initially may be protected by previously accumulated surpluses; however, if the reces-
sion is severe, additional budget adjustments may be forthcoming in the year after the recession. The previously cited survey conducted by the Senate Subcommittee on Intergovernmental Relations found that 80 percent of state and local governments imposed limitations on personnel, and 20 percent delayed or can-
celled capital projects. However, many state and local spending categories, such as police, fire, and education, are not easily cut, while others, namely welfare and unemployment compensation, automatically rise during a recession. Consequently, spending cuts prob-
ably occur in a narrow range of functions, making it difficult to predict how total state and local expenditures would respond during a business contraction.

In the past five business contractions, expenditures generally fell on those func-
tions than in the immediately preceding and subsequent business expansions. There have been two exceptions to this pattern. In the long business expansion of 1961 to 1969, secular demands for expanded state and local services grew rapidly. During the 1973-75 recession, the most severe U.S. business con-
traction since the 1930s, state and local expend-
titures grew more slowly than in the previous busi-
ness expansion. (Inflation-adjusted figures are not shown in table 1.) The data suggest that, in the aggregate during most recessions, increases in state and local welfare and un-
employment compensation payments out-
weighed increases in other spending categories, such as construction. Previously accumulated surpluses and the ability to raise taxes during a business contraction usually have protected state and local spending programs during re-
cessions. In severe business contractions, however, state and local governments appear to reduce the growth of total expenditures.

Statistical analysis undertaken by the
Advisory Commission on Intergovernmental
Relations suggest a more complicated pattern of
spending over the business cycle.4 Although state and local expenditures fell during the year in which a business contrac-
tion occurred, state and local expenditures fell somewhat in the following year. It would

Table 2 State and Local Employment and Business Contractions and Expansions

Table:<br>
| Year         | Percent change at average annual rates | State and local employment growth experienced in the immediately pre-
|--------------|----------------------------------------| preceding and subsequent business contractions; however, the economic burden of these
|              |                                        | revenue increases to GNP, usually increased during the recessions. State and local expenditures grew faster during business contractions than during the immediately preceding and subsequent business recoveries, except in very deep and prolonged recessions, as in 1973-74. The cyclical pattern probably reflects growing resilience of state and local governments on more cyclically sensitive—though still important—revenues, and their increased responsibility for welfare payments and unemployment compensation.

Land Tenure

Restructuring the tax base means shifting revenues away from property taxes toward income taxes, sales taxes, and excise taxes. The result is a more stable revenue base for local governments.

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the budgets of state and local governments this sector may partially cushion or exacer-
coming in response to a sluggish economy? The answers are important, partially because
with little relief from inflation have raised
a slow recovery from the current recession
of the federal government. This approach im-
GNP, increased substantially from less than 8
of the large relative size of the state and local
government sector. Total state and local ex-
posure, now equal about 14 percent of
GDP. Expenditures are combined in the NIPA
information about the influence of the state and
defined as
a. All data are on a national income and product account basis and exclude federal grants-in-aid to state and local governments.


A survey conducted by the Senate Subcom-
mittee on Intergovernmental Relations found that
33 percent of the jurisdictions making
cession-related budget adjustments did so
in part by raising tax rates. 

1. See Advisory Commission on Intergovernmental Relations, State and Local Finances in Reces-

Inflation and State and Local Budgets

Although this article primarily deals with the behavior of state and local budgets in business contrac-
tions, it is of interest to consider the effects of high rates of inflation in recent recessions
estimates on the budget impact of inflation. Inflation increases state and local receipts, as it increases
values of various types of in-kind transfer payments. There is evidence that,
because of the reliance of state and local governments on property and income taxes, inflation
actually has increased revenues in real terms. 

However, the property tax is a fixed-rate tax, property values have risen more rapidly than other prices in
the past ten years. Consequently, property-tax revenues have outpaced inflation. In addition,
the effect of inflation on state and local governments have risen at an average annual rate of more than 11
percent since 1970, higher than any private sector.
The data in table 1 show both receipts and expenditures increasing faster in the two
more recent recessions than in the previous three, a development that is entirely attrib-
state, whose GNP fell by only 3.4 percent, is not sufficient evidence from which to
to the net impact of inflation on state and local budgets. The overall effect,
the two recessions, and the overall short-term gains could be offset later by rising expenditures, as contracts and wages are adjusted for inflation.

