cash to the coparticipators of its revenues (Provinces and municipalities) which has meant greater borrowing from the Central Bank.

Turnabout of savings by the social security system.—Although related to the other determinants above, the single most important contributor to the secular decline in public sector saving in Argentina has been the turnabout in savings performance by the social security system. From 1950 through 1958 this system was a net saver for the public sector, receiving about 5 percent of GNP while disbursing as little as 2 percent, chiefly pensions and retirement benefits. From 1956 to 1959 the revenues fell from 5 to 3 percent of GNP (for the reasons already discussed) and have not greatly increased while payments have risen from 2 to about 4 percent as the system has matured with more employees becoming eligible for benefits and as demographic trends have produced an older population. Thus the system became a net dissaver of almost 1 percent of GNP in 1962–63. This turnabout of 4 percent of GNP (from a net saver of 3 percent to a net dissaver of 1 percent) goes far to explain the overall fall in public sector saving of 5 percent to zero and even slightly below.

Inefficient public enterprise.—The public enterprises, chiefly the railways, have constituted a continuing drag on any hope for public sector saving in Argentina. During the past 5 years, subsidies for current operations of the public enterprises have equaled from one-half to the total amount of the National Government deficit. In this same period when public sector gross savings fell short of public sector in-

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[3] As another index, currency and bank deposits (both time and demand) measured as a percentage of GDP fell from 42 percent in 1955 to 25 percent in 1959 and 22 percent in 1963.

vestment by anywhere from 1 to 6 percent of GNP, enterprise deficits have remained about 2 percent of GNP, large enough to have either eliminated this savings gap in good years or cut it by from one-third to one-half in poor years.

Not only is the current deficit important but also the drain on investment resources is of major proportions. About half of the total public sector investment (or about three-fourths of National Government investment) is poured into public enterprises whose main contribution to public sector saving has so far been negative. Combining current transfers to losing public enterprises with their investment expenditures has resulted in expenditures generally in excess of the national deficit as well as the savings gap (gross saving less gross investment). So far there has been no reduction in this drag on public sector saving: between 1961 and 1964 when the real value of national revenues fell by 30 percent, the real value of subsidies to cover operating deficits of enterprises rose by 10 percent as did the real value of capital expenditures of public enterprises.

The profitable enterprises, chiefly YPF (oil), have been able to offset only about one-third of the losses of the enterprises with deficits. However, even the presence of profits in some enterprises is somewhat illusory as these funds are invariably kept within the enterprise to help finance capital expenditures; secondly, these "profits" are in most cases "cash flow" and thus often do not represent any net profit or net saving by these enterprises.

Overvaluation of the exchange rate.—When the official rate of the peso is overvalued relative to its equilibrium rate, public revenues suffer. After exchange devaluations, as in late 1955 and 1958, foreign trade taxes rose very sharply (for this and other reasons) in 1956 and 1959. (As exchange depreciation is theoretically equivalent to subsidizing exports and taxing imports, a secular trend tending to overvalue the peso also tends to reduce foreign trade taxes.) Import taxes, tied to generally constant or falling international prices, fall in real terms if domestic inflation proceeds without compensating exchange depreciation. Likewise, there is less of a surplus to be taxed in the export sector that faces rising domestic costs and relatively fixed, or exogenously determined, world prices. Any failure to adjust foreign trade tax policy and/or readjust the exchange rate has and will reduce the Government revenue from foreign trade taxes.

C. SAVING BY SOURCE OF ORIGIN

Public sector saving can be seen as originating in four basic subsectors of government activity: the Central Government, the social security system, public enterprises, and the Provincial and municipal governments. Table A–5 indicates the amount of saving in each subsector; this is done by eliminating all transfers within the public sector so that receipts and payments with the private sector are considered by themselves in the period 1959–64. Revenues are allocated to the subsector in which they originate; thus, taxes shared by the Central Government are allocated to the Central Government as this is the subsector that both legislates the taxes and collects them.

TABLE A-5.—*Source of gross saving within the public sector* [1]

[In billions of current pesos]

[AS—after sharing of Central Government collected taxes; BS—before sharing]

	1959		1960		1961		1962		1963		Preliminary, 1964	
	AS	BS	AS	BS	AS	BS	AS	BS	AS	BS	AS	BS
1. Central Government:												
Current receipts	67	79	97	123	123	155	121	155	153	193	155	199
Current expenditures	45	45	62	62	75	75	99	99	110	110	148	148
Consumption	41	41	57	57	70	70	90	90	99	99	134	134
Transfers and subsidies	4	4	5	5	6	6	8	8	11	11	15	15
Interest on public debt	1	1	2	2	3	3	4	4	6	6	9	9
Private and nonprofit enterprises	3	3	3	3	3	3	4	4	5	5	6	6
Gross saving	22	34	35	60	48	80	22	56	43	83	7	51
2. Social security:												
Receipts	22	22	33	33	43	43	41	41	60	60	81	81
Payments	23	23	32	32	46	46	52	52	66	66	81	81
Gross saving	−1	−1	0	0	−3	−3	−11	−11	−6	−6	−1	−1
3. General government—National level: Gross saving (1)+(2)	+21	43	+35	70	+45	77	+11	45	+37	77	+6	50
4. Public enterprises:												
Surpluses	3	3	5	5	9	9	10	10	14	14	20	20
Deficits	−23	−23	−18	−18	−21	−21	−30	−30	−32	−32	−44	−44
Gross saving	−20	−20	−13	−13	−13	−13	−20	−20	−18	−18	−24	−24
5. National Government: Gross saving	+1	+23	+22	+37	+33	+65	−7	+38	+19	+59	−18	+26
6. Provinces and municipalities: [2]												
Current revenue	32	20	57	32	76	44	81	47	103	63	114	70
Current expenditures and transfers	29	29	40	40	60	60	73	73	83	83	109	109
Gross saving	+3	−9	+17	−8	+16	−16	+7	−27	+20	−20	+5	−39
7. Public sector: Gross saving	+5		39		49		0		+39		−13	

[1] Transfers within the public sector are excluded.
[2] Rough estimates by CONADE for 1961 and later years.

NOTE.—Details may not add due to rounding. Later revised data for 1964 indicate National Government gross saving (after sharing) to be −28.

In the period 1950–58 the social security system provided about half the gross public sector saving that was close to 5 percent of GNP for 6 of the 9 years of the period. Since 1958, the social security system has been either a zero saver or a dissaver of up to 1 percent of GNP. In general in the 1959–65 period the effect of the social security system can be considered almost negligible—not in terms of what it should have saved—but in terms of any substantial saving or dissaving.

The major finding in disaggregating the public sector by sources of saving is that the considerable revenue-generating abilities and saving of the Central Government have been dissipated by two subsectors: deficits in public enterprises and the failure of the Provinces and municipalities to generate revenue from their own tax sources. In 1960 the Provinces and municipalities paid for 80 percent of their current expenditures by their own revenue sources; by 1964 this share had dropped to 64 percent. Due to their own limited ability to borrow and/or create money, this financial gap was made up by increasing their share of the Central Government tax collections by 20 percent (from 33 to 40 percent) as well as increasing their financial transfer from the Central Government by more than fourfold when prices had just more than doubled.

Thus one key to understanding and correcting the deterioration of public sector saving—from the revenue side—is to look *outside* the Central Government itself. The three other subsectors are vital to any comprehensive explanation. While in 1950–57 the surpluses of the social security subsector could counterbalance the deficits of the enterprises and the deficiencies of provincial and local finance, the 1959–65 period is chiefly characterized by (1) the elimination of the social security subsector as a counterbalancing force; (2) the growing drag of enterprise deficits; and (3) the erosion of the provincial and municipal governments' own revenue sources, chiefly the property tax with lagging assessments and a very low (average) 0.9 percent gross receipts tax coupled with poor tax administration.

Much of the dilemma of Argentine public finances can be seen in the following diagram:[4] while the National Government established tax policy for and/or collected some M$N280 billion (in 1964), only about one-third (M$N125 billion) of this revenue flowed into the National Treasury. The other receipts were either earmarked for decentralized organizations, such as Vialidad (roads), or were shared by Provinces and municipalities (giving them little incentive to fully exploit their own revenue sources), or flowed into the social security system in prescribed transfer payments. Yet, at the same time, the National Treasury was then required to cover not only its own growing administrative expenses but also to make considerable additional financial transfers to cover current account deficits and/or capital expenditures of the decentralized organizations, public enterprises, Provinces, municipalities, and the social security system. This resulted in a public sector "saving gap" of about M$N140 billion in 1964, virtually all of which had to be financed by the Central Government.

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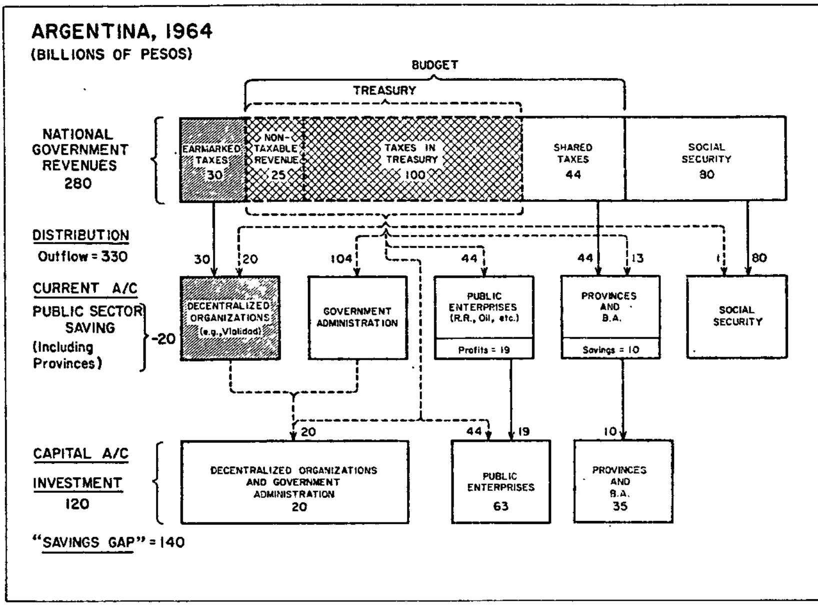
[4] Using rough preliminary data. See later chapters for revised data. Later adjustments do not significantly alter the analysis or policy implications. Certain additional earmarked non-tax revenues for special accounts and decentralized organizations (about M$N30, billion) are not included.



D. STATISTICAL DISTORTIONS

In analyzing the public sector accounts, a number of important adjustments must be made. In 1957 the fiscal year was changed from the calendar year (1956 and before) to a November 1 to October 31 fiscal year. For 1957 the transition fiscal year was January 1 to October 31. This has resulted in the years after 1957 understating ratios of revenues and expenditures to GNP compared with such ratios of earlier years. As GNP data are based on calendar years, the present 2-month lag in the corresponding fiscal year tends to lower these ratios by about 1 percent of GNP given the typical 25 to 30 percent annual inflation rate. For example, the R/GNP percentage (current public sector revenue to GNP) for 1961 of 19.5 percent given in Table A–2 would have to be raised to about 21.5 percent to make it comparable with years before 1957. Thus, some of the secular downward movement in the R/GNP percentage for Argentina during the past 15 years is due to this change in the fiscal year.

The National Government treasury accounts revenues are recorded on a cash accounting basis while expenditures are recorded on a quasi-accrual basis. Thus, while some M$N40 to 50 billion in acknowledged tax liabilities are not recorded, an offsetting M$N49 billion in acknowledged but not paid current liabilities are recorded. This amount of current liabilities is an increase of about M$N7 billion over the previous year, thus the amount of adjustment is smaller being based on the difference rather than the absolute amount. The expenditures are not on a fully accrual basis, however. Such amounts are recorded when the Treasury has been ordered to pay them. For example, as of September 30, 1964, the liability to private contractors was M$N4.4 billion. There must still be considered the body of commitments and liabilities that represent to a large degree work completed but not yet approved, goods arrived but suppliers not yet ordered to be paid, and so on. This volume of commitments and liabilities yet to be ordered paid is considerable, standing at some M$N60 billion to private contractors, quite different from the M$N4.4 billion recorded but unpaid liabilities mentioned above.

In general this combination of cash and quasi-accrual method of accounting has led to a recorded overstatement of public sector saving in 1963 and a subsequent understatement for 1964 due to the lag in actual services performed and/or goods received being recorded in the Treasury statements. Unfortunately, the Argentine Government has not sufficient data to allow the Government accounts to be shifted to a fully accrual basis, nor to make possible relevant balance sheet statements of comparative obligations within the public sector or between the public and private sectors for different periods of time. In analyzing the recorded public sector saving performance in the last 2 years, 1963 looks surprisingly good despite the 1962–63 recession and liquidity crisis. On the other hand, 1964 appears much worse than it perhaps should, given the economic upturn of some 8 percent, the substantial easing of credit, and an estimated 36-percent increase in the money supply. Part of this paradox seems due to the lag in recording the substantial increase in expenditures and the differential effects of increased tax arrears. When the present Government came into power in October 1963, much of government finances were in transitional difficulties which, in the process of being ameliorated, fell into record in fiscal 1964. Heavy transfers and payments were made to support decentralized organizations of the state, the social security system, public enterprises, provincial and municipal governments for expenditures that had accrued in 1963 but entered the books in 1964. Likewise, the general collapse of tax revenues, taxpayer morality, and taxpayer payment plans fell to a large extent on the shoulders of 1964 when tax collections, payment plans, and financing were rearranged and rescheduled. Taxpayers were awaiting another tax moratorium, were using liberal investment allowances from earlier years, and/or were carrying forward substantial losses from the earlier recession. Thus, much of the initial effort of the tax administration was in the reestablishment of fiscal order following the 1962–63 recession, restoring taxpayers to regular collections, negotiating accumulated tax arrears, and trying to engender confidence and certainty in the tax system. This lag in the Treasury's cash-quasi-accrual accounting system's explaining the 1962–63 real revenue decline goes part of the way—but far fram all the way—in explaining the surprising depth to which public sector savings fell in 1964.

Data provided in the various tables showing consolidated public sector savings are subject, therefore, to a considerable margin of error due to the above factors as well as to the roughness in the provincial and municipal data. These latter data are Argentine Government preliminary approximations for years after 1961. They are based chiefly on an assumed constancy of proportion between the earlier national, provincial, and municipal data, a constancy assumption which is not altogether reliable.

However, even though it has been difficult to generate complete data consistency and precision (especially with much data being continually revised) not only for the public sector but also for such fundamentals as GNP and price indices, the basic trends in public sector saving have been so pronounced that whatever data do exist seem sufficient for analytical conclusions and policy choices. It should be accented, though, that there is much less imprecision in the National Government gross saving figures than in the consolidated public sector account.

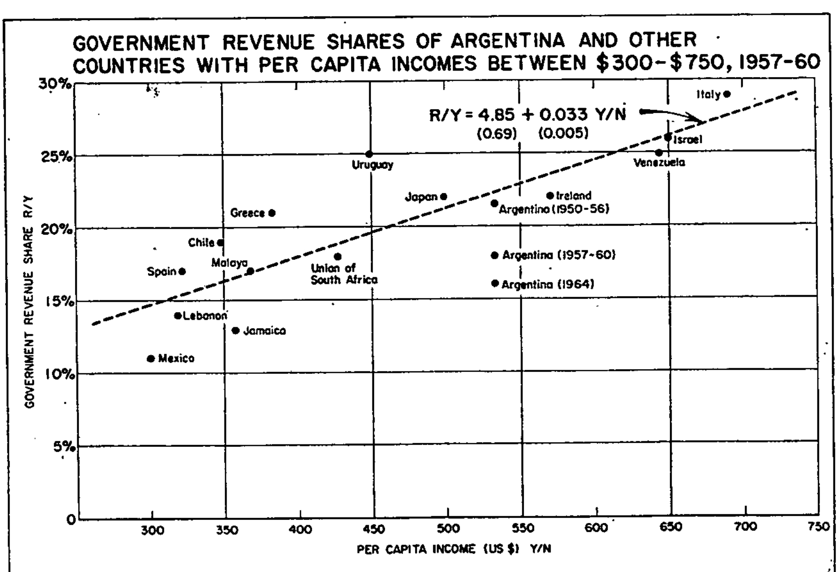
Much of the underlying data and background information are to be found in the statistical tables appended to this report. The major source has been the Public Sector subdivision of the CONADE (National Development Council), functioning under the Office of the President of the Argentine Republic.

III. Structure and Trends in Public Finances

A. Revenue

Public Sector: Size and Trend of the Government Revenue Share

Current revenues of the consolidated public sector ranged between 20 to 23 percent of GNP during 1950–57 but since then have ranged between 16 to 20 percent. Compared to 14 other countries within a similar per capita income range between US$300 and US$750, a regression analysis indicates that a government revenue share of about 22 percent for Argentina would be expected. For countries within this middle income range, per capita income is a significant indicator of government revenue shares. See the following chart. (However, for countries with lower per capita incomes the degree of "openness" (as measured by imports/GNP) is a significant indicator whereas per capita income is not; for countries with per capita incomes above US$750, other indicators are more important, e.g. welfare and defense



expenditures, whereas per capita income is not statistically significant.)[5]

Compared to other Latin American countries, Venezuela, Brazil, and Ecuador have higher government revenue shares while Peru and Chile have revenue shares close to the 20 percent Argentina achieved in 1961.

Composition of the Government Revenue Share

Argentina's revenue structure had been divided almost evenly between direct and indirect taxation during much of the past two decades. This is a much greater reliance on direct taxation than most comparable countries and other Latin American countries, especially if taxes on extractive (e.g. oil) companies are attributed to foreign trade taxes. The composition of Argentina's revenue system (including all levels of government) in 1959 was:

	Percent
Direct taxes:	
Taxes on income	17.1
Taxes on wealth	5.0
Social security contribution	21.2
Total direct	43.3
Indirect taxes:	
Internal indirect taxes	34.8
Foreign trade taxes	21.9
Total indirect	56.7
Total	100.0

However, since 1955 when tax revenues were almost evenly split between direct and indirect taxes, there has been a shift toward a greater proportion of indirect taxes. Much of this has been due to an increase in foreign trade taxation (from 2 percent of all tax revenues in 1955 to 20 percent in 1961),[6] a decline in social security revenues (from 29 percent of revenues in 1955 to 22 percent in 1961), and a longer run increase in the sales and turnover taxes (from 5 percent of revenues in 1945 to 15 percent in 1961), coupled with a deal decline in property taxation (from 11 percent of revenues in 1945 to only 2 percent in 1961). Thus, by 1961 the ratio of direct to indirect taxes had fallen to 40–60 compared to the 50–50 split achieved as late as 1955. One of the underlying factors for this shift can be attributed to the Government instability and political uncertainty after 1955 which undercut much of the patterns of voluntary or enforced compliance usually required for effective direct taxation. However, this growth of taxpayer resistance, evasion, and avoidance has earlier historical roots.

These trends for the composition of public sector tax revenues are shown in table A–6 for the period 1955–61. Municipal and provincial data are not available for subsequent years.

[5] See H. H. Hinrichs, "Determinants of Government Revenue Shares of Less Developed Countries," *Economic Journal*, September 1965 as the source for the following chart; Argentine per capita income is set at US$533, this figure being used for all years noted despite small changes in per capita income that have occurred; other sources have established Argentina's per capita income to be as high as US$732; see also H. H. Hinrichs and R. Bird, "Government Revenue Shares in Developed and Less Developed Countries", *Canadian Tax Journal*, September–October 1963. In the chart Uruguay appears farther away from the regression line than it probably should be as the 25 percent R/Y figure is based on post-1960 data and the per capita income figure may well be closer to $500 to $550.

[6] In the early 1950's agricultural exports were "taxed" through the system of exchange rates.

TABLE A-6.—*Trends in the composition of tax revenues,*[1] *1955–61, as percent of total taxes*

	1955	1956	1957	1958	1959	1960	1961
1. Social security (N+P+M)	29.1	25.6	26.3	25.0	22.3	21.4	22.0
2. Income tax	14.4	12.6	14.1	15.6	13.9	14.7	14.4
3. Foreign trade taxes	2.1	14.3	9.7	9.8	21.9	19.8	19.5
(a) Export retentions		4.7	2.8	.1	6.4	7.3	2.8
(b) Import surcharges		7.4	4.1	4.0	11.4	8.6	12.9
(c) Others	2.1	2.2	2.8	5.7	4.1	3.9	3.8
4. Manufacturing value-added tax	9.5	7.4	9.3	10.2	7.7	10.3	11.0
5. Tobacco	5.9	5.3	5.3	5.4	4.9	5.1	4.8
6. Tax on oil and electricity	10.0	7.7	6.9	6.5	6.6	5.2	4.6
7. Gross receipts tax (P+M)	3.4	2.6	3.8	3.8	3.5	3.3	3.5
8. Stamp taxes (N+P+M)	3.9	3.8	4.8	4.4	3.4	2.9	3.5
9. Property taxes (N+P+M)	4.6	3.8	3.7	3.5	2.8	2.3	2.4
10. Others	17.1	16.8	16.1	15.8	13.0	15.0	14.3

[1] National Government (N), provisional (P), municipalities (M); all unmarked are also National Government.

Source: Estudio Sobre Politica Fiscal en la Argentina, OAS/BID, vol. II, 1963.

The public sector can be divided into the National Government (including the social security system and public enterprises), the provinces, and municipalities. Each of these will be discussed in turn.

National Government

The composition and trends of national government revenues (before tax-sharing with the provinces and municipalities) are presented in table A-7 and the following chart.[7] As close to three-fourths of all government revenue is collected by the National Government, the preceding comments concerning the trends and composition of public sector revenues apply here as well. An important characteristic of these revenues is that only about one-third flow into the National Treasury with the bulk being directly channeled to the social security system, special accounts, decentralized organizations of the state, and provinces and municipalities. See the flow diagram in the preceding chapter. This trend has intensified during the past 5 years with the provinces and municipalities being able to increase their share of certain revenues (chiefly income, wealth, and sales taxes) from 33 percent to more than 40 percent (up to 46 percent for certain key taxes).

