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Equity in School Financing: The Courts  
Move In

A Decade of Growth for Social Spending

Budget Surpluses for State and Local Gov-  
ernments: Undercutting Uncle Sam's  
Fiscal Stance?

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# business review



**IN THIS ISSUE . . .**

**Equity in School Financing: The Courts Move In**

. . . Changing attitudes and financial crises of local governments have thrust the issue of equitable school financing into the arena of major social concerns, with the courts defining and implementing the objectives.

**A Decade of Growth for Social Spending**

. . . Social spending at all levels of government has steadily increased, now accounting for a hefty slice of the national income.

**Budget Surpluses for State and Local Governments: Undercutting Uncle Sam's Fiscal Stance?**

. . . Recently state and local governments have begun posting fatter and fatter surpluses which are partially offsetting the expansive impact on the economy of Federal deficit spending.

**On our cover:** The Capitol Building of the Commonwealth of Pennsylvania is located at State and Third streets in Harrisburg. Designed by Joseph M. Houston of Philadelphia, it was completed in 1906 and dedicated on October 4 by President Theodore Roosevelt. An E-shaped granite structure of Italian Renaissance design, the Capitol is 520 feet long and 254 feet wide. Its dome, towering to a height of 272 feet, is visible from almost every point in the city. (Photo courtesy of the Pennsylvania Department of Property and Supplies.)

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# Equity in School Financing: The Courts Move In

by

Anita A. Summers

*On March 21, 1973, the United States Supreme Court, in a razor-thin 5 to 4 decision, upheld the constitutionality of the present methods of school financing in Texas. Writing for the majority, Justice Lewis F. Powell, Jr. declared that “the consideration and initiation of fundamental reforms with respect to state taxation and education are matters reserved for the legislative processes of the various states. . . .”*

*The article presented here, written before the Court ruling, highlights the underlying issues leading up to this decision. Specifically, it deals with recent efforts to develop more equitable methods of school financing and the role that courts are playing in defining and implementing equity in education.*

Mankind has long sought equity. Everyone—from King Solomon to President Nixon—has been for it. The question which leads to conflicting views is, what does it mean? Whether income distribution, garbage collection services or education is being considered, these questions need to be answered: equity for whom? equity measured by what? equity determined by whom? School financing has been thrust into the spotlight by changes in American values and crises in municipal financing. To date, most of the debate has been in the courts. While the final judicial verdicts are not in yet, changes in defining and implementing equity in education are in the offing.

## EDUCATIONAL EQUITY COMES OF AGE

**Social Self-Consciousness.** Although a major issue in the last century, equity in the financing of education has again become a

live topic among lawyers, educators, politicians, and social scientists. And this is not at all surprising. Two major developments—one social, one economic—have converged, inexorably, on education. During the past 25 years, Americans have moved through a painful exploration of social concerns, leading to a quest for more precise definitions of rights. Racial discrimination, rights of the poor, and women's liberation have been drawn through the maze of courts, legislatures, activist groups, and academia. Economist Kenneth Boulding has called this trend a movement from a period of personal self-consciousness (the era of Freud) to a period of social self-consciousness. These changing attitudes have also pushed a child's right to be educated to the forefront of items to receive a definition of equity.

**Crisis in Municipal Finances.** The condition of local finances—in particular, urban finances—underscores the urgency of defining equity in education as well. In many large cities education revenues are inadequate to meet school needs. (Indeed, total local revenues are viewed as inadequate to meet municipal needs in many major cities.)<sup>1</sup> Center cities have certainly had intense competition for their tax dollar. Their high-cost population and old physical plant have resulted in increasing demand for noneducational services.<sup>2</sup> But growth in tax

receipts, coming mainly from property taxes, has been sluggish—as income of city residents has climbed, property tax revenue has not risen proportionately. Adding to the revenue problem has been the erosion of city tax bases, as families and firms have headed for the suburbs.<sup>3</sup> Accompanying these developments, taxpayers have viewed educators' requests for more funds with increasing wariness. Improvements in skills have been minor, student turbulence has continued for years, and dropout rates have remained high. Yet, educational expenditures have soared. For nearly three decades elementary and secondary school expenditures have jumped significantly higher than the 7 percent increase in expenditures on all output in the United States (Gross National Product). Per pupil expenditures have more than doubled in the last 10 years.

The educators' views that funds are inadequate and local taxpayers' wariness and reluctance to provide more funds mean that, for large urban school districts, the financial crisis is particularly acute. Those most concerned over this general financial inadequacy are the ones who feel most disadvantaged in the general educational process. Hence, there has been a rash of lawsuits across the country brought by parents and children who feel that they are being shortchanged in the parceling of educational funds.

**The Ultimate Objective.** Because of changing attitudes and financial crises of local governments, the question of educational equity begs for definition, with the courts playing a major role in the process. Obviously, the child is the prime objective

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<sup>1</sup> While most major cities have faced financial difficulties during the past years, state and local governments as a whole have not. For a discussion of the aggregated budget posture of state and local governments, see Donald L. Raiff and Richard M. Young, "Budget Surpluses for State and Local Governments: Undercutting Uncle Sam's Fiscal Stance?" in this issue.

<sup>2</sup> Center cities spend about a third of their revenue on education, suburban areas about half. In the Philadelphia area, in 1966-67, local taxes were 6.2 percent of personal income in Philadelphia, 4 percent in the suburbs—but, \$51 per capita went to education in Philadelphia and \$85 per capita in the suburbs.

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<sup>3</sup> Center city family incomes are more than \$2,000 less than suburban family incomes. Suburban retail sales in the 37 largest SMSAs increased 106 percent between 1958 and 1967; center city sales increased by only 13 percent.



of the educational process. How is equity best defined for the child? The courts, through constitutional interpretation, may be better equipped to define the objective in a less demanding way by requiring equity for the taxpayer. The legislatures, by responding to their constituencies, may be better equipped to respond to the more demanding statement of the objective—that is, equity for the child. In either case, providing all children in a specific jurisdiction with an equal learning opportunity is the ultimate objective.

### EQUITY—FOR THE TAXPAYER OR THE CHILD?

There are two sides to an education budget—revenues and expenditures. Debates about equity in school financing frequently move around loosely between the two sides. If equity for the child (or the school or the school district) is the goal, then the expenditure side is emphasized, and the question is whether or not public education funds are being *spent* “fairly.” Court cases with this leaning emphasize the inferior education received by children of the poor or children in minority groups. If equity for the taxpayer is the objective, then revenue is stressed, and the question is whether or not public education funds are being *raised* “fairly.” Court cases with this leaning emphasize the relatively low amount of funds raised in poorer areas with equal tax effort. Clearly, the child and the taxpayer are not entirely different entities—the taxpayer is often the parent of the pupil. But, when measuring the degree of equity, it is useful to emphasize the different hats they are wearing. And taxpayer equity is easier to measure than pupil equity.

#### Equity for the Taxpayer in the Courts.

Three lawyers specializing in the area of school finance reform were quick to recognize the relative manageability of a taxpayer equity standard in the eyes of the courts.

They worked out an approach known as “fiscal neutrality,” which side-stepped the issue of equity in output (educational quality) by focusing on the issue of equity in dollar availability.<sup>4</sup> They argued that educational funding should be unbiased in the sense that equal tax effort (equal millage on the value of property) should raise equal dollars per child. While almost all states have some form of “equalization” standards, unequal amounts per pupil still are raised from equal millage because property values vary so widely (Hawaii being the exception).

The landmark decision of *Serrano v. Priest* in California was the first in a series of cases successfully argued using this principle of fiscal neutrality. Schoolchildren and their taxpaying parents from a number of Los Angeles County school districts sued a number of county and state officials on the grounds that the method of financing education in the state of California violated the equal protection clauses of the state and U. S. constitutions. They contended that the state-mandated tax structure resulted in their paying higher tax rates to receive the same or less revenue for education as those in other school districts in the state. The outcome, they argued, was lower educational quality despite high tax efforts for many school districts. On August 30, 1971, the California Supreme Court ruled that:

We have determined that this funding scheme invidiously discriminates against the poor because it makes the quality of a child’s education a function of the wealth of his parents and neighbors. Recognizing as we must that the right to an education in our public schools is a fundamental interest which cannot be conditioned on wealth, we can discern no compelling state purpose necessitating the present method of financing.

<sup>4</sup>J. E. Coons, W. H. Clune, and S. D. Sugarman, “Educational Opportunity: A Workable Test for State Financial Structures,” *California Law Review* 57 (1969): 305.



We have concluded, therefore, that such a system cannot withstand constitutional challenge and must fall before the equal protection clause.

The post-Serrano period has seen a steady flow of successfully and similarly argued cases in a number of states. In Minnesota the "fiscal neutrality" argument was used with success. The United States District Court found that the state had organized a tax system which resulted in less education revenue for some school districts. The state legislature revised its school aid formula, and the plaintiffs withdrew their case. Similar decisions were reached in cases in New Jersey, Arizona, Kansas, and Michigan in 1972.