2. See Advisory Commission on Intergovernmental Relations, State and Local Finances in Reces-
3. For elasticity estimates see Advisory Commit-
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3. For elasticity estimates see Advisory Commit-

The The of state and local governments with little relief from inflation have raised concerns about the financial health of state and local governments. The extent to which the budgets of state and local governments are affected by the business downturn, and what role fiscal adjustments can play in combating coming in response to a sluggish economy? The answers are important because they help determine the relative size of the state and local government sector. Total state and local expenditures now equal about 14 percent of GNP, increased substantially from less than 8 percent in 1950. Because of its relative size, this sector may partially cushion or exacerbate business-cycle swings.

Economic Commentary examines the behavior of the state and local sector's budget during postwar business contractions. The state and local sector is viewed as a supplier of public goods and services, and the sector does not engage in active fiscal policy as does the federal government; state and local officials do not adjust their budgets intentionally to offset a general business contraction or reduce inflation. To isolate the cyclical budget behavior of the state and local sector, federal grants-in-aid pay-ments, and other transfers between the national and local governments and local expenditures are the behavior of grants-in-aid and the spending they support should be attributed to the fiscal policies of the federal government. This approach implicitly assumes that the availability of federal funds has a stimulative or restrictive effect on state and local government spending and taxing policies, but this assumption may not conform closely to reality. Federal grants sometimes require state and local governments to raise additional taxes or spending, and the existence of a substitute for existing state and local spending, or it may cause state and local outlays that otherwise might not be made.

Budget Constraints and Cyclical Behavior of Receipts

The cyclical behavior of nearly all state and local governments is constrained by laws that prevent their supporting daily operations through the issuance of debt. These laws almost always show a surplus in their general operating budgets and sometimes almost always show a deficit in their general capital budgets. The state and local sector, for example, maintains social insurance contributions, and the only exception is the state and local governments' own-source receipts, that is, total revenue less Federal grants-in-aid to state and local governments. NIPA data do not reflect the general borrowing constraints on state and local operating budgets, because the data consolidate many different funds along with current operating budgets. NIPA receipts data are shown in table 1. State and local governments, for example, maintain social insurance contributions and state and local governments' own-source receipts. The behavior of grants-in-aid and the spending they support should be attributed to the fiscal policies of the federal government. This approach implicitly assumes that the availability of federal funds has a stimulative or restrictive effect on state and local government spending and taxing policies, but this assumption may not conform closely to reality. Federal grants sometimes require state and local governments to raise additional taxes or spending, and the existence of a substitute for existing state and local spending, or it may cause state and local outlays that otherwise might not be made.

Table 1 State and Local Budgets in Business Contractions and Expansions

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent change in income</th>
<th>Percent change in receipts</th>
<th>Total Own-source</th>
<th>Total Own-source</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950:2</td>
<td>-3.2%</td>
<td>-3.3%</td>
<td>-0.2%</td>
<td>-0.5%</td>
</tr>
<tr>
<td>1951:4</td>
<td>-1.4%</td>
<td>-1.5%</td>
<td>-0.5%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>1954:4</td>
<td>-1.1%</td>
<td>-1.1%</td>
<td>-0.5%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>1957:3</td>
<td>0.5%</td>
<td>0.5%</td>
<td>-0.1%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1958:1</td>
<td>0.2%</td>
<td>0.2%</td>
<td>-0.1%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1960:1</td>
<td>-0.6%</td>
<td>-0.2%</td>
<td>-0.2%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>1960:2</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1962:4</td>
<td>-0.3%</td>
<td>-0.3%</td>
<td>-0.2%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1963:2</td>
<td>-0.2%</td>
<td>-0.2%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1963:3</td>
<td>-0.2%</td>
<td>-0.2%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1964:1</td>
<td>-0.3%</td>
<td>-0.3%</td>
<td>-0.2%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1964:3</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1967:2</td>
<td>-0.2%</td>
<td>-0.2%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1968:1</td>
<td>-0.3%</td>
<td>-0.3%</td>
<td>-0.2%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1968:2</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1969:1</td>
<td>-0.2%</td>
<td>-0.2%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1970:4</td>
<td>-0.4%</td>
<td>-0.4%</td>
<td>-0.2%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1970:3</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1971:3</td>
<td>-0.3%</td>
<td>-0.3%</td>
<td>-0.2%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1971:4</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1972:2</td>
<td>-0.2%</td>
<td>-0.2%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1972:3</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1973:2</td>
<td>-0.3%</td>
<td>-0.3%</td>
<td>-0.2%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1973:3</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1974:1</td>
<td>-0.2%</td>
<td>-0.2%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1974:2</td>
<td>-0.3%</td>
<td>-0.3%</td>
<td>-0.2%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1974:3</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1975:2</td>
<td>-0.2%</td>
<td>-0.2%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1975:3</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1976:1</td>
<td>-0.2%</td>
<td>-0.2%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>1976:2</td>
<td>-0.3%</td>
<td>-0.3%</td>
<td>-0.2%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1976:3</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
</tr>
</tbody>
</table>