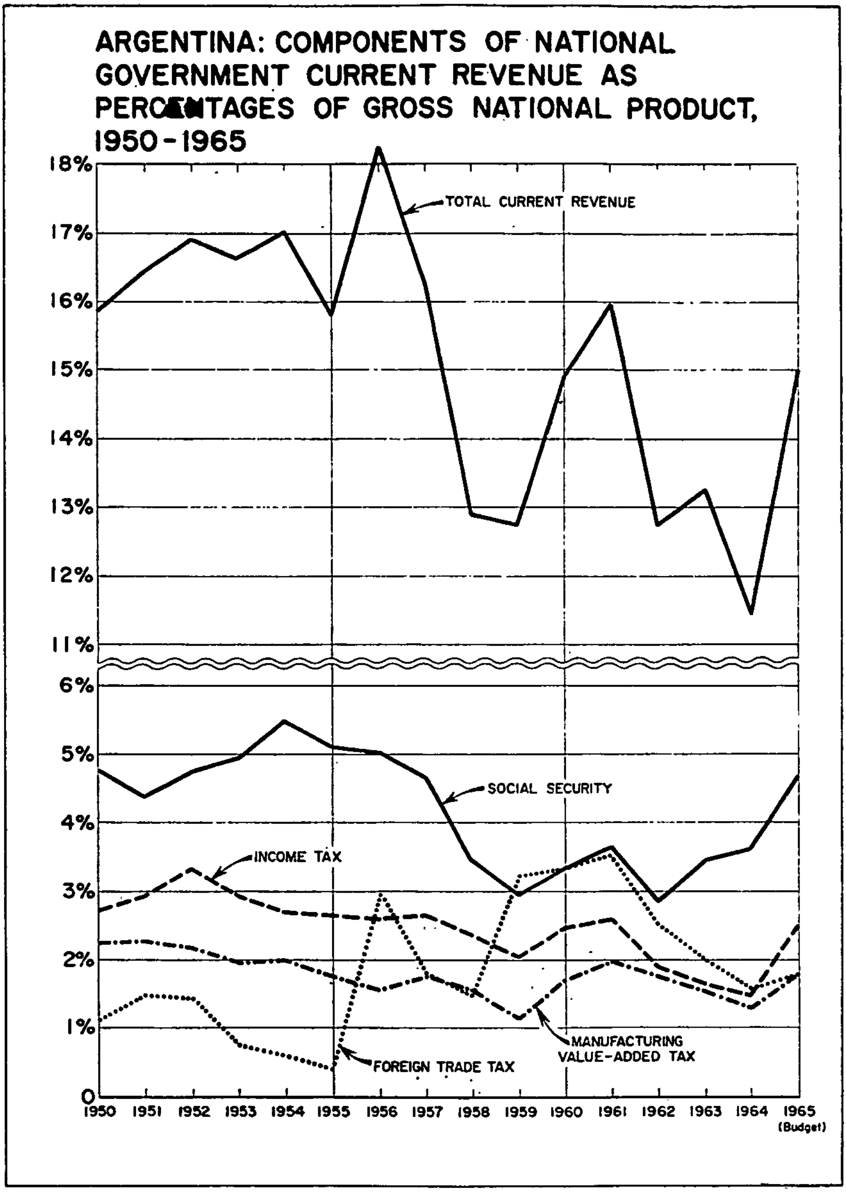
TABLE A-7.—*Tax revenue of National Government as percent of GNP, 1950–65*

Year	Social security	Income tax [1]	Foreign trade taxes	Manufacturing "sales" (value added) tax [1]	Total tax revenue
1950	4.77	2.73	1.10	2.25	15.88
1951	4.38	2.93	1.46	2.26	16.43
1952	4.75	3.32	1.41	2.17	16.94
1953	4.95	2.92	.75	1.96	16.64
1954	5.48	2.70	.60	2.00	17.01
1955	5.10	2.66	.38	1.75	15.81
1956	5.02	2.60	2.95	1.54	18.25
1957	4.67	2.66	1.83	1.75	16.21
1958	3.43	2.35	1.47	1.54	12.90
1959	2.98	2.04	3.20	1.12	12.77
1960	3.32	2.46	3.32	1.72	14.92
1961	3.65	2.60	3.52	1.99	15.98
1962	2.87	1.90	2.51	1.79	12.74
1963	3.48	1.65	2.00	1.53	13.28
1964	3.22	1.30	1.42	1.15	10.18

[1] Before tax sharing with Provinces and municipalities.

NOTE.—1964 based on a preliminary revised GNP estimate of M$N2,500,000,000,000.

[7] The chart is based on preliminary budget and GNP figures for 1965.



The leading taxes collected by the National Government are:[8]

Income Taxation

The 1965 budget expects income taxes to yield M$N41 billion (after tax-sharing of nearly 46 percent), more than double the normal collection in 1964. This represents about 10 percent of expected national

[8] Fuller discussion and resolution of some of the tax policy issues raised here and in following sections are undertaken in the final part of this report under the "Reconstruction of Public Finances" in the short and long run.

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revenues. Since 1961, income tax revenues (even before tax-sharing) have remained nearly constant in money terms resulting in a deterioration in real terms of 50 percent by 1964. The causes have been many: liberal investment allowance provisions that have reduced effective income taxation of agricultural income to 3 percent (on the basis of a Treasury survey); increased exemptions and minimum family allowances to more than keep up with the inflation; increased tax evasion since the more vigorous enforcement in 1960–61; and the economic recession of 1962–63 which lowered tax liabilities in those years plus the lag in collection from the higher incomes in the economic upswing since mid-1963, as well as the other more general reasons discussed earlier that apply to the overall deterioration of revenues.

The income tax in Argentina is essentially designed to tax the upper middle class, the wealthy, professionals, and incorporated and unincorporated businesses. The increased deduction proposed by the Government for a family of four would eliminate those with wage and salary incomes below M$N32,500 per month, more than twice the minimum wage in such a case (14,500—which is yet to be effectively applied). This "minimum subsistence" exemption level is more than three times per capita income as compared to the United States where the equivalent exemption (plus the minimum standard deduction) is about equal to the per capita income level. Out of a population of nearly 22 million, there are 1 million on the income tax rolls (of which 100,000 are companies and 900,000 individuals) with some 3,400 industrial and commercial companies paying slightly more than 30 percent of all income tax revenue.

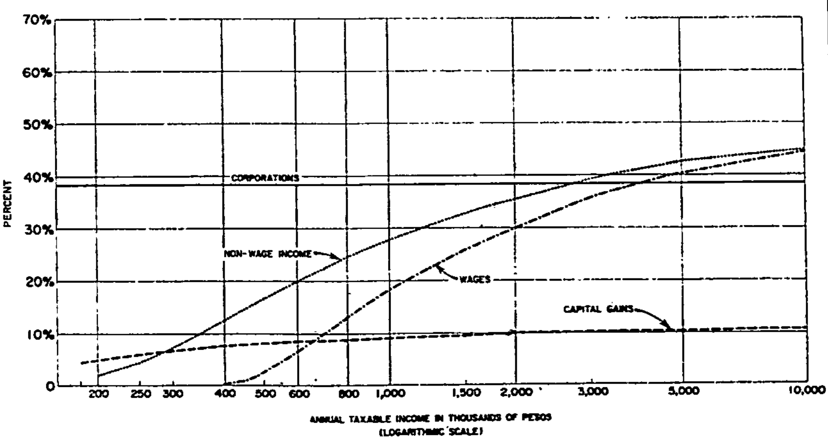
Some 1 percent of all income taxpayers produces more than half of all income tax revenue. The income tax is withheld at the source and is generally calculated by the employer. However, only the net tax amount after all exemptions and deductions is withheld so that generally there is underwithholding. (As contrasted with U.S. withholding which results in substantial overwithholding and annual refunds.) There is a serious lag effect in that in the current year only half of the current tax falls due (in August), this being based on last year's tax and then often paid in monthly installments. The balance falls due on April 20 of the fololwing year. Then additional monthly payments (from 3 to 20) are allowed with less than market interest rates of between 1 and 2 percent monthly being charged. (These rates have now been increased to roughly 4 percent.)

The income tax is global in that overall taxable income is in effect subject to a progressive rate schedule. However, income is divided into four different categories for various special provisions: (1) income from real property, (2) income from investments, (3) income from business activity, (4) income from personal services, wages and salaries. A distinctive feature is that the income tax applies only on a territorial basis, reaching only income from Argentine sources and not foreign income of Argentine citizens.

A chief issue of tax policy centers on the taxation of stockholders. Prior to November 16, 1962, shareholders could elect to either (1) register their securities at the Tax Office, not be subject to an 8-percent dividend tax withheld at the source, but include dividends within their personal income and take a tax credit of up to 33 percent of the dividends received; or (2) be subject to the 8-percent dividend tax at the source and not include dividends within personal income (and not receive a tax credit). Subsequent to November 16, 1962, the first alternative method was eliminated. As from January 1, 1963, capital gains on securities were exempt from the capital gains tax (previously only nonhabitual traders were exempt). As most Argentine corporations issue stock dividends (also subject to the 8-percent dividend tax) rather than cash dividends, the most important form of stockholder income has been from selling stock dividends and realizing capital gains. This effective exclusion of stockholder income from the progressivity of the income tax (the dividend tax rate being limited to that of the lowest income tax rate bracket) seriously dilutes the equity of the otherwise global income tax.

Income tax rates (1964 schedule) on personal taxable income increase progressively from 8 to 53 percent (not including the 20 percent "emergency tax" on net annual tax liabilities). (See following chart for rates to apply in 1965.) Rates have risen since 1955 when they ranged from 7 to 39.6 percent. Inflation has had the effect of reducing the real width of the tax brackets, thus pushing many middle-class professionals into steeply rising marginal tax rate brackets. Corporate income is subject to a flat 33 percent rate plus the 8 percent dividend tax, totaling 38.36 percent (because the dividend tax is computed on the income less the 33 percent corporate tax). In 1962 a temporary "emergency tax" was imposed (and renewed ever since) which subjected net taxes above M$N50,000 to a 20 percent surcharge. This has increased the effective revenue yield of the income tax by about one-seventh, about M$N5.5 billion expected for 1965. Corporations also pay a 1 percent "substitute inhertance tax" on net worth that is intended to compensate for nonregistered bearer shares escaping death taxes. (Individuals may also pay a similar tax to exempt them from all death taxes.) About M$N3.4 billion is expected from this "substitute inheritance tax" on both corporations and individuals in 1965.

ARGENTINA: AVERAGE TAX RATES ON VARIOUS INCOME TYPES



Excess Profits Tax

An excess profits tax with rates from 10 to 30 percent on net income (after exemptions) in excess of 12 perecnt of corporate capital was suspended after 1961 for the duration of the "emergency tax" mentioned above. The "emergency tax", initially a "once only" measure, was retained through 1964 and then continued for succeeding years as well (with the rate falling from 20 to 15 percent, with the excess profits tax being repealed. Even by 1959 the excess profits tax had declined in importance due to a revaluation of assets which had the effect of both increasing depreciation allowances and reducing the profit rate on the increased book value of the assets.

Depreciation Allowances

Argentina authorized in article 81 very liberal depreciation allowances for investments made after January 1, 1960. These ranged between 10 to 50 percent for buildings, 50 percent for breeding stock, farm improvements (including houses for resident owners), mines, shipyards, and 100 percent for machinery and transport equipment. Additional concessions were made for investment in steel, petrochemical industries, and for enterprises locating in Patagonia. These allowances and concessions have been one of the major factors in the downward trend, in real terms, in income tax revenues and the number of taxpayers, especially in the agricultural sector. Between 1959 and 1962, the number of taxpaying companies fell by one-third in industry and by 60 percent in agriculture. Investment increased substantially in the early 1960's but it is difficult to estimate how important this tax factor was in the decisionmaking process. A government study indicates that it was of minor importance. Most of these concessions were reduced or eliminated in the 1965 legislation. The relevant issue for current tax policy should appear to center on the value of the marginal investments induced by these tax incentives in comparison to the loss in tax revenue from all investment allowances and the consequences of this loss in revenue. (Income tax revenue fell—for this and other reasons—by one-half in real terms between 1961 and 1964).

Internal Indirect Taxation

In 1965 taxes on internal consumption, production, and transactions are expected to yield (after tax-sharing) about M$N116 billion,[9] 28 percent of total national revenues, or close to 4 percent of GNP. In 1964 these taxes yielded M$N70 billion which was 27 percent of total national revenues, or close to 3 percent of GNP. During the past decade these taxes tended to decline somewhat less than the decline experienced by taxes on income and wealth. Since 1961, they fell by about 20 percent in real terms compared to the 50-percent real decline in income tax revenues. Internal indirect taxes can be divided into three basic categories: The Manufacturers' Sales Tax, Various Specific Excises, and Earmarked Taxes.

Manufacturers' sales tax: (impuesto a las ventas).—This tax is designed to be a single-stage tax at the manufacturers' (and importer/exporter) level. To avoid "pyramiding" of the tax on purchases within the manufacturing sector, such purchases are deductible in computing net taxable sales. However some manufacturers complain of a

[9] Excluding a possible additional M$N13 billion increase in taxes on petroleum products.

liquidity strain because of the lag between bearing the tax burden on purchases of components which only sometime later become deductible from future sales. In essence, the tax takes on the character of a value-added tax, though computed differently from the French TVA. Up to 1965 rates had ranged between 1.25 percent and 13 percent with the general rate at 10 percent. At present tax payment on the current year's sales are made on the basis of nine monthly payments equaling 75 percent of the *previous* year's tax liability with the balance due the following February 28. In 1965 this tax (after 46 percent tax-sharing) is expected to yield M$N25 billion for the National Government.

Various specific excises and other indirect taxes.—There are more than 70 specific excise taxes ranging from "common necessities" (matches and sugar) to "sumptuary items" (tobacco and alcohol) to "luxuries." However, this area of taxation has two distinctive features: two-thirds of all excise tax (*internos unificados*) revenue (M$N17 billion in 1965 excluding petroleum products taxes, stamp taxes, and certain earmarked taxes) comes from taxing tobacco; second, the "specific" rather than "*ad valorem*" nature of many of the tax rates (such as on liquor and petroleum products) has resulted in a lower price elasticity than has been common for indirect taxation elsewhere. Other countries have often been successful in using *ad valorem* excises, coupled with current monthly tax payment, as a mechanism to minimize the effect of inflation on the real value of tax revenues.

Earmarked taxes.—Nearly M$N20 billion was collected in 1964, chiefly by the State Petroleum Corp. (YPF), in taxes on gasoline, oil, lubricants, etc., which was either retained by YPF or earmarked to highway funds. Total earmarked revenues (from the indirect tax area) in 1964 reached M$N28.5 billion equal to about one-fourth of the total revenues (after tax-sharing) that, unlike the earmarked revenues, entered the Central Treasury. An important issue in tax policy facing Argentina is both the proliferation of excises, many without significant revenue yields (especially after costs of collection are considered), as well as their exclusion from collection and control by the Central Treasury.

Social Security Contributions

Social security collections are the single largest component of national government and public sector revenues, yielding M$N80.5 billion (excluding M$N9.5 billion in government contributions) in 1964. Most of these revenues are paid into 12 major "Cajas" representing different government, industrial, and commercial groupings. Contribution rates vary slightly among these groups but the most common are a 15 percent rate on wages paid by employers and an 11 percent rate paid by employees. These are to be paid in by the 15th of the month following the wage period. In fact, such collections have been in continual arears, equaling close to M$N45 billion outstanding in 1964. Because of a general moratorium on payments because of the 1962–63 recession, payments have been rescheduled to be paid in 12 to 72 monthly payments (until 1970). This serious lag in payments has been one of the chief sources of finance for companies, some of which have not only failed to pay their share of the contributions but have also retained the 11 percent of wages withheld from their employees. A number of companies have recorded these liabilities as long-term obligations—the total amount sometimes exceeding the net worth of the company itself.

These contributions provide for pensions to be received either after a certain length of service by the employee (27 to 30 years) or at a certain age (as low as 47 years for women in the merchant marine or public utilities, more commonly at 55 years for men in industrial and commercial employment, and as high as 60 years for rural workers, domestic servants, professionals, and the self-employed).

The trend in collections as (a percent of GNP) has been falling from 5.5 percent achieved in 1954 to 3.2 percent in 1964 while the trend in payments has been rising in the same period from about 2 percent to about 4 percent, thus eliminating the social security system as a net contributor to public sector savings. Revenues have fallen off due to the structural weaknesses in the public finance system discussed earlier while the level of transfer payments has increased both due to demographic factors producing an older population and political pressures to increase the coverage and size of pensions.

Foreign Trade Taxes

Taxes on foreign trade are the most important revenue source for the Central Treasury and, following social security collections, the second most important for the National Government (if internal indirect taxes are considered individually). In 1964 foreign trade taxes produced more than M$N37 billion in revenue, close to 1.5 percent of GNP. However, this was less than half that achieved in the import boom of 1959–61 following the devaluation in late 1958. It was also less than half the revenue share generated in the earlier devaluation in 1956. The level of the foreign trade tax share has tended to vary inversely with the divergence between official and equilibrium exchange rates thus producing a strong tax revenue byproduct to foreign trade and exchange rate policy.

Most revenue has come from import surcharges (M$N22 billion in 1964) and export retentions (M$N9 billion) with minor amounts from customs duties as such, and port charges. In 1960 revenues from export retentions equaled import surcharge revenues. Foreign trade taxes emerged into their own after the elimination of the multiple-exchange rate system in 1955 and the sharp devaluation in late 1958. Import tax revenues have averaged close to 20 percent of total import values while export retentions have fallen to about 4 percent of export values. Import tax revenues are expected to increase with the elimination of capital import exemptions (which were repealed in 1962 but still applied to imports contracted for prior to that date; in 1963–64 about 65 percent of capital imports entered free of surcharges). In the highly complex tariff and surcharge schedules, rates generally range from zero to 300 percent with capital goods beginning at 40 percent and competitive raw materials beginning at 20 percent. A Tariff Commission has under study a program to rationalize and integrate the present complex system.

Provincial Governments

The 22 provincial governments combined have budgets equal to about one-third that of the National Government (including the social security system). (It rises to one-half if the social security system is excluded.) However, their own revenue resources only produce about

7 percent the revenue collected by the National Government (including social security), having fallen from 12.5 percent in 1955 and 11 percent in 1959. This is the root of the fiscal dilemma for provincial governments. The serious decline of the provinces' own revenue sources has meant both an increase in the sharing of National Government revenue and in additional direct transfers from the National Government. The provinces' share of total tax revenues (including these shared taxes) collected by the Central Government rose by nearly 50 percent between 1957 and 1964, rising from 17 to 25 percent of such tax revenues. For certain revenues (income and sales taxes) the provinces' share has risen to 46 percent.

The provinces' own revenue sources are based on a gross receipts tax (producing about one-third of revenues collected by the provinces), stamp taxes (about one-fourth of such revenues), and property taxes (about one-fifth). The gross receipts tax has a rate generally about 0.9 percent with differences among provinces and types of receipts (as tax exemptions have been used by the provinces as investment incentives). Property taxes have progressive rates from about 1 to 7 percent of the assessed valuation. However, lags in reassessments have seriously eroded the tax base resulting in a drop in real revenue by more than 50 percent in the past 5 years. In most cases assessments have not been increased since 1961 when simple coefficients were used to update past assessed valuations. A provincial revenue structure that has lags in updating tax bases, has generally poor administration, and low tax rates (to compete for industry) is bound to have a price inelastic tax system: between 1961 and 1964 prices more than doubled but provincial tax collections increased by only about 50 percent.

Buenos Aires Province accounts for about two-fifths of all provincial revenues. While data for all provinces are not available for recent years, the fiscal 1964 budget for Buenos Aires Province may provide a rough indication of the current revenue sources at the provincial level.

General revenues of Buenos Aires Province

[In billions of pesos]

Revenues collected by the Province	20.6
Stamp taxes and charges on services	4.0
Property taxes	5.3
Gross receipts taxes	7.0
Death and gift taxes	.9
Taxes on automobiles	1.7
Taxes on electrical consumption	.4
Casino and lottery profits	.5
Miscellaneous taxes and charges	.8
Share of revenues collected by National Government	20.0
Income tax share	3.9
Sales tax share	4.4
Share of other income and wealth taxes	2.0
Share of excise taxes	4.6
Share of taxes on gasoline and oil	3.1
Revised share of back taxes	2.0
Total general revenues	40.6

Municipalities

Municipal budgets combined have been averaging about one-half that of the combined Provincial budgets. Many similarities exist between the municipal and Provincial public finance structure and problems: the City of Buenos Aires accounts for about two-fifths of total municipal data, about the same relationship as Buenos Aires Province to all Provinces; revenue sources are roughly similar with the same structural deficiency of declining real revenues due to their price inelasticity; finally, municipalities receive shares of Provincial taxes comparable to Provincial sharing of nationally collected revenues (with the exception that the City of Buenos Aires as the Federal District receives a tax share directly from the National Government).

Flexibility of the Revenue System

Long-term.—The overall revenue system is inelastic in respect to both changes in income and price. In theory one might expect the opposite given the rate of inflation and generally progressive tax rate schedules. However, in fact—considering changes in the tax laws (especially increased deductions for investment and increased exemptions for families), tax rates, and the increase in evasion and avoidance—the system is inelastic. The arc elasticities for changes in National Government revenues (after tax sharing which, for the National Government, was an eroding factor) relative to money GNP for the period 1956–64 are very low. (This is a measure of the percentage change in revenues in this 8-year period as a fraction of the percentage change in money GNP.)

