The Financing of State and Local Government Activities in the Postwar Period *

The term "government" in this country is probably most commonly associated with the activities of the Federal Government. But it is a fact that there are also fifty state governments and some 91,000 county, city, and other local governments, which carry out a myriad of functions, from building major highways and providing schools for our young people to collecting refuse. These governments have been one of the most rapid growth sectors in the economy during the postwar period. Indeed, with a population growing both in numbers and in complexity of needs over this period, state and local governments have registered about a sixfold increase in their expenditures and a twofold rise in the number of persons they employ. At the same time, these governments have found it increasingly difficult to finance their additional responsibilities. Although their tax revenues have grown substantially since 1946, state and local governments have had to rely to an increasing extent on obtaining funds through debt operations and from Federal grants-in-aid. Without the Federal grants-in-aid, it is highly likely that many of the new services and facilities provided by state and local governments in the past several years would have been long delayed if not completely forestalled. Since the forces making for additional state and local government services can be expected to continue to operate in the future, further revenue problems seem virtually assured for the state and local government sector in the years ahead. Additional financial support from the Federal Government also seems a reasonable expectation—certainly for the immediate future—as the Administration's legislative program and recent legislation foreshadow a sizable expansion in this direction.

This article summarizes the growing role that state and local governments have played in the postwar years, outlines the major forces which have spurred the increased activities by this sector, examines the revenue problems which state and local authorities face, and describes the variety of techniques by which Federal grants-in-aid have been made available to these governments. Such a broad summary, of course, must necessarily be built on generalizations and cannot adequately describe either the knotty problems of individual states and communities or the ways in which these problems have been tackled.

THE GROWTH IN STATE AND LOCAL GOVERNMENT EXPENDITURES

In the aggregate, state and local governments constitute an increasingly important sector of the national economy. Purchases of goods and services by such governments currently run at an estimated annual rate of nearly $67 billion, and in fiscal 1964—the latest year for which such data are available—an additional $20 billion was spent for such items as interest on debt, transfer payments, and insurance trust systems as well as the public operation of utilities and liquor stores (measured on a gross basis). Present total budgetary expenditures by state and local authorities are thus probably in excess of $87 billion, of which about $10 billion comes from the Federal Government. In contrast, fiscal 1965 cash expenditures of the Federal Government, *excluding* the cost of national defense, amounted to $66 billion. The inclusion of defense outlays—which are, of course, a predominantly national function—raised expenditures by the Federal sector to $122 billion.[1]

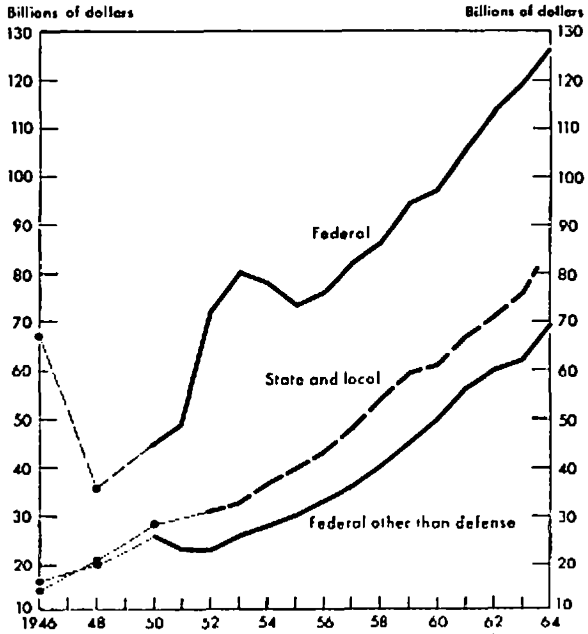
The post-World War II rise of state and local expenditures has been the continuation of a long and generally steady trend (see Chart I). Between 1946 and 1964, total expenditures by these governments multiplied nearly six

* L. Richard Gabler, Economist, had primary responsibility for the preparation of this article.

[1] Federal grants-in-aid to state and local governments are included in the above figures on Federal cash outlays. These cash figures quoted from budgetary accounts are on a somewhat different basis from the Census figures used in Chart I.

Chart I

EXPENDITURES BY FEDERAL AND STATE PLUS LOCAL GOVERNMENTS SINCE 1946



Note: Federal data are for fiscal years ended June 30. State and local data are on calendar-year basis except for 1964 when fiscal-year total is used. Dashed lines for early postwar period are used to indicate that data for some years are unavailable in a form comparable to that of later years.

