THE INCREASING ROLE OF INTERGOVERNMENT TRANSFER PAYMENTS IN THE PERFORMANCE OF STATE AND LOCAL FUNCTIONS

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In discussing the division of functions between governments at various levels, it is well to keep in mind two significant facts regarding the existing division and the way it is being financed.

In the first place—and contrary to the impression spread by those who ritualistically pin the "welfare state" label on the activities of Washington—the almost all-consuming preoccupation of the Federal Government is the fulfillment of its constitutionally imposed responsibility to "provide for the common defense." Nearly 80 percent of all of the revenue Washington collects is devoted to activities related to this single, all-important function.

Second—and largely obscured from public consciousness because of the impact of the mountainous Federal expenditure—is the fact that most of the outlay for civilian public services is directly underwritten by the States and the local governments themselves.

Stated another way, although Washington collects about 70 percent of the tax dollars levied by all governments, the States and localities are paying for more than 70 percent of the total cost of all civilian public services from their own direct tax levies and charges and by going increasingly into debt.

In fiscal 1956, according to a recent study of the Bureau of the Census, the expenditures of all governments approximated $101 billion (excluding all insurance-trust outlays and the utility and liquor-store operations of the States and localities).[1] Of this total, the Federal Government spent about $67.5 billion, including $3.3 billion transferred to the States and localities in the form of grants. The States and localities, for their part, raised and spent $33.3 billion, excluding the Federal grants they received.

Over half of all this governmental spending in 1956—almost $54 billion—went to meet the costs of past wars and to pay for national defense. These exclusively Federal outlays paid the cost of veterans' benefits, interest on the war-incurred debt, maintenance of the Armed Forces, overseas aid, the atomic program, stockpiling, etc.[2]

The remaining governmental expenditure—slightly less than $47 billion—represents the total outlay by all governments for civilian purposes in 1956. This combined Federal, State, and local govern-

[1] Summary of Governmental Finances, Bureau of the Census, document G–GF56, August 23, 1957. Census concepts of Federal receipts and expenditures are not precisely comparable to those of the Budget Bureau because of the effort of the Census Bureau to conform in structure to the system it uses for classifying State and local data.

[2] This total is derived from The Budget of the United States Government for the Fiscal Year Ending June 30, 1958. Other figures come from Bureau of the Census sources, unless otherwise noted.

mental spending to meet civilian needs equaled about 11 percent of the value of all goods and services produced in the United States in 1956. In comparison, the outlay for this purpose was 9 percent in 1929[3] when, however, there was no depression and war-created public construction lag to be overcome and no comparable pressure for expanded public services resulting from the unprecedented postwar population rise.

In 1956, public expenditures for civilian purposes were divided between the Federal Government and the States and localities in the following manner:

	Amount (billions)	Percent
Federal, total	$13½	29
(Grants to the States and localities)	($3⅓)	(7)
State and local, exclusive of Federal grants	$33⅓	71

Most of the $10 billion of Federal spending for civilian purposes (excluding the grants to the States and localities) went for postal services ($2.9 billion) agricultural aids ($2.9 billion) and other natural resource and nonhighway transportation development purposes ($2.1 billion). Only slightly more than $2 billion remained to meet the cost of all of the other civilian functions assumed directly by the Federal Government.

The States and localities spent most of the $33⅓ billion they raised from their own resources in 1956 in the performance of 10 major functions. Their outlay for these functions, in relation to total governmental outlays for them, follows:

Function	State and local outlay exclusive of Federal grants (billions)	Percentage of total governmental outlay
Education	$12.7	95
Highways	6.2	88
Health and hospitals	2.7	90
Public welfare	1.9	53
Police protection	1.3	89
Sanitation	1.3	100
Fire protection	.7	100
Local parks and recreation	.5	100
Local libraries	.4	100
Housing and community development	.3	62

The part played by the States and localities in providing these major civilian services is not only surprisingly large; during the postwar years it has been expanding.