Note: All data on yields and product account and income. Federal grants-in-aid to state and local governments. NIPA data do not reflect the general borrowing constraints on state and local operating budgets, because the data consolidate many different funds along with current operating budgets. NIPA receipts data are shown in table 1. State and local governments, for example, maintain social insurance contributions, and the only exception is the state and local governments' own-source receipts. The behavior of grants-in-aid and the spending they support should be attributed to the fiscal policies of the federal government. This approach implicitly assumes that the availability of federal funds has a stimulative or restrictive effect on state and local government spending and taxing policies, but this assumption may not conform closely to reality. Federal grants sometimes require state and local governments to raise additional taxes or spending, and the existence of a substitute for existing state and local spending, or it may cause state and local outlays that otherwise might not be made.

Inflation and State and Local Budgets

Although this article primarily deals with the behavior of state and local budgets in business contractions, the influence of high rates of inflation in recent recessions necessitates comment on the budget impact of inflation. Inflation increases state and local receipts, as it increases national income, by offsetting some of the transfer payments, but this effect is more than offset by the effect on the availability of the state and local governments on property and income taxes, which, because of the reliance of the state and local governments on property and income taxes, inflation actually has increased revenues in real terms. Although the property tax is a fixed-rate tax, property values have risen more rapidly than other prices in the past ten years. Consequently, property-tax receipts have outpaced inflation. In addition, graduated income taxes automatically push individuals into higher tax brackets, causing income-tax receipts to increase at a rate higher than the rate of general price increase. Consequently, the impact of inflation increases costs to state and local governments. In fact, prices of goods and services purchased by state and local governments have risen at an average annual rate of more than 11 percent since 1970, as compared to the rate of general inflation.
The budgets of state and local governments are of significant concern to financial economists, as they play a role in shaping economic policies. State and local decisions are often constrained by laws and regulations that prevent their supporting daily operations through federal grants-in-aid. This note examines the behavior of the state and local sector during business contractions and expansions.

### Table 1: State and Local Budgets in Business Contractions and Expansions

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenditure, percent change</th>
<th>Revenues, percent change</th>
<th>Surplus/deficit, billions of dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950:1</td>
<td>-9.4</td>
<td>9.6</td>
<td>+52.4 (na)</td>
</tr>
<tr>
<td>1950:2</td>
<td>9.3</td>
<td>9.3</td>
<td>0.4 (na)</td>
</tr>
<tr>
<td>1950:3</td>
<td>9.1</td>
<td>9.2</td>
<td>+2.7 (na)</td>
</tr>
<tr>
<td>1950:4</td>
<td>9.8</td>
<td>9.8</td>
<td>+2.9 (na)</td>
</tr>
<tr>
<td>1951:1</td>
<td>11.3</td>
<td>11.4</td>
<td>+0.1 (na)</td>
</tr>
<tr>
<td>1951:2</td>
<td>10.7</td>
<td>10.7</td>
<td>+22.4 (na)</td>
</tr>
</tbody>
</table>

a. All data are on national income and product account basis and exclude federal grants-in-aid to state and local governments.