Source: United States Department of Commerce, Bureau of the Census: 1962 Census of Governments, Vol. VI, No. 4, and Governmental Finances in 1963-64.

times, from $14.1 billion to $80.6 billion.[2] In comparison, Federal expenditures for programs other than defense increased less than five times. State and local expenditures for goods and services presently absorb about 10 per cent of total gross national product, compared with a 4.8 per cent share in 1946. Furthermore, these governments presently employ approximately 10 per cent of the nation's civilian labor force, as against only 5.8 per cent in 1946.

There are many reasons underlying this rapid rise in the economic significance of state and local governments. Like most of the civilian sector of the economy, state and local governments entered the postwar years with a large backlog of expenditures. At the same time, there have been other forces at work, all associated with the economic development and change that have characterized the nation itself. In the main, these factors include the growth in population and its continuing mobility, particularly to urban and suburban communities, the expanding requirements generated by increased automobile ownership, technological advances, rising incomes and standards of living, and the increased responsibilities undertaken by governmental authorities.

All types of spending have been affected in one way or another by these various forces, but the rates of increase over the postwar period, measured both in terms of total amounts and on a per capita basis, differ among the several categories (see Table I for the per capita figures). Expenditures for education—the fastest growing component of over-all state and local government spending—currently account for nearly 40 per cent of total expenditures. Such expenditures have been sharply stimulated by the rise in the number of children of school age and by the lengthening of the average term of a person's education. At the same time, teacher pay scales have risen and there has been an upgrading of educational services including higher qualifications for the teaching staff and higher standards for school buildings and facilities. Most basically, the nation is recognizing more clearly the need for, and the value of, education.

Highway construction is a second category of state and

Table I

STATE AND LOCAL GOVERNMENT EXPENDITURES PER CAPITA, BY FUNCTIONAL PURPOSE

Calendar 1946 and Fiscal 1964

At prevailing prices

Purpose	1946	1964	Percentage increase 1946 to 1964
Education	$23.74	$138.67	484
Highways	11.83	60.96	415
Public health, housing, and recreation*	10.01	46.56	365
Police, fire, and sanitation	8.09	30.57	278
Public welfare	9.97	30.13	202
Interest on public debt	2.98	12.31	313
General control and financial administration	4.97	13.40	170
All other	6.44	29.55	359
Total	$78.00	$362.20	364

Note: Total excludes expenditures for government utilities, liquor stores, and insurance trusts. Because of rounding, figures do not necessarily add to totals.

* Includes health, hospitals, local parks and recreation, housing and urban renewal, and natural resources.

Sources: United States Department of Commerce, Bureau of the Census, *1962 Census of Governments*, Vol. VI, No. 4, and *Governmental Finances in 1963-64*.

[2] Throughout this article, state and local data for 1946 are on a calendar-year basis while 1964 figures relate to the fiscal year ended June 30, 1964.

local government spending which has shown a sharp rise over the postwar period, and it is a field in which Federal assistance to the states and Federal-state cooperation have been of particular importance. The need for highway expenditures is, of course, directly related to ever-increasing automobile ownership and the utilization of more and of heavier trucks — developments which have necessitated the provision of additional highways, including multi-tiered bridge facilities, as well as the repavement of extensive mileage of roadways with improved surfaces. The increase in traffic density and the proliferation of other problems associated with "urban sprawl" have stimulated state and local governments to create community and regional planning agencies, which directly or indirectly have further enlarged the activities of state and local governments.

Urbanization has been mentioned as another force in the growth of state and local government spending. Continuing migration from the farm to the city has accelerated the need for additional police and fire protection as well as for added water and sewerage facilities. And the more densely populated the urban centers become, the more complicated and expensive it is to provide these services. Furthermore, the recent acceleration in movement from city to suburban communities has forced state and local authorities to meet comparable needs in these newly developed areas, without eliminating the need for services in the center city where the population is by and large also still rising.

These major pressures have operated throughout the country, though the degree of the pressure and the response of state and local authorities have varied from one area to another. Thus, there continues to be a wide variation among the different states in amounts spent per capita in any given year. In 1964, for example, total budgeted state and local expenditures per capita in the various states ranged from a high of $576 in Nevada to a low of $217 in South Carolina[3] (see Table II). Education expenditures per capita — the single most important functional category—varied from $201 in Utah to $91, again in South Carolina. Although a small part of the variations among states can be attributed to differences in price levels, it is nonetheless true that the dollar spread also reflects wide variations in the quantity, and probably the quality, of public services provided.