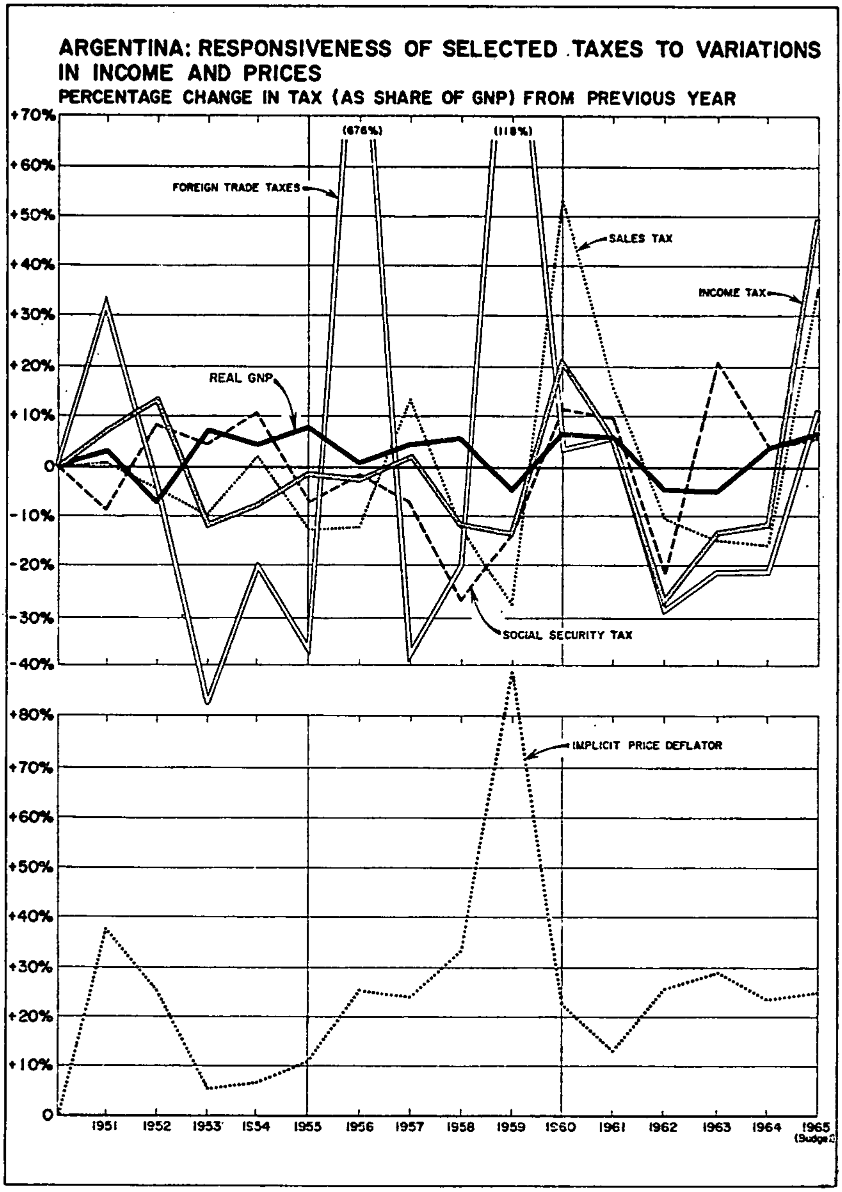
1956–64 arc elasticities

Total National Government revenues	0.50
Income tax	.23
Internal indirect taxes	.54
Foreign trade taxes	.44
Social security taxes	.62

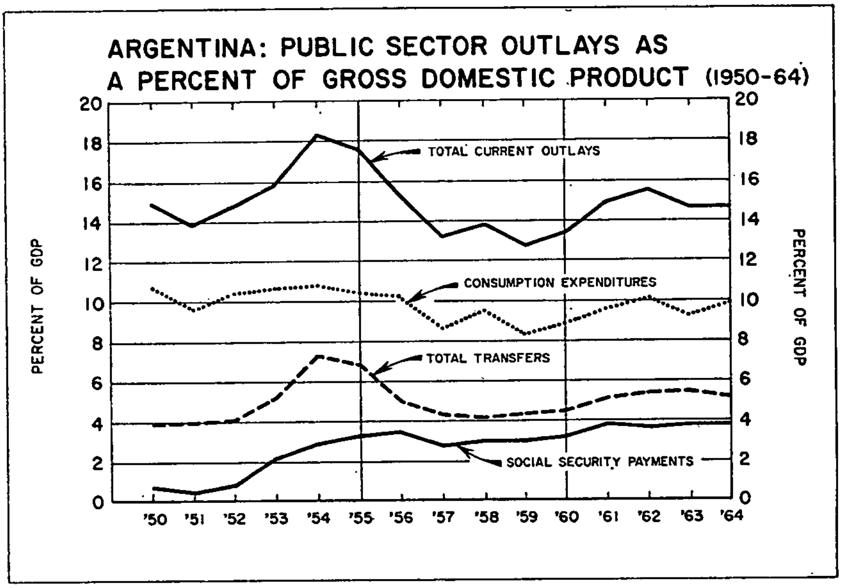
In this period (1956–64) prices (GNP deflator) rose tenfold while real GNP increased only 17 percent (less than 2 percent a year resulting in no significant increase in real per capita income). Thus, for this 8-year period the chief cause of the erosion of real revenues seems related more to the great change in prices rather than to the much smaller change in real income.

Examination of point elasticities (or the slope of a regression line on a log-log scale) for total public sector current revenues indicates an inelastic system for the period 1950–64 wherein money revenues increased only about 90 percent as rapidly as did money GNP. Interestingly enough, in the 1950–57 period revenues were slightly elastic while, after 1957, they became inelastic. Combining both changes in income and price for 1950–64 for the public sector is especially revealing in indicating the very inelastic response revenues have had to price changes.[10]

[10] Log (revenues) $=0.847$ Log (money GNP) $+0.060$ Log (price deflator) -0.329.



Short term.—Over the course of cyclical changes in income the revenue system has tended to function with a 1-year lag. This would be expected due to the lag in tax collections which generally are payable in the year following the income or sales on which the taxes are based. However, since 1958, a further factor, lack of liquidity, appears to have shifted some tax payments to coinciding with income changes—but at a lower plateau. For example, in a prosperous year income and sales taxes are accrued but are not yet payable while in the following recession year, these taxes now become payable but few taxpayers have the funds to pay them. The frequent ups and downs in the business cycle since 1958, combined with the severe drop in liquidity since then, thus appears to have shifted the revenue function of the public sector partly from a lagging one that collected 20 to 23 percent of GNP to one more closely related to the business cycle but at a lower level of 15 to 20 percent. See the following chart for the responsiveness of selected National Government taxes to variations in real income and prices.



Appendix I*

The Argentine Constitution contains no provisions pertaining to the sharing of tax revenues between the Federal Government and the Provinces. In matters of taxation, it only gives to the Federal Government the exclusive power to levy customs (export and import) duties and the power to levy any other taxes, equitably and proportionally imposed upon the population.

The sharing of taxes is based primarily on the 1935 tax reform the main purpose of which was to bring some uniformity into the tax system and provide for a more equitable distribution of the tax burden as well as tax revenues. It must be stressed, however, that the participation of a Province in the sharing program is not automatic but is contingent on a Province's acceding, by means of a law-treaty (ley-convenio), to the program.

There are four categories of tax revenues which are being shared by the Federal and Provincial Governments in Argentina. The first category contains revenues from taxes on income, capital gains, excess profits, and sales; the second consists of excise taxes; the third of taxes on gratuitous transfers (gift or inheritance) of capital stock; and the

*Source: Legislative Reference Service, Library of Congress; reprinted in the *Congressional Record,* S–80, Jan. 11, 1967.

fourth of contributions to the National Highway Fund (automotive fuels tax).

The mechanics of sharing vary from one category to another, and in most cases have themselves undergone some changes during the existence of the sharing program, especially during the early years of transition between the old system and the new. In the first category, the tax collections are divided, first, into the Federal and total Provincial shares. The two respective shares have varied from year to year and in 1964 (last available) stood at 60 and 40 percent respectively. In addition, a constant 6-percent share, taken out of the Federal share, is allocated annually to the Federal Capital District (the City of Buenos Aires). Thus, in effect, the 1964 distribution resulted in the Federal Government's keeping 54 percent, all the participating Provinces 40 percent, and the Federal District 6 percent. The Provinces' share was further allocated according to a formula which takes into consideration a number of variables. Thus, the first 25 percent of the total Provinces' share is allocated among them according to their population; the second 25 percent according to their own revenues excluding borrowing, tax-sharing, and Federal subsidies; the third 25 percent according to each Province's expenditures; and the last 25 percent in equal parts.

A different formula is used for the distribution of the second category of tax revenues (excise taxes). Here the shares allocated respectively to the Federal Government and to the participating Provinces as a body are determined in the same ratio as that of the total national population to that of the participating provinces (excluding the Federal Capital District which does not participate in this program). In practice the ratio is approximately 55 to 45 percent. The 45 percent share going to the Provinces is further allocated among them according to the following formula: 98 percent of the Provinces' share is distributed on the basis of two indexes: population and production of commodities on which excise taxes are levied and of primary materials used in the manufacture of the former. Currently 80 percent of the amount allocable according to these two indexes is distributed according to population and 20 percent according to production.

The remaining 2 percent of the Provinces' share is distributed in proportions inverse to the amounts per capita resulting from the allocation of the first 98 percent.

The taxes of the third category are distributed among the Federal and Provincial Governments according to their tax base. This means, in effect, the Federal Treasury keeps those collected in the Federal Capital District and in the national territory of Tierra del Fuego. In practice, some 50 to 55 percent of the revenue from this tax accrues to the Federal Government.

The Highway Fund revenues (fourth category) are shared 65 percent by the Federal Government (including Federal Capital) for the construction of trunk highways, and 35 percent by the Provinces. The latter's share is allocated as follows: 30 percent in equal parts, 20 percent in proportion to the populations, 20 percent in proportion with the Provinces' highway investments from their own sources, and 30 percent in proportion to the consumption of automotive fuels in each of them.

CENTRALIZATION AND DECENTRALIZATION IN PUBLIC FINANCE WITH SPECIAL REFERENCE TO CENTRAL AND LOCAL GOVERNMENT IN ENGLAND AND WALES*

BY ALAN WILLIAMS**

I. THE MEANING OF DECENTRALIZATION

1. It is important to be quite clear from the outset that there are two distinct elements in what is sometimes loosely termed "decentralization," the *political* and the *administrative*. It will be helpful in clarifying this issue if we adopt the terminology of Poul Meyer (8:57) * * * who draws a careful distinction between *centralization—decentralization* on the one hand, and *concentration—deconcentration* on the other:

> Centralization is a purely structural concept, denoting that the primary juridical competence is at a very high level . . . This does not mean that decisions in a centralized administrative structure are always made at the top level, but it means that the highest level is always in a position to direct the subordinate agencies which actually make the decisions, and to reverse these decisions . . .
>
> The alternative concentration—deconcentration indicates the extent to which delegation of administrative competence has taken place down through the horizontal levels of the administrative pyramid . . . Decentralization, however, . . . renders the local and regional bodies independent of the central power, or, at any rate, it increases their powers to make their own decisions. As a result of decentralization, administrative power is transferred to local authorities; . . . i.e. the primary competence rests now with the local authorities which are not subject to the directions or appellate powers of the central administration.

2. One other concept that will be found useful in the subsequent discussion is that of "administrative tutelage". On this Meyer writes (8: 285):

> The term administrative tutelage is a translation of the French *tutelle administrative*. The concept is created by continental administrative law to designate the supervisory authority exercised by the central administration over the fundamentally independent local governments . . . but the classical concept . . . covers only some general supervisory powers which do not essentially encroach upon the independence.

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* Reprinted from *International Institute of Public Finance*, Congress of Istanbul, 1964, Netherlands.

** University of Exeter, Exeter, England.

NOTE.—Where major references are cited in the text, the first number in the bracket indicates the list number of Part X—References, while the second number, which follows the colon, is the page reference in the cited work.

Examples of such "classical" tutelage are "control of legality of decisions" and periodical audit of local authorities' accounts by an official appointed by the Central Government. Meyer proposes, however, "to widen the concept of tutelage in that we include the whole field of action lying between the traditional tutelage and the actual hierarchical power." (8:285).

3. It is precisely on this intermediate zone that our attention must be focused since it is here that the issue "local autonomy vs. central control" is currently being worked out in England and Wales. In a recent comprehensive study (12:77) "the central political problem of local government" was posed thus:

> "How much local autonomy can there be when the local government authority depends on the central government for most of its revenues?" The answer to this question is concerned mainly with the precise connotation of "autonomy" in this context . . . There will always have to be accountability to the national authority ultimately responsible for the affairs of the state as well as accountability at law. For it is the responsibility of the central authority no less than of the local, to see that the services the nation has decided to provide for its members are in fact provided, and that the standards regarded as proper are in fact observed, but accountability itself has become an ambiguous term . . .
>
> If an authority acts with the knowledge that it may be brought to account for anything it has done which is not in accordance with law, economy, or need, as laid down by the State, then there is a general implication that the authority can act in awareness of all the laws, limitations, and needs to which its activities relate. If an authority is required to obtain approval from another authority of the central government before it acts, the general implication is that it is not capable of acting in awareness of all the laws, limitations and needs to which its actions relate, and, further, that the central government authority is.
>
> We believe that the "controlling" function of the central government in relation to local government can properly, and best, be discharged by making known, in explicit form, the laws, limitations and needs which relate to local government actions, or by making arrangements for them to be known.

4. Here "accountability" means broadly what Meyer calls "classical tutelage," and "control" his broader interpretations of tutelage, except that at one point (8:289) Meyer observes:

> It is a common feature of the traditional administrative tutelage, that local governments have to obtain the approval of the central administration before special actions can be taken. It is especially true of some financial operations, for example, the tutelage authority must frequently sanction a proposed loan.

Thus, what might be called "prior accountability" has always formed a part of the tutelage concept. Another awkward intermediate case arises when

> The law . . . entrusts the local government with "permissive powers," i.e. the local authority may do certain things if it thinks fit . . . while . . . the state agencies are unable to force the activities upon the local governments . . . In these cases the powers of

the local government are confined to the "permission" . . .: if the function is actually performed it must be performed in accordance with the rules laid down by the state. (8:290)

5. D. N. Chester has described vividly (2:102) how formal powers of tutelage can be used to generate informal pressures which enable the Central Government to exercise control over a much wider sphere than the strict legal notions of "tutelage" or "accountability" would indicate:

> The need to secure approval of loans offers a good opportunity for the Minister . . . to ask the Local Authority to do something for the Ministry in return . . . The Ministry has made use of this power on occasions to keep a check on the general financial position of the Local Authority . . . Loan sanction has sometimes been withheld for the provision of independent sewage schemes with a view to persuading a Local Authority to make use of the facilities of a neighboring large Local Authority or to arrange some other form of joint scheme. Finally, there is the general use of this power to secure that the buildings or other public works which the loan represents are in keeping with the ideas of the Department concerned . . . But the application also gives the Ministry the opportunity to exert a more positive power in that it can refuse to sanction the townhall loan on the grounds that the Local Authority could better spend this money on (say) a new sewage scheme . . .

6. There is thus a subtle interplay of forces here. Parliament, through legislation, established some ground rules concerning the division of responsibility between Central and Local Government, and these statutory provisions are backed by the whole apparatus of the courts of law. In addition, the Central Government is allotted some supervisory functions over certain activities for which local authorities are nominally responsible, and this supervision may in some circumstances comprise extremely detailed and specific inspection. This too is backed by legal sanctions. But it is the third strand that is of primary interest here; namely, the dependence of local authorities upon the Central Government in the financial field, which renders them susceptible to a whole range of formal and informal pressures, which not only reinforce the legal and administrative controls, but also extend their scope.

7. In what follows, attention will be directed chiefly to the economic and financial pressures, rather than the legal and administrative sanctions. Nevertheless, a brief account of the latter will be given first, to provide the setting within which the former operate.[1]

II. Legal and Administrative Relationships Between Central and Local Government

8. "The ties connecting local government with the central administration are (1) the power of Parliament to pass those Acts which it deems desirable to be administered by local authorities; (2) the in-

[1] For further details see pp. 9–18 and App. I of Reference (1). I shall not deal with the relationships between the various "tiers" of Local Government within the administrative countries, nor qualify my remarks to take account of the differences between the various types of local authority.

terpretation which is put upon those Acts by the courts as to the intentions of the legislature; and (3) the supervision exercised by those departments which are charged with the duty of securing the efficient functioning of services for which their ministers have been made responsible by Parliament." (1:25)

9. As regards (1) and (2)

> . . . the sanctions especially applicable to local government are two: on the one hand, an authority may be *restrained*, by proceedings undertaken to establish that the fact is *ultra vires*, from any act which is not specifically allowed it by Act of Parliament; on the other hand, a Ministry may apply for a writ of mandamus in order to *oblige* an authority to carry out functions allocated to it by Parliament. (12:214)

Local authorities are not as constrained statutorily as might appear from this brief account of the doctrine of ultra vires, for besides the general Acts of Parliament which apply to all local authorities, and which are usually initiated by the Central Government, it is open to any local authority to sponsor a private Act of Parliament, concerned specifically with its own activities, for which it does not require the consent of the Government department concerned (although consultation with such departments is usual).[2]

10. On the other hand

> The Principal Acts governing the provision of local services often contain clauses allowing the Minister responsible to Parliament for the service to make regulations concerning matters related to the service which require control of a statutory kind but which are either too detailed to burden the main Act with or cannot be determined with the necessary precision before the service provided under the Act is working . . . What happens is that, Parliament having defined limits within which the Minister *may* make regulations, a statutory regulation gives him specific power to control within those limits. If, as is so often the case, some time elapses between the coming into force of the Act and the issue of the regulation, a statutory regulation effects a transfer of discretionary power from the local authority to the central government department. (12:215)

11. Turning finally to (3) in paragraph 8 above:

> In general, the central government department exercises advisory power in three ways: by issuing to all authorities circulars drawing attention to desirable or recommended procedures, by replies and suggestions on specific questions submitted by individual authorities looking for guidance from the Ministry as a central clearinghouse for information about the running of the service, and through informal advice and recommendations made to individual authorities by inspectors and other officials when they consider that a service, in some one or more of its aspects,

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[2] On this device, Peacock and Wiseman (9:99) comment: "This has not been a negligible power; the history of government activity in Britain is to an important degree a history of the evolution of services by individual local governments the successful experiments later being taken up and generalized by legal action of the central government. The development of the present education and public health services, for example, owes a great deal to the initiative of pioneering local councils that stimulated the central government to encourage emulation elsewhere."

is deficient or substandard or is being faultily administered in some other way. (12:215)

In addition, certain local authority "schemes and proposals" (e.g., development plans under the Town and Country Planning Acts, and some of the health services . . .) must be examined by the relevant government department, which has the power to approve or reject them before they become effective; bylaws . . . require ministerial confirmation; and the dismissal of certain local authority chief officers, e.g., most full-time medical officers of health and sanitary inspectors, is dependent upon the consent of the minister concerned. (1:26)

12. At this stage you may be wondering what freedom of maneuver is left to local authorities. A recent and authoritative view of the current situation, as seen by one of the most eminent local authority finance officers, runs as follows:

> Though they are greatly influenced by the central government, English local authorities do not act as its agents, except for a few easily defined tasks, notably the construction and maintenance of trunk roads and the collection of vehicle excise duties. Their officials receive no directions from the central government, and, unlike some of their continental counterparts, they escape the hazardous task of serving two masters. English local authorities possess the characteristics of true self-governing bodies. They are democratically constituted, accessible to the people, sensitive to local opinion, and they employ their own officials. They have a very considerable range of duties and responsibilities and dispose of about 6 percent of the national income. Local authorities have their own local tax—the local rate. They enjoy autonomy in budgeting . . . Finally, . . . there is little statutory regulation of their internal management.
>
> There are, however, disturbing trends in English local government, of which the most serious is the inroad into local autonomy brought about by supervision from Whitehall and greater dependence upon the central government for funds. Limited to one local tax, that on the occupancy of real property, and compelled to accept the whittling away of the basis of this tax by legislation . . . English local authorities in the aggregate now depend upon the central treasury for about half of their funds . . . That this is not a healthy state of affairs is generally recognized, but its significance . . . is its tendency to weaken the sense of responsibility of the members and to encourage them to look to the government departments for leadership. This tendency has been reinforced by the prevailing desire for uniformity of public services . . . In the Scandinavian countries the central governments allow, and the public accepts, some latitude in the payment of benefits and in the nature of the social services rendered by the local authorities. In England anomalies and local differences are less readily tolerated so that, notwithstanding their desire for autonomy, local authorities pay great regard to the actions of other local authorities, an attitude which of itself militates against experiment and variety. (7:14)

This brings us firmly into the financial sphere, with which the rest of this paper will be mainly concerned.

III. The Fundamental Problem of Local Government Finance

13. I have elsewhere (13 : 143) characterized the fundamental problem of Local Government finance as:

> how resources shall be placed at the disposal of local authorities in such a way that they are able to fulfil adequately the functions which both the local and national electorate demand of them without sacrificing to an intolerable degree the concomitant demands for equity and efficiency.

Resources need to be placed at their disposal because, in general, acceptable sources of local revenue are not sufficient to meet the expenditures required to sustain the services allotted to local authorities. This is in spite of the fact that many of the more important services have in recent decades been transferred from Local to Central Government.

14. The general considerations underlying this process have recently been analyzed by Peacock and Wiseman (9 :29) :

> . . . economic development . . . may generate two kinds of pressure for the movement of responsibility for public expenditures toward higher (larger) organs of government. First, the very fact of improved transport and communications, by increasing the knowledge of particular groups about the mode of life and standards of public service enjoyed elsewhere in the community, is likely to generate pressures for improved and uniform standards of public services, and these pressures may only be capable of satisfaction by greater centralization of control over the size and character of public spending. Second, the improvements in transport and communications may not only make such larger areas of control possible, but may also make them economically efficient . . .
>
> On the other hand . . . there are social pressures tending in the opposite direction. The lower levels of government . . . are themselves political units, with a history and a tradition. They cannot be expected to surrender their authority easily, and . . . the pressure to preserve local autonomy is important politically at both central and local government levels. At the same time, the historical development of local governments usually leaves them with wide responsibilities of varying character. Changes in those different activities cannot be expected to be uniform, so that any concentration process that does occur must affect different local functions in very different fashions . . . by the higher levels of government taking the greater share of responsibility for the expanding types of government expenditure, by the shift of responsibility for particular services from lower to higher authorities, by lower authorities losing effective autonomy because they become more dependent upon the higher authority as a source of revenue, and by the creation of new authorities under the broad control of central government to deal with such problems as urban conurbations or the provision of particular services such as water supply.[3]

[3] The "concentration process" referred to here does not mean concentration as defined by Meyer (see par. 1.) but rather what he calls "centralization", since Peacock and Wiseman's "concentration process" "is concerned not so much with changes in the total volume of public expenditures as with changes in the responsibility for such expenditures" (9 : xxiv). See also (9 : 96).

15. Some of the statistical material upon which this analysis was based is presented in the section IV below, but before considering this it will be advantageous to examine these general considerations a little further. The financial activies of local authorities may, to all intents and purposes, be determined for them because *either* the legal and administrative requirements with respect to the services they are to provide are so stringent and demanding that in meeting the minimum level of expenditure all independent sources of local revenue are effectively exhausted; or even if there is untapped local financial capacity, the local authority may find itself legally or administratively incapable of undertaking the further functions it has in mind.

16. In what follows I shall be more concerned with the first kind of limitation than with the second. It will lead us to consider, in turn. (*a*) central control over the current expenditures of local authorities (sec. V); (*b*) central control over local sources of tax revenue (sec. VI); (*c*) the structure of Central Government grants to local authorities (sec. VII); and (*d*) the control exercised by the Central Government over both the capital expenditure of local authorities and their methods of financing it (sec. VIII). I shall attempt to show that the close regulation of local taxation (arising from a variety of reasons and not specifically intended to reduce local fiscal autonomy) has forced greater dependence on grants (i.e. upon central taxation), which in turn has rendered local authorities more susceptible to pressure from the Central Government. However, it is important to note that much of the control which the Central Government exerts over local authorities is really independent of the grant structure, depending not so much on the *nature* of the grant, but rather upon the fact that grants have become an indispensable source of revenue.

17. However, I would like to state quite categorically that I do not regard crude indices, such the ratio of grant receipts to total expenditure, or of local authority expenditure to total expenditure of the public sector, as an adequate representation of the degree of centralization or decentralization in the public finances of an particular country. The relationship between local autonomy and central control is far too complex and subtle for this to be more than a first approximation, and sometimes a very misleading one. Thus, although I shall present some such basic statistical material in the section which follows, I shall not myself draw hasty conclusions from it, and beg the reader to exercise similar restraint.

IV. The Development of British Local Government Finances 1890–1955

18. To get a sense of perspective it will be useful to look briefly at the development of the finances of the British Local Government since 1890.[4] It should be noted that the date presented here refers to the United Kingdom as a whole, and not simply to England and Wales, but since the broad trends are the same, and England and Wales account for the major part of the totals, this is not a serious discrepancy.