In the 8 years from 1948 to 1956, State and local expenditures financed from their own sources (excluding Federal grants and insurance trust, utility and liquor-store activities) rose $17.5 billion—from $15.8 billion to $33.3 billion—a rise of 111 percent. In the same period Federal grants to the States and their subdivisions rose $1.4 billion, or only 73 percent.

[3] Musgrave and Culbertson, The Growth of Public Expenditures in the United States, 1890–1948, National Tax Journal, June 1953.

The substantial effort of the States and localities to meet the soaring postwar demand for greater outlays for civilian governmental functions is reflected in the rapid rise in the tax collections and the debt of these governments.

Between 1948 and 1956, State and local tax collections rose almost 100 percent from $13.3 billion to $26 billion, and a further rise to $28 billion is estimated for 1957. Meanwhile, State and local debt skyrocketed 162 percent—from $18.7 billion in 1948 to $49.2 billion in 1956. A further rise in debt of about $5 billion is estimated to have occurred in 1957. Almost three-fourths of this indebtedness is owed by the local governments.

The foregoing discussion has dealt primarily with the part the various governments play in performing civilian functions from revenues derived from their own sources. It is important to note, as well, the role of intergovernment transfer payments and the increasingly significant distinction between financing a government function and the performance of it—a distinction which is particularly important at the local level.

Because of the public controversy over the Federal grants-in-aid, it has been less noted that grants and the sharing of revenue have become increasingly important in the interrelationship between the States and their subdivisions. In fact, the local governments actually are the ultimate beneficiaries of almost all intergovernmental revenue transfers. Indeed, were it not for this factor many local governments could not possibly have continued to perform their traditional functions, or have attempted to assume newer ones.

In 1956 the general expenditures of the States and localities totaled $36⅔ billion—they spent the $33⅓ billion which was raised from their own resources plus the $3⅓ billion received in Federal grants. Two-thirds of this total, however—about $24½ billion—was spent by the local governments although they were able to raise only $16.2 billion from their own local sources.

The ability of the localities to spend substantially more on the performance of their functions than they raised themselves, was due to the receipt of $6.2 billion in net grants and shared revenue from the States plus $0.3 billion received in direct grants from the Federal Government.

The States, for their part, raised $15.1 billion from their own general revenue sources and received $3 billion in Federal grants. But they disbursed $6.2 billion more to their local governments than they received from them and, thus, revenue available to the States for their own direct expenditure was only $11.9 billion.

Actually, the local governments not only received intergovernmental revenue transfers equal to the entire amount of the Federal grants-in-aid; they were also the recipients of an additional transfer of revenue from the States of an almost equal amount. Without this substantial financial aid—more than half of which was allocated for education—local government outlays could not possibly have accounted for more than half of the outlay of all governments for civilian purposes during the course of 1956.

Despite this intergovernmental aid, the mounting needs of most local governments continue to exceed the revenue from all sources available to meet them. How to find enough money to meet the ever-rising demand for increased local services—and particularly for those which must be assumed by our metropolitan areas—is a major problem we must solve. Its urgency has increased with the rapid change in the way our people live.

America has gone through two great changes in its living patterns. In the last quarter of the 19th century and the 1st quarter of the 20th century, we shifted from a basically rural to a basically urban society. Inevitably, the rise of the cities rapidly increased the cost of traditional local functions—for education, sanitation, police and fire protection, parks and libraries, and for public health.

With the second great change in American life—a shift from an urban to a basically metropolitan society—the demand for expanded local public services has become explosive.

In 1955, almost 60 percent of our entire population was living in 172 metropolitan areas located in 42 States and the District of Columbia. These 95 million metropolitan residents now live in an area that covers only 7 percent of the entire territory of the United States. Furthermore, this concentration is continuing to increase. In the last 5 years alone, 97 percent of our 12 million population rise occurred in the metropolitan areas.[4]

At a recent conference of State and metropolitan officials it was aptly observed that—

> The metropolitan area does not respect geography. It jumps over and around rivers and land masses. It ignores the political lines of districts, villages, towns, cities, counties, and States.[5]

The metropolitan core city, its suburbs and its satellite cities are now one compact and interrelated community, and its boundary becomes further extended every day.

