

MONTHLY

# Business Review

FEDERAL RESERVE BANK of CLEVELAND

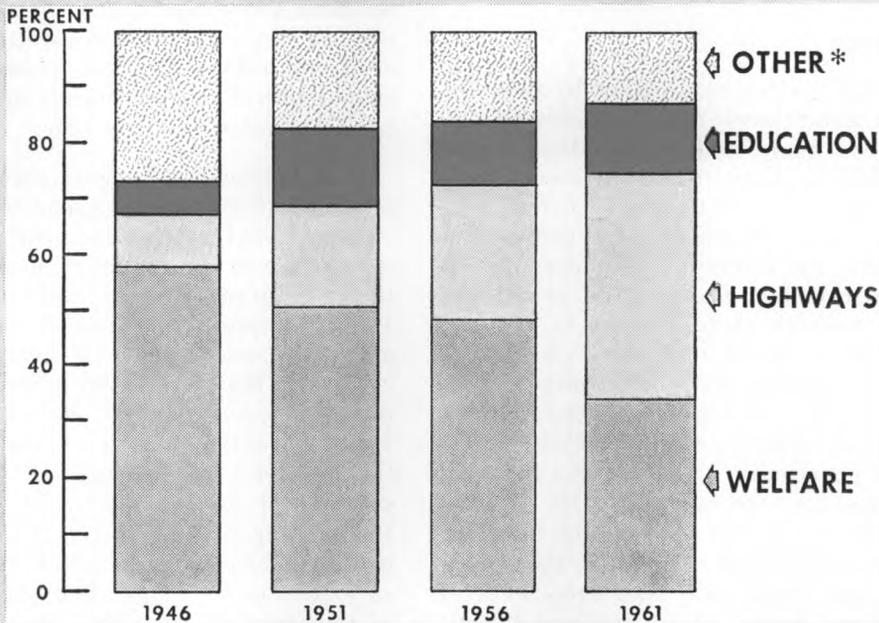
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## FEDERAL GOVERNMENT PAYMENTS to STATE GOVERNMENTS, by FUNCTION

Percentage Distribution — Selected Fiscal Years



\* Includes payments mainly for public health, recreation, and employment security.

Source of data: U.S. Department of Commerce

# State Intergovernmental Payments and Receipts

**T**HE various states stand in a unique position in the complex of fiscal arrangements which transfers funds from one level of government to another, in that they receive funds from both the Federal government and local governments and also pay out funds to local governments. The economic effects of these transfers of funds are far-reaching not only because of the large amount of funds involved but also because of the redistribution of resources which occurs among governments and within the economy at large. In fiscal year 1961, the most recent year for which data are available, the states received over \$6.7 billion in intergovernmental revenues and paid out over \$10.1 billion.

## Background

The fiscal arrangements whereby different levels of government provide funds to one another are many and varied. Most transactions involve direct money payments from one level of government to another, but there are other situations where the benefit accruing to one government is "indirect." An important example of an indirect aid by one level of government to another is the tax-exempt status afforded by the Federal government to interest payments received by the owners of state and local government securities. The tax-exempt status of such securities aids state governments indirectly by reducing interest costs, at the expense of the Federal government which forfeits potential tax revenues. Another example would be the ability to deduct state and local taxes from Federal income taxes. Such indirect aids are difficult to quantify, however, and are excluded from this discussion.

*Direct Aids.* The two most common forms of direct aid advanced from one government to another are "shared taxes" and "grants-in-aid". Different levels of government tax are said to share revenues when one government collects the tax and allocates part of the revenue to another government. Thus, the amount of revenue obtained each year by the recipient government depends upon the amount of the tax collected. This device is most generally used between state and local governments, with the state collecting the tax. The main purpose of such an arrangement is an attempt to derive greater efficiency in tax collection. In some cases, the larger governmental unit may be able to collect and administer a tax more efficiently and economically than can the smaller government. Taxes commonly collected by state governments and shared with local governments include license taxes and selected excise taxes.

Probably the best-known form of direct aid advanced from one government to another are "grants-in-aid". Grants-in-aid are direct money payments advanced usually by the larger government to the smaller government for the purpose of conducting a specific program. The amount paid to the recipient government is determined legislatively and is not necessarily derived from one tax source. The funds are often required to be matched by the recipient government, and the granting government may exercise some control over the rules and regulations governing the program supported. Grants-in-aid are best known as extensions from the Federal government to the state governments, but state governments also extend similar aid to local governments.

*Other Aid.* Grants-in-aid and shared taxes account for nearly all of the fiscal transactions between the three levels of government, i.e., Federal, state, and local government. However, there are numerous smaller transactions which exist between different levels of government. The bulk of these occur almost exclusively as payments from local governments to state governments. Such transactions include: (1) reimbursements for services performed by the state for the local government; (2) repayment of advances and loans made by the state for the local government; and (3) amounts paid for application to debt service on debt issued by the state for the benefit of the local government.