The case receiving the greatest attention now is one originating in Texas and argued before the United States Supreme Court on October 12, 1972. A group of Americans of Mexican descent (children and their tax-paying parents) originally sued the Texas State Board of Education, San Antonio School Districts and others. The United States District Court, in December 1971, declared the Texas educational financing system unconstitutional and ordered it corrected by the 1973-74 school year. An appeal was brought to the Supreme Court and a ruling is anticipated this spring.

Press coverage to the contrary, local property taxes *have not been* declared unconstitutional, and the level of educational spending in any school district *has not been* mandated. What has been strongly affirmed (with one exception noted below) is the concept of *fiscal neutrality*. The definition of equity in education mandated by the courts is taxpayer-oriented. It measures education in terms of dollars available to spend and defines equity in terms of equal dollars per child from equal tax rates. It skips over the question of whether a difference in educational expenditures results in a difference in educational quality. It says, simply, that each child should have an equal amount

available to be spent on education with the same tax effort on the part of the school district (see Box for details of several proposals aimed at meeting the fiscal neutrality standard).

**Equity for the Child.** Impressive as these equalizing recommendations and decisions may be, the lack of concentration on equity for the child is deplored by many. A striking feature of the 50-odd recent court cases involving school finance reform is that no case stands which has ruled in favor of requiring equal educational quality for the children in different school districts in a state.<sup>5</sup>

In 1954, the U. S. Supreme Court in the famous Brown case, in which racial segregation was the central issue, ruled:

Today, education is perhaps the most important function of state and local governments . . . Such an opportunity, where the state has undertaken to provide it, is a right which must be made available to all on equal terms.

Not until February 1968, however, was this basic philosophy related to school finance reform. Poor children in Detroit complained that they were receiving a quality of education inferior to that in the more affluent suburbs, and demanded correction through reforms in educational finance. In June 1968, a few months later, a similar complaint landed in the courts in Illinois. Students and parents argued that a school finance system that did not educationally compensate the disadvantaged—a system that did not allocate money according to "educational needs"—was unconstitutional.

<sup>5</sup> Judge J. Skelley Wright did rule in *Hobson v. Hansen* in 1971, in Washington, D. C., that per pupil expenditures on teachers' salaries and benefits in the D. C. schools should not deviate more than 5 percent from the mean, that this covers "only inputs which do have a direct bearing on the quality of a child's education," and this is a "judicially manageable standard."



## MEETING THE FISCAL NEUTRALITY STANDARD

One group of proposed schemes involves moving toward more centralized financing of education. The state would raise all funds for education and dispense them uniformly throughout its districts. This concept meets the only requirement of Serrano, the requirement of fiscal neutrality (different school districts receive money in a way which is divorced from wealth). Moreover, it permits some leeway in dispensing funds. For example, equal expenditures per pupil with corrections for cost differentials (teachers' salaries, books) over the state would be consistent with the concept of fiscal neutrality, as would equal per pupil expenditures with corrections for cost differentials related to student needs.

Another proposal known as "power equalizing" has evolved. This scheme is consistent with the present decentralized form of education and fuses egalitarian and libertarian views. One version includes (1) a flat grant per child to be provided by the state to insure a basic adequate amount of spending, (2) a categorical grant to respond to specific needs (for example, transportation, municipal overburden, underachieving students), and (3) a local tax source. Local school districts would raise money as they see fit (with the taxes allowed to them in their respective state constitutions), with one proviso. Districts which raise less than the average amount raised in the state from any given tax rate would receive the difference from the state. The state would obtain these funds from the districts which raise more than the average amount. Thus, for each 1 percent a district taxes itself, it will raise an amount of money per pupil to be spent on education equal to that of every other district in the state. This scheme meets the fiscal neutrality mandate and, indeed, exceeds it (consideration of the needs of different types of students and school districts, as reflected in the flat and categorical grants, is not part of the ruling).\*

Thus, the "power equalizing" plan appears to satisfy the courts, keeps many aspects of local taxation intact, leaves school administration to local districts, and allows individual districts to spend more on education if they so choose.\*\*

\* A simple power-equalizing scheme has been applied to school districts in Pennsylvania to illustrate what the impact might be (see Appendix). The hypothetical plan assumes that present state and Federal aid would be the flat grant and categorical aid components.

\*\* All the ramifications of such a plan are not known, of course. It is possible, for example, that rich districts, finding their greater-than-average capacity to produce tax revenues for education used for others, would opt for more of other public services, and send their children to private schools—thereby reducing the tax revenue to be redistributed.



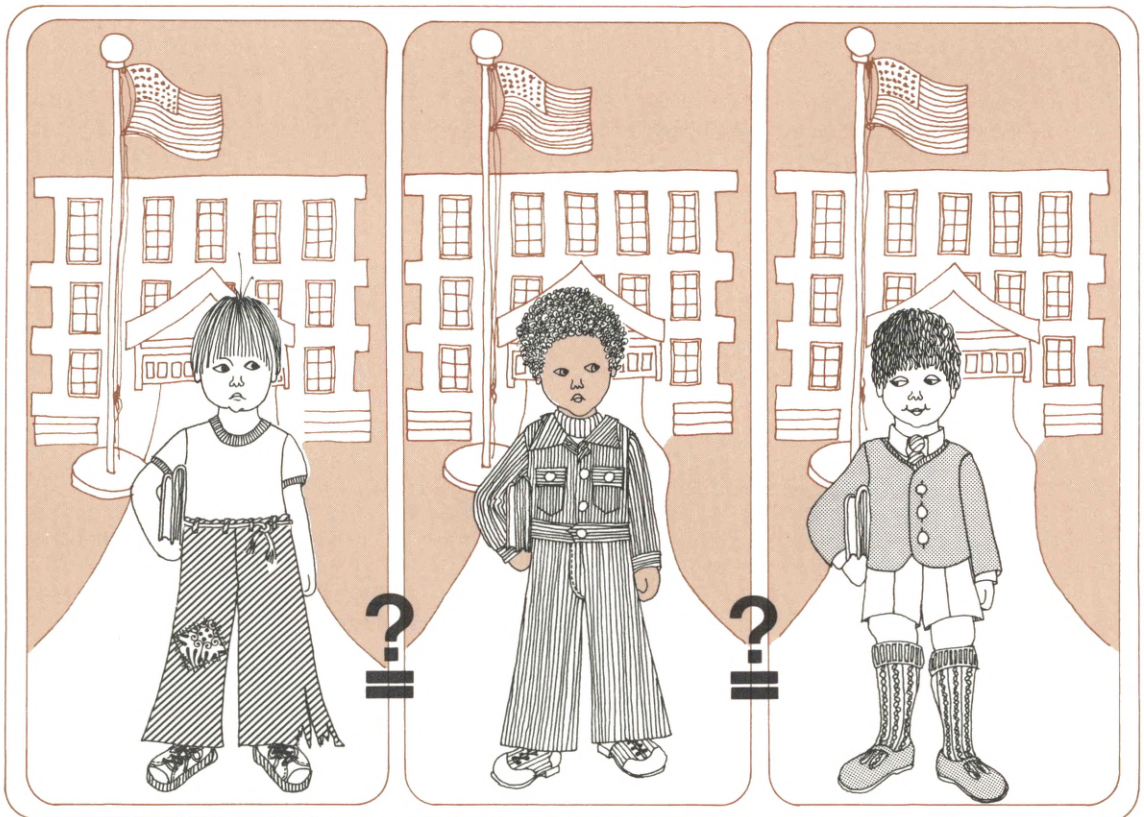
The next year, students and taxpayers in Virginia sued their state's public school and finance officials, charging the state with not fulfilling its obligations, because per pupil expenditures varied widely over the school districts in the state. None of these cases brought about changes in educational financing procedures. The courts referred to the absence of a "judicially manageable standard" and the confusing guidance of an educational needs criterion. Following these rulings, many other cases were dismissed and many were voluntarily withdrawn.

Only when those who complained of inequity moved from the issue of equal educational quality to the issue of taxpayer

equity did the courts begin to render affirmative decisions. The difficulties the courts faced in developing manageable criteria for determining what constitutes equal educational quality are the same that educators face when evaluating various educational programs: What quantitative measures should be employed in determining whether programs have achieved their objectives?

**WANTED: STANDARDS FOR EQUITY IN EDUCATIONAL QUALITY**

Equal per pupil expenditure makes things equal, but in many cases not fair. The edu-





cation of a physically handicapped child must cost more than that of a normal child. His educational demands are greater if the same achievements are desired. Currently, most financing schemes allot extra funds for such a child. And the costs and results are readily ascertainable. The more subtle question arises with the less visible handicaps related to poverty or race.