What explains this wide range in per capita spending among the various states? A number of studies have suggested that some part of the disparity in expenditures per capita can be attributed to demographic differences among states, such as the degree of urbanization, population density, and rate of population increase. But it has also been found that an even more significant factor is the difference in fiscal capacity—as represented by per capita income—among the various states. It might be argued that this explanation begs the question: state and local government spending itself can increase local per capita income—through its direct income effects on local residents as well as by improving productivity in the private sector. Therefore, a relatively high level of per capita spending by such governments may contribute to, and a low level detract from, fiscal capacity. Quite possibly, the different political histories and institutions of the various states—factors that are not readily quantifiable—also have a bearing on the willingness to tax residents and hence on expenditures. It is nevertheless clear that over the short term these considerations are small solace to those state and local executives and legislators who, in addition to having the virtually universal revenue problems discussed in the next section, are forced to deal with these problems in areas which have presently low per capita income.

Table II

HIGHEST, AVERAGE, AND LOWEST AMOUNTS SPENT PER CAPITA IN THE VARIOUS STATES BY STATE AND LOCAL GOVERNMENTS

Fiscal 1964

Purpose	High	United States average	Low
Education	$201	$139	$ 91
Highways	192	61	38
Public health and recreation*	59	31	14
Police, fire, and sanitation	51	31	11
Public welfare	64	30	12
General control	14	7	3
Total expenditures	$576	$362	$217

Note: Figures exclude Alaska, Hawaii, and the District of Columbia.
* Includes health and hospitals and local parks and recreation.
Source: United States Department of Commerce, Bureau of the Census, *Governmental Finances in 1963-64*.

INTERNAL SOURCES OF FINANCE: TAX AND DEBT OPERATIONS

Financing the rising volume of expenditures has posed serious difficulties. Although the growth in over-all economic activity during the postwar period has, of course, increased the traditional tax base of state and local govern-

[3] Figures exclude Alaska, Hawaii, and the District of Columbia.

ments, these authorities have repeatedly been forced both to impose new levies and to increase tax rates on existing revenue sources. State governments, which can tap a wider variety of revenue sources than do local authorities, have been active in using these sources. Between 1946 and 1963, no less than fourteen states instituted a tax on cigarettes, while general sales taxes were added as a source of funds by thirteen states. At the same time, four states added an individual income tax to their sources of revenue and five adopted a corporate income tax. The list would be very much longer indeed if it did not exclude those cases in which states increased rates on previously tapped tax sources.[4]

The financing of local government expenditures has been a problem of at least similar difficulty. These governments rely almost exclusively upon property taxes — in 1964 such taxes provided about 90 per cent of all local tax revenues. While the postwar increase in property valuations has swelled the property tax base, there has still been a steady need to raise the property tax rates themselves. Residents of newly developed suburban communities have been particularly affected by such tax increases, as they often have seen the taxes on their property double after the first few years of occupancy and then double again.

While rising state and local government taxes have almost become a fact of life in the postwar period, such increases have not been easy to effect. Earlier increases in tax rates have made further levies all the more difficult. Moreover, interstate competition to attract new industry, and similar competition among localities, has undoubtedly hampered efforts to add to current revenues, particularly in the case of corporate taxes. States and localities generally offer some form of inducement to attract new corporations to their areas, with the long-range view toward creating new job opportunities and increasing the over-all tax base, and this competition imposes a constraint on tax rates which neighboring state or local authorities can levy. Disregard of the level of taxation in nearby communities in any given community's decision might repel, rather than attract, new industry and thus prove self-defeating.

Although the property tax is also the largest single source of the combined total of state and local tax revenues, its relative share has declined a bit over the postwar period. In 1964, these levies accounted for some $21.2 billion, or 36.3 per cent, of state and local general revenues (see Table III). Second in importance as a source of revenue were the sales and gross receipts taxes, which provided an additional $15.8 billion. Since there is neither a national sales nor a national property tax, state and local government levies on these sources do not overlap with the Federal tax structure. State and local authorities make far less use of the personal income and corporate profits taxes, and these taxes of course constitute the major source of Federal revenues.