19. The trend of total Local Government expenditure in the past

[4] For a fuller treatment see (9: chap. 6) and (3: chap. IV).

70 years is shown in appendix table A, where it is noticeable that although it has grown faster than the gross national product (see column (5)) it has fallen in relation to total Government expenditure (see column (4)), in other words, Central Government expenditure has grown still faster in relation to GNP. Some of the details of this decline in the ratio of Local to Central Government expenditure are brought out in appendix table B, which is really a functional breakdown of the overall figure given in column (4) of table A. The most marked change here is the local authorities' declining share of social services expenditure (other than housing) and in economic services (i.e., services to industry, agriculture, commerce, etc.). Nevertheless, as appendix table C shows, social services and housing together still account for more than two-thirds of all Local Government expenditure. Within this category of "social services" the major component is education.

20. What has been happening during this period has been that the personal health services have been transferred from local to central control, and so has responsibility for the major social security provisions (transfer payments for the relief of poverty). In addition, though this is not shown in the figures, local authorities have lost most of their more important trading activities through the nationalization of public utilities. To some extent this transfer of functions to the centre has been obscured statistically by the rapid rise in expenditure on the services remaining, notably education and housing.

21. Turning to the long term trend in revenue sources, we see from appendix table D, that grants have increased markedly in importance relative to local revenue since about 1920, and that most of the increased grants have been allocated for specific purposes. The bulk of these allocated grants have been for the social services, as will be seen from appendix table E. By 1955 they had come to play a dominant role in the financing of these services.

22. Peacock and Wiseman offer as an explanation of this shift (which they call the "concentration process") the following observations (9:118):

> Wars are times when the resources of the community have to be mobilized for specific purposes and by inevitably authoritarian methods, with slight regard for such issues as the desire to decentralize authority or to preserve local autonomy. Consequently, it is the Central Government that finds itself with expanded revenue sources in the aftermath of war. However, the relative inadequacy of local resources which arises in this way need not in itself imply a decline in the relative importance of local expenditure. . . We have indeed seen that local authorities have become increasingly dependent upon grants-in-aid; the reduced relative importance of local expenditures has occurred despite this. . .

23. But the effects of wars are acknowledged to be only part of the explanation:

> First, the *nature of the economic environment* in which local governments operate has changed greatly since 1890. Local governments have been particularly affected by rising standards of living and by the ease, speed and convenience of transportation. and the associated growth in size of economic and social organiza-

tions and of conurbations. At the same time, the major and inescapable problems of urban life—the creation of basic amenities such as sewerage, general public health services, and so on—have been understood and largely solved during the period, leaving local governments with the relatively less onerous task of maintenance of established standards. Second, the simultaneous *change in social ideas* has also influenced expenditure and activity. Local governments have shared in the growing acceptance of government intervention, which has encouraged the development of government activity as a whole. But within that activity, there has been a general shift in emphasis from relief of outright distress . . . to provision of public services on the basis of desirability (as education) and a growing consciousness . . . of the state as one comunity to which common standards should apply. There can be no doubting . . . that the economic and social changes under consideration have carried with them a diminution of interest in safeguarding local powers, autonomy, and responsibility—often, when pressure for common standards of service is involved, generating positive opposition to such autonomy. (9:119).

24. It is this process of eroding local autonomy, due especially to the pursuit of common national standards, that will be analyzed in some detail in the remainder of this paper, which concentrates upon the period since 1948.

V. Current Expenditures

25. Leaving capital expenditure on one side for the time being, the breakdown of current expenditure by economic categories is shown in appendix table F. From this it is clear that most (i.e. more than two-thirds) of local authorities' current expenditure goes on the purchase of goods and services, the next largest item being interest payments, which are better considered in connection with the capital transactions described in section VIII below. The current expenditure on goods and services is shown in more detail in appendix table G, from which the dominant role of education expenditure emerges quite clearly. Hence the importance of education grants, to be discussed in section VII below.

26. Our immediate concern, however, is with direct controls exercised by the Central Government over the current expenditure of local authorities. By "direct controls" I mean financial regulations not associated formally with any grant. Although there is no general requirement that local authorities budgets must be approved by the Central Government, there are particular items in the current budget for which Central Government sanction is required.

27. Taking the education service as an example, the Education act of 1944 provides, inter alia, that Ministeral approval is required before a local authority may (i) make grants to help in discharge of liabilities of aided secondary schools; (ii) conduct or assist research; or (iii) assist a University to improve further education facilities. On the positive side, the Minister may direct a local authority to provide transport facilities for pupils, and, in general, may give directions enforcing duties under the act when he is satisfied that local author-

ities have failed to discharge their duties. He will have little difficulty in discovering when they have so failed, because among the Minister's duties is that of causing inspections to be made of every educational establishment.

28. These direct legislative powers are buttressed by the power given to the Minister to make regulations on various matters, e.g. prescribing standards to which school premises are to conform, requiring local authorities to provide milk, meals and other refreshments for pupils, etc. The bulk of the Statutory Instruments issued by the Ministry have been concerned with grants and other financial matters (like scholarships) and with teachers' salaries. The latter constitute the largest item of current expenditure on education, and all authorities are required to conform to a national salary scale laid down by the Minister. Of all the powers that have immediate and sizable repercussions upon the levels of Local Government current expenditure, the power to determine teachers' salaries is undoubtedly the most important.

29. Finally, the Minister issued circulars and memoranda, but these are mainly concerned with local educational policy, and not with financial matters. Nevertheless some of them have obvious financial implications, e.g. those concerned with the qualifications, remuneration and superannuation of teachers, and scholarships and aid to pupils.

30. Obviously, the minimum standards laid down by the Minister by these various methods of "administrative tutelage" may well set very severe limits to the freedom of maneuver open to local authorities in their budgeting, since the mere satisfaction of these minimums may strain the resources of many authorities (even after taking grant receipts into account). The extent to which effective autonomy is curtailed depends of course upon the ambitions of the authority as well as upon the portion of its resources absorbed in this way. In the case of those authorities which would, in any case, have provided what they are required to provide, there is no effective impairment of local autonomy even if all but a small fraction of their resources are allotted to providing the required minimum. It is the poor and/or niggardly authority, or the authority with markedly different ideas about the proper pattern of local expanditures, that is likely to find its autonomy substantially abrogated.

VI. Local Taxation

31. It is from this sort of consideration that independent local sources of revenue acquire part of their importance in relation to local autonomy. In the introduction to a comparative survey of Local Government financial problems conducted by the International Union of Local Authorities for their 1955 Rome Congress, one reads:

> There is a conviction that the absence of financial independence is one of the main causes of lack of independence in the field of local government in general. Efforts are made to find means of remedying the present state of affairs, even though it is not always clear where such remedies must be sought. Is the possession of one's own field of local taxation—in addition to grants from higher authorities—the decisive factor . . .? Or is it the existence of a Local Government Fund whose sources of supply, principles

of apportionment and administration have been settled in a satisfactory manner? Must the core of the difficulties encountered be sought in the supervision and control exercised by higher authorities over local government budgets and over all matters pertaining to finance? (5:7)

32. In Britain there is no Local Government Fund, nor have there been any recent proposals to establish one. Local revenues (apart from grants) are derived partly from trading revenues and rents, but mostly from local rates (see table F), which are virtually the only local tax.

33. The local rate is a tax upon the occupation of land and buildings. Properties assessed for rates (which are called "hereditaments") are valued according to their net annual rental, and the amount of local rates payable by the occupier during each year is determined by multiplying this "ratable value" by the "rate poundage" fixed for that year by the local authority in question. The rate poundage is expressed in shillings and pence, e.g. 21s. 6d, which means that for every 20s (equal £1) of ratable value, 21s. 6d. has to be paid in local rates by the occupier in that year. Each local authority fixes its own rate poundage in the light of its estimated needs for the coming year.

34. The fixing of the rate poundage is, however, virtually the only degree of freedom that local authorities have with respect to this tax. The decision as to what kinds of property shall be liable, the basis of their valuation, and the actual process of valuation, are all outside their sphere of responsibility (except for some minor exemptions which they are permitted to grant to charitable, educational and philanthropic bodies). Thus, since 1929 all agricultural land and buildings (except dwellings) have been exempt from local rates ("derated"), and industrial and freight-transport hereditaments partially derated. Temporary derating was also granted to shops after the 1956 revaluation had sharply raised their relative share of rates to a level that was considered intolerable.

35. Before 1948 local authorities conducted their own valuations of property for rating purposes. But when ratable value came to play an important part in the calculation of grant entitlement (as we shall see in section VII below), it was considered essential to standardize valuation procedures between authorities. Hence the responsibility for valuation was transferred to a department of the Central Government which was charged with carrying out a quinquennial revaluation of all hereditaments. But even then the procedures laid down for the valuation of the different classes of hereditament were far from uniform. Ordinary dwellings were to be valued at 1939 rentals, whereas the others were to be based on current rentals, and it was on this basis [5] that the first major revaluation, which came into effect in 1956, was conducted. The second major revaluation, due to take effect in 1963, is to be based on the current rental values for all classes of hereditament, and is to coincide with the abolition of all derating except that applicable to agriculture, which will continue to be completely derated.

36. Thus, although local authorities each fix their own tax rate, they have virtually no control over any other aspect of their tax. In

[5] The details are set out in table 144 of the *104th Report of the Commissioners of H.M. Inland Revenue*, Cmnd. 1598, London, H.M.S.O., 1962.

itself, of course, this would not constitute a limitation on the volume of tax revenues that can be raised since there is no statutory upper limit on the level of rate poundages.[6] But in fact their ability to raise funds in this way is limited by the widespread unpopularity of this tax, which is more marked even than the usual reluctance of citizens to pay taxes. There are many reasons for this, some rather irrational and others not so irrational. The most irrational reason is the common feeling that a rate poundage in excess of 20 shillings in the £ is somehow exorbitant, whereas one of less than 20s is tolerable. Local authorities have themselves cashed in on this obsession with the rate poundage as such (rather than the actual amounts of rates payable) by sharply increasing their total rate yields when the 1956 revaluation raised ratable *values* substantially, thus enabling a marked increase in yields to occur, yet with a lower rate poundage.[7]

37. A more rationally based objection to a high level of local rates is concerned with the incidence of the tax, which is widely held to be regressive with respect to income. A recent study (see appendix table H) has to some extent confirmed this view, indicating that rate payments constitute a higher proportion of the incomes of poorer people than they do of richer ones. However, there are some reasons, in principle, to doubt whether this "formal" incidence of local rates is a good index of their *true* incidence. There are two main reasons for these doubts. Firstly, because it may be that part of the incidence of local rates is shifted from the occupier to the owner, if the net rents received by the latter are lower than they would have been in the absence of local rates. It would not take much of a shift of this kind at the lower levels to make the true incidence proportional or even mildly progressive, if it is assumed that houseowners are richer than house-occupiers. The second reason is that dwellings only constitute about a half of all ratable value, and the incidence of local rates on business properties of various sorts is much more obscure. But whatever the facts of the situation are, it remains true that most people believe local rates to be regressive, and therefore inequitable, and it is this that constitutes the most effective limitation to their use as a source of local revenue.

38. Proposals have been canvassed for other sources of taxation to be assigned to local authorities, either by tax-sharing arrangements with the Central Government or by the outright transfer of tax jurisdiction in certain fields (see particularly reference (11)). So far the Government has firmly rejected all such suggestions, stating in the 1957 White Paper on Local Government Finance (Cmnd. 209) that they:

> . . . do not think it practicable to devise a satisfactory new source of local revenue by authorizing the collection of a local income tax or other such impost on top of the national system of taxes; nor do they think it appropriate to earmark for the direct benefit of local authorities, or to hand over to them, the motor duties or any other of the taxes now levied nationally.

And there, for the time being, the matter rests.

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[6] Except in the case of certain minor authorities.

[7] Between the years 1955–56 and 1956–57, the average level of rate poundage in England and Wales fell from 22s. 10d. to 15s. 8d (a fall of over 30 percent). The total amount of ratable value (which constitutes the tax base) however, increased to such an extent that the average amount raised in local rates per head of population rose from £8 19d. to £11 13s., an increase of about one-fifth in a single year.

VII. The Grant Structure

39. Even with the little elbow room left to them in the field of local taxation, it still would not *necessarily* follow that local autonomy would be seriously impaired, for the grant structure might be so designed that adequate resources were placed at their disposal, with no strings attached. Indeed, in view of the unpopularity associated with local rates, and the popularity associated with high standards of local services, it might indeed be preferable to having to raise the money directly from the local citizenry. In fact, however, the ideal grant system, like the ideal tax system, has proved rather elusive, and what we actually have is a set of measure which may be assessed by various criteria, but no single one of which gets top rating in each and every case.

40. Grants are given with various motives, in varying forms, and with varying results. It is therefore necessarily to distinguish the different cases under each of these headings.

(*a*) *Motives*

41. Kjeld Philip (10:92) distinguishes the following six motives:

(*1*) The higher body wishes to *encourage* the lower in a particular proceeding.

(*2*) Financial *equalization* is to be created between the local governments, and thus between the citizens living in various areas.

(*3*) The final aim of the higher body is to take over the management, but it does not yet feel politically powerful enough for this intervention, and so as the first, and generally the easiest step, it takes over part of the financing.

(*4*) *Technical taxation conditions* may lead to a desire for a state grant. Income tax and several other taxes are for example not suited to local use, but these taxes are dominant at the present day. There may therefore be a temptation . . . to let the State take over the financing.

(*5*) In certain cases there may be practical reasons why other functions (e.g. administrations and/or management) should be transferred from a lower to a higher department, but it may then be found politically unreasonable that this circumstance should release some taxpayers from burdens, and lay them on others. Ordinary *conservatism* may thus play a part.

(*6*) Lastly, it must be added that if it is desired for other reasons to make a state grant, or the like, it is important to do it in such a way that the receiving body carries out the administration as *responsibly* as possible. This last motive is thus not an independent motive leading to a state grant. Rather it may be said that it is a motive that leads to hesitation in giving a state grant, and perhaps to the choice of the form of grant.

42. I propose in what follows to concentrate on the encouragement motive (1), the equalization motive (2) and the responsibility motive (6), for I think that these have been the most powerful influences shaping the British grant structure in recent years.

(*b*) *Forms*

43. Kjeld Philip (10: 104) has also provided us with a useful classification of intergovernmental financial arrangements:

I. Grants-in-aid to Local Governments;
II. Tax sharing between State and Local Governments;
III. Tax sharing between Local Governments;
IV. Intermunicipal grant arrangement; and
V. Local Government grants to the State.

For Britain only class I has to be considered. This Philip (10: 104) subclassifies as follows:

A. General or unallocated grants;
B. Specific or allocated grants for purposes; and
C. Specific or allocated grants for measures;

and each of these may be cross-classified into the following categories:

1. Same percentage;
2. Varying percentage;
3. Grants fixed by criterion;
4. Grants fixed by estimate; and
5. Amount beyond a certain sum.

44. The distinction between general and specific grants is an obvious one, the former being available for any Local Government service, the latter in specified field only. The distinction between "purposes" and "measures" is, I think, more dubious and less helpful. On this Philip writes (10:105):

> The special grants are to be used . . . either for a special aim, e.g. the school system, old age pensions, the roads system, etc., or for particular measures, e.g. the payments of teachers' or midwives' salaries, and the payment of the food for school meals. The grants designed for an aim are thus more general than those designed for a measure, and no sharp dividing line can be known between them.

It seems to me, therefore, to be more helpful to regard Philip's A, B, C, classification more simply as a continuum, labeling one extreme "General or Unallocated" and the other "Specific or Allocated", and to attempt to appraise the degree of specificity implied by each grant in each case by assigning it to some position on this relative scale.

45. The cross-classification 1 to 5 (percentage, varying percentage, etc.) is also capable of useful simplification by using the "fixed-variable" axis with respect to local expenditure; for instance, a grant of class 3, based on some "objective" criterion like population, could be considered "fixed" in relation to levels of local expenditure, while a percentage grant would be variable, and a grant of type 5 would be 100 percent variable once the minimum sum was reached (and fixed—at zero—up to that point).

46. By these modifications we move toward Chester's classification, (2: 129) which begins by introducing what is, for us, a special additional consideration, the general "conditionality" of the grant. His classification is based on three tests, which are set out as follows:

(1) Is payment of the grant made dependent upon the fulfillment of certain conditions, or is it unconditional?
(2) Is the grant "specific" or "general" . . . ?
(3) Is the grant "fixed" or "variable" . . . ?

In a sense, the financial criteria (2) and (3) are particular aspects of the general criterion (1), so it may be more helpful to interpret the "conditional—unconditional" axis as referring to the restrictiveness of the nonfinancial conditions imposed, and the degree of coercive power wielded in order to insure compliance.

(c) Effects on the Finance of Education

47. The general financial structure of current grants in the United Kingdom is set out in appendix table I (capital grants will not be considered since they are of minor quantitative importance). Two things should be noted in particular: (1) that up until 1958 the grants for education accounted for over 70 percent of all grants, and for about 60 percent of all education expenditure, and (2) that after 1958 the "unallocated" grants suddenly account for the major portion of all grants, with a corresponding fall in other types of grant, the overall proportion of total current expenditure that is met by grants remaining constant at about 55 percent. It is the influences that have brought about these phenomena that I shall discuss in this section.

48. The chief source of finance for the education service, before 1958, was the "Education Main Grant". This was based on a formula which contained three elements: a fixed sum per schoolchild, plus a certain percentage (60 percent of net approved expenditure, *less* an amount based on the particular local authority's yield. Thus, the first element is a sort of "unit" grant, the second a fixed percentage grant, and the latter a sort of matching requirement, varying with the "richness" of the authority in question. Since the second element was by far the most important quantitatively, we may regard the Education Main Grant to all intents and purposes as a percentage grant.

49. The Education Main Grant is specific, in that it can only be used for educational expenditure. But it is not very specific, since we have already seen that education expenditure is a major component of local authority so that restricting the use of grant money to this field is not in practice a severe infringement of local autonomy. Moreover, because such a grant has a sizable "income effect" as well as a discriminating effect in favour of education expenditure, there is little doubt that despite the earmarking of grant receipts for education, the receipt of grant has enabled *local* resources to be diverted to other purposes, e.g. parks, libraries, etc.[8]

50. The Education Main Grant is clearly "variable"; indeed with a marginal percentage rate of 60 percent of approved net expenditure, it is highly sensitive to variations in local expenditure. This was, in fact, the major point argued against it:

> The worst feature, from the standpoint of local autonomy, was that, of the total money of grants now given from the Exchequer to local authorities, two-thirds was in the form of percentage grants. The local authority spent the money knowing that whatever it spent, so much percent would automatically be reimbursed by the Exchequer. The Government departments seeking to watch the taxpayers' interest inevitably had to keep tabs on each local authority's spending." (Minister of Housing and Local Govern-

[8] In a survey of local authority expenditure patterns in the West Midlands, it was found ". . . that expenditure on Education varied more than expenditure on Amenities, in which there was far less pressure toward uniformity by the government and far fewer rewards, financially, for high expenditure. The implication was that authorities who were benefiting especially from the Education Grant were using the extrafinancial resources to reduce their own contribution and using the difference to supplement expenditure on other services. Thus the effect of generous Education Grants to poorer authorities seemed to be to subsidize not only education but other services too . . ." (12: 108). The theoretical foundations for, and implications of, this phenomenon are explored further in my *Public Finance and Budgetary Policy,* London (Allen and Unwin), 1963, pp. 171–180.

ment in the House of Commons, as reported in *The Times*, July 30, 1957).

51. Others have defended the percentage system in equally strong terms. For instance, D.S. Lees and his collaborators (6: 158–160) assert that it is:

> . . . pointless to ask whether percentage grants encourage "extravagance" by local authorities . . . for we have no idea how much specific operations by local authorities *ought* to cost, and . . . very little is now known about "necessary" or "avoidable" costs . . . All we know at present is that local authorities spend as they do and that some spend more than others.
>
> High costs may be due to peculiar local circumstances . . . (or) . . . to high standards of service . . .
>
> Economical spending is not the same as low spending; economy means an absence of waste, and avoidance of unnecessary expenditure. Thus if an authority is supplying a service at a standard above the average, and is doing so at a minimum cost, that part of its expenditure above the average is unnecessary only if the high standard of service itself is unnecessary . . . The standards that official policy wishes to achieve are set by the authorities who progress quickly and not by those who lag behind. Given the aims of official policy, it would be the height of folly to penalize the authorities that are achieving the aims most successfully.

52. Here there is evidently a head on collision between the "responsibility motive" on the one hand and the "encouragement motive" on the other. Rather than delve further into this, however, let us turn finally to the third criterion, that of conditionality. As indicated above, a great deal of control was associated with the Education Main Grant, and one of the reasons given for its abolition (and that of some other specific grants) in 1958, and the substitution of the General Grant, (which is based mainly on fixed per capita sums for varying sections of the population—see paragraph 54 below) was that although—

> . . . Departments would continue to exercise control at key points, . . . Ministers' responsibilities for general policy ought not to entail meticulous scrutiny of the detailed management of the services (Minister of Housing and Local Government as reported in *The Times*, July 30, 1957).

However, later in the same debate in the House of Commons, the Parliamentary Secretary to the Minister of Education sought to calm the widely publicized and strongly expressed fears that the new General Grant would lead to a general deterioration in the quality of educational provision in some authorities. He stated that:

> The Government saw no reason why the change in the method of calculating the grant should affect the apportionment of statutory responsibility between the Minister and the local authorities . . . (The) Minister's power to lay down minimum standards and to enforce them would remain . . .
>
> The Government recognized that expenditure on education must go on increasing . . . The Government did not propose that the burden of the cost of this development should be borne exclusively by the rates. In fixing the amount of general grant the Government would take account of the need to develop the educa-

tion service and they would aim at keeping a fair and reasonable balance between grants and state-borne expenditure . . . (As reportd in *The Times*, July 30, 1957).

53. The 1958 Local Government Act, instituting the General Grant, in fact specified that, in determining the annual aggregate amount of grant to be disbursed, the Minister is to take into consideration:

(*a*) The latest information available to him of the state of relevant expenditure[9] . . . , and the current level of prices, cost and remuneration, together with any future variation in that level which can be foreseen;

(*b*) Any probable fluctuation in the demand for the services giving rise to relevant expenditure, so far as the fluctuation is attributable to circumstances prevailing in England and Wales as a whole which are not under the control of local authorities; and

(*c*) The need for developing those services and the extent to which, having regard to general economic conditions, it is reasonable to develop those services.