Should heavier allotments be made to overcome these socioeconomic differences? To answer yes, one needs to have much more in the argument than “help the disadvantaged.” If more is spent for such a child, is he, in fact, helped in his school achievements? The much-publicized Coleman Report concluded that “when schools with economically and racially similar students were compared, differences in school policies and resources were rarely associated with pedagogically significant or statistically reliable differences in verbal achievement.”<sup>6</sup> Does that mean that money doesn’t matter—that spending more on the disadvantaged won’t help, because socioeconomic and genetic characteristics matter most? Perhaps. But the issue is certainly not a settled one.<sup>7</sup>

<sup>6</sup> James S. Coleman, Ernest Q. Campbell, Carol J. Holson, James McPartland, Alexander M. Mood, Frederic D. Weinfeld, and Robert L. York, *Equality of Educational Opportunity*, 2 vols. (Washington: Government Printing Office, 1966).

<sup>7</sup> The Department of Research of the Federal Reserve Bank of Philadelphia, as part of its continuing interest in the economic problems of Philadelphia’s public sector, is conducting a study of resource inputs and achievement outputs of Philadelphia public school students. The effects of various school inputs (examples are teacher quality and equipment), socioeconomic inputs (examples are family income and race), and school climate inputs (examples are the number of disruptive incidents and the proportion of low achievers) are being analyzed in relation to changes in pupil achievement over a period of years. Inputs important to low achievers will be sorted out from inputs important to high achievers. Similarly, sorting will be done by race and by income levels.

Until such issues are better specified, schemes for school finance reform which detail allotments might be better implemented through flexible arrangements which allow for additions and retractions for specific educational requirements. In the absence of detailed attention to these needs, large cities may emerge the losers. For example, Philadelphia, under one simple formula, would be less well off (see Appendix). A more sensitive indicator of needs, however, would produce a result more helpful to center cities. In short, if educational policymakers are to achieve the ultimate objective of an equal learning opportunity for all children, they must develop manageable standards for assessing educational quality.

#### WHAT NEXT?

Now, it is education—not housing, welfare or job training—whose equity characteristics are under fire. The courts, in particular, have been called upon to define the standards.

What has clearly emerged is a general acceptance in many states of a minimal standard of equity to be enforced by the courts. That is, within the state, equal tax rates must generate equal dollars for education. If the U. S. Supreme Court upholds this position, plans for implementing it in states where cases have already been decided will move along rapidly. In other states, litigation will surely develop. If the Court does not uphold the position, the issue will have been tossed back to the states for examination within the frameworks of their constitutions. The results will be slower—and, of course, less uniform.

Beyond this minimal standard, developments are more likely to be seen in state legislatures than in the courts—and preferably so. The legislature, in the development of state support formulas, already has considerable experience in defining equity in

terms of meeting the educational needs of different categories of students. The search for more accurate answers to the question of the role of educational resources in educating the disadvantaged is proceeding, but still has some distance to go before yielding a useful judicial yardstick.<sup>8</sup>

The one certainty is that change in the area of school financing is inevitable. Even if radically different schemes are not implemented, the objective of educational equity will get a new look. The role of the property tax in school financing will probably diminish, as new taxes are examined. If nothing else, the property tax system is likely to be overhauled. Improved equalization procedures, and new computer techniques for keeping the tax revenue moving with property values will be implemented more rapidly as a consequence of the energetic search for educa-

tional equity. Moreover, this search, along with the fiscal crises of many urban schools, creates a compelling pressure to seek out the effective use of limited educational inputs. When funds are scarce, the question of who should get how much sharpens and the answer becomes visible in its impact.

During this period of reexamination and change, the schools are expected to continue to operate. For the urban schools the task of operating is staggering. Not only must they await further judicial opinions, but they must also deal with taxpayers that are increasingly reluctant to give more to education. ■

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<sup>8</sup> Thus, in one suit in Illinois, the court said, “. . . there are no ‘discoverable and manageable standards’ by which a court can determine when the constitution is satisfied and when it is violated.”



## APPENDIX

### WHAT ONE EQUALIZING METHOD WOULD DO IN PENNSYLVANIA

In the table below a few school districts were selected, somewhat arbitrarily, to illustrate what the current (1971-72) range of per pupil expenditures is, what the current local tax effort is for education, and what changes in school district expenditures could occur if a simple, hypothetical, and equalizing method were adopted:

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)*	(9)*
				(2)-(3)-(4)			(6)×\$26.58	(8)+(3)+(4)
							Local Tax Revenue Per Pupil Using Equalizing Formula	Total Tax Revenue Per Pupil Using Equalizing Formula
Administrative Unit	Total Revenue Per Pupil (\$)	State Aid Per Pupil (\$)	Federal Aid Per Pupil (\$)	Local Revenue Per Pupil (\$)	Local Tax Effort For Education (Mills)	Local Tax Revenue Per Mill Per Pupil (\$)	(\$)	(\$)
Central Fulton	623	417	18	188	50.9	3.69	1353	1788
Clearfield Area	766	500	22	244	24.0	10.17	638	1160
Lebanon	859	362	26	471	28.5	16.53	758	1146
Stroudsburg Area	901	252	17	632	22.7	27.84	604	872
Neshaminy	985	432	6	547	33.1	16.52	880	1318
York	1131	508	7	616	31.4	19.62	835	1350
Radnor	1275	91	0	1184	32.3	36.66	859	950
Lower Merion	1329	110	1	1218	19.7	61.83	524	635
Philadelphia	1347	531	15	801	22.2	36.08	591	1136
Average of 139 Reporting Districts	899	372	9.4	712	27.0	26.58		

\* Calculations are available, on request, for the remaining 130 reporting school districts.

Source of data, Columns (1)-(6): *Economic Aspects of Public Education in Pennsylvania, 1971-72*, Graduate School of Education, University of Pennsylvania.

- (1) These are a selected group of school districts from the 139 reporting units, illustrating a wide range of expenditures.
- (2) Total revenue per pupil is equal to the amounts spent on operating expenditures, capital equipment, and transportation. Excluded are bond proceeds. Pupils are weighted by grade: K = 0.5, 1-6 = 1.0, 7-12 = 1.1 and only those on the active rolls are included.



- (3) State aid includes foundation support, designed to provide minimum support and to equalize somewhat, and specific allocations for school construction, health services, etc.
- (4) Federal aid, largely Title I funds.
- (5) Local revenue per pupil equal total revenue less state and Federal aid.
- (6) Local tax effort is measured by the ratio of all tax revenues used for education to the total market value of real property, expressed in dollars per thousand (mills). No correction has been made for unequalized assessments.
- (7) Local tax revenue for education is calculated on a per pupil per mill basis.
- (8) The mean raised per mill per pupil for all communities, \$26.58, is multiplied by the current, local tax effort to obtain the hypothetical local revenue per pupil.
- (9) The amount raised locally under the hypothetical plan is added to Federal and local aid to obtain the hypothetical total revenue per pupil.

What can be seen from the table? *Total revenues per pupil (column 2), with the present form of equalizing, vary widely.* Philadelphia has the highest of the reporting districts and Central Fulton, one of the lowest, has less than half the per pupil expenditures. Variations in needs (transportation, costs, socioeconomic) not incorporated in present equalization methods account for some of this spread. Variations in effort and wealth account for the rest.

*Locally raised revenues (column 5) vary even more widely.* In the small sample in the table, Lower Merion is six times Central Fulton. Two factors, effort and wealth (as measured by property values) are involved in this result.

*Local tax effort (column 6) varies widely.* The community poorest in property value of this sample shows the greatest effort (Central Fulton), and the community richest in property value shows the least effort (Lower Merion).

*Communities show a large spread in taxed property value.* Because property values vary so widely, the amounts of revenue raised per mill per pupil (column 7)—that is, what the same tax effort produces per pupil—varies widely. One mill raises \$3.69 per pupil in Central Fulton, and \$61.83 in Lower Merion.

*If the revenue from a mill were the same (equal to the present average) for all school districts, low per pupil spenders would receive more, and high per pupil spenders would receive less (column 8).* This hypothetical plan would leave each community expending its present tax effort. Essentially, a redistribution of school revenue would occur from high property value districts to low property value districts. This can be seen by comparing columns 8 and 5.