While about 70 percent of the 172 metropolitan areas are still confined within a single county, 30 are now intercounty and the boundaries of 11 of these areas extend into 3 and even 4 counties. In addition, there are 24 metropolitan areas that are now interstate.

The arrival of the metropolitan era has intensified traditional local problems and added a host of new ones. The need for rapid mass transportation between the core city and its suburbs. for an expanded water supply, for the proper planning of land use to protect residential areas from the encroachment of those that are commercial and industrial, for construction of low-cost housing and for the retarding of community blight, for the ending of water and air pollution and the elimination of industrial wastes are all concerns of the entire metropolitan area and must be cooperatively resolved. Effective fulfillment of all of these expanding local responsibilities now requires a new kind of governmental effort—a united metropolitan area approach.

A variety of methods to achieve this end are now being undertaken. In some places, the consolidation of existing historical political units within the metropolitan area is being urged. In others, more and more areawide functions are being undertaken by the counties. Elsewhere, informal cooperative metropolitan federations are being established. In some areas, special purpose governmental authorities, intracounty and even interstate in their functions, are being set up.

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[4] The States and the Metropolitan Problem, a report to the Governors' Conference by the Council of State Governments, 1956.

[5] Report of the Arden House Conference on Metropolitan Area Problems, September 21–23, 1957.

All of these efforts must be encouraged. Yet, even while new administrative techniques are being devised to make the performance of local functions more efficient, more money to finance them is still critically needed.

The magnitude of the financial problem is suggested by an official estimate of public works construction needs alone.

In 1956, total State and local outlays for new public works reached a record $9.4 billion and the local governments accounted for 60 percent of this total. Nonetheless, even this huge expenditure for highways, educational buildings, water and sewerage works, hospital and institutional buildings and other non-Federal public enterprises met less than half of the current need. According to the United States Departments of Labor and Commerce, State and local governments should now be investing $20.4 billion in new public construction each year if the backlog of need is to be overcome by 1965. It must be substantially eliminated by then if "new and severe community problems are to be avoided," the Federal experts warn.[6] Yet, in 1956, total State and local public construction only measured up to 46 percent of this goal, and each year we fail to reach it the backlog grows.

In 1956, the direct expenditure of the States for the performance of their own general functions reached a record total of more than $12 billion, about 26 percent of all governmental outlays for civilian purposes. About $4.3 billion was spent for highway construction and maintenance, $1.7 billion for institutions of higher learning, $1.6 billion for public assistance, $1.4 billion for State hospitals and institutions, $0.7 billion for natural resources development, and $0.2 billion for highway police activities.

All States are under constant pressure to increase their outlays for the performance of their own statewide functions, particularly to meet the rising demand for higher education, mental health services, recreational facilities and other services. At the same time, there is also an insistent demand that the States relieve their hard-pressed local governments of some of the functions that traditionally have been theirs—local roadbuilding and maintenance and public assistance, for example.

Even more important, there is a mounting pressure on the States to exercise their superior taxing power and their leadership function to help raise far more revenue to finance local functions and to help increase the efficiency of the local performance.

The "creature" local governments must be allowed—in fact, must be encouraged and aided—to coordinate their efforts to solve mutual areawide problems, both intrastate and interstate in scope.

Furthermore, the States must assist their localities to increase local property tax yields, the source of 87 percent of the direct tax revenue of all local governments and of 74 percent of the tax collections of the cities in 1956. Unjustified State-imposed tax-rate limitations must be ended. Frequent reassessments and uniform statewide assessment procedures must be encouraged. Besides, the States must provide leadership in an effort to professionalize the role of the tax assessor.