54. What happens is that local authorities submit estimates of their expenditures, which are then "examined closely in the several Departments".[10] Various adjustments are then made to take account of any pay increases awarded (e.g. to teachers) or increases in prices (e.g. for coal). The next decision is what proportion of the total expenditure should be left to be borne by the rates, and what proportion should be met by grant (it will be seen from appendix table I that this has remained approximately constant with the grant amounting to just over 55 percent of relevant expenditure *overall*). The distribution of the grant to particular authorities is calculated by reference to a formula, the "objective factors" in which are population, children under 15, persons under 5 and over 65, etc., and including a "rate deduction factor" to introduce a "matching requirement" which varies inversely with the "poverty" of the authority (in terms of local tax-raising potential). Quantitatively, two-thirds of the grant is payable on the "population" element, and a further 30 percent for the "schoolchildren" element. All the other elements are a relatively minor proportion of the total, though they may be rather important for particular authorities.

55. It will be clear from this, I think, that the "encouragement motive" is hardly relevant to this grant. Variations in standards of provision have no effect on the grants, except to the extent that they keep more of the population alive, or attract population from other authorities, or stimulate a high birthrate. It seems, on the contrary, to be a major victory for the "responsibility motive" yet achieved without actually reducing the relative importance of grant moneys overall. It is also clear that very little real additional freedom has accrued to local authorities by the change in the form of the grant payment. As D. S. Lees and his collaborators prophetically observed (6:167–8):

[9] I.e. expenditure on education, local health, fire services, dental care, and a few other miscellaneous services of minor quantitative importance.

[10] *Local Government Finance (England and Wales). General Grant Order 1960*, p. 4.

There is a vast apparatus of detailed central control of local affairs about which authorities are right to be concerned, but which has nothing to do with the *form* of Exchequer Grants . . . Inquiries at the estimate stage will be made no matter what the form of the grant *if* the grant is adjusted in amount year by year. It is only a grant fixed in amount for a period of years which evades this annual scrutiny and such a grant is manifestly unaaceptable as long as the costs of grant-aided services continue to rise . . ..

(*d*) *Effects on the Equalization of Fiscal Resources*

56. We have not so far given much attention to the equalization motive. Both the old Education Main Grant and the new General Grant formulas included a "rate deduction factor" which served to reduce grant payments to the "richer" authorities relatively more than to the "poorer" ones. As already mentioned, "richer" and "poorer" refer to the local tax-raising potential of the authority, which, in turn, means the amount of rate revenue that would be raised by a given rate poundage (see sec. VI earlier). But besides these relatively minor equalizing elements in other grants, there is also a grant concerned explicitly with equalization of resources. Up until 1958 it was known as the Exchequer Equalization Grant (EEG), but since then it has been slightly amended, and renamed, more accurately, the Rate Deficiency Grant (RDG). Both Grants are "general" or "unallocated" grants, in the sense that the grant moneys are not earmarked for specific services.

57. The common feature of the two grants was that they provide additional revenue only for those authorities whose rate resources are below the national average. They are, strictly speaking, only partly "equalizing" since they do not reduce the resources available to the above-average authorities (the "nonreceivers"). Broadly speaking, the EEG and RDG both provide the "receiving authorities" with the additional rate revenue that they would enjoy if their ratable resources per head were equal to the national average. In the case of the EEG this was achieved by "crediting" each receiving authority with a "notional" amount of ratable value and "paying the rates" on that credited ratable value (CRV). Whatever rate poundage an authority levies on its own ratepayers, it can also "levy" on its CRV, thus determining the amount of EEG payable. The calculation is essentially the same for RDG, except that the yield of a given rate poundage per head is used instead of ratable value per head.

58. Clearly, for those authorities receiving these grants, they do constitute some limited compensation for the ratable value "lost" through derating and systematic undervaluation to the extent that they may have "lost" more than average. For nonreceivers, of course, there is no such compensation.

59. Given the actual rate poundage, both EEG and RDG are percentage grants, varying according to the extent to which the authority's actual ratable value (or rate product) per head falls below the national average. Thus, in the poorest authority, three-quarters of expenditure *not borne by other grants* is borne by the RDG. For receiving authorities as a whole the proportion is just over one-fifth. The presence of an "encouragement motive" may also be inferred, therefore, though it

would be limited to the very poor authorities, and be dependent upon their willingness to levy suitably higher rate poundages on their own ratepayers.

60. There were fears expressed under the EEG that this percentage aspect of the grant would lead to excessive expenditures by some authorities, but one official report concluded that "there is at present no evidence that the form of the grant has induced extravagance on the part of the local authorities receiving it." ("The Report of the Committee Appointed to Investigate the Operation of the EEG in England and Wales", London, H.M.S.O., 1953), but the Committee did feel that if any loosening of central control occurred "some limits upon expenditure ranking for grant are desirable". Hence, since the substitution of the General Grant for the superseded specific grants was considered to constitute such a loosening of central control, when the RDG contemporaneously replaced the EEG in 1958, a fresh provision was inserted into the Grant formulas with this aim in view.

61. This new limitation device is rather complicated, but it works roughly as follows:

The trend in expenditure in any particular authority is compared with the trend in expenditure for all authorities of its type (e.g. County Boroughs, Counties, Metropolitan Boroughs, etc.). If the authority's expenditure per head is below the average for its group, then it may increase up to the average and still have this expenditure rank for RDG. If, on the other hand, its expenditure per head is above the group average, then it may only increase its expenditure at the same rate as the group average is increasing—any expenditure in excess of this does not rank for RDG. If the expenditure per head of the group happens to be falling, the authority is allowed to maintain its own past average.[11]

62. The subtlety of this provision cannot but evoke admiration for the ingenuity of its inventors. It leaves below average spenders virtually unaffected, and keeps the others firmly in line. As the official White Paper on Local Government Finance (Cmnd 209. p. 12) put it:

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[11] The details of the provision are as follows:
Let x_1, x_2, and x_3 be the actual expenditures per head of weighted population for a particular authority in the years 1, 2, and 3 respectively.
Let X_1, X_2, X_3 and X_4 be the average expenditure per head of weighted population for the class of authorities to which the above authority belongs for the years 1, 2, 3, and 4 respectively.
Let p_4 be the weighted population of the particular authority in the year 4.

Then, if $\frac{x_1+x_2+x_3}{3}$ is less than $\frac{X_1+X_2+X_3}{3}$, "normal expenditure"—the maximum amount of relevant local expenditure that will qualify for RDG—is

$$p_4\left(\frac{X_1+X_2+X_3}{3}\right).$$

But if the above inequality is reversed, then there are two separate cases to be distinguished:

(i) if X_4 is greater than $\left(\frac{X_1+X_2+X_3}{3}\right)$, then normal expenditure is

$$\frac{X_4}{\left(\frac{X_1+X_2+X_3}{3}\right)} \quad \textit{times} \quad p_4\left(\frac{x_1+x_2+x_3}{3}\right)$$

(ii) while if the inequality in (i) is reversed, then normal expenditure is

$$p_4\left(\frac{x_1+x_2+x_3}{3}\right).$$

> The effect will be that in considering a new project or an expansion of a service there can be no assurance that the increased cost will attract rate deficiency grant; and so far as this grant is concerned each new project will have to be considered on the basis that the whole cost might fall on the rates.

63. The main criticisms that have been levied against this (apart from the view that it is quite unnecessary since the need to levy a high rate poundage is itself a sufficient guarantee against "extravagance"), is that there is no reason to suppose that unavoidable costs will rise at the same rate in all authorities in a particular group, or that they will all need to expand their services at the same rate or at the same time (especially when the wide diversity of characteristics manifested *within* each group is considered—see 1: 7–8.) Moreover, RDG is paid on expenditure after the General Grant has been deducted. Whereas the earlier percentage grants did reduce the differences between high- and low-cost authorities, it is difficult to see how the General Grant can do so to anything like the same extent, especially as regards a service-like education where costs per schoolchild may vary considerably. Thus some authorities will be penalized twice, by the General Grant taking inadequate account of their needs and leaving them with unduly high expenditure to finance from rates now, and then by RDG failing to take into account any increase in rate-borne expenditure at an above-average rate. Thus it seems fair to conclude, with D. S. Lees [12], that

> The element of consistency in the limiting device in the present context is that it will cause RDG to work in much the same way as the new general grant.

64. In other words, the "responsibility motive" has gained in influence relatively to the "encouragement motive," yet without abandoning the "equalization motive." (This is an interesting approach to a solution of one of the classical problems confronting intergovernmental transfers, and one which has recently been posed and argued afresh in a federal context by A. H. Birch, K. V. S. Sastri and R. L. Watts.[13]) It is very illuminating to note that it is possible within this framework to have sizable grants from the Central Government, and still maintain financial "responsibility" *at the margin*, where it really matters from an economic viewpoint. It would be still better if a really satisfactory basis existed for computing "standard" costs, so that a unit grant system could be widely used for the major services, but so far little progress has been made in this direction.[14]

VIII. The Capital Account

65. It will be seen from appendix table K that the bulk of capital expenditure is devoted to housing, and although this has declined in amount both absolutely and relatively since the peak year 1954, it still accounts for nearly half the total. In recent years there have been sharp increases in capital expenditures on basic environmental services

[12] (1) "The Reform of Local Finance", *Local Government Finance*, LXI (August 1957), p. 184.
[13] "Intergovernmental Financial Relations in New Federations", in *Federalism and Economic Growth in Underdeveloped Countries*. (U.K. Hicks, et al., London, 1961, pp. 113–150)
[14] See (6 : Chs. VII, IX, X).

(esp. roads) and to a lesser extent in social services other than housing. But the general trend has been for local authority capital expenditure to decline in relative importance.

66. It is in the financing of this capital expenditure, however, that the most dramatic changes have occurred during this last decade. This is brought out clearly in lines 8 and 9 of table K. In the early years of the decade the bulk of the financial resources required were obtained by borrowing from the Central Government (or more correctly, from one of its agencies, the Public Works Loan Bond, of which more anon). In 1952 three-quarters of the capital finance came from this source. Yet by 1958 LA's were actually repaying more debt to the Central Government than they were borrowing from it. By then, about two-thirds of gross fixed capital function was being financed by direct borrowing from the public, and the bulk of the remainder from internal sources. Throughout the period, capital grants from the Central Government have played a minor role quantitatively.

67. Once more the issue before us is the extent to which local authorities have been free agents in these matters, and the extent to which they find themselves effectively manipulated by the Central Government. Two recent official views on this subject seem eminently quotable in this context. First of all, the Radcliffe Report on the Working of the Monetary System (Cmnd. 827, 1959) stated (par. 90):

> The capital investment programs of the local authorities are subject to close control by the Central Government, in that an authority is required to obtain a loan sanction for every project which it proposes to finance from borrowed money; the extent to which authorities may finance capital projects from revenue is effectively limited by the manner in which central authorities limit the qualification for grant of such projects. These are the negative aspects of central control; positively the central authorities by virtue of social legislation in effect determine the scale and direction of the investment of local authorities in most of the main fields of expenditure (notably housing and education).

68. The 1960 White Paper "Public Investment in Great Britain" summarized the position thus:

> In the education program, each major project and the total of minor projects to be started by each local education authority require the approval of the Minister of Education . . .; in the housing program, the acceptance of tenders by the housing authorities requires the approval of the Minister of Housing and Local Government . . . Control of most other local authority investment depends on the necessity for a local authority to obtain for each amount borrowed a loan sanction from the appropriate Minister . . .; this is not necessary, in England and Wales, if borrowing powers have been obtained under a private Act of Parliament. In all cases local authorities' borrowings require Treasury approval under the Control of Borrowing Order, 1958. For some programs, such as most investment in water and sewerage . . . the loan sanctions procedure or Treasury control of borrowing is the only form of direct Government control. Local authorities investment expenditure must, however, take account of their general financial position, in which the level fixed by the government for

the general grant is an important factor, and it is influenced indirectly, like the rest of the economy, by monetary measures affecting interest rates.

69. It will be seen below, however, when considering the role of the Public Works Loan Bond (P.W.L.B.), that local authorities are not influenced *quite* like the rest of the economy as regards interest rates. The interaction of the general grant and the RDG with the control of capital investment will also be further considered subsequently. But our immediate concern is direct control over the capital expenditure itself.

70. Direct control over capital expenditure for grant-aided services is usually exercised by requiring the submission to the appropriate Ministry of annual programs, which will then be approved as ranking for grant, supported as eligible for loan sanction, or reserved for further consideration. There have also been attempts to exercise control by requiring long-term programs to be submitted as well, the object being to enable the nation's resources to be allocated more sensibly by a careful selection and timing of public investment projects. Such long-term forecasts were requested particularly in the immediate postwar years, and the forecasters were asked to approach the task with "thorough realism taking account of the marked excess of demand over supply which should be assumed to continue throughout the period covered by the estimates." This plea was in vain, however, and the grossly over-optimistic plans that were submitted rendered the exercise largely useless. In 1954, a rather more cautious request was made asking for the submission of any investment projects costing more than £50,000 each which could be started in the then-existing conditions within the following 6 or 7 years. This survey seems to have served its purpose better than the previous one, but whether this was due to a more chastened response or to reduced stringency in the economy generally it is difficult to say.

71. The granting or withholding of approval for any item of capital expenditure as qualifying for grant is extremely important in some services, and seems often to be used to exert a stimulating rather than a depressing influence upon capital expenditure. For instance:

> The Ministry of Transport admits the cost of road improvements for percentage grant and the Home Office follows a similar course for civil defense capital expenditure irrespective of how the local authority finances its share. Other Ministries have closely controlled the amount of capital expenditure met from revenue on grant aided services, though the restrictions have been removed from services covered by the general grant from April 1, 1959.
>
> Different forms of control have been used. Sometimes the local authority is required to seek prior approval to capital expenditure from revenue, for example . . . for housing . . . Perhaps the most important form of control used by Ministries, however, has been the disallowance for grant purposes of capital expenditure from revenue over certain limits, since controls of this type applied to education and health services . . . (until) . . . April 1, 1959. For education, where the sums involved are greatest, the limit . . . was, generally speaking, the amount of capital expenditure met from revenue in a previous year or the product of a

> penny rate, whichever was the greater. From April 1, 1956 the ceiling was raised to the product of a 3d. rate with a limit of £10,000 for any single item . . . In 1955–56 some £5.5 m of the capital expenditure on all aspects of the education service, representing 7.5 percent of the total, was met from revenue. By 1958–59 the amount so met had risen to 10.3 percent of the total . . . (and) . . . In 1959–60, the first year of the general grant, the amount . . . increased to 11.7 percent of the total . . . Local authorities receiving rate-deficiency grant . . . are subject to another general control . . . The Minister can make such adjustments to the grant as appear to him necessary to correct abnormal treatment of capital expenditure charged to revenue . . . but no such adjustment seems ever to have been made.
>
> Moreover, an indirect but infinitely more subtle control was added . . . (namely) . . . the limitation factor imposed . . . At the time of writing there is no experience of the operation of this arrangement, but clearly . . . at the time of incurring expenditure each authority will be insufficiently informed as to the spending policy of authorities in the same class. Consequently, some authorities . . . may feel compelled to choose between either restricting normal revenue expenditure or capital expenditure charged to revenue . . . (4:41–43).

72. Having thus, by one means or another, restricted the financing of capital expenditure out of revenue, we come to the power wielded by the Government through the loan-sanction procedure. This has wider ramifications than may appear at first sight,[15] for it provides an occasion for a close scrutiny of the finances of the authority in the field in question, and may be used as a lever to secure its cooperation in some other project in which the Central Government is interested. Conditions will probably also be laid down as to the nature of the investment project, its design and execution, and so on. Indeed the power wielded in this way will be considerable for the majority of authorities for which there is not the option of "going it alone" if the conditions laid down are disliked.

73. But the Central Government has yet another measure for controlling local authority capital expenditure, namely by controlling their access to the capital market. Again, the Radcliffe Report provides an excellent summary of the position.

> From 1945 to the end of 1952 the approved capital needs of local authorities were mainly financed by the Public Works Loan Board (PWLB) (and therefore by the Exchequer) at rates of interest roughly equivalent to the current yield on gilt-edged securities of similar length. From the beginning of 1953 to October 26, 1955, local authorities were free to borrow either from the PWLB or by issues of stock or mortgages, as they thought fit: but owing to the unstable conditions in the gilt-edged market and the attractiveness of the PWLB rate very few local authorities issued stock during this period. Since October 26, 1955, they have only been able to borrow from the PWLB at a rate of interest

[15] See Chester (2: 101) part of which was quoted in para. 5 earlier.

> reflecting the current level of local authority credit in the market (i.e. at a rate slightly higher than the current yield on gilt-edged securities of similar lengths), if they could show that they were unable to raise the money in the stock market or the mortgage market. Access to the stock market is regulated by the Bank of England, which exercises on behalf of the Treasury a control of the terms and timing of issues of local authority stocks, in the interests of orderly marketing and in order that local authority issues may be in keeping with Government financing policy. While somewhat more money has been raised by local authority stock issues since October 1955 than in the previous period, given the conditions prevailing in the gilt-edged market it has only been possible for a very small part of the funds required to be raised by this method. Local authorities who wished to make an issue have had to wait for a period of years before being allowed to go on to the market; a long queue of would-be borrowers developed, despite the monetary authorities' decision in May 1957 to shorten the queue by putting a minimum of £ 3 m. on the size of the issues. Authorities whose issues were postponed or frustrated . . . were forced to turn extensively to the mortgage market, despite the higher rates ruling in that market. After September 1957 many authorities were indeed content to make a virtue of this necessity, since they reckoned that interest rates were abnormally high, and went in for extensive short-term borrowing in the expectation of being able to fund their borrowing when longterm rates were lower (par. 93).

74. All this may sound so watertight that it may come as a surprise to discover that the borrowing behaviour of local authorities *still* does not always conform to the wishes of the Central Government. The increasing resort to short-term funds (bank overdrafts, bills, etc.) has in fact been clean contrary to the policy of the monetary authorities who were simultaneously trying to reduce the liquidity of the monetary system by converting short-term debt into long, and as well as by various other measures. The Radcliffe Committee therefore came to the conclusion that it would be better if the borrowing of local authorities were centralized through the PWLB. Their reasons for this were:

> First, the sums are large . . ., so that their weight in the market is not always negligible and from the point of view of monetary control it is preferable that the timing should be completely at the discretion of the monetary authorities. Secondly, the fragmentation implied by independent borrowing involves unnecessary cost, in that the lower marketability of small issues has to be paid for in a yield differential which, if they borrowed from the Exchequer *via* Public Works Loan Board, could be avoided. Thirdly, the level of their capital investment is now largely determined by the requirements of social legislation, and is closely controlled by the central government. For all these reasons we recommend that the Exchequer should stand ready to provide longterm capital through the Public Works Loan Board, at the current gilt-edged rate (at the time of borrowing) for the relevant maturity,

to any local authority that is not able or does not want to raise the money it requires in the market on its own credit at a comparable rate. (par. 596)

75. This recommendation has not been acted upon, and that is more or less where the matter rests at present. It will be seen, however, that this issue is more concerned with the technical problem of debt management than with the implications of the respective borrowing mechanisms for local autonomy.

IX. Summary and Conclusions

76. The 1955 Rome Congress of the IULA, referred to earlier, subscribed to the following set of recommendations:

(1) By universal recognition, financial self-sufficiency is indispensable for the effective autonomy of local authorities; they are therefore justified in claiming an adjustment of their revenues to meet the ever growing complexity of their own functions and responsibilities.

(2) Except in those countries where current regulations give satisfactory results and require no change, this process of adjustment should aim at affecting local financial autonomy on a wider basis; the sources of local revenues should also be direct, whenever feasible, and always quite distinct from those of the State.

(3) Local authorities should in any case be allowed to participate in the assessment of taxes undertaken by the State through the exercise of their own special experience and the collaboration of their own departments.

(4) Subsidies or contributions granted by the State and other superior authorities should not affect local autonomy; grants must therefore be made preferably for general purposes and even in the case of grants for specific purposes, the authorities concerned should abstain from imposing too heavy limitations and too strict controls, but should place greater confidence in local administrators.

(5) Appropriate bodies should be set up in each country where they do not already exist in order to resolve the difficulties met with today in finding the funds to implement local authorities' programs. The specific and sole aim of these bodies should be to hold credit for the use of local authorities and they should be assured of adequate funds up to the limit that can be permitted by the respective national economies. ("Proceedings of the Rome Congress". The Hague, 1956, pp. 41–42).

77. Judged by these criteria, the effective autonomy of local authorities in England and Wales is pretty attenuated these days. For it has been shown that:

(*a*) the bulk of their current expenditure is determined by social legislation prescribing (costly) national minimum standards;

(*b*) they are limited to one local tax, in which they have virtually only the power to fix the rate of tax;

(*c*) a large proportion of their expenditure is consequently met by grants, which, whether specific or general, have been associated with close financial control and supervision;

(*d*) capital expenditures have, if anything, been more closely regulated than current expenditures;

(*e*) the grant system has been used to influence the amount of capital expenditure which may be met out of revenue; and

(*f*) not only has most borrowing required the approval of the Central Government, but the Central Government has also regulated the means of access of local authorities to the capital market.

78. Nevertheless, it cannot be said that local authorities are merely regional offices of the Central Government. To return to Poul Meyer, in spite of all these varying manifestations of "administrative tutelage", it is still true to say that "local authorities constitute a political factor in themselves, and by virtue of their political character can fight for power and influence in a far more effective manner than the various organizations within the administrative hierarchy . . ." (8: 243). Indeed, some commentators go further. D. N. Chester, for instance, asserts:

> A system of government cannot be judged . . . solely in terms of administrative efficiency. Even if it could be proved . . . that a State would be better administered if everything were left wholly to officials, there would still remain strong arguments in favor of the widest citizen participation . . . if, therefore, local government ceased to exist, a great educational force and an element of great worth in a democratic community would have disappeared . . . (2:21).

Hence, the conflict between the desire, on the one hand, to assign Local Governments a sufficiently important role in the public sector to make participation in its work attractive, while, on the other hand, keeping Local Government on a tight enough rein to ensure that nationally adopted objectives are not frustrated. It has been this conflict that has produced the particular pattern of centralization and decentralization of public finances now manifested by Local Government in England and Wales.

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Appendix:

STATISTICAL TABLES

Note that this statistical material refers to the whole of the United Kingdom, and not simply to England and Wales. The following tables are presented:

A. Government Expenditure at current prices in selected years, 1890–1955.
B. Local Government Expenditure (by Functions) as percentage of total Government Expenditure on each Function in selected years, 1890–1955.
C. Percentage distribution of Local Government Expenditure by Functions in selected years, 1890–1955.
D. Local Government Revenue Sources in selected years, 1890–1955.
E. Distribution of allocated grants by selected Functions in selected years 1920–55.
F. Current account of United Kingdom Local Authorities at current prices in selected years, 1938–60.
G. Local Authorities' current expenditure on goods and services at current prices in selected years, 1950–60.
H. The formal incidence of local rates, 1952–53.
I. Current grants to Local Authorities by the Central Government in selected years, 1950–60.
J. Current grants based on expenditure now qualifying for general grant in selected years, 1957–58 and 1962–63.
K. Local Authorities' capital account at current prices in selected years, 1950–60.