*When the present equalizing state and Federal aid are added on to the equalized local tax revenue per mill, the total tax revenue for schools is larger for school districts with higher tax effort (column 9).* Thus, Central Fulton would, in this hypothetical plan, have the largest amount (and the largest increase in amount) per pupil available to spend. This can be seen by comparing columns 9 and 2. It would benefit greatly from the fact that, without the plan it was able to raise only \$3.69 per pupil per mill—much less than the average for the reporting districts in the state of \$26.58. And, in addition, it would be rewarded for its very large tax effort—50.9 mills, com-

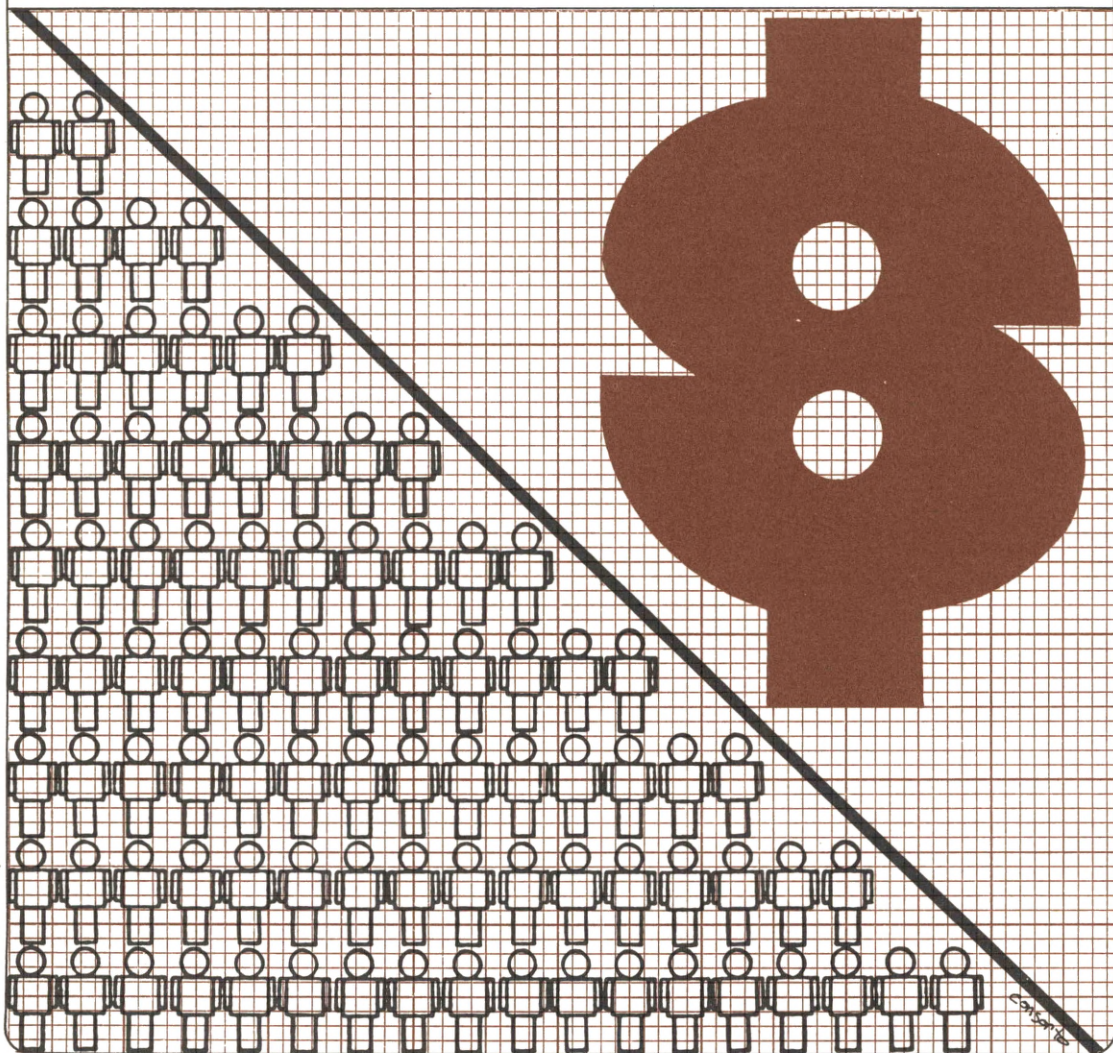


pared with the 27.0 average for the state. Lower Merion, on the other hand, would have much less available to it. It would lose on two accounts—from the fact that it could raise \$61.83 per pupil per mill (much higher than the \$26.58 state average), and from the relatively low tax effort of 19.7 mills (much lower than the 27.0 state average). Philadelphia would emerge somewhat worse off—it is able to raise somewhat more than the average per pupil per mill, but its tax effort is less than the average.

Clearly, many factors have not been incorporated in this hypothetical plan. Many would advocate much more weight being given to those with socioeconomic disadvantages than is now incorporated in the equalizing aid. And many would want to allow for the municipal overburden of cities. Both of these would result in a very different revenue availability for Philadelphia.

# A Decade of Growth For Social Spending

by robert ritchie

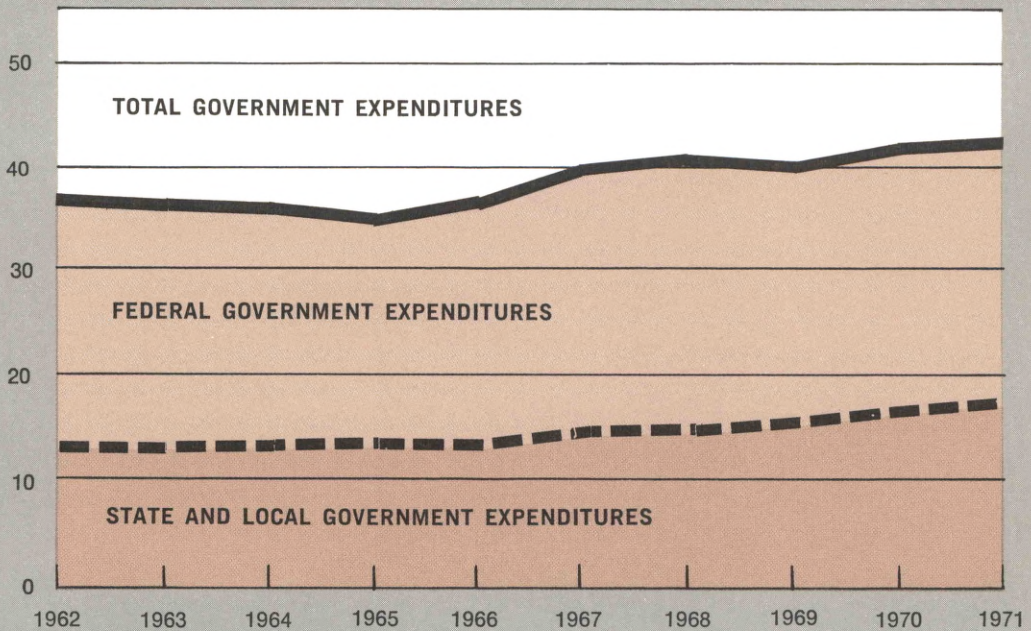




**CHART 1**

**DURING THE PAST 10 YEARS PUBLIC SPENDING UPPED THE SHARE OF NATIONAL INCOME FUNNELED THROUGH FEDERAL, STATE, AND LOCAL BUDGETS**

Percent of National Income



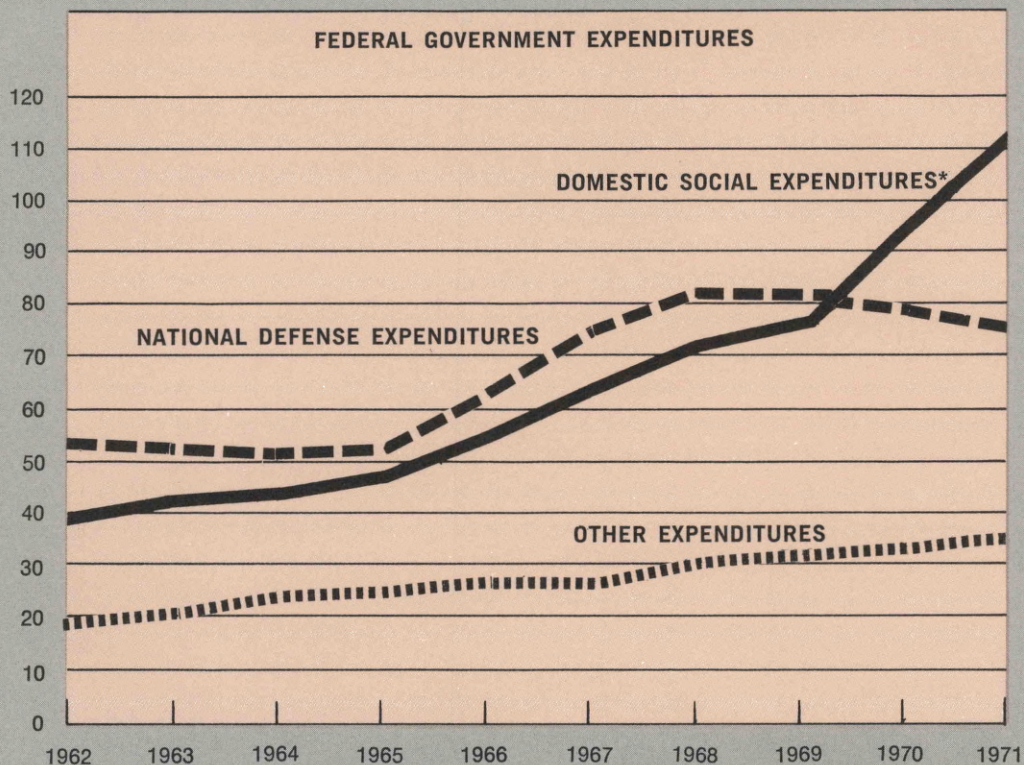
Source: U. S. Department of Commerce, *Survey of Current Business*