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[6] Construction Review, May 1955, p. 4, published by the U. S. Departments of Labor and Commerce.

With more and more Americans working in one community but residing and paying taxes in another, local governments must increasingly depend on the State to levy and collect general taxes and then share the revenue equitably among them. By this means, and particularly through greater statewide use of progressive levies on income and profits, total revenue available to local governments will increase and can be distributed more fairly, more revenue can be obtained from taxes based upon ability to pay, and there need be less dependence on the plethora of local sales and payroll taxes that are currently being imposed. Furthermore, only through special State grants-in-aid based on the broad taxing power of the State can be poorer localities achieve at least minimum standards in the performance of their local functions.

Clearly, more revenue can be obtained to finance State and local functions by a greater use of State income taxes. In 1956, less than 17 percent of all State taxes came from this source. In 13 States, including some of the most industrialized and urbanized like Illinois, Michigan, New Jersey, Ohio, Indiana, Washington, and Texas, no individual income and corporate profit tax is collected at all. Even though the Federal Government has long extended an invitation to all of the States to enjoy a share of the revenue collected by its progressive income tax—through the allowance of deductibility against the Federal tax, wherever State income taxes are imposed—most States have failed to take full advantage of this revenue-sharing opportunity.

The expectation of several decades ago that the States would provide great leadership in the effort to find new solutions for changing and complex State and local problems has not been fulfilled. Although progress in some States can be cited, most State legislatures are still dominated by those who look backward and are unresponsive to modern needs. Archaic and, apparently, almost unchangeable State constitutions keep the States and localities tied to inefficient and outmoded practices that block progress toward more efficient government. State and local taxes are still based almost entirely on regressive levies. Although additional revenue could be obtained from progressive taxes on income and profits, efforts to install them are met with the fearsome argument that employers will be driven to other States where the "tax climate" is more favorable.

Rather than obstructing the solution of local problems, as is now so frequently the case, State governments more appropriately should be the channels through which new inspiration, ideas, and revenues flow to their political subdivisions. This, above all, should be the function of State governments today.

Despite the necessity for continuing vast outlays to meet the costs of past wars and present defense requirements and for expanded public expenditures to meet civilian needs, the dominant mood is for fiscal retrenchment. Willingness to make every necessary sacrifice for national security is widely proclaimed. The necessity for a greater effort to meet school, highway, health, community development, and other civilian needs is widely acknowledged. At the same time, the demand for tax cuts mounts.

With the Federal Government collecting 70 percent of all tax dollars, inevitably Washington is the main target of the economy and tax reduction drive. And, since war and defense related costs can hardly be cut substantially, it is the one-fifth of all Federal expenditures spent for civilian services that is facing closest scrutiny. Above all, the Federal grants-in-aid are now under attack.

All Federal, State, and local grants should be ended, the National Association of Manufacturers says.[8] The chamber of commerce, on the other hand, favors Federal grants for highways, airports, marketing research, and natural resource development, but would end all those that help raise public service standards for individuals—public assistance, child welfare, education, unemployment compensation administration, and school lunches.[9]

Is Federal financial aid to the States and localities to help them perform their functions a legitimate Federal function? Since the Civil War, when the first State land-grant colleges were established with Federal aid, the congressional majority has viewed that it is. On the one hand, it is widely believed that Federal funds should be used to assist poorer States and localities raise their standards of public service to a reasonable minimum. Furthermore, Federal grants-in-aid—through the use of the matching principle—stimulate the recipient States and localities to undertake and, to add their own financial support to, new forms of public service which Congress deems vital to the national welfare.

The variation in the capacity of the people of the different States to meet public service costs—like the variation between the localities within each State—is substantial.