Key to source references:

NIE=*National Income and Expenditure* Blue Book, H.M.S.O. London.
PW=Peacock and Wiseman, *The Growth of Public Expenditure in the United Kingdom*, London, 1961.

TABLE A.—*Government expenditure at current prices in selected years, 1890–1955*

[Pounds in millions]

Year	Central Government (1)	Local government (2)	Total (3)	Local government as percent of total (4)	Local government as percent of GNP (5)
1890	£81	£50	£131	38.4	3.4
1900	182	99	281	35.2	5.1
1910	142	130	272	47.9	6.1
1920	1,275	317	1,592	19.9	5.2
1928	695	399	1,095	36.5	8.8
1938	1,056	531	1,587	33.5	10.0
1950	3,479	1,060	4,539	23.4	9.1
1955	4,607	1,536	6,143	25.0	9.2

Source: PW, tables 12 and 13.

TABLE B.—*Local government expenditure (by functions) as percentage of total government expenditure on each function in selected years, 1890–1955*

Year	Administrative and other (1)	Law and order (2)	Social services (3)	Housing (4)	Economic services (5)	Environmental services (6)
1890	46	57	71		94	98
1900	53	62	73		97	98
1910	48	68	68		96	99
1920	29	65	35	100	38	97
1928	40	78	43	100	88	95
1938	40	81	44	100	80	89
1950	30	78	23	89	24	93
1955	32	80	28	94	37	74

Source: PW, table 16.

TABLE C.—*Percentage distribution of local government expenditure by functions in selected years, 1890–1955*

Year	Administrative and other (1)	Law and order (2)	Social services (3)	Housing (4)	Economic services (5)	Environmental services (6)
1890	14.4	10.2	38.7	----------	26.9	9.8
1900	8.8	6.2	37.5	----------	35.6	11.9
1910	8.2	6.8	46.2	----------	27.8	11.0
1920	6.6	6.9	40.3	14.4	24.0	7.8
1928	4.9	6.0	40.8	14.8	25.9	7.6
1938	4.6	5.9	42.4	15.1	22.7	8.6
1950	5.0	5.8	38.8	28.7	13.0	8.5
1955	3.8	6.0	42.8	25.7	12.7	8.8

Source: PW, table 15.

TABLE D.—*Local government revenue sources in selected years, 1890–1955*

[Pounds in millions]

Year	Allocated grants		Unallocated grants		Total grants		Local rates and other sources	
	Amount (1)	Percent (2)	Amount (3)	Percent (4)	Amount (5)	Percent (6)	Amount (7)	Percent (8)
1890	(1)	(1)	(1)	(1)	£10	25	£31	75
1900	(1)	(1)	(1)	(1)	20	30	46	70
1910	(1)	(1)	(1)	(1)	32	31	71	69
1920	£65	29	£3	1	68	30	163	70
1928	99	34	7	2	107	36	190	64
1938	105	28	57	16	162	44	206	56
1950	280	43	57	9	337	52	319	48
1955	462	46	83	8	545	54	461	46

[1] Not available.

Source: PW, tables 11 and A-18.

TABLE E.—*Distribution of allocated grants by selected functions in selected years, 1920–55*

Year	Law and order			Social services			Housing			Economic services		
	Amount (1)	Percent A (2)	Percent B (3)	Amount (4)	Percent A (5)	Percent B (6)	Amount (7)	Percent A (8)	Percent B (9)	Amount (10)	Percent A (11)	Percent B (12)
1920	£10	16	47	£48	74	39	£1	1	34	£5	8	12
1928	12	12	48	56	56	37	12	12	81	18	18	29
1938	14	14	48	56	53	28	18	17	77	13	12	20
1950	27	10	47	198	71	56	27	10	68	21	8	23
1955	41	9	49	325	70	56	56	12	73	32	7	25

Note.—Percent A—Grants to the service in question, as percent of total allocated grants. Percent B—Grants to the service in question, as percent of total expenditure on that service.

Source: PW, tables A-18 and A-19 (from which percent A derived).

TABLE F.—*Current account of United Kingdom local authorities (at current prices)*

[Pounds in millions]

	1938		1948		1950		1952		1954		1956		1958		1960	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
EXPENDITURE																
1. On goods and services	£309	64.1	£529	73.0	£565	72.6	£688	73.3	£784	70.2	£950	69.1	£1,131	68.4	£1,325	67.7
2. Interest payments	68	14.0	66	9.1	81	10.4	108	11.1	142	12.7	189	13.7	243	14.7	289	14.8
2a. To Central Government	(1)	(1)	22	3.0	37	4.8	59	6.3	88	7.9	114	8.3	124	7.5	123	6.3
3. Transfer payments	30	6.2	52	7.2	53	6.8	65	6.9	74	6.6	106	7.7	114	6.9	124	6.3
4. Current surplus (gross)	75	15.6	78	10.8	79	10.2	83	8.8	117	10.5	130	9.4	166	10.0	218	11.1
Total	482	100.0	725	100.0	778	100.0	940	100.0	1,117	100.0	1,375	100.0	1,654	100.0	1,956.	100.0
REVENUE																
5. Rates	212	44.0	317	43.7	337	43.3	392	41.7	460	41.2	556	40.4	649	39.2	764	39.1
6. Current grants from Central Government	133	27.6	281	38.8	298	38.3	372	39.6	422	37.8	521	37.9	632	38.2	741	37.9
7. Gross rents, dividends, interest, profits, etc	137	28.4	127	17.5	143	18.4	176	18.7	235	21.0	298	21.7	373	22.6	451	23.1
Total	482	100.0	725	100.0	778	100.0	940	100.0	1,117	100.0	1,375	100.0	1,654	100.0	1,956	100.0

[1] Not available.

Source: NIE 1957 and 1961, tables 5 and 36.

TABLE G.—*Local authorities current expenditure on goods and services (at current prices)*

	1950		1952		1954		1956		1958		1960	
	£ m	Percent	£ m	Percent	£ m	Percent	£ m	Percent	£ m	Percent	£ m	Percent
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Education	241	42.7	310	45.1	365	46.5	461	48.5	571	50.5	692	52.2
Other social services	68	12.0	83	12.1	90	11.5	106	11.2	123	10.9	138	10.4
Basic environmental services	175	31.0	208	30.2	236	30.1	276	29.1	317	28.0	363	27.4
Other	81	14.3	87	12.6	93	11.9	107	11.2	120	10.6	132	10.0
Total	565	100.0	688	100.0	784	100.0	950	100.0	1,131	100.0	1,325	100.0

Source: NIE 1961, table 40.

TABLE H.—*The formal incidence of local rates. HEW 53.*

[Figures other than percent are in pounds]

Gross household income	Mean gross income	Average rate payment per household	Rates as percent of mean gross income	Mean net income [1]	Rates as percent of mean net income
	(1)	(2)	(3)	(4)	(5)
Under 100	81	8	10.4	81	10.4
100 to 199	146	10	6.8	143	6.9
200 to 299	256	11	4.2	244	4.4
300 to 399	352	11	3.3	333	3.4
400 to 499	444	12	2.8	418	3.0
500 to 599	541	13	2.4	503	2.6
600 to 699	645	15	2.3	592	2.5
700 to 799	750	17	2.3	675	2.5
800 to 899	843	19	2.2	742	2.5
900 to 999	946	18	1.9	824	2.2
1,000 to 1,499	1,162	22	1.9	974	2.2
1,500 to 1,999	1,684	26	1.5	1,294	2.0
2,000 and over	4,170	39	1.0	2,285	1.7
Total	571	14	2.4	494	2.8

[1] After subtracting direct taxes from mean gross income.

Source: H. F. Lydall and R. F. F. Dawson, "Household Income, Rent and Rates," Bulletin of the Oxford Institute of Statistics, vol. 86 (1954). Cols. (1) to (3) from table 10; col. (4) from table 7; col. (5) derived.

TABLE I.—*Current grants to local authorities by Central Government in selected years, 1950–60*

[Pounds in millions]

Nature of grants	1950			1952			1954			1956			1958			1960		
	Amount	Percent A	Percent B	Amount	Percent A	Percent B	Amount	Percent A	Percent B	Amount	Percent A	Percent B	Amount	Percent A	Percent B	Amount	Percent A	Percent B
1. Unallocated	£57		19.1	£68		18.3	£81		19.2	£88		16.9	£114		18.0	£592		79.9
2. For education	175	72.6	58.7	223	71.9	59.9	255	69.9	60.4	334	72.5	64.1	406	71.1	64.2	76	11.0	10.3
3. For other social services	25	36.8	8.4	31	37.3	8.3	32	35.6	7.6	35	33.0	6.7	42	34.1	6.6	6	4.3	.8
4. For basic environmental services	35	20.0	11.7	43	20.7	11.6	48	20.3	11.4	56	20.3	10.7	61	20.3	9.7	60	16.5	8.1
5. Other	6	7.4	2.0	7	8.0	1.9	6	6.5	1.4	8	7.5	1.5	9	7.5	1.4	7	5.3	.9
Total	298	52.7	100.0	372	54.1	100.0	422	53.8	100.0	521	54.8	100.0	632	55.9	100.0	741	55.9	100.0

NOTE.—Percent A—As percent of total current expenditure upon the service in question. Percent B—As percent of all current grants to local authorities.

Source: NIE, 1961, table 40.

TABLE J.—*Grants based on expenditure now qualifying for general grant*

	Various specific grants		General grant			
	1957–58 actual	1958–59 actual	1959–60 revised estimate	1960–61 revised estimate	1961–62 estimate	1962–63 estimate
Expenditure (million pounds)	593	644	723	770	818	851
Grant (million pounds)	331	363	402	429	454	472
Grant as percent of expenditure	56.2	56.4	55.6	55.7	55.5	55.4

Source: G. C. Jones "The First Year of the New Grants," Local Government Finance, May 1960 and Local Government Finance, General Grant Order 1960, London, HMSO, 1960.

TABLE K.—*Local authorities capital account (at current prices) in selected years, 1950–60*

[Pounds in millions]

Gross fixed capital formation	1950		1952		1954		1956		1958		1960	
	Amount (1)	Percent (2)	Amount (3)	Percent (4)	Amount (5)	Percent (6)	Amount (7)	Percent (8)	Amount (9)	Percent (10)	Amount (11)	Percent (12)
Housing	£264	65.0	£352	65.1	£363	63.1	£296	52.3	£247	46.2	£261	43.3
Other social services	56	13.8	77	14.3	79	13.7	108	19.1	126	23.6	129	21.4
Basic environmental services	50	12.3	77	14.3	94	16.3	111	19.6	115	21.4	148	24.5
Trading services	20	4.9	17	3.1	20	3.5	26	4.6	25	4.7	30	5.0
Other	16	3.9	17	3.1	19	3.3	25	4.4	22	4.1	35	5.8
Total	406	100.0	540	100.0	575	100.0	566	100.0	535	100.0	603	100.0
Local authorities gross fixed capital formation as percent of total for economy as a whole	23.9		25.7		22.7		18.2		15.3		14.7	
Financed by:												
Current surplus (gross)	79	19.5	83	15.4	117	20.3	130	23.0	166	31.0	218	36.2
Capital grants from central Government	17	4.2	16	3.0	30	5.2	22	3.9	34	6.4	46	7.6
Net borrowing from central Government	262	64.5	409	75.7	260	45.2	91	16.1	−29	−5.4	−35	−5.8
Other borrowing (net)	48	11.8	32	6.0	168	29.2	323	57.1	364	68.0	374	62.0
Total	406	100.0	540	100.0	575	100.0	566	100.0	535	100.0	603	100.0

Source: NIE, 1961, tables 41 and 52.

FINANCIAL REFORM IN THE FEDERAL REPUBLIC OF GERMANY*

BY KOMMISSION FÜR DIE FINANZREFORM

I. PURPOSE OF FINANCIAL REFORM

543. The constitutional and financial order in the Federal Republic requires that public duties and functions in the relations between Federal Government and the States be mutually defined as clearly as possible. In spite of the rules of competence set out in the statute, practical application throughout the last decade has shown that a number of questions relative to duties have remained unclarified and that this has led to a great deal of overlapping and frequent disputes between Federal and State authorities. The unorganized juxtapostion of performance of public duties through several agencies favors an uneconomic expenditure pattern and endangers the fabric of the Federal system. For cooperation between Federal Government and States, which in important areas responds to an urgent demand, formulas have been devised in the course of time which are constitutionally assailable and not sufficiently harmonized.

544. Therefore, one of the essential tasks of financial reform is to clarify relations of competence, which have become confused, to clarify the financial responsibility of the Federal Government and the States and, where joint action is required, to steer cooperation between Federal Government and States into orderly channels. By so doing, the recommendations set out in the "Opinion" aim at maintaining the substance of the Federal system, but at adjusting them to the demands of the modern, internationally interdependent, industrial society. The leitmotif is "cooperative Federalism", which combines the desired variety with the necessary unity of the Federal forces, for the benefit of the community and its parts.

545. Such an arrangement of distribution of duties offers the basis for a reform of the Federal equalization of burdens which is aimed at an equitable distribution of tax revenues between Federal Government and States. The new distribution system is to afford Federal Government and States, through sufficiently lasting regulation, as equal as possible a participation in the growth rate of receipts from Big Taxes. But this regulation is at the same time to be so flexible as to be adjustable to the requirements of Federal and State financial and economic policy.

*Source: *Gutachten über die Finanzreform in der Bundesrepublik Deutschland.* [Expert Opinion on Financial Reform in the Federal Republic of Germany] Kommission für die Finanzreform (Stuttgart, 1966), pp. 157–169. Translated for the Joint Economic Committee by Legislative Reference Service, Library of Congress, Elizabeth Hanunian, translator.

546. Because the local tax system has led to excessively large inequalities in taxpaying capacity, has paralyzed financial self-sufficiency of many communities, and has steered economic growth into unsound channels, it also requires reform. Since these discrepancies are due primarily to the predominance of the tax levied on capital and profits of industrial enterprises, it was necessary, first of all, to reexamine the local tax system. The reform strives for a more uniform distribution of receipts from taxes to the communities for a more adequate participation of the citizens of the community in the burdens of the local community, for an improved capitalization and, therefore, a permanent strengthening of municipal self-sufficiency.

547. In view of the increasing importance of financial policy with a view to guaranteeing currency stability and permanent economic growth, fiscal reform must, in the opinion of the Commission, also focus on improvement in economic and budgetary facilities. The reform is aimed, in particular, at placing public funds, more effectively than heretofore, into the service of economic policy at the national level and of a long-term policy of structural development.

II. New Forms of Cooperation Between Federal Government and the States

548. While the Constitution establishes, in the area of legislation, concrete provisions to govern the jurisdiction of the Federal Government and the States, only general rules exist in the area of administration. In the past this has led, in the area of the so-called unregulated administration, to numerous ambiguities and differences of opinion between the Federal Government and the States, primarily with regard to jurisdiction in matters of financing. In this area, in line with the concept of legal state, a clarification in depth is required on which, under the Commission's proposal, the Federal Government and the States are to agree separately. For this purpose, an administrative agreement has been drafted, setting out clearly defined limits for the future and also providing for clarification with regard to settlement of newly arising differences of opinion.

549. Under the Constitution, the States enforce the Federal laws as basically their "own affairs." Therefore, they are responsible for administration, under the supervision of the Federal Government which is limited to watching over the legality of administrative action. Thereby, too, they regularly bear the expenses inherent in the enforcement of the laws. This arrangement is inappropriate in cases in which the Federal law orders disbursement of funds and, therefore, establishes the recipients as well as the conditions for and the amounts so explicitly as to leave practically no room for administration by the States as their "own affair." There is no real justification for burdening the States with the expenses of enforcing the law. We may cite as examples the laws on savings bonuses, on rent and encumbrances, on grants for [higher] education, etc.

In the future, therefore, the Federal legislator is to be authorized to order, with the consent of the *Bundesrat*, Federal administration, for carrying out functions of that type. As a result, the enforcement of laws concerning payments in cash, especially financing costs, would be shifted into the Federal area where, due to its nature, it rightfully belongs.

550. The strict separation of functions which formerly characterized the relations not only between Federal Government and individual States, but also between and among States, is today being complemented, in important areas, by diverse forms of cooperation. Important State efforts are thus brought in harmony in every form, shape and manner and carried out jointly without in every case being grounded in constitutional law and based on financial security. In its present state this development demands that, insofar as possible, a clear distinction be made between Federal and State jurisdiction, and that, whenever necessary, especially when large investments are involved, regulations be established, anchored in constitutional law, to govern the pursuance of "joint activities," and guaranteeing an appropriate, legally incontestable settlement commensurate with the importance of the efforts.

551. Accordingly, a new constitutional proviso is to open the way, through Federal legislation and with the consent of the *Bundesrat*, for changing determined activities heretofore within the competence of the States, into joint efforts provided the activities are in the public interest and, because of the sizable funds involved, require long-term, joint planning on the part of the Federal Government and the States. Joint activities of this type are presumed to lie in the following areas:

—New construction and enlargement of institutes of higher learning in the science field [science and technology];
—Promotion of research facilities outside these institutes [extension];
—Construction and expansion of local [community] road traffic and transportation facilities;
—Measures designed to improve the agricultural structure;
—Measures concerning regional economic policy in the interest of supraregional territorial regulation.

552. The joint pursuance of activities is to be based on establishment by the Federal Government and the *Bundesrat*, through joint resolutions, of plans and guidelines to govern the carrying out of joint efforts. The drafting of plans and guidelines is to devolve exclusively on the States concerned. The Federal Government and the States concerned are to share in financing costs on a 50–50 basis. For unreasonable burdens on financially weak States special regulation is provided under the interstate equalization of burdens system.

553. In the area of the right to pay [wages and] salaries the Federal Government has [full] jurisdiction only over its own civil service, and basic jurisdiction over all other civil servants of States, Communities and other public corporations. Experience has taught that these regulations are inadequate for maintaining the necessary uniformity of wages and salaries throughout the Federal territory. The unjustified preference given to certain wage-earner groups, which is already evident, the methods applied in the breakdown of the pay system make necessary, in view of the importance of employee salaries for the overall public budget, the establishment of limits under a general law, to be observed [to be implemented in detail] by States, communities, and other public corporations. Hence, the competence of the

Federal Government with regard to general legislation [Rahmen—, or Mantelgesetzgebung] according to article 75 GG must be supplemented.

554. The interrelation of Federal and State budgets, as well as the need for effective joint financial planning, require uniform rules of procedure with regard to budget and budgetary statistics. It should be laid down in article 109 GG that the *Bundestag* may, with the consent of the *Bundesrat*, regulate the budget law, according to modern criteria, uniformly for Federal Government and States.

555. The financial policy of the Federal Government is also important for States and communities. Therefore, the Commission has resolved to propose modification also of article 113 GG. Under the present version, which is still in force, the Federal Government is authorized to deny approval of *Bundestag* resolutions that endanger balancing the budget. This provision has proved politically impracticable. The main reason is thought to be that the veto power which the Federal Government may exercise in order to disapprove a resolution is provided for at too late a stage, i.e., only subsequent to the final vote on a resolution. It should be possible for the Federal Government to declare its doubts to the *Bundestag* as to parliamentary resolutions of this type at an earlier stage (for instance, after the second reading), to enable the *Bundestag* to consider objections of this kind prior to the close of the legislative process.

III. Reorganization of Federal Equalization of Burdens

556. Equitable distribution of tax receipts to the Federal Government and the States and their flexible adjustment to new functions require explicit regulation in the constitution of the distribution of costs, which would preclude, insofar as possible, disputes concerning the extent of financial responsibility of Federal Government and States. Today this purpose is served by the general principle of distribution of costs set out in section 4, No. 1, of article 106 GG, according to which Federal Government and States will separately pay the expenses resulting from the performance of their duties.

557. However, it will be necessary, by means of supplementing this general principle, to remove certain ambiguities which have come up in the past and, in addition, to regulate the distribution of costs for the new Institute of Joint Efforts [Institute der Gemeinschaftsaufgaben]. Accordingly, expenses inherent in the enforcement of Federal laws are in the future to be borne by the States, if the laws are enforced by the States as their "own affairs"; in the event of Federal administration they are to be borne by the Federal Government. For full application of this principle, only a few laws already in effect require correction which is related to the proposal providing for Federal administration in the case of laws governing regular cash payments by the public authorities.

558. For joint efforts, provision is made for participation of the Federal Government in the expenses of the individual States in the amount of 50 percent of material expenses; for financially weak States, provisions is made for a supplementary special regulation under the interstate financial equalization system.

559. Furthermore, in the relations between Federal Government and States, the unlimited financial responsibility of the State, whose authorities are being activated in carrying out a function, for the personal and material costs of administration should be explained in the basic law. This regulation takes account of the fact that, in the enforcement of Federal laws, the States are responsible for the administrative setup and, as employers, for the administrative personnel and, therefore, must pay the expenses.

560. At present, receipts from taxes are divided between the Federal Government and the States in such a way that both share, at certain variable rates, in receipts from income and corporation taxes [Verburdssystem]. All other taxes are assigned either exclusively to the Federal Government or exclusively to the States [Trennsystem]. Coexistence of these two systems is possible even under a new fiscal statute [reform]. However, it is the opinion of the Commission that certain essential corrections are required.

561. The *Verbundsystem* will meet its purpose most adequately if the volume of *Verbund* taxes is so large, and if their composition is so diverse, that changes in receipts will compensate each other and that the risk inherent in fiscal developments will be appropriately divided between Federal Government and States. These goals will be attained better than heretofore by inclusion into the Verbund, along with income and corporation taxes, also turnover tax and turnover equalization tax.

562. With a view to the other taxes, it is recommended that because of their supraregional character, the tax on capital transactions, the insurance tax and the tax on bills of exchange, be transferred to the Federal Government; compensation to the States could be brought about by a correspondingly larger share in the taxes in which they share jointly.

563. Under the new distribution of taxes consideration will likewise be given to the communities. Above all, constitutional conditions are to be created for their participation in local income taxes which are an essential part of fiscal reform at the community level.

564. Transportation difficulties, especially in the so-called congested areas, will require in the coming decade, according to official estimates at hand, capital investment on the part of the communities and associations of communal corporations which, even considering the extensive grants-in-aid on the part of the States, cannot be managed with presently available funds. It will be necessary, therefore, and appropriate for the communities to pay a bigger share in road traffic taxes. Consequently, the Federal legislator is to be authorized to give the States, under a quota to be established by law, a share in the Federal mineral [fuel] oil tax receipts. In order of size, this would involve a share of about 15 percent of receipts from this tax allocated to road construction. The funds are to be turned over to the communities with the proviso that they be used exclusively for additional promotion of urgent investments in transportation at the local level.

565. Equalization of burdens [taxes] among the States has in general proved a success as to its constitutional authority and its organization. It can also absorb, without radical changes, the effects of a fiscal reform. With regard to the expenses of joint efforts, a special

equalization of burdens [tax] among the States is to guarantee that the promotion of joint efforts, due to considerations of national policy, will not be frustrated by the financial weakness of individual States. For this purpose, about one-half of the share of the States is to be distributed to all States in accord with ability to pay, thereby reducing the individual share to be paid by financially weak States to 25 percent of regional expenditures.