CHART 2

**MOREOVER, UNCLE SAM BEGAN SPENDING MORE ON DOMESTIC SOCIAL PROGRAMS\* THAN ON NATIONAL DEFENSE**

Millions of Dollars



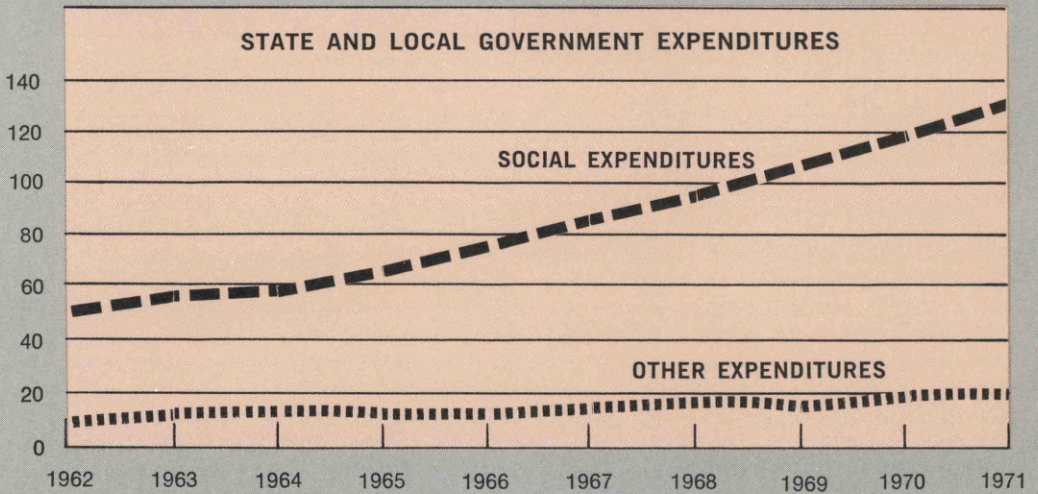
\* Domestic social programs include expenditures on education, health, labor, welfare, veterans benefits and services, commerce, transportation, housing, and natural resources. Other expenditures include spending on space research and technology, general government, international affairs and finance, and agriculture. Federal expenditures are larger than attributed in Chart 1 because of Federal grants-in-aid.



**CHART 3**

AND, STATE AND LOCAL GOVERNMENTS, WHICH USUALLY DEVOTE MOST OF THEIR BUDGETS TO SOCIAL PROGRAMS, INCREASED THESE EXPENDITURES CONSIDERABLY.

Millions of Dollars

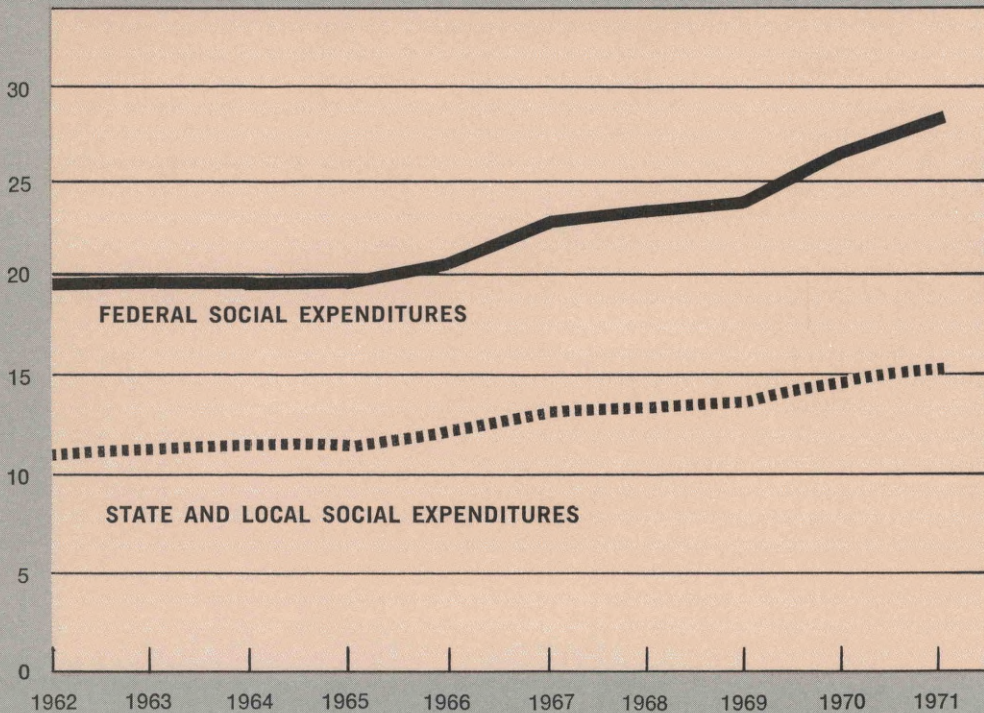




**CHART 4**

**AS A RESULT, GOVERNMENTS' SOCIAL SPENDING ACCOUNTS FOR MORE THAN A QUARTER OF THE NATIONAL INCOME.**

Percent of National Income





# Budget Surpluses for State and Local Governments: Undercutting Uncle Sam's Fiscal Stance?

by  
*Donald L. Raiff and  
Richard M. Young*

Each year since 1969 the Federal Government has run budgetary deficits larger than any since the end of World War II. Although deficits and surpluses are not the only channels through which governments' budgets affect the economy, they are the biggest attention-getters (see Box). The reason for this is that a big deficit typically signifies a boost to economic expansion, sometimes too hefty a boost. The concern expressed in some quarters is that Uncle Sam's deficit for 1973 will push an already expanding economy into a runaway boom accompanied by a rising rate of inflation.

While national attention has centered on the Federal red ink, relatively little notice has been taken of the new fiscal position of state and local budgets. In the last few years state and local governments, as a

group, have switched from "balanced" budgets to ones with unprecedented surpluses.<sup>1</sup> And another surplus is in the cards for '73.

Because of this state and local surplus for '73, the Federal deficit projection substantially overstates the stimulative impact of the public sector on the economy. Thus, rather than catapulting the economy into an overheated boom, the *total* fiscal stance of the public sector may be a tempering influence on economic expansion in 1973 and 1974.

<sup>1</sup>The surplus is on a National Income Account basis as published by the U. S. Department of Commerce in its *Survey of Current Business*. The aggregation is over all state and local governments, both their regular budgets and the social insurance funds which they control (see footnote 2).

## MORE TO A BUDGET THAN SURPLUSES AND DEFICITS

Surpluses and deficits are probably the most widely discussed aspect of government budgets when it comes to assessing the economic outlook for the nation. The reason for this is that a deficit typically has an expansionary effect on the economy, and a surplus a contractionary one. But there is more to understanding a budget's effect on the national economy than being aware of its surplus or deficit position. Three sometimes elusive aspects—a budget's level, its composition, and its financing—also have important effects on output, employment, and inflation.

**Budget Level.** Aside from a surplus or deficit, the importance of the level of the budget is a result of the balanced-budget multiplier—a concept familiar to every student of introductory economics. The Federal Government stimulates the economy when it moves from a given surplus or deficit to a budget having higher expenditures and taxes but the same surplus or deficit. This effect is generated because Washington spends all additional revenues while John Q. Taxpayer would have saved part of his incremental disposable income had there been no tax increase.\* Rapid increases in taxing and spending by state and local governments since 1945 presumably added to national income by an amount equaling the balanced-budget multiplier times the size of any equal increase in taxes and expenditures. In lieu of this effect, Uncle Sam would have found it necessary to reshape his fiscal posture to achieve the employment and growth levels of postwar years.

**Budget Composition.** Revamped taxes and expenditures can also greatly affect a budget's impact on the economy. One expenditure may generate a feedback through the capital goods market, while another may not. For example, a billion dollar increase in spending on tanks will not affect GNP the same as a billion spent on city parks. One tax payment may be deductible in computing a second tax, so equal reductions in payments of the two taxes have much different impacts on the income left in the hands of the taxpayer. For example, a reduction in the city wage tax will not affect employment in the same way as an equal reduction in the Federal income tax.