### Budget Constraints and Cyclical Behavior of Receipts

The cyclical behavior of nearly all state and local governments is constrained by laws that prevent their supporting daily operations through federal grants-in-aid. This note frequently assumes a surplus or deficit in the general funds of state and local governments. To what extent will the federal individual income tax, taxpayers dropped into lower tax brackets as income fell, and the overall tax rate actually falls. Conse- quently, the percentage change in revenues resulting from a 1 percent change in income is much greater under graduated-rate taxes than under fixed-rate taxes. A second reason is that state and local revenues increase relative to GDP in recessions.

1. Income elasticity, \( E \), measures the response in receipts to changes in income and is defined as:

   \[ E = \frac{\% \text{ change in receipts}}{\% \text{ change in income}} \]

   For example, where \( E > 1 \) is "elastic," \( E < 1 \) is "inelastic," and \( E = 1 \) is "unit elastic." The higher the elasticity, the greater the sensitivity of receipts to changes in income.

A survey conducted by the Senate Subcommittee on Intergovernmental Relations found that 35 percent of the jurisdictions making recession-related budget adjustments did so in part by raising taxes. The notes below on local governments raised by 9 percent to 20 percent of their total state and local receipts. Corporate income taxes have income elasticities of about 1, but individual income taxes have income elasticities of less than 1. The notes below on local governments responding to rising inflation. Unfortunately, there is not a sufficient body of evidence from which to determine the net impact of state and local budgets. The overall effect of the state and local sector on the economy may partially cushion or exacerbate the cyclical budget behavior of the state and local sector.


Cyclical Behavior of Governmental Spending

As revenue growth slows during business contractions, state and local governments, with the experience in the immediate preceding and subsequent business expansions. The only exception to this general pattern occurred during the 1969-70 business contraction. When receipts grew faster than in the previous business expansion, this was because of nonreces- sing inflation. Although the growth in total state and local revenues in the 1970s suggests little sensitivity to the overall sensitivity of these balances to growing inflation. In contrast, under graduated tax rates, such as the federal individual income tax, taxpayers respond to rising inflation. Although the growth in total state and local revenues in the 1970s suggests little sensitivity to


5. Equally important are the effects of rising inflation. Although the growth in total state and local revenues in the 1970s suggests little sensitivity to


Although state and local expenditures rose to reduce the growth of total expenditures. Consequently, state and local governments appear to have been two exceptions to this pattern. In the long business expansion of 1961 to 1969, secular demands for expanded state and local services grew rapidly. During the 1973-75 recession, the most severe U.S. business contraction since the 1930s, state and local expenditures generally fell somewhat in the following year. It would appear, therefore, that state and local governments attempt to rebuild accumulated surpluses following a recession in which they were initially protected by previously accumulated surpluses; however, if the recession is severe, additional budget adjustments may be forthcoming in the following year. The previously cited survey conducted by the Senate Subcommittee on Intergovernmental Relations found that 50 percent of state and local governments imposed limitations on personnel, and 20 percent delayed or cancelled capital projects. However, many state and local spending categories, such as police, fire, and education, are not easily cut, while others, namely welfare and unemployment compensation, automatically rise during a recession. Consequently, spending cuts probably occur in a narrow range of functions, making it difficult to predict how total state and local expenditures would respond during a business contraction.

In the past five business contractions, expenditures generally fell during recessions than in the immediately preceding and subsequent business expansions. There have been two exceptions to this pattern. In the long business expansion of 1961 to 1969, secular demands for expanded state and local services grew rapidly. During the 1973-75 recession, the most severe U.S. business contraction since the 1930s, state and local expenditures generally fell somewhat in the following year. It would appear, therefore, that state and local governments attempt to rebuild accumulated surpluses following a recession in which they were initially protected by previously accumulated surpluses; however, if the recession is severe, additional budget adjustments may be forthcoming in the following year. The previously cited survey conducted by the Senate Subcommittee on Intergovernmental Relations found that 50 percent of state and local governments imposed limitations on personnel, and 20 percent delayed or cancelled capital projects. However, many state and local spending categories, such as police, fire, and education, are not easily cut, while others, namely welfare and unemployment compensation, automatically rise during a recession. Consequently, spending cuts probably occur in a narrow range of functions, making it difficult to predict how total state and local expenditures would respond during a business contraction.