566. Equalization of burdens [tax] among the States requires that the regional receipts from taxes correspond to the economic power to pay taxes of the individual States. Due to increasing economic interdependence (combines) and modern industrial management (supraregional wage and salary administration), the relationship between regional receipts and regional ability to pay taxes is, with regard to big taxes, often falsified in statistics. This development should be opposed by a breakdown of income tax and corporation tax as well as turnover tax which, in the interest of administrative simplification, must be limited to the big tax cases, which have an effect on financial policy.

567. The provisions of the internal revenue act should be adjusted to the new tax law, in the course of which the obvious defects of the present legal status could be eliminated. It is recommended that turnover tax and transportation tax be transferred to State administration and that provision be made for Federal administration concerning all taxes handled by State revenue authorities in the receipts of which the Federal Government participates.

IV. Fiscal Reform at the Local Level

568. Fiscal reform also includes a reform of local finances, based on the concept of local government, that is, tax sources must be assigned to local governments for the utilization of which they alone are responsible—though within certain limits—while the allocation of funds [grants] by the State should be merely of a supplementary nature.

569. Since the effectiveness of any fiscal reform depends on local efforts to be implemented by efficient executive bodies, the question of territorial [regional] reform, which has not yet been resolved, is also closely tied to the reorganization of local finance.

570. The income of local governments is at present made up of local taxes, predominantly real estate. In addition, local governments today are receiving, by virtue of equalization of burden taxes, grants-in-aid from the State in steadily increasing, and today very considerable, amounts.

The local tax system which represented, in its original conception, an arrangement in line with self-government, has in recent decades been adversely affected by three factors: The excessive growth rate of the tax on capital and profits of industrial enterprises, in particular, the tax on operating profits, the stagnation of the land tax, and the absence of a local income tax. The result is a unilateral burden on business and strong fluctuations in local tax receipts. The preponderance of the tax on capital and profits of industrial enterprises has also led to variations in tax receipts according to locality. In view of the present strain on the operating profits tax, strong doubts must be raised against this tax also from tax-structural viewpoints.

571. Therefore, any local fiscal reform must be aimed at a reform of tax on capital and profits of industrial enterprises. Based on the concept of self-government, a total elimination of this tax is frequently demanded, and its replacement by State grants-in-aid, is to be ruled out. The relationship of business to the community and the expenses which these enterprises cause to the community, do justify, within certain limits, special fiscal charges.

It is therefore recommended that the tax on operating profits be eliminated in its entirely, but that business be locally taxed in the future commensurate with working capital and payroll.

572. In order to create a reasonable relation between payroll and working capital taxes, rates are to be fixed at two per thousand on capital, and at four per thousand on the payroll, and a uniform local collection rate for both taxes introduced. As for the tax on working capital, provision is made for an increase of about 50 percent, while the payroll tax would be collected at its present average rate, but in all communities.

573. The losses incurred in local budgets (approximately DM5.5 billion in 1964) [$1.35 billion] due to the tax on capital and profits of industrial enterprises is to be equalized by participation of the communities in local payments out of the lower proportional part of the State income tax [Gemeindeeinkommensteuer]. By authorizing the communities to fix rates for their share in the income tax, this participation is given the character of a local tax [Gemeindesteuer]. (This is to make possible adjustment of the local [Gemeinde] share at plus-minus 10 percent or plus-minus 20 percent at the expense or in favor of the taxpayer.)

Through local income taxes a more uniform taxation of the citizens as well as a more evenly spread participation of the communities in overall tax revenues is the goal. Furthermore, the circle of citizens heretofore sharing in the financing of local expenses will be greatly enlarged and civic interest in local self-government will be revived. Not until precise statistical inquiries are made will it be possible to show which communities have difficulties due to elimination of the tax on operating profits, and what measures are recommended for overcoming such difficulties.

574. Participation of the communities in Federal income tax receipts will lead to corresponding losses for Federal Government and States which will be offset, in a minor way, by the possibility of deducting the business tax in the determination of income or corporation taxes. According to rough estimates, based on 1964 budget figures, one may figure, considering a business tax loss of DM5 billion, in view of increased receipts from income and corporation taxes, of perhaps DM1.2 [$300 million] to 1.5 billion [$375 million].

575. The Commission makes no specific proposals for covering the losses to Federal Government and States; but it does point to several possibilities of bridging the gap. It is possible that the tax on net turnover [sales], or a harmonization brought about within the frame of the EEC, especially with a view to France, will provide the Federal Government and States with sufficient additional funds to cover a

considerable part of the losses. Of course, the annual revenue increment might be used for coverage in full or in part. One might also think of elimination of outdated tax benefits and apply additional tax receipts created by introduction of self-assessment and levying appropriate interest payments on all tax arrearage. Consideration might be given to a transitory measure such as levying, for a span of about 5 years, a degressive surtax on business income, with a view to corporation taxes (equalization tax on operating profits) in favor of Federal Government and States, to enable them to sustain the losses in income tax receipts through introductions of income taxes at the local level.

576. The anticipated increase in assessment on real property should lead, in the opinion of the Commission, to a sufficient increase in receipts from land tax A and B. At present concrete proposals cannot be made since the results of the reassessment cannot yet be determined. At any rate, the land tax is to stand, as an important basis of the local fiscal system and to be in proportion with business tax and income tax at the local level.

577. The aim of the proposed application of a part of the mineral oil tax to local transportation efforts is to further improve the financial power of the community. This shifting of funds finds its justification in the considerable and still increasing financial needs of the communities with a view to investments in transportation.

578. In view of the large financial requirements for urgent investment efforts, the Commission holds that an increase to about DM1.5 billion [$375 million] in financial strength at the local level is indispensable. For that purpose, the share of the communities in the income tax is to be assessed in such a way that it will exceed the loss of income due to the [elimination of the] business tax by about DM1.5 billion [$375 million]. Such an arrangement would lead in a number of communities, especially in those which did not share in the growth rate of the business tax or only below average, to an essential increase in taxpaying capacity and would release, in part, the funds heretofore channeled into them by way of local equalization of burdens tax, for application to communities heretofore collecting large business taxes where temporary difficulties are anticipated due to reduction of the business tax. This shifting of tax revenue would serve to diminish the growth rate of public consumption expenditures and, at the same time, to increase public capital expenditures.

V. Ways and Means of Economically Sound Fiscal and Credit Policy

579. The modern industrial state must put its economic and social policy into the service of—

- —internal and external financial stability;
- —strong economic growth as uniform as possible;
- —optimal utilization of the available labor force and other national production factors; and,
- —a certain reduction of inequality in the distribution of income and wealth.

These objectives must be encouraged by the Federal Government more effectively than heretofore by means of an adequate fiscal and credit policy. For that purpose it must be provided with the necessary instruments.

580. In particular, the Federal Government should be invested with sufficient authority to take tax measures limited in time, as well as to absorb and neutralize purchasing power. These powers must, of course, be tied to strict requirements and be limited in time; they should be applied exclusively in order to head off dangers to the overall economic stability. The measure adopted should be valid for a period not in excess of 12 months.

581. It should be possible for the Federal Government to lower income and corporation taxes by 5, 10 or 15 percent and, conversely, in the event of stronger inflationary pressure, to introduce, on a temporary basis, a 5 or 10 percent surtax on income and corporation taxes. Provision should be made for corresponding authority with regard to excise taxes, in particular—insofar as technically possible—taxes on tobacco and liquor monopolies. Because of the anticipated harmonization of tax rates within the EEC, the turnover tax would no longer be convenient for a fiscal policy of this type.

582. Economic measures of this type might be complemented by tax incentives with a view to increasing or decreasing private investment.

583. The economic success of measures of this type depends decisively on rapid effects on taxpayers as to taxation and revenues. For that reason, the Commission recommends that self-assessment with a view to income and corporation taxes and interests on all tax arrearages be introduced as a way to achieve timely taxation.

584. The Commission holds the view that it will be necessary, in times of prosperity with dangerous inflationary pressure, to withdraw additional tax revenues from circulation; that they should by no means be used for additional expenditures.

585. The present budgetary policy, especially of the Federal Government, is defective in that appreciation of projects of financial import is limited as a rule to presently debated individual cases and their effects on the current or, at any rate, the following budget. This practice is further encouraged by the fact that neither the Legislature nor the Government have a clear concept of the impact that the obligations resulting from their resolutions will have no future budgets.

586. The Federal Government should, therefore, be constitutionally bound to draft, in consultation with the State governments a budget plan covering several years and comprising the overall public budget, and to base their management of the budget, by way of financial guidelines, on this plan. The budget plan is to be submitted to *Bundestag* and *Bundesrat* for review and appreciation of the financial effects of their resolutions on a long-term basis and in an overall budgetary context.

587. The budget plan of the Federal Government would not bind the State governments, but they are to be constitutionally bound to cooperate in the drafting of the plan. From integration of the political and economic necessity and the financial policy of the States, communities, and other public corporations into the Federal process, it should follow that, even without official obligation, the budget plan worked out in cooperation with the State governments would also have an effect on regional planning.

588. The budget plan should be drafted for a span of from 4 to 6 years, but should be regularly amended and adjusted to developments (sliding planning).

589. Developments in recent years have clearly shown that, in the interest of national legal tender and with consideration to undisturbed economic processes, improved mutual adjustment of the credit needs of and the demands made by public corporations on the capital market is an absolute "must." It is recommended therefore, that the Federal Government be authorized, by constitutional proviso [amendment], in order to stave off dangers to overall economic stability, to issue regulations, via decree, concerning the extent and kind of the public debt, to be binding on all public corporations. In view of the purpose of this intervention, its validity is to be limited to 1 year.

590. On the other hand, the Commission majority was unable to decide on affording the Federal Government opportunities for direct influence on the expenditures of the States, communities, and other public corporations. Aside from legal problems, which would result from the provisions of article 109 and article 79 (sec. 3) GG, it is the opinion of the Commission that the right to intervention by the Federal Government in the expenditures of the aforementioned corporations is incompatible with the principles of the Federal structure of the Nation and with the principle of local self-government, and that, beyond that, they might open the door to an intolerable situation of "dirigisme." On this point, one of the Commission members cast a negative vote.

591. The measures taken with regard to fiscal policy and credit policy will be the more effective the more they complement one another. Therefore the Commission recommends that the monetary policy facilities of the German *Bundesbank* [Federal Reserve Bank] be expanded in order to enable it to influence the borrowing activities of private enterprise (credit limitation). It further recommends an expansion of the regulation on minimum reserves, inclusion of the social [security] institutions in the obligation to maintain their liqud assets [on deposit] with the *Bundesbank*, expansion of the open market policy of *Bundesbank* by means of name papers, as well as extension of the provisions concerning the granting by the *Bundesbank* of Federal and State loans, etc., to open market credit.

VI. Time Schedule

592. The Commission's proposals aimed at financial reform consist of a compact, integrated system, which should, if possible, be passed in the form of legislation. Provision should be made for this to be done sometime during the current legislative period.

593. The regulations governing the reform of the financial system might be put into effect at the beginning of fiscal 1968, while financial reform at the local level (Gemeindefinanzreform), because it is tied up with the European harmonization of the tax on net sales and due to the many transitory and adjustment measures, especially in the area of local equalization of burden taxes, could not be envisaged until the beginning of 1970. This, however, does not prevent the required legislation from being passed along with the general financial [or fiscal]

reform. It may even be deemed necessary in order to have sufficient time for administrative organization preparatory to the reform measures.

594. The Commission is aware that the realization of a comprehensive financial reform will meet with many difficulties. It is also aware that the goal of the reform, that is, to achieve an improved financial arrangement between Federal Government and States and to bolster self-sufficiency at the local level, cannot be attained without considerable financial efforts.

Financial reform is of vital national importance. The Federal Government and the political parties represented in the *Bundestag* have repeatedly expressed the view that this issue must be resolved without further delay.

The Commission feels that its expert opinion [findings] contains useful indications as to how the Federal financial system may be lastingly improved. It emphasizes expressly that its recommendations form a complete unit and, therefore, can be successful only if they are realized without substantial cuts. Yet, it is entirely possible for the proposed legislative measures to be put into effect in several stages, provided the final goal is not lost sight of.

Financial reform is a joint effort. Its resolution must be brought about through close cooperation of Federal Government, States and communities. Therefore, the parties concerned must not view the Commission's recommendations within the narrow frame of short-term advantages of their own, or with regional special interests in mind. If they do, the reform is doomed to failure.

THE THORNY WAY TO FINANCIAL REFORM*

Interview with Dr. FRITZ NEUMARK**

POLITICAL ACTIVITY ABSOLUTELY ESSENTIAL

WIRTSCHAFTSDIENST. Professor Neumark, the advisory committee has proposed to institutionalize the joint tasks. Is such an institutionalization really essential? Could we not allot larger means to the States that would thus enable them to carry out these tasks themselves?

NEUMARK. If you look at it only from the standpoint of financing, your question will have to be answered in the affirmative. But as for the joint tasks we agreed that planning should be carried out by the States and the Federation, and, therefore, emphasis has to be placed on this joint planning. Otherwise, these tasks could indeed be solved through a different apportionment of the "Verbundmasse" [joint effort?]. We now have to consider that it was not we who actually proposed to declare specific tasks a joint task. We only cited examples. The decisive issue is whether or not Federation and States will agree to handle as a joint task any task, that according to the constitution should be handled by the States, on account of its great national or supraregional significance as a result of which financing and planning are jointly done.

WIRTSCHAFTSDIENST. Does this proposed institutionalization of the joint tasks reflect a certain criticism of the way these important tasks have been carried out to date?

NEUMARK. One cannot deny that there is a certain criticism. The States, of course, can say that if they had received more money, they would have been in a better position to carry out their tasks—let us say in the sphere of science and research—than some of them had been carried out so far. But I believe that there are tasks which on account of their importance cannot satisfactorily be solved by the States. Therefore, we will have this cooperation between Federation and States once both agree that they are faced with a joint task.

WIRTSCHAFTSDIENST. And this is even much more valid when, not only financing but also coordination is involved which in some sectors, as for instance education, has not at all always been satisfactory.

NEUMARK. Quite correct. And I would like to point out that after only 2 or 3 years something similar was adopted in the United States after very long and tenacious fights. The States and especially the mu-

*Interview with Dr. Fritz Neumark, Frankfurt au Main, reprinted from *Wirtschaftsdienst* No. 7, July 1966, pp. 355–360. Translation for Joint Economic Committee by the Legislative Reference Service, Library of Congress, Paul Vidal, translator.

**Professor Neumark is honorary President of the "Institut International de Finances Publiques", Chairman of the Scientific Advisory Board at the Federal Ministry of Finance and member of the Scentific Advisory Board at the Federal Ministry of Economy. He was chairman of the committee on tax harmonization of the EEC and member of the commission for financial reform from 1964 to 1966.

nicipalities there, which are likewise charged with the tasks of schooling and education, resisted for political reasons the acceptance of the so-called grants in aid, that is, subsidies of the Federal Government. They now realized that there is no other alternative if certain minimum standards have to be met all over the country.

WIRTSCHAFTSDIENST. Consequently, in our case, the municipalities should be included in this concept of joint tasks, that is inclusion in this planning. Would this not mean that the municipalities would be led by the strings? Is there not the danger of losing autonomy on which the municipalities have always insisted inasmuch as they are the weakest in the threefold system of Federation, States, and municipalities?

NEUMARK. In this connection may I make a comment which perhaps will not be endorsed by all members of the committee: You know that they say—much of it has also been mentioned in the expertise—that we need a stronger central control in many domains because we aim at a uniformity of living conditions and living standards in all the territory of the Federation. In this respect, of course, there is a fundamental difference between the German concept of national life and those upheld in Switzerland and the United States. In the United States one does not aim at all to achieve more or less equal living conditions in the municipalities, as for instance education, et cetera. What they want is that certain minimum standards be maintained through the aid of Federal subsidies. The competition of the municipalities should, however, be preserved inasmuch as certain conditions can be created that will result in higher standards, and this, I believe, is sound competition in the political sphere.

WIRTSCHAFTSDIENST. Professor Neumark, a very decisive measure that has been proposed is, we believe, the communal income tax. Now they have criticized such a communal income tax and said that it is too complicated, and for this reason it should not be introduced.

NEUMARK. At the committee, after listening to the opinions of the experts in this domain and after studying the questions of possible complication, we arrived at the conclusion that it is very possible to reduce by measures, to which we have hinted in our expertise, the degree of complication to a minimum. You must not forget that on the one hand, of course, we tried to make allowance for the concept of the municipalities financial autonomy by permitting them to vary the income taxes according to our directions. But these variations will not exceed 20 percent of the income tax in question: for the individual this is of relatively little importance that is, a deduction, or what is more realistic, an additional increase of DM92 [approximately $23] or—in case of married persons—DM185 [approximately $48] per year. In this manner, however, and contrary to the procedures followed in the case of the present trade tax, a relative large number of taxpayers will be used to pay for the municipal expenses with the result that thanks to the possibility of varying the rates of assessment there will be a manipulating amount for the municipalities of 1 to 2 billion Deutsche marks [approximately $250 to 500 million]. This we consider is very desirable. We should not forget these advantages when we think of the negligible complications.

WIRTSCHAFTSDIENST. Professor Neumark, in a modern political economy income tax is used for important political goals. The most important are economic political and such political goals that directly refer to the incomes. Will these goals not be affected adversely, if we differentiate the income tax according to the regions?

NEUMARK. I do not believe that such thing will happen. We, indeed, must not forget that the share will not be very important which according to our conception will flow in the future to the municipalities from the joint tax of the States and Federation which, now as before, we have to consider as income tax. The large part of the revenue will stay with the States and the Federation whereby, of course, it has to be considered that, if our proposals were to be carried out, the Federation will have a higher share in income and corporation tax. This fact results from the reinforcement of the "Verbundmasse" [joint effort?]; that is, the participation of the States in the returns of the turnover tax which hitherto was only controlled by the Federation. May I mention in this connection something that is often overlooked; that is, the so-called municipal income tax only refers to the income tax proper; the corporation tax, now as before, will exclusively be the concern of the states and the Federation. In this respect the economic political possibilities of manipulation are fully preserved.

WIRTSCHAFTSDIENST. Will the economic political efficiency of the income tax not be reduced if the municipalities are allowed to decrease the rate of assessment? In such case, the communities could defeat the purpose of a tariff amendment decreed by a Federal law.

NEUMARK. I believe that this will not happen, inasmuch as the revenue quota of the municipalities is too small for it. Do not forget that this quota refers to only one part of the income tax which is subject to the so-called proportional rate of 19 percent at present of which the municipalities will only receive 38 or 48 percent, depending on whether or not the favorable or less favorable version of our proposals will be accepted for them. On the other hand, the Federation could also effectuate, now as before, total economic and thorough results ranging in the billions as surplus or deficit by means of a 10 or 15 percent variation up or down of the general tariff. I therefore believe that in view of the relatively short range of the so-called income tax of the municipalities this negative effect will not be felt.

WIRTSCHAFTSDIENST. Professor Neumark, there is another proposal that aims at the abolishment of business profit tax, increase of business capital tax and general levy of payroll tax. Now it has been said that such an arrangement would adversely affect the political goals of the middle class. Do you believe this objection to be justified?

NEUMARK. I must frankly admit that the term middle class policy is not very clear cut. In certain respects it cannot be denied that middle class policy and expansion policy could exclude or still oppose each other. If you observe the trend toward concentration in the German economy—and not only in the German economy—that has been going on for the last 10 and especially for the last 2 or 3 years, one can say that it resulted from the technical and economic exigencies; aside from the drive toward the large-scale enterprises (partially comparable to the drive toward the larger market, as we have seen it with the EEC [Europen Economy Community]) there are also state interventions which artificially promote concentration such as certain tax measures, as I would like to say. It is logical to criticize on the one hand that we favor a business tax policy allegedly directed against the middle class, if, on the other hand, nothing is done to eliminate revenue law measures that promote so much concentration, such as systems of organizations and especially such as they appear in the law on turnover tax. Here, therefore, I notice contradictions and I would say: Let us first start on the middle class policy in such a way that measures promoting concentration will be eliminated.

WIRTSCHAFDTSDIENST. According to the idea expressed by experts the municipalities would be allowed to assess substantial taxes of their own. Would you not say that it would be much wiser to maintain instead the allotments in a larger measure?

NEUMARK. We, of course, will retain a mixed system. We will not be able to do without appropriations in addition to the municipalities own revenue incomes. But the municipalities insist, and justly, I believe, that it is in the nature of true self-government that it be able to cover at least a substantial portion of its expenditure from its own income. I do not believe that we have emphasized too much in our proposals the financial autonomy of the municipalities. Of course, I still have to add something here. If we also maintain with some justification that in addition to the Federation and the states the municipalities, too, indulged in waste, then it has to be admitted that some municipalities had been sinners judging by the way in which they carried out certain necessary projects during the last years. On the average, however, it cannot be denied that the municipalities whose budgets show a by far larger amount of capital expenditures than those of Federation and states, will have to shoulder the main burden of necessary future investments in order to safeguard a sound economic growth by means of public measures.

WIRTSCHAFTSDIENST. Professor Neumark, in connection with the present appropriations one sometimes gets the impression that the municipalities do not know exactly under what criteria they should receive them. Would it not be advisable to establish general noncommittal criteria according to which such appropriations should be made?

NEUMARK. I have no reservations to agree to it wherever possible, and possible it is in many cases.

WIRTSCHAFTSDIENST. One of the questions of a more political nature broached by the experts and extensively discussed by the public was that a larger participation of the citizens or of their representatives at least could be brought about by changing the structure of the municipal taxes. Do you believe that there really will be a larger participation of the citizen or their representatives after such a change?

NEUMARK. Theoretically at least there is such a possibility, but it is hard to predict whether or not the citizen will make use of it as is the case in England, Switzerland and especially in the United States. I will put it very cautiously: If the business profit taxes are at present the backbone of the municipal taxes, and if one considers that, as a result of the progressive increase of the taxfree amounts, this particular tax today is no more a business tax in the sense that it includes the majority of the tradesmen but only a diminishing number of large scale industrial enterprises, then it is obvious that something is rotten in the municipal financial system. Only a very small fraction of the members of the community are connected to the municipal finances through this most important tax. If the so-called municipal revenue tax will be introduced, a much larger percentage of members of the municipality, such as the workers, employees, officials and those in the professions will be interested in finding out for what purposes the municipality spends the money. If there are superfluous or excessively high expenses, they will get the receipts for them and the rate of assessment will then be increased from 90 or 100 percent to 110 or 120 percent. And this would affect a very large number of members of the municipality and not only—as at present—a few large-scale enterprises which for the most part can shift the burden of the tax.