**Budget Financing.** If a government budget is not balanced, important feedbacks could result from using surplus funds or raising funds to cover the deficit. For example, to cover a deficit, government must compete with other potential borrowers for funds, thus forcing up interest rates on these competing securities. The higher interest rates will feed back through interest-sensitive demands in the economy. A secondary response would even involve monetary policy if it were aimed at controlling these interest rates.

In short, a budget is an intricate affair, and its effects, like its level and make-up, are not so easy to pigeonhole.

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\* This is a simplistic view of the stimulative impact of such a move. It ignores both the possibility of a desire on the part of some governmental units to build up surpluses and the possibility that consumers may value certain government expenditures as income.



## SUDDEN SURPLUSES FOR STATE AND LOCAL GOVERNMENTS

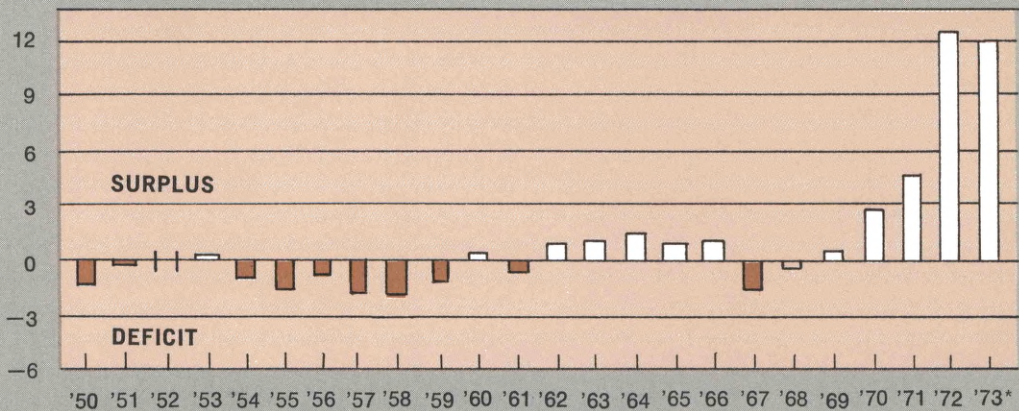
From 1950 to 1969 the average budget position for state and local governments was about a quarter of a billion dollar deficit (see Chart 1).<sup>2</sup> It was largely business as

usual, with outgo nearly matching income. Then, almost overnight, state houses and city halls found themselves with mounting surpluses. Two important trends set in simultaneously during the mid-1960s to help swell state and local coffers—a pickup in the growth of revenues and a moderation

**CHART 1**

### UNTIL RECENTLY, STATE AND LOCAL GOVERNMENTS CAME CLOSE TO A BALANCED BUDGET POSTURE

Billions of Dollars



\* Estimated

Source: U. S. Department of Commerce, *Survey of Current Business*

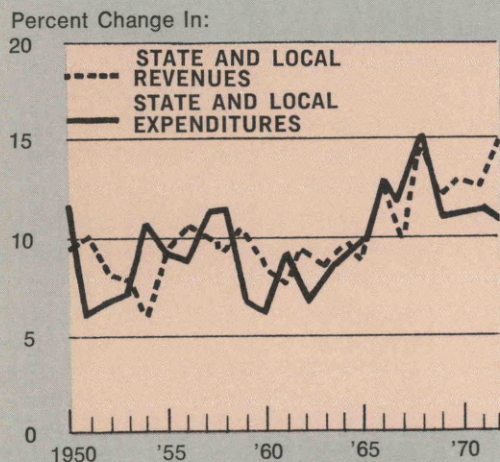
<sup>2</sup> This position was the result of offsetting surpluses in social insurance funds and deficits in general revenue funds. Since 1950, social insurance funds have maintained growing surpluses while general revenue funds have run deficits, leaving the sector in a net position near a balanced budget. The recent sector surplus is a result of surpluses in both social insurance funds and general funds. Any movement back to a balanced budget for the total sector could involve both social insurance funds and general revenue funds. A likely approach to balancing the budget would be the return of general revenue funds to a deficit position with surpluses maintained in social insurance funds.

in the rate of growth of expenditures (see Chart 2).

Several developments have accounted for the increased rate of growth of state and local revenues during the last five years. New sources of revenue have been tapped. Rates on existing taxes have jumped considerably, particularly those on sales and income. More funds have been squeezed from nontaxable sources such as increased fees at public hospitals and hiked tuitions at public



**CHART 2**  
**WHILE BOTH REVENUES AND EXPENDITURES HAVE GROWN RAPIDLY AT THE STATE AND LOCAL LEVEL, REVENUE GROWTH RATES SINCE '69 HAVE REMAINED ABOVE EXPENDITURE GROWTH RATES**



Source: U. S. Department of Commerce, *Survey of Current Business*

educational facilities. General revenue sharing, too, has spurred the recent growth of revenues from the Federal Government (see Chart 3).

The slowdown in the growth rate of expenditures can be traced largely to a slowdown in construction activity. School construction, for example, has declined every year since '68. This decline can be traced to a number of factors—changing demographic patterns and the corresponding reduced demand for expanded facilities, voter rejection of school bond issues, and a period of relatively high interest rates which deterred all forms of building activity by governments.

As a result of this budgetary switch, state and local coffers posted a surplus of \$3 billion in '70, nearly \$5 billion in '71, and over \$12 billion in '72. While easing the strain on many budget officials at the state and local levels, these surpluses can pose problems for those trying to gauge the impact of public spending and taxing on the economy. Surpluses can and do provoke miscalculations in Federal budget projections. Moreover, they blunt the stimulative impact of large Federal deficits on the economy.

### CLOUDING THE FISCAL PICTURE

State and local budgets interact with those at the Federal level in many ways. The most obvious are the direct transfers from the Federal Government which turn up as expenditures for it and revenues for states and localities. Not so obvious but more relevant for evaluating the impact of the public sector on the economy is the effect of state and local tax and expenditure decisions on Federal tax revenues.

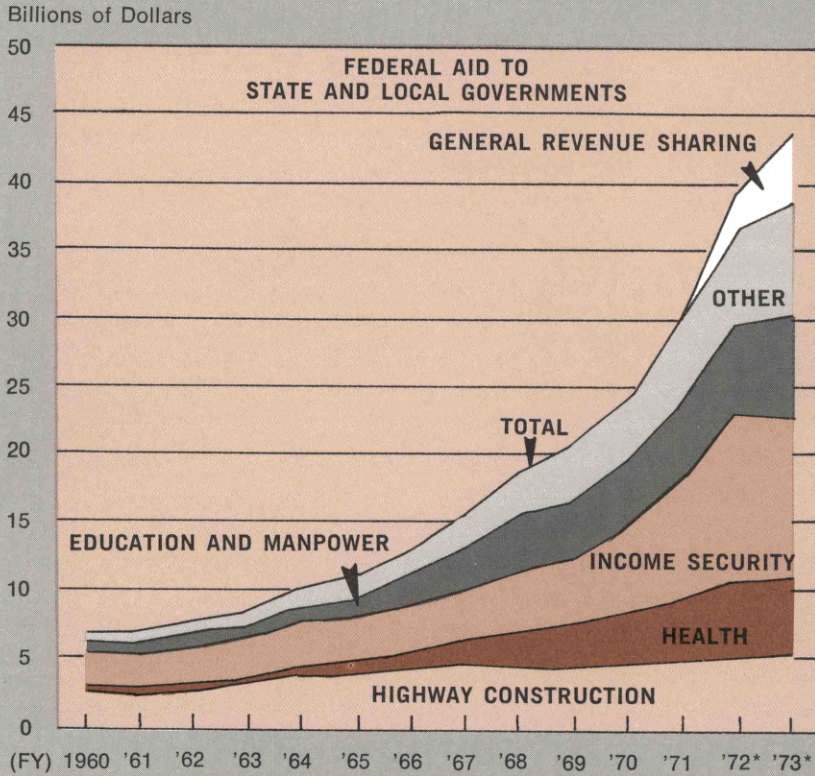
It's theoretically possible for the Federal Government to take into account the budget position at the state and local level when designing its own fiscal stance. To do this requires forecasting the revenues and expenditures for the state and local sector. Since historically the state and local level has come up with a "balanced" budget, one forecasting method might be to project expenditures then assume taxes would be adjusted so that revenues would match them. If this method were used and state and local tax collections generated surpluses rather than balanced budgets, Federal tax collections would be lower than expected. Thus, projections of the Federal budget posture would miss the mark.

An immediate reduction in Federal tax collections would result from increases in state and local taxes because many of these tax payments are deductible for purposes of calculating Federal taxes. If the unexpected state and local tax revenues were offset by



**CHART 3**

**FEDERAL GRANTS-IN-AID TO STATE AND LOCAL GOVERNMENTS  
HAVE DOUBLED SINCE 1968**



\* Estimated

Source: Office of Management and Budget

an equal drop in Federal tax revenues (with expenditures holding the line), then the story would end here. But in general the offset is not complete, leaving total

government tax receipts initially higher. Thus, there is some contractionary effect on the economy. Incomes would be reduced from what they otherwise would have been,



and tax revenues would begin to slip. Since the Federal Government relies more heavily on income taxes, its revenue loss would be proportionately greater.