### Federal-State Fiscal Relationships

The extension of grants by the Federal government to states is a long-standing relationship. From the inception of the Federal system, the Federal government has aided states in matters considered to be in the national interest. As early as 1785 the Federal government, operating under the Articles of Confederation, sought to aid education by granting land for public school use. In 1862, the well-known Morrill Act established land grants for the creation of colleges. These early grants were outright gifts, requiring no matching of funds by the state and involving no Federal supervision of programs. However, beginning late in the 1800's grants for education and research were increased, especially in the area of agriculture, which were accompanied by the gradual imposition of Federal standards and conditions for the programs supported.

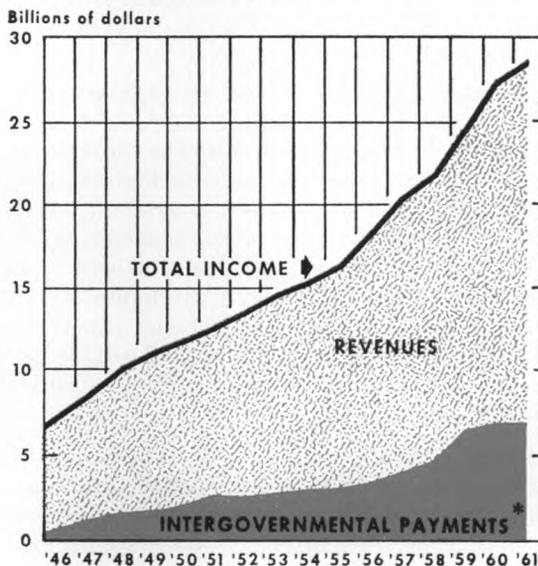
The Federal Road Act of 1916 was the first really significant grant program. Not only were the amounts extended larger than earlier, but Federal approval and supervision of projects were initiated. Matching provisions were included and each state was required to set up a highway department in order to receive the funds.

The Depression of the 1930's and World War II were periods when a great number

of emergency measures were established and subsequently repealed. During this period, grants for social welfare, health, and security made up about 80 percent of the total grants by the Federal government to the states. The most important and lasting measure enacted was the Social Security Act of 1935 which set up, among other things, assistance programs for certain groups, i.e., the blind, dependent children, and the aged poor. In more recent years, reflecting the changing needs of the economy, new programs of grants for interstate highways, airports, urban renewal and higher education have been established. (See the cover chart.)

*Recent Developments.* At the end of fiscal year 1961, grants for highway programs accounted for 41 percent of total Federal grants to states, for welfare programs 34 percent, and for education 13 percent. State governments received over \$6.4 billion in grants-in-aid from the Federal government in fiscal year 1961, nearly 8½ times the amount received by the states in fiscal year 1946.

### INCOME of ALL STATES Fiscal Years 1946 - 1961



\* Includes both Federal government and local government payments to state governments.  
Source of data: U. S. Department of Commerce

Since World War II, payments from the Federal government to the states have increased steadily not only in absolute terms but also as a percent of the total income of the states. In fiscal year 1946, Federal payments accounted for only 10 percent of the total income of the states, whereas in fiscal 1961 Federal payments were equivalent to 22 percent. Thus, nearly one-quarter of all state government expenditures in fiscal year 1961 was made possible through payments from the Federal government. (See the chart on the preceding page.)

*Objectives.* Federal aid programs are designed either to stimulate the states to undertake additional services or capital projects, or to support existing services or projects, or a combination of both.

*Stimulative Grants.* The highway aid program provides a good example of a stimulative grant. In that case, a national system of roads for defense and other purposes was felt to be needed by the Federal government, and it was deemed unwise to initiate programs in an independent fashion. Thus, stimulative programs serve to induce states to expand expenditures in a particular field and are not designed to lessen or support state expenditures.

*Support Grants.* Fiscal or support programs, on the other hand, are designed to do what the term implies, reduce the burdens on state budgets. In this case the Federal government feels that the need is generally well-recognized and that the program is adequately performed by the states. The aim here is to assure support for at least minimum standards across the U. S. in certain functions. Such support is necessary and desirable because of the variations in the fiscal abilities of the various states.

It is difficult to draw a line between the two types of programs. Quite often both aims, stimulative and support, are intertwined in one program. Furthermore, some grant programs which have begun as stimulative measures have become, over the long run, support programs.

*Pros and Cons of Federal Grants.* The rationale of existing arrangements between the state and the Federal government with regard to aid is based in large part on the following premises: (1) the Federal government has a larger variety of tax and borrowing resources than do most state or local governments; (2) the Federal government may be capable of collecting and administering certain taxes more efficiently and economically than smaller governmental units; (3) many state and local governments have experienced a widening gap between tax revenues and total expenditures during the postwar period; and (4) the Federal government, in many instances, is able to float bond issues more efficiently and economically than many state and local governments.

On the other hand, those who feel that Federal grants should be discontinued or reformed in some manner submit that Federal grants distort state budgets, in the sense that there may be an inclination to neglect other programs to provide funds for matching grants. Furthermore, less wealthy states may strain their budgets in an attempt to provide matching funds.