State and local governments have also made extensive use of debt operations as a source of finance. For the most part, however, the funds obtained by borrowing have not gone into the general revenue pool but rather have been used almost exclusively for the expansion of capital facilities, such as the building of new schools and roads. (Many state and local authorities are barred by law or Constitutional restriction from borrowing for any other purpose.) The positive association between the volume of new debt issues by state and local governments and total capital spending by these authorities has been particularly strong in the years since 1953. Prior to that time, the relationship was obscured by the substantial amount of debt that had to be issued in the 1946-50 period to finance bonus payments to World War II veterans and

Table III

INTERNAL GENERAL REVENUE SOURCES FOR STATE AND LOCAL GOVERNMENTS

Calendar 1946 and Fiscal 1964

In billions of dollars

Sources	1946		1964	
	Amount	Percentage of total	Amount	Percentage of total
Individual income taxes	$ 0.4	3.5	$ 3.8	6.5
Corporate income taxes	0.4	3.5	1.7	2.9
Sales and gross receipts taxes	3.0	26.1	15.8	27.1
Property taxes	5.0	43.5	21.2	36.3
Other taxes	1.3	11.3	5.3	9.1
Charges and miscellaneous	1.4	12.2	10.7	18.3
Total	$11.5	100.0	$58.4	100.0

Note: Excludes revenues from government utilities, liquor stores, and insurance trusts as well as from Federal grants-in-aid. Because of rounding, figures do not necessarily add to totals.
Sources: United States Department of Commerce, 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 1963-64*.

[4] A partial list of current state government fiscal efforts shows that these pressures have continued in the first six months of 1965. During this period, two states (including New York) added the sales tax, while nine increased existing rates: one state added the cigarette tax, while twenty advanced previous rates.

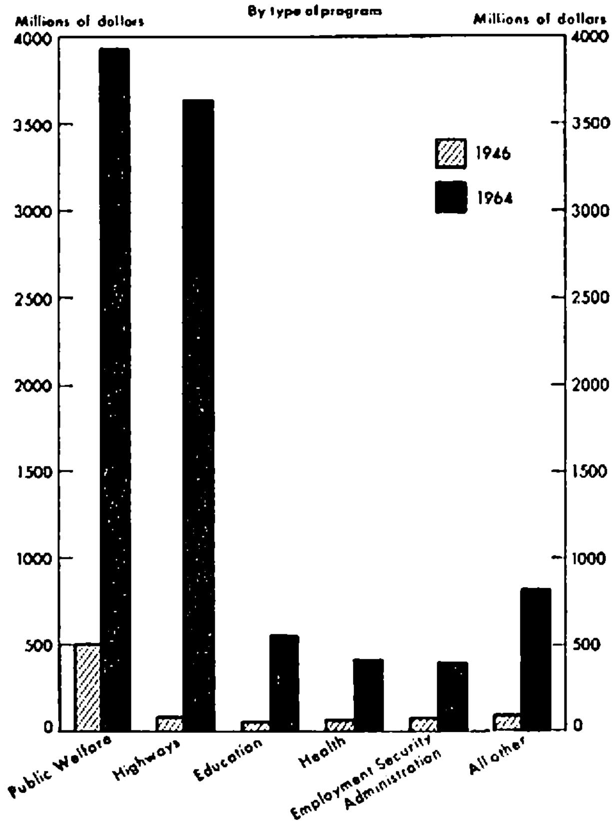
then by the restrictions on the issuance of new state debt that was imposed during the Korean war years.

In the aggregate, state and local government borrowing provided some $7.2 billion in funds during 1964, equivalent to about 12 per cent of the amount raised by taxation and other general revenues. In 1946, on the other hand, state and local governments reduced their outstanding debt. On a net basis, some amount has been borrowed by these governments in at least every other year of the postwar period, so that the rise in total state and local government debt outstanding since the end of World War II has been quite steady. Indeed, the amount of such debt has multiplied by almost six times, from $15.9 billion in 1946 to $92.2 billion in 1964. Interestingly, virtually all the debt incurred by state and local governments is long term. Short-term debt amounted to only 5 per cent of the total outstanding at the end of 1964.

Chart II

FEDERAL GRANTS-IN-AID TO STATE AND LOCAL GOVERNMENTS, FISCAL YEARS 1946 AND 1964

By type of program



Sources: United States Department of Health, Education, and Welfare, *Trends* (1964 Edition, Part I); *Social Security Bulletin*, June 1965.