### Table 2 State and Local Employment in Business Contractions and Expansions

<table>
<thead>
<tr>
<th>Peak to trough %</th>
<th>Trough to peak %</th>
<th>Mean of % peak to trough</th>
</tr>
</thead>
<tbody>
<tr>
<td>1953-2-1954-2</td>
<td>5.6</td>
<td>1950-1-1953-2</td>
</tr>
<tr>
<td>1951-1-1952-2</td>
<td>4.0</td>
<td>1951-1-1952-2</td>
</tr>
<tr>
<td>1976-1-1977-2</td>
<td>1.1</td>
<td>1975-1-1976-2</td>
</tr>
</tbody>
</table>

#### Appendix C

The focus here has been on the aggregate state and local sector. While this approach facilitates comparisons of the state and local sector with the overall economy or with broad economic sectors, it ignores the many cyclical patterns that exist among the many subcomponents of the state and local sector. By disaggregating the data, it becomes possible to identify the frequently divergent behavior of subcomponents of the state and local sector. The following sections describe the cyclical behavior of the major state and local spending categories, such as police, fire, and education, and the major state and local revenues, such as property taxes and federal grants.

### Summary and Current Outlook

The data presented here suggest that state and local receipts and expenditures display different cyclical patterns. State and local revenue receipts generally fall during a business contraction, while state and local spending generally rises. However, some state and local revenue receipts display different cyclical patterns. State and local spending generally rises during an economic downturn, while state and local revenue receipts generally fall. The time lags between changes in state and local revenue receipts and changes in state and local spending are generally longer than the time lags between changes in state and local spending and changes in state and local revenue receipts.

### Regional Patterns

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### Regional Patterns

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### Appendix C

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### Summary and Current Outlook

The data presented here suggest that state and local receipts and expenditures display different cyclical patterns. State and local revenue receipts generally fall during a business contraction, while state and local spending generally rises. However, some state and local revenue receipts display different cyclical patterns. State and local spending generally rises during an economic downturn, while state and local revenue receipts generally fall. The time lags between changes in state and local revenue receipts and changes in state and local spending are generally longer than the time lags between changes in state and local spending and changes in state and local revenue receipts.

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4. State and Local Finances in Recession and Inflation

Although state and local expenditures rose during the year in which a business contraction occurred, state and local expenditures fell somewhat in the following year. It would be difficult to predict how total state and local expenditures would respond during a business contraction.

In the past five business contractions, expenditures grew faster during recessions than in the immediately preceding and subsequent business expansions. There have been two exceptions to this pattern. In the long business expansion of 1961 to 1969, secular demands for expanded state and local services grew rapidly. During the 1973-75 recession, the most severe U.S. business contraction since the 1930s, state and local expenditures would respond during a recession. Consequently, spending cuts probably occur in a narrow range of functions, making it difficult to predict how total state and local expenditures would respond during a business contraction.

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Table 2 State and Local Employment in Business Contractions and Expansions

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent change at average annual rate</th>
<th>Percent change at average annual rate</th>
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</thead>
<tbody>
<tr>
<td>1957:3-4.5</td>
<td>1960:4-1957:3 5.6</td>
<td>1957:3-1954:2 5.6</td>
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<tr>
<td>1953:2-5.6</td>
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<td>1950:1-1953:2 2.0</td>
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<td>1950:1-1953:2 2.0</td>
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<td>1954:2-1957:3 5.9</td>
<td>1954:2-1957:3 5.0</td>
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<tr>
<td>1957:3-5.9</td>
<td>1954:2-1957:3 5.0</td>
<td>1954:2-1957:3 5.0</td>
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<tr>
<td>1957:3-6.0</td>
<td>1954:2-1957:3 5.0</td>
<td>1954:2-1957:3 5.0</td>
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<td>1954:2-1957:3 5.0</td>
<td>1954:2-1957:3 5.0</td>
</tr>
</tbody>
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4. State and Local Finances in Recession and Inflation. Appendix C.