In 1956, for example, per capita income in West Virginia and New Mexico was only one-half of the income in Delaware, and in Mississippi it was about one-third. These income variations are dramatically reflected in public service standards. In the fall of 1956, Delaware reported an additional public school classroom need of only 1.2 percent of its existing supply. In contrast, West Virginia's need was 11.3 percent and Mississippi 37.6 percent.[10] Furthermore, the selective-service disqualification rate—which largely reflects standards of education and health—was only 7.9 percent for Delaware in contrast to 13.1 percent for New Mexico, 14.3 percent for West Virginia, and 45.3 percent for Mississippi.[11]

The varying degree of achievement by these States does not reflect a lesser effort on the part of the poorer ones. On the contrary, whereas Delaware was spending only 1.9 percent of the personal income of its residents to support public schools in 1953–54, Mississippi was spending 2.6 percent; West Virginia, 2.9 percent; and New Mexico, 3.1 percent.[12]

Because of our increasingly interdependent way of life, local and State boundaries have lost much of their importance of an earlier day. With millions of families now migrating annually across local and State boundaries pursuing opportunity in an economy which now is nationwide in scope, the adequacy of essential public services—both in the communities from which they come and to which they go—is now a nationwide concern. The establishment of minimum nation-

[8] Testimony of Dr. Harley L. Lutz on behalf of the National Association of Manufacturers before the House Subcommittee on Intergovernmental Relationships Between the Federal Government and the States and Municipalities, July 31, 1957.
[9] Federal Grants-In-Aid Programs, Chamber of Commerce of the United States.
[10] U. S. Office of Education, Circular No. 490, January 1957.
[11] Statistical Abstract of the United States, 1956, U. S. Department of Commerce.
[12] National Education Association, Research Division Bulletin, August 1956.

wide education, health, and public welfare standards for all Americans is not merely a national concern because we are a humane people; we need them also to protect the standards of the communities into which the new arrivals come. And we need them to strengthen our national security as well.

In 1956, Federal grants financed about 9 percent of all State and local functions. What lies ahead?

There is no doubt that many States can meet more of their own expanding revenue needs through a more adequate and equitable effort. In addition, the States and their subdivisions can do much more to increase the efficiency with which they now perform their functions. Furthermore, as Congress periodically reviews the Federal grant programs, changes in emphasis and in matching formulas doubtless will occur. Nonetheless, it is the opinion of this writer that the role of Federal grants inevitably will become larger, not smaller, in the years ahead.

Not only will State and local needs grow, as will the Federal responsibility to help meet them, but State and local dependence upon the superior taxing power of the Federal Government will also continue to increase.

In 1956, the 500 largest industrial corporations in the United States sold roughly one-half of the Nation's manufacturing and mining output, a total of about $175 billion. They earned nearly two-thirds of all after-tax manufacturing and mining profits.[13]

Increasingly it becomes evident that only the Federal Government has sufficient means to secure an adequate and equitable tax contribution from the powerful private industrial, commercial, and financial enterprises which dominate the American economy today. Increasingly, the Federal Government—like the States in behalf of their localities—must exercise its broader taxing power to collect revenue, and then to share it on the basis of equitable formulas.

The attack on Federal grants-in-aid by the NAM and chamber of commerce seldom charges that the purposes now served by these grants are unworthy of public support. It is only alleged that the States and localities are able to bear the cost. Yet, without doubt those who seek to whittle away the Federal grants are fully aware that this transfer of the cost would accomplish substantial tax savings for wealthy corporations and individuals since the Federal tax structure, despite its imperfection, is essentially based upon ability to pay in contrast to the regressive character of State and local levies. Furthermore, it cannot be doubted that many of the services now supported by Federal grants in poorer States and localities would be terminated because State and local revenue resources are insufficient to sustain them.

Is the Federal fiscal dilemma of increased demands for civilian expenditures and growing demands for a general tax reduction susceptible to congressional accommodation? This writer believes that it is. Is not the present an opportune time for the Congress to close the unjustified tax loopholes and end the illegal evasions that could bring a multi-billion-dollar addition to Federal revenues?

[13] Fortune magazine, July 1957.