FEDERAL GRANTS-IN-AID

In the face of the heavy demands placed upon state and local governments, the increase in their taxes and borrowing has been insufficient to prevent them from becoming gradually more dependent upon financial assistance from the Federal Government. The bulk of Federal assistance is provided by means of so-called "grants-in-aid" programs. These grants have been designed both to help implement programs of a general or national interest and also to provide relief for hard-pressed state and local governments. The amount of such grants has grown from a total of $844 million in 1946 to approximately $9.8 billion in 1964. In the latter year, this represented approximately 16.7 per cent of total taxes and other general revenues raised by state and local governments, compared with only 7.3 per cent in 1946. Grants to help support public welfare programs and to help build public roads and highways have shown the sharpest increase over the postwar years (see Chart II). These two types of grants together amounted to some $7.5 billion in 1964.

Financing available under present Federal grants-in-aid programs can generally be distinguished from one another with respect to two broad criteria—the way in which the actual Federal payments are allocated among states or localities, and the amount (if any) of "matching" funds which the state or local unit must agree to put with the Federal grants in order to carry out the over-all program. Allocation formulae are generally based on some index of "program need", with need typically measured by various population totals or subtotals of the state concerned. In some instances, the size of the Federal allocation is inversely related (at least in part) to the fiscal capacity of the state. As regards the matching of grants, the majority of current Federal programs require the same proportion of matching funds (typically 50 per cent) from each state or area, though there are some programs which permit poor states or areas to provide a smaller share than rich states.

While some type of allocation and matching funds formula applies to almost every one of the Federal grants-in-aid programs presently in operation, the exact combination of formulae associated with any particular program has been varied depending on the goals which the program is designed to achieve. Two types of goals are generally distinguished:

(1) ATTEMPTS TO STIMULATE STATE AND LOCAL UNITS TO UNDERTAKE NEW, OR EXPAND EXISTING, SERVICES. An example of this type of grant is the Federal Highway Program for the so-called "ABC System". This program under

which states can apply for assistance on building or rebuilding all their more important roads (and which should be distinguished from the Interstate Highway System) generally requires the states to raise matching funds equal to 50 per cent of the total cost of the roads to be constructed.[5] The allocation formulae, on the other hand, vary with the type of road built. Aid for primary roads, the most heavily traveled facilities, is based on a combination of three factors—the number of square miles, the population of the state, and the existing number of miles of rural postal routes in the state. Aid for secondary roads —somewhat more local ones—is based on an essentially similar three-criteria formula, while Federal grants for urban road extension projects, which take the primary and secondary systems into urban areas, are based entirely on urban population figures. Grants under the Highway Program thus take no account of the relative fiscal capacity of the area in which the roads are being built.

(2) ATTEMPTS TO EQUALIZE THE BENEFITS AND BURDENS OF PUBLIC EXPENDITURES AMONG STATES. Programs aimed at this goal are intended to help assure that a governmental function achieves a national minimum level, regardless of the limitations of any state or local area in its ability to finance such programs. This is accomplished either by gearing the Federal allocation inversely to some selected measure of a state's fiscal capacity or by requiring smaller matching funds in states which have only limited tax and fiscal resources. In either case, the "poor" states receive a proportionately larger share of Federal financial support for any given program. The fact that such a program incorporates an equalization feature, however, does not preclude the simultaneous use of other measures of program need in the distribution scheme. In such cases, the allocation formula might be rather complex, with the amount of funds granted varying directly with an index of program needs and inversely with an index of fiscal capacity. As an example, Federal grants for construction of waste treatment facilities are allotted to states according to the following formula: one half according to population, and one half according to per capita income.[6]

Equalization features of one sort or another have been incorporated in approximately one third of the Federal grants-in-aid programs enacted in recent years (the Education Bill of 1965 is an example). In aggregate amount, however, they still do not bulk large in the total of Federal grant programs, and they have generally been combined in any single program with an allocation scheme based on measures of program need. As of 1962, twenty-three of sixty Federal programs incorporated some equalization provision, while in dollar terms only 18.6 per cent of the total Federal grants was based on this concept.[7] Moreover, the concept itself continues to generate considerable Congressional debate. As stated by the Advisory Commission on Intergovernmental Relations:[8]