Moreover, this sequence—kicked off by underestimated state and local revenues—may also lead actual Federal expenditures to exceed those projected in the budget. As the economy reacts to contractionary pressure from a state and local surplus, for example, more people become eligible for unemployment benefits and other income maintenance programs.

An unexpected surplus at the state and local level complicates the problem of projecting the Federal budgetary position. Also, because of errors introduced into the projection by the interaction of two budget sectors, it is much more difficult to assess the overall fiscal stance of the public sector.

### BLUNTING THE FEDERAL DEFICIT

Although often overlooked, the effects of government spending and taxing decisions on the economy depend on the *total* of all government units. Traditionally, however, most analysts refer only to Federal budget statistics rather than a summation over all levels of government. One reason for this approach is that historically state and local governments have seldom strayed far from a balanced budget position. Thus, the total government deficit (or surplus) position approximated the Federal deficit (or surplus). Hence, in terms of the impact of the deficit (or surplus) no great error was made in concentrating on the Federal sector rather than the total government budget.

Surpluses chalked up at lower levels of government over the past three years made the Federal deficit a poor indicator of the public sector's overall fiscal stance. As Chart 4 shows, the Federal budget position was a close approximation of the total government surplus or deficit through 1969. Beginning in 1970, state and local surpluses generated a

split between the Federal and the total government position that reached some \$12.7 billion in 1972. That means analysts who relied on the Federal deficit in '72 as an indicator of fiscal stimulus to the economy substantially overestimated the expansive impact of the public sector. The total government deficit—the one that counts in terms of heating up the economy—was \$12.7 billion less than the Federal deficit because of surpluses at the state and local level.

### MORE SURPLUSES?

While hindsight is 20/20, projecting the future impact of the total government sector on the national economy is fraught with uncertainties (see Appendix). The first problem is pinning down the behavior of states and localities. It may be true that the current surpluses reflect a change in the traditional behavior of this sector and that they can be expected to continue at the current levels. However, the surpluses may be the result of a failure to anticipate correctly the course of revenues or expenditures. In this case, surplus-laden governments might attempt to return to a balanced budget position. The likelihood of this happening seems higher than continuation of the growth of surpluses. For example, a recent survey of governors and state legislative leaders found almost half the states weighing the possibility of tax reductions.<sup>3</sup>

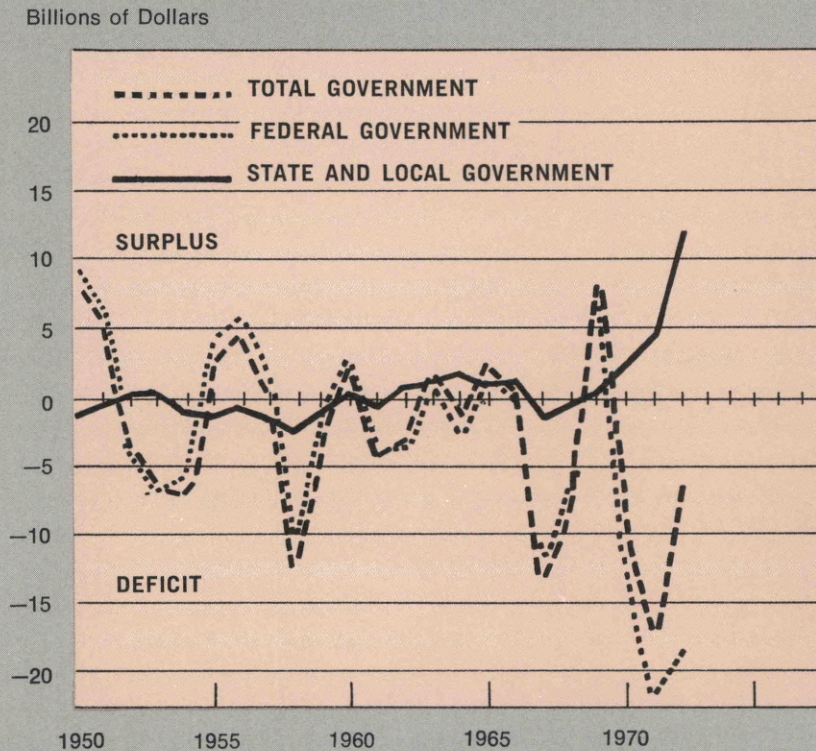
But changing tax legislation and expenditure plans takes time. Hence, it's a good bet that state and local surpluses are going to be with us in '73, even if their elimination is sought. And these large surpluses would mean that the Federal deficit again overstates the public sector's boost to economic expansion. The contractionary effect of the large surpluses would offset a

<sup>3</sup> *New York Times*, February 27, 1973, p. 14.



**CHART 4**

**THE NEAR BALANCING OF STATE AND LOCAL BUDGETS BEFORE 1970 MEANT THAT THE FEDERAL BUDGET POSITION WAS A CLOSE APPROXIMATION OF THE TOTAL GOVERNMENT SURPLUS OR DEFICIT**



substantial portion of the stimulative effect of the Federal deficit as was the case in '72. Thus, the total fiscal impact of the public sector on the economy could be relatively

small. Indeed, it could be small enough to serve as a brake on economic expansion in '73 and '74, rather than contribute to an overheated boom as some have suggested.



## APPENDIX

## STATE AND LOCAL BUDGETS, THE FEDERAL DEFICIT, AND THE NATIONAL ECONOMY

Tables 1-3 contain estimates of the effects of alternative courses for state and local budgets on the Federal deficit, Gross National Product (GNP), the Implicit Price Deflator for Gross National Product (IPD), and the unemployment rate (U).\*

Table 1 is a projection based on the assumption that state and local governments continue to behave as they have in the recent past. This results in surpluses in their budgets of \$12.5 billion in 1973 and of \$9.1 in 1974. These surpluses offset a large portion of the Federal deficit for this period so that in total the government deficit position is only slightly greater than \$7 billion in 1973 and drops to less than \$2 billion in 1974. Despite the contractionary impact of the state and local budget position, the unemployment rate declines in both 1973 and 1974, inflation as measured by the Implicit Price Deflator rises, and nominal GNP continues to grow at a rapid clip.

TABLE 1  
SURPLUSES CONTINUE

	1972	1973	1974
State and Local Budgets			
Expenditures	162.7	179.8	201.7
Revenues	175.4	192.3	210.8
Surplus/Deficit	12.7	12.5	9.1
Federal Budget			
Expenditures	246.7	270.2	281.9
Revenues	228.7	250.4	271.1
Surplus/Deficit	-18.0	-19.8	-10.8
Total Government			
Surplus/Deficit	-5.3	-7.3	-1.7
GNP	1151.9	1262.2	1350.9
(Percentage change)	(9.7)	(9.6)	(7.0)
IPD	145.9	150.4	155.9
(Percentage change)	(3.0)	(3.1)	(3.7)
U	5.6	4.9	4.8

\* Each of these estimates was prepared using a modified version of the MIT-PENN-SSRC Quarterly Econometric Model. Major policy variables were held constant over the three forecasts. In particular, all Federal expenditures except transfer payments to unemployed persons were held constant. The increase in state and local expenditures was assumed to be distributed proportionally across all items categorized as purchases of goods and services in the National Income Accounts. The tax decrease was distributed proportionally between the two major tax items—indirect business taxes and personal income tax and nontax receipts. The latter procedure resulted in a smaller impact on disposable income for the tax-decrease alternative since the largest part of the decrease feeds through the corporate sector with its high marginal tax rate at the Federal level.



**TABLE 2**  
**SURPLUS ELIMINATED BY EXPENDITURE INCREASE**

	1972	1973	1974
State and Local Budgets			
Expenditures	162.7	187.3	210.8
Revenues	175.4	192.3	210.8
Surplus/Deficit	12.7	5.0	0.0
Federal Budget			
Expenditures	246.7	269.3	281.1
Revenues	228.7	252.5	274.2
Surplus/Deficit	-18.0	-16.8	-6.8
Total Government			
Surplus/Deficit	-5.3	-11.8	-6.8
GNP	1151.9	1275.7	1370.4
(Percentage change)	(9.7)	(10.7)	(7.4)
IPD	145.9	150.9	157.3
(Percentage change)	(3.0)	(3.4)	(4.3)
U	5.6	4.1	4.2

Tables 2 and 3 illustrate the effects of two alternative paths to a balanced budget for the state and local sector. In both cases it is assumed that the sector surplus is reduced to \$5 billion in 1973 and that the budget is balanced in 1974. In Table 2 this is achieved by holding revenues at the level in Table 1 and increasing expenditures, and in Table 3 by holding expenditures at the level in Table 1 and decreasing taxes.