WIRTSCHAFTSDIENST. Professor Neumark, in this connection will something be done for a reasonable system of expenditures for the municipalities? If they have to get the means themselves, and if the representatives of the municipality have to give accounts to their fellow members about their expenses, then superfluous or excessively high expenses will not occur at all.

NEUMARK. I fully agree with you and for this reason I can only answer your question in the affirmative.

WIRTSCHAFTSDIENST. By changing the system of the municipal taxes, a total leveling of the financial power among municipalities of different sizes will not and shall not be achieved. But the decrease of the differences that we may expect would probably be a tool with which the expensive services of the public authorities in the big cities and with it their power of attraction could be diminished. This would counteract the agglomerations in the large spaces [cities]. Do you believe that this would be an additional effect of the tax reform?

NEUMARK. I believe that this will be an additional effect and, moreover, I hold that it is an effect purposely aimed at by the committee. I am by no means a person who is against the big city; as cultural centers I consider them worthy to be maintained and promoted. But the accompanying symptoms which we have experienced in specific centers on account of the vary large agglomeration of the population cannot be sanctioned in the long run, and for this reason we welcome from a middle and even long-range standpoint a tax policy that will stop centralization.

WIRTSCHAFTSDIENST. Professor Neumark, we have heard people say that the big cities and municipalities are much worse off than the smaller ones. We heard the slogan: The injustice starts with 10,000. Do you agree with this opinion especially with regard to the effects on the financial reform?

NEUMARK. We have made trial calculations and there is no doubt that not all big cities but three or four are immeasurably placed at a disadvantage.

WIRTSCHAFTSDIENST. Which cities?

NEUMARK. Well, one of them is Frankfurt, others are Düsseldorf and Ludwigshafen. We accepted it and said: For one part this is the result of an excessively artificial expansion because these three cities, if we do not include the special cases of Wolfsburg and Schweinfurt, are among the first of the cities without districts with regard to the amounts of business revenue tax they yield (Deutsche marks per inhabitant). But we do not want to undo what once has become accepted, and, therefore, we believed that remedial measures will have to be taken by means of a change in the interstate financial adjustment in such cases in which a really excessive reduction of their own revenues will occur as a result of the replacement of the business profit tax by the so-called municipal income tax.

WIRTSCHAFTSDIENST. Professor Neumark, the joint expenses play an important part in the findings of the experts. If these tasks are of such great importance and solved only unsatisfactorily at present, would it then not be necessary to increase the taxes?

NEUMARK. This is a question to which I would like to reply very much on account of the misconception spread about it in the public, partly because of ignorance and partly on account of demagoguery. If you look once at this so-called financial quota; that is, the proportion of the tax revenues of all three levels including compensation of charges to the gross national product, then you will notice that this quota has changed very little in the Federal Republic during the last 15 or 20 years, once one point up and once one point down; and all this, in spite of the fact that the tax revenues, thanks to the progressive income tax, had risen overproportionally—at least some times. Why these ups and downs that have been characteristic of the total tax quota? Because one had always tried to stop the overproportional increase of the tax revenues and tax quotas by means of reductions in taxation which had been carried out almost regularly since 1952. To a certain extent this makes me feel better somehow. Confronted with these facts one cannot pretend that it is the goal of our national economy to steadily expand. It, however, does expand absolutely but not relatively as people so often say. And there is one thing which we must not overlook: we are demanding more and more from the state in the domain of social consumption and in the area of the so-called social investments whose importance for the total economic growth is more and more recognized.

If this is the case, the competent authoritative bodies—Parliament and Government—sooner or later will be faced with the choice whether we—and be it only temporarily—have to put up with an increase of the tax quota by means of increasing certain taxes, or whether we want to wait longer than usual for carrying out traffic investments, education investments, etc. If the economy continues expanding, there will be an automatic tax accrual. We then have again the choice between a new lowering—let us say after 5 years because at present it is not under discussion—of the income and perhaps also the corporation taxes and the maintaining of the present rates and with it a speedier carrying out of the investments. But every financial policy as every economic policy is actually nothing less than a choice between two alternatives. We cannot demand a quicker pace in the sphere of education, scientific research, hygiene, et cetera, and insist at the same time on decreasing the taxes. This is especially out of the question when there are inflatory tensions and when one should rather consider an increase of taxes instead of a decrease; increase them also for economic political reasons in order to help soften the unilateral policy of restriction of the Federal Bank which at this moment might perhaps be unavoidable.

WIRTSCHAFTSDIENST. Another grave reproach directed at present against the states and the Federation is that there is not enough done in carrying out the reform proposals in the political field. Do you also believe that there is not enough political activity with regard to the financial reform?

NEUMARK. I find it hard to say something about it. As far as I know the problems are discussed on the one hand on the so-called political level; that is by the prime ministers of the states and, of course, by the authoritative bodies of the Federal Government and on the other hand their technical feasibility is discussed by the competent ministerial counselors or ministerial directors. In my opinion it is very probable that some states will have hesitations for purely political reasons and for reasons of an excessively emphasized federalism. This I regret. If I am not mistaken, the municipalities have so far been committed most of all. They, of course, proposed certain plans of alternation—which is understandable—but they principally agreed with our suggestions.

I believe that an engagement of the public authorities is very much necessary because for years certain reforms had been earmarked urgent by the Government, Parliament and the large public but no decisive step had yet been taken in this field. I am not thinking of the budgetary reform which now should be pushed forward but of which we have been talking for 10 years. I furthermore wish to mention the turnover tax reform, the substitution of our present system by a surplus value tax of which Parliament has been discussing for 5 years; maybe it will be carried out in the near future. In any case, I would like to emphatically express my hope that the financial reform should not suffer the same fate of the two other reforms already mentioned before: to be put into cold storage for 5 or 10 years, but it will be necessary for the Federal Chancellor and the Prime Ministers of the states to do their utmost for the speedy materialization of the reform. Time presses and we have to do very extensive legislative work. According to our calculations the present Federal Diet could, if it soon decides on the principal political issues and if bureaucracy speeds up on the preparation of the bills, just be in a position to pass the extensive legislation to the extent that it could be materialized in its different stages in about 1970. I do not believe, what certain responsible government departments have been declaring for years, to be right: we urgently need a financial reform, we only wait for the experts' opinion; after it has been made available it seems that there is now a stagnation, because one cannot notice very well that something important is happening. I still hope that something will happen soon.

WIRTSCHAFTSDIENST. Professor Neumark, by saying that nothing happened did you mean to imply that in your opinion too little has been done?

NEUMARK. Of course, I am not posted on details, but I believe that one should not limit—as it is current now—public utterances to generalities or one should not leave it up to the authoritative bodies, not politically responsible, to express themselves critically or positively. Through systematic clarification we must see to it that it will be recognized in time which are the arguments for and against the different solutions and why one does not think favorably of some points in the committee's expertise and should substitute them by another conception. But in such case one must submit to the large public a compact counterconception. In this connection I would like to point out that in my opinion the most valuable and also partially critical but preponderantly positive remarks came recently from Profesor Haller, my Heidelberg colleague, under the title: "The Expertise for the Financial Reform" in "Konjunkturpolitik" [Economic Policy], the magazine for applied research on economic policy. I still may add that a few days ago I learned much to my satisfaction that certain proposals for fiscal and financial policies contained in our expertise had been accepted in its basic idea or even partially verbatim in a government bill for a law on economic activity stabilization or whatever its final name will be. This bill, however, has not yet taken the last hurdle: the discussions in the Cabinet. Let us wait and see what will become of it. Apart from this I regret that according to all appearances one of the most important economic political reform measures has not yet been considered mature to the extent that it would be accepted and carried out in Germany; that is, the variation of the tax burdens and especially the income tax burdens according to the economic cyclical requirements.

INTRODUCTION TO THE TAX SYSTEM OF GERMANY*

BY HARVARD LAW SCHOOL INTERNATIONAL PROGRAM ON TAXATION IN CONSULTATION WITH THE UNITED NATIONS SECRETARIAT

1/3. CONSTITUTIONAL PROVISIONS AFFECTING TAXATION

1/3.1 SCOPE OF SECTION

Tax jurisdiction, in the widest sense of the term, includes the power of a political body to legislate in matters of taxation, to administer a tax, and to appropriate the proceeds thereof. This section discusses the division of tax legislative powers between the Federal Government and the States (1/3.2) and the distribution of tax revenue between the Federal Government, the States, and the municipalities (1/3.3). In addition, it covers the constitutional rights of the taxpayer (individual or entity) in relation to the government in its capacity as tax collector (*Fiskus*) (1/3.5). The constitutional rules which govern the administration of taxes and other public charges are treated in the section on tax administration (1/6).

Certain constitutional problems which exist in other federated countries do not arise in the Federal Republic because of the structure of its legal system or specific statutory regulation. Since there are no State or local taxes on property or transactions which might constitute a burden on the free movement of goods within the entire area of the country, there is no need for rules against restrictions of interstate commerce through burdensome taxes. The question of whether income, receipts, or property of the Federal Government, or of a State or a municipality, is taxable or exempt from taxation is entirely unrelated to the question of which government owns the property or collects the receipts or the income. The important consideration is whether the ownership of the property, or the realization of income or receipts, flows from the exercise of the public power of the government in question or from governmental activities in the nature of a participation in the general commerce of the country. For this reason, property which the Federal Government, a State, or a municipality uses in the exercise of its public functions is exempt from contributions under the Equalization of Burdens Law (3/4), which is a Federal impost, and the net worth tax (3/2) and real property tax (3/3), which are State taxes. For purposes of the corporation income tax, the government is not a taxpayer insofar as it realizes income in the performance of governmental or administrative functions, but business enterprises

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*Reprinted from World Tax Series; William S. Barnes, Director, *Taxation in the Federal Republic of Germany*, Harvard Law School, Chicago, 1963, Chapter I.

operated by a government in general are taxed like other commercial entities (5/4). The exemption from income tax of interest from certain securities issued by Federal, State, or municipal agencies is entirely unconnected with constitutional limitations; it reflects measures of financial policy which were taken at various times in order to further the reconstruction of the country and gradually to restore a normal capital market (2/1.3, 6/1.9, 9/1.9). In the field of the turnover tax, the law states specifically that the exercise of the public dominion does not constitute a business or professional activity (16/2.5), so that deliveries of property or the performance of services for a consideration are not taxable turnovers insofar as these acts are within the public functions of the government agency concerned.

1/3.2 LEGISLATIVE POWERS OF THE FEDERAL GOVERNMENT AND THE STATES

Tax jurisdiction in the legislative sphere is divided between the Fedral Government and the States. While the municipalities are entitled to the proceeds of certain taxes (1/3.4), they have practically no legislative powers in this field.[1] The statutes which reserve the proceeds of certain taxes (such as the trade tax) to the municipalities are Federal laws. The distribution of tax revenue among the various municipalities within a State is regulated by State law.

Insofar as the Federal Republic and the States are concerned, tax legislative power is either exclusive or concurrent. The exclusive jurisdiction of the Federal Republic extends to two matters only—customs duties and Federal monopolies (GG art. 105(1)). In the field of customs duties, the Federal prerogative covers the substantive rules of customs law as well as the rates of the tariff. Although the rights of the Federal Government in this field are not limited by States' rights, important restrictions as well as duties of positive action exist under international agreements, among which the Treaties of Rome, through which the European Economic Community (Common Market Organization) and Euratom were created, and the General Agreement on Tariffs and Trade (GATT) are of paramount importance.

The exclusive legislative power of the Federal Government further extends to fiscal monopolies. "Fiscal monopoly" (*Finanzmonopol*) is the term used to describe the exclusive right of a political body to appropriate the proceeds from the sale of certain goods or the compensation for certain services rendered. Unlike the situation in former centuries, when the fiscal prerogatives of the king (royalties in the original sense of the term) were a widespread and important source of government revenue, only a few of these monopolies are in existence at the present time. Among these, the alcohol monopoly (*Branntweinmonopol*) is the most important.[2] The production of alcohol in the Federal Republic and the sale of alcohol for any purpose is under the exclusive control of a separate Federal agency which is a producer of alcohol as well as (with minor exceptions) the sole buyer of the output of private distilleries. The fixed prices at which this agency sells alcohol to distributors include tax charges that vary with the use of the

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[1] Some very minor taxes, such as the dog tax and the tax on hunting privileges, are regulated by the municipalities.

[2] Collections from this monopoly amounted to DM1,023.4 million in calendar year 1960 (1/7.1).

product for beverages, cosmetics, and medical or industrial purposes.

In the field of all major taxes, the Federal Government and the State governments have concurrent legislative powers. As explained below, the concurrent legislative power of the State is actually a subsidiary power because it exists only as long as the Federal Government does not exercise its power to legislate. The taxes listed below are within the area of concurrent tax judisdiction of the Federal Republic and the States (CG art. 105(2)).

1. Taxes on income, net worth, inheritances, and gifts.
2. Excise taxes (*Verbrauchsteuern*) and transactions taxes (*Verkehrsteuern*) except as noted below. Excise taxes are taxes on the production or sale of certain consumption goods; these taxes are ultimately shifted to the consumer by being included in the price of the product. The principal excise taxes are listed at 4/6. Transactions taxes are taxes on certain transfers and other legally relevant acts, such as the inheritance tax (4/2), the various capital transfer taxes (4/3), and the real property transfer tax (4/4). By far the most important transactions tax is the turnover tax (ch. 16); this tax, however, is an exclusively Federal tax insofar as legislation and appropriation of revenue are concerned. As a further exception to the above rule, the concurrent legislative jurisdiction of the Federal Government does not extend to transactions taxes of "exclusively local application,"[3] such as the fire protection tax (GG art. 105 (2) No. 1) (4/6.4). These taxes are within the exclusive legislative jurisdiction of the States.[4]
3. The so-called *Realsteuern*, that is, the real property tax (3/3) and the municipal trade tax (ch. 15). With respect to these taxes, the legislative power of the Federal Government does not extend to the multipliers (*Hebasätze*) by which the effective rates of these taxes are determined from year to year.

Within the field of concurrent tax jurisdiction, the exercise of legislative power by the Federal Government displaces the exercise of this power by the States. Expressed differently, the power of the States to regulate a certain tax by statute comes to an end once the Federal Government has preempted the field. However, the Federal Government can exercise its legislative power only if one of the two conditions below is present.

1. The Federal Government claims the proceeds of a tax entirely or in part in order to defray Federal expenditures (GG art. 105(2)).
2. There is a need for Federal legislation (GG art. 72(2)). This need is deemed to exist if the subject matter of the tax cannot be regulated effectively by State law, or if regulation on the State level would be detrimental to the interests of other States or the country as a whole, or if legislation by the central authority is necessary to safeguard the uniformity of the law within the entire country or its economic unity (GG art. 72(2)). The decision on whether one or the other of these conditions is present lies with

[3] *Steuern mit örtlich bedingtem Wirkungskreis.*

[4] The real property transfer tax (4/4) is regulated by Federal law. The States, however, are entitled to legislate in this field by determining the additional rates of the tax (4/4.6) and certain other matters.

the *Bundestag*, subject to review as to constitutionality by the Federal Constitutional Court (GG art. 93).

1/3.3 DISTRIBUTION OF TAX REVENUE AMONG THE FEDERAL GOVERNMENT, THE STATES, AND THE MUNICIPALITIES

a. Introduction

Tax jurisdiction, in the sense of the power to legislate, is not coextensive in present-day Germany with the right of a political body to appropriate the proceeds of a tax. With the major exception discussed below, each tax is specifically assigned to the Federal Government, the states, or the municipalities for collection, and each government is confined to the sources of revenue that are reserved to it in this manner. In this, the system of government finances established by the Basic Law of the Federal Republic is entirely different from the systems which existed under the Imperial Constitution of 1871 and the Weimar Constitution of 1919. Under the former, the "power of the purse," like political power in general, was for the most part in the hands of the sovereign states. The financial resources of the Reich were limited to customs duties and excise taxes (*Verbrauchsteuern*); if the revenue from these sources was not sufficient to meet its obligations, the Reich was dependent on contributions from the states (*Matrikularbeiträge*), which were not always granted with enthusiasm. The situation was completely reversed under the Weimar Constitution of 1919. Under that constitution, most of the political power and the revenue from all major taxes were concentrated in the Reich, which in turn distributed part of its collections to the financially dependent states. Both the Constitution of 1871 and that of 1919 resulted in complicated, though very dissimilar, systems of "financial equalization" (*Finanzausgleich*) through which the distribution of revenue from the states to the Central Government or from the Central Government to the states was accomplished. Under the Basic Law of the Federal Republic, these "vertical" systems of revenue distribution have been replaced by a "horizontal" system, under which the more affluent states transfer certain portions of their revenue to those states whose collections are not sufficient to defray their expenditures (1/3.4).

b. Assignment of Tax Revenue to the Various Governments

1. Federal taxes.—The Federal Government is entitled to the revenue from the taxes and charges listed below (GG art. 106(1)).

1. The turnover tax (ch. 16).
2. Customs (import) duties (4/7).
3. Excise taxes (*Verbrauchsteuern*) (4/6), except for the beer tax. This classification includes the taxes on tobacco, mineral oil, coffee, tea, salt, sugar, substitutes for sugar, champagne, brandy, acetic acid, matches, light bulbs, playing cards, and the coal levy for the construction of miners' homes.
4. The transportation tax (4/6.2).
5. The revenue from fiscal monopolies (1/3.2).
6. The contributions under the Equalization of Burdens Law (3/4).

2. State taxes.—The States are entitled to the revenue from the following taxes (GG art. 106(2)):

1. The net worth tax (3/2).
2. Transactions taxes (*Verkehrsteuern*) (Chapter 4), except for the turnover tax and the transportation tax. This classification in-

cludes the three capital transfer taxes (4/3), the real property transfer tax (4/4), the tax on drafts and bills of exchange (4/6.1), the insurance tax (4/6.3), the tax on bettings and lotteries (4/6.5), and the tax on motor vehicles.

3. The inheritance (gift) tax (4/2).
4. The beer tax.
5. The taxes of exclusively local application (1/3.2).

3. Municipal taxes.—The municipalities receive the proceeds from the so-called *Realsteuern*—the real property tax (3/3) and the municipal trade tax (chap. 15)—in addition to the revenue from some other taxes of limited significance, such as the amusements tax, the tax on beverages, the dog tax, the tax on restaurants, bars, and cabarets, and the tax on hunting privileges. If the territory of a state is coextensive with that of a municipality, as in the city states of Hamburg and Bremen, the revenue from these taxes accrues to the state (GG art. 106(6)).

4. The church tax.—In all states, a church tax is collected on behalf of the established religious bodies. The church tax is computed as an addition to the assessed income tax of resident individuals and to the withholding tax on wages and salaries (*Lohnsteuer*) (8/1.1). In the state of Baden-Württemberg, church tax is also collected from corporations and other taxable entities, at the same rate that applies to individuals.

There are, in all, over 40 different Federal, state, and municipal taxes. The relative revenue yield of the various taxes is shown in table 11 (1/7.1).

Only in the case of the individual and corporate income taxes is the system of allocating the entire revenue from specifically described taxes to one or the other government not followed. The proceeds of these taxes are shared by the Federal Government and the states. The Basic Law originally allocated one third of the collections from the two income taxes to the Federal Government and two-thirds of the collection to the states (GG art. 106(3)). It provided further that the existing ratio could be changed by Federal statute in the event that the relationship between Federal revenue and expenditures on the one hand, and state revenue and expenditures on the other, should become so unbalanced that a substantial deficit developed on either the Federal or the state level.[5] In order to prevent arbitrary demands for revision, the Basic Law establishes the principle that both the Federal Government and the states are responsible for the expenditures which necessarily result from the functions assigned to each and that necessary expenditures must be defrayed out of ordinary revenue on each level of government. In cases of conflict between the budgetary requirements of the Federal Government and those of the states, the various requirements must be adjusted equitably and in a manner which does not overburden the taxpayers or disturb the economic unity of the country as a whole (GG art. 106(4)).

From April 1, 1958 until the present time, the Federal portion of the

[5] Art. 106(4) of the Basic Law prohibited changes in the existing ratio prior to Apr. 1, 1958. As explained in the text, the first and so far the only change was made as of that date. After Apr. 1, 1958, the ratio of distribution cannot be changed more often than once every 2 years. Laws which change the distribution of income tax revenue between the Federal Government and the States require the consent of the Council of States (GG art. 106(4)). The time limit of 2 years does not apply if the Federal Government burdens the States with additional expenditures or withdraws sources of revenue from the States (GG art. 106(5)).

proceeds from income tax and corporation income tax collections has been 35 percent, and the state portion 65 percent. The state portion of the revenue is shared by the various states in the proportion of the collections of income tax and corporation income tax made in each state (GG art. 107(1)).[6] Disproportionately high or low collections in the various states are adjusted between the states by the financial equalization procedures discussed at 1/3.4.

The states are obliged to grant a participation in their shares of the income tax and corporation income tax to the municipalities and associations of municipalities located in their territories. The extent to which the municipalities participate in the state collections is determined by state law (GG art. 106(6)).

1/3.4 FISCAL EQUALIZATION PROCEDURES AMONG THE STATES

The rule which prescribes the division of state taxes (including the state portions of the income tax and corporation income tax) among the states on the basis of the collections made in each state is one of expediency which weighs the scales heavily in favor of the industrialized and densely populated states. In order to correct this imbalance, article 107(2) of the Basic Law calls for a Federal statute through which an equitable distribution of revenue among the various states shall be attained. According to the constitutional scheme, the technique by which this distribution is to be accomplished consists in equalization payments made by the affluent states to the needy states. The provision cited specifically prescribes that in measuring the financial strength and financial requirements of each state, those of the municipalities located therein shall be given due consideration.[7]

The consitutional mandate has been implemented by successive statutes, most recently by the Law of June 23, 1961 (*Länderfinanzausgleichsgestz 1961*). In essence, the system applied in measuring the financial strength or weakness of the various states consists of three steps. First, an adjusted collection figure is computed for each state. This figure consists of the total tax collections of the state for a particular fiscal year, increased by the collections from the real property tax and the trade tax made by the municipalities located in the state, and decreased by extraordinary expenditures incurred by the state during the fiscal year. As the second step, a per capita collection figure is computed for the entire area of the Federal Republic on the basis of the combined adjusted collection figures for all states. This per capita figure multiplied by the number of inhabitants of each state results in the "equalization figure" of each state. Equalization payments are made by each state whose adjusted collection figure exceeds its equalization figure; conversely, a state is entitled to equalization payments if its adjusted collection figure is less than 95 percent of its equalization figure. The specific equalization payments made by certain states and the amounts to which other states are entitled are published in the regulatory ordinances implementing the equalization law.

[6] See GG art. 107(1) and *Zerlegungsgesetz* of Mar. 29, 1952, BGBl 1952 I p. 225. For the trade tax see GewStG secs. 28–35.

[7] Art. 107(2) of the Basic Law further provides that supplementary payments to indigent States can be made out of Federal funds. This provision is operative in favor of West Berlin, which is not a part of the Federal Republic and does not participate in the system of interstate equalization payments.

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