> . . . the question of equalization touches some of the more sensitive and debated issues involved in the operation of a federal system. This governmental system leaves primary responsibility for most civil functions of government with the States and, to the extent each determines, with local governments. However, since the adequacy of the job done by each State in the critical functions affects every other State and thus the Nation, the inability of some to do an adequate job in a key functional area is generally accepted as warrant for national concern and intercession. By the same token, the greater the relative deficiency in required fiscal resources, the greater should be the relative amount of national aid. However, while American philosophy of government recognizes national concern with the adequacy of State and local performance in services affecting the national strength and welfare, it also cherishes the concept of the independence of the State. It wants to defend each State's right to set its own expenditure program levels and to minimize State dependence on Federal aid. Inequalities in program levels among the States, even when dictated by unequal fiscal resources rather than free choice, tend to be treasured as a hallmark of local self-determination in operation.

Since a consensus has not been reached in favor of any particular form of Federal grant, it seems reasonable to expect that the present diversity in techniques will remain a feature of future Federal programs.

[5] States in which public land areas exceed 5 per cent of the total land area receive relatively larger Federal grants.

[6] A third possible category might be mentioned, namely, programs in which the Federal Government assumes the entire cost of a particular program. An example would be disaster relief from flood or storm damage. In dollar size, these programs are the smallest of the classifications.

[7] Advisory Commission on Intergovernmental Relations, *The Role of Equalization in Federal Grants* (January 1964), pp. 42-43.

[8] *Ibid.* p. 9.

THE FEDERAL TAX SHARING PROPOSAL

One of the more recent proposals concerning Federal grants to assist state and local governments in coping with their present unmet needs suggests that a portion of individual income tax receipts, presently collected by the Federal Government, be specifically earmarked and returned to the states. Unlike existing Federal programs, these funds would not be restricted to a specific function but distributed with no strings attached. Since Federal income tax receipts are more responsive to increases in aggregate economic activity than the sales and property taxes, which are the main sources of state and local revenues, this proposal makes it possible for the states to share more fully in the process of national economic growth than has been possible with their present sources of taxation. The case for the plan has been put as follows by a leading advocate, Walter W. Heller, former Chairman of the Council of Economic Advisers: "The supply of readily available federal revenue is rising faster than the demands on the federal purse, but the state-local situation is reversed—expenditure demands are rising faster than the readily available revenue supply."[9] While the immediate outlook for the adoption of this plan is problematical, it has been widely discussed and has attracted a great deal of interest on the part of state and local officials.

No firm figures have ever been mentioned publicly as to the amount of Federal funds that might be redistributed to the states under the Tax Sharing Proposal. One of the more significant features of the proposal is that the states would not be required to "match" the Federal grants and hence no additional pressures would be placed on presently strained state and local tax sources.

[9] Walter W. Heller, "The Future of Our Fiscal System", *The Journal of Business* (July 1965), p. 240. A similar statement was made by Governor Anderson of Kansas in the *Saturday Review*, January 9, 1965, pp. 31-32.

It was originally suggested that the Federal revenue be distributed among states according to population. Yet, because of the variety of allocation formulae currently used, ample precedent for any one of several possible distribution schemes might be cited, and some compromise arrangement may prove necessary to satisfy divergent state interests. Indeed, each of the features of this proposal—the amount to be apportioned among states, the basis of the distribution, and the "no strings" provision—is likely to pose problems difficult to resolve.

OUTLOOK FOR THE FUTURE

Regardless of the future of the Federal Tax Sharing Proposal, it seems reasonable to expect the Federal Government to continue, and probably to expand, its present participation in meeting certain costs of state and local government activities. A number of the programs associated with the "Great Society"—aid to education, the war on poverty, housing, and community redevelopment—already point in that direction. Despite their achievements to date, state and local governments will continue to face a wide variety of additional public needs. Obviously, problems of water and air pollution, overcrowded schools, and substandard recreation and housing facilities, as well as inadequate health care and hospital space, persist. In our vast and diversified country, these services can often be most efficiently provided only through programs run at the state and local level. Additional fiscal efforts by state and local authorities will certainly be required. Nonetheless, state and local tax structures appear inadequate now and in the future to provide fully for the range and quality of public goods and services demanded. Thus, the present challenge is to develop intergovernmental relationships that will enable state and local governments to carry out their vital role. Clearly, innovation and experimentation will be needed in future Federal-state cooperation and in planning and budgeting public programs if aggregate outlays on such programs are to result in maximum social benefit per dollar spent.