Research Department
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City Hall's Capital Spending

Business forecasters have been worrying about the prospects for business plant-equipment spending, because of the overcapacity problems and financial woes that afflict so many corporations. But these analysts might also do well to examine governmental capital-spending plans, in view of the serious problems now emerging at statehouses and city halls throughout the land. These plans are important not least because state-and-local governments normally account for one-fifth to one-sixth of the nation's total capital spending.

Gross fixed capital formation of state and local governments roughly tripled in magnitude over the past decade and a half, to about $41 billion in 1974. (According to the Commerce Department's tally, the total includes purchases of both new and used facilities and equipment.) In current-dollar terms, spending increased continually throughout the period; in real terms, however, the strong uptrend peaked in 1968, and expenditures fell every year thereafter except 1974.

The fortunes of several major industries have been closely tied to state-local capital spending over the years. Highways generally have accounted for roughly 40 percent of the total, although their share has fallen in recent years because of such factors as the impoundment of Federal grants. Educational facilities normally have accounted for 24 to 30 percent of the total, especially during the educational boom of the late 1960's. Sewer-treatment and water-supply facilities have always taken 9 to 12 percent of the total, and their share has risen in recent years with increases in Federal environmental grants.

Finding (and using) funds

The strongest increases in state-local capital spending occurred in the 1960's, especially in the 1965-68 period. Paul Schneiderman, writing in the *Survey of Current Business,* attributes the gain in that period both to the rising availability of funds and to the burgeoning demand for government services. With economic growth, the state-local tax base expanded—and with tax rates also rising, an ever-rising flow of funds became available to cover both current expenditures and debt service on a growing number of bond issues. Also, with population (especially school-age population) rapidly increasing in the 1960's, state-local governments had to provide and equip all types of new facilities, frequently in completely new suburban communities.

Capital spending in the 1969-73 period moved irregularly upward in current-dollar terms—but declined after adjustment for inflation—reflecting significant variability in funding as well as underlying demographic and economic factors. Population and income continued to grow during

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this period, but the growth of suburban communities and of the school-age population noticeably decelerated and thus held down the demand for new facilities. Moreover, governments began shifting their priorities toward social-welfare programs, and thereby restricted the amount of current receipts available for capital projects. More importantly, in at least several years of this period, Federal impoundments of grant funds and the tight-money impact on bond markets put an upper limit on what could be financed.

Last year's 17-percent increase in spending—several times the normal annual increase—was atypical of the past half-decade's experience. Highway spending expanded significantly, largely because of the release of impounded Federal highway-aid funds. Education outlays also increased, being a major beneficiary of the initial distribution of Federal revenue-sharing funds. Several smaller categories—health-and-hospitals and sewer-and-water facilities—increased even more, reflecting easier access to bond-market financing and (especially) greater availability of Federal money.

Variability in financing

The recent sharp fluctuations in state-local capital spending thus can be traced to the significant shifts that have occurred in the availability of funds. Aggregate state-local government receipts from their own sources, although allocated mostly to current expenses rather than to capital spending, have been a steady source of funds. Moreover, governments have benefitted from improved asset management, with the ratio of state-local liquid assets to total expenditures falling from the range of 0.53-0.59 to the range of 0.42-0.48 over the last half-decade. On the other hand, the major sources of funds for capital projects—the bond markets (roughly 40 percent of the total) and Federal grants-in-aid (22 percent)—have varied significantly from year to year.

This variability has been greatest in the long-term debt market, with the bond-financing share of capital spending ranging from a low of 33 percent (1969) to a high of 55 percent (1971). The legal or traditional rate ceilings governing state-local borrowing have severely limited their ability to borrow in tight-money periods, when market interest rates soar. Some governments have resorted to short-term bond-anticipation notes in cases of postponement or cancellation of long-term borrowing plans, but this approach is only a temporary expedient—as New York has so well demonstrated. Since bond funds predominantly finance highway, education, and sewer-and-water projects, those

sectors of the construction industry are hard hit whenever such long-term funds dry up.

In the aggregate, Federal grants-in-aid have increased more than seven-fold over the past decade and a half, but the share allocated to capital-spending projects has fallen from about 40 percent to about 20 percent of total grants. In other words, the growth of capital grants has been outpaced by that of grants for current expenditures, especially for public welfare, education and health. Over time, Federal aid has been most conspicuous in the highway field, financing roughly 40 percent of all highway projects. But the rise of the revenue-sharing program in the last several years has shifted the emphasis somewhat, since revenue-sharing funds allocated to capital projects have gone mostly to non-highway purposes.

Recession and after

After last year's upsurge, capital spending by state and local governments has increased only modestly in 1975, perhaps to about $43 billion. The recession caused a slackening of own-source receipts, as well as a disproportionate decline in the share of such receipts earmarked for capital projects. Federal capital-grant programs generally showed little increase, and capital projects received a smaller proportion of revenue-sharing funds as state-local governments reverted to a more traditional allocation of such funds. The bond market in contrast provided record amounts of funds—but it did so at record high rates, and it provided little if anything for the worst-hit communities.

Capital-spending prospects will remain uncertain in 1976, as state and local governments continue to work their way out from under the fiscal crisis caused by the double impact of recession and inflation. Their own-source revenues should improve as the economy improves, but many capital-spending plans will still remain mothballed. For example, California's current budget calls for sharp reductions in highway spending and personnel, reflecting Governor Brown's comment, "There are matters of higher priority than pouring concrete," and New York City's tight budget has forced cessation of work on 46 construction projects already underway. In addition, the Federal government's own fiscal problems will probably mean only a modest gain in Federal capital grants.

The bond market meanwhile may be hard-put to supply funds at recent levels, considering the heavy demands on the market expected from other borrowers, especially the Treasury. For that matter, the rejection of a number of large bond issues on the ballot this November indicates a strong preference by voters for a slowdown in capital spending.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/26/75	Change from 11/19/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	86,630	+ 513	+ 2,435	+ 2.89
Loans (gross, adjusted)—total	65,185	+ 427	– 1,658	– 2.43
Security loans	1,412	+ 34	– 10	– 0.70
Commercial and industrial	23,249	+ 315	– 940	– 3.89
Real estate	19,625	– 13	– 355	– 1.78
Consumer instalment	10,099	+ 17	+ 290	+ 2.96
U.S. Treasury securities	8,758	+ 148	+ 4,105	+ 88.22
Other securities	12,687	– 62	– 12	– 0.09
Deposits (less cash items)—total*	87,022	– 293	+ 6,009	+ 7.42
Demand deposits (adjusted)	23,627	– 765	+ 366	+ 1.57
U.S. Government deposits	403	– 71	– 39	– 8.82
Time deposits—total*	61,213	+ 499	+ 5,277	+ 9.43
States and political subdivisions	5,887	+ 70	+ 192	+ 3.37
Savings deposits	21,705	+ 104	+ 3,642	+ 20.16
Other time deposits‡	30,057	+ 159	+ 1,163	+ 4.03
Large negotiable CD's	15,953	+ 384	+ 353	+ 2.26

Weekly Averages of Daily Figures	Week ended 11/26/75	Week ended 19/12/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	39	29	+ 61
Borrowings	1	3	275
Net free (+) / Net borrowed (–)	+ 38	+ 26	– 214
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (–)	+ 1,384	+ 1,531	+ 1,241
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (–)	+ 544	+ 544	+ 521

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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