Notice first the very similar paths for both the Federal Government and total budget deficit in the two tables and compare them with very different courses for GNP, price inflation, and unemployment. This is a striking example of the importance of the level and composition of the budget as opposed to the surplus/deficit position.

In Table 2 the stimulus of the increased expenditures results in a GNP for 1973 more than \$10 billion greater than that in Table 1 and for 1974 almost \$20 billion higher. The inflation rate is concomitantly higher and the unemployment rate lower. While the total government deficit increases it does not increase by the full amount of the reduction of the state and local surplus since the base for Federal tax collections has increased and the deficit at that level has been reduced.



**TABLE 3**  
**SURPLUS ELIMINATED BY TAX DECREASE**

	<b>1972</b>	<b>1973</b>	<b>1974</b>
State and Local Budgets			
Expenditures	162.7	179.8	201.7
Revenues	175.4	184.8	201.7
Surplus/Deficit	12.7	5.0	0.0
Federal Budget			
Expenditures	246.7	270.1	281.7
Revenues	228.7	254.1	277.0
Surplus/Deficit	-18.0	-16.1	-4.7
Total Government			
Surplus/Deficit	-5.3	-11.1	-4.7
GNP	1151.9	1264.7	1357.9
(Percentage change)	(9.7)	(9.8)	(7.4)
IPD	145.9	150.4	156.0
(Percentage change)	(3.0)	(3.1)	(3.8)
U	5.6	4.8	4.7

In Table 3 reduction in state and local taxes stimulates income only slightly since in 1973 more than half the reduction is offset by increased Federal taxes and in 1974 more than two-thirds is offset. Despite the small differences in the total government budget deficit between Tables 2 and 3, output, employment, and inflation in the latter case follow a path much closer to that of Table 1. Each of the two courses of adjustment back to a balanced budget has an expansionary impact on the economy but tax reductions will have a much smaller impact than expenditure increases. The two main reasons for this differential impact are (1) even when the tax reduction results in an equal increase in disposable income the fact that consumers will save some part of it means that it will not be as stimulative as an equal increase in expenditures, and (2) a decrease in taxes at the state and local level will not be as stimulative as an equal decrease at the Federal level. This is because a decrease at the Federal level implies an increase in disposable income of equal amount while a decrease at the state and local level results in a smaller increase because Federal income taxes will take a chunk of the return.

The alternative courses presented are not necessarily equally probable, rather they were selected only to demonstrate the possible extremes of adjustment. Legal restrictions, on both the use of social insurance funds and deficit positions of certain local governments, may cause the occurrence of the extremes to be highly unlikely. The information to be gleaned from these simulations is intended only to demonstrate the size of the effects from possible forms of adjustment.



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*Business Review Topics,  
Fourth Quarter 1972,  
Selected by Doris Zimmermann*

*Articles appearing in the Federal Reserve Bulletin and in the monthly reviews of the Federal Reserve banks during the fourth quarter of 1972 are included in this compilation. A cumulation of these entries covering the years 1969 to date is available upon request. If you wish to be put on the mailing list for the cumulation, write to the Publications Department, Federal Reserve Bank of Philadelphia.*

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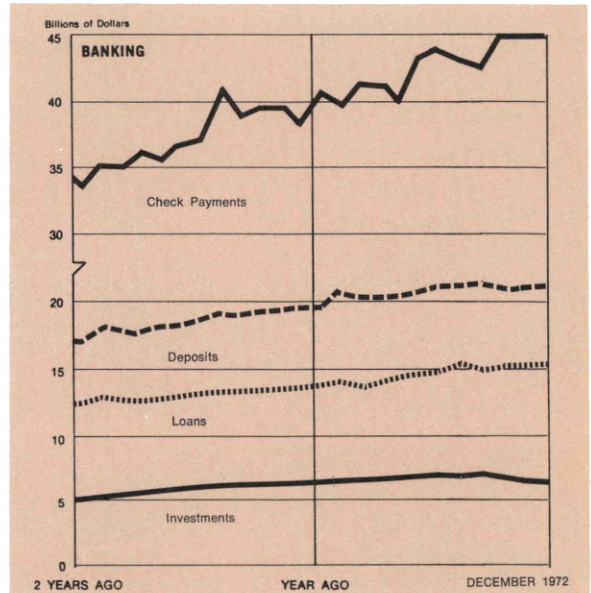
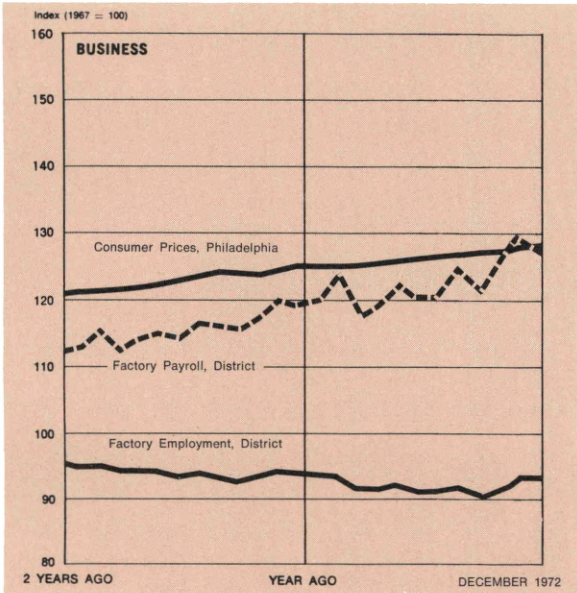
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# FOR THE RECORD...



SUMMARY	Third Federal Reserve District			United States		
	Percent change			Percent change		
	Jan. 1973 from		1 mos. 1972 from	Jan. 1973 from		1 mos. 1972 from
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
<b>MANUFACTURING</b>						
Production.....				+ 2	+11	
Electric power consumed...	N/A	N/A				
Man-hours, total*.....	- 2	+ 4				
Employment, total.....	- 1	+ 2				
Wage income*.....	- 2	+12				
<b>CONSTRUCTION**</b> .....	+73	+53		+ 5	+14	
<b>COAL PRODUCTION</b> .....	+12	- 1		- 2	-10	
<b>BANKING</b> (All member banks)						
Deposits.....	- 1	+11		+ 2	+12	
Loans.....	- 1	+18		0	+19	
Investments.....	0	+ 4		0	+ 7	
U.S. Govt. securities.....	- 1	- 3		+ 1	+ 4	
Other.....	0	+ 7		0	+ 9	
Check payments***.....	+11†	+31†		+ 6	+25	
<b>PRICES</b>						
Wholesale.....				+ 1	+ 7	
Consumer.....	0†	+ 3†		0	+ 4	

LOCAL CHANGES Standard Metropolitan Statistical Areas*	Manufacturing				Banking			
	Employment		Payrolls		Check Payments**		Total Deposits***	
	Percent change Jan. 1973 from		Percent change Jan. 1973 from		Percent change Jan. 1973 from		Percent change Jan. 1973 from	
	month ago	year ago	month ago	year ago	month ago	year ago	month ago	year ago
Wilmington.....	0	+ 3	- 6	+12	+ 9	+ 36	-76	-88
Atlantic City.....	- 3	+ 1	- 6	+12	+16	+ 18	+ 1	+18
Bridgeton.....	- 1	+ 4	N/A	N/A	N/A	N/A	+ 2	N/A
Trenton.....	- 1	+ 2	- 5	+13	+10	+ 42	+10	+16
Altoona.....	+ 1	+ 1	+ 1	+ 6	+ 9	+ 27	+ 1	+18
Harrisburg.....	- 1	+ 3	+ 2	+12	+14	+ 30	0	+20
Johnstown.....	0	+ 3	+ 1	+12	+14	+ 18	+ 1	+14
Lancaster.....	- 1	+ 7	+18	+40	+ 2	+158	+ 1	+16
Lehigh Valley.....	- 1	+ 3	- 2	+12	+ 9	+ 28	+ 1	+16
Philadelphia.....	- 1	+ 1	- 2	+10	+12	+ 30	- 1	+14
Reading.....	- 1	+ 2	+ 1	+13	+ 7	+ 15	+ 1	+19
Scranton.....	- 1	- 1	- 2	+ 6	+ 8	+ 24	+ 1	+14
Wilkes-Barre.....	- 1	- 2	- 2	+ 5	+ 4	+ 44	0	+33
Williamsport.....	N/A	N/A	N/A	N/A	+22	+ 45	+12	N/A
York.....	- 1	+ 1	- 3	+11	+12	- 40	+ 2	+15

\*Not restricted to corporate limits of cities but covers areas of one or more counties.  
 \*\*All commercial banks. Adjusted for seasonal variation.  
 \*\*\*Member banks only. Last Wednesday of the month.





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## **business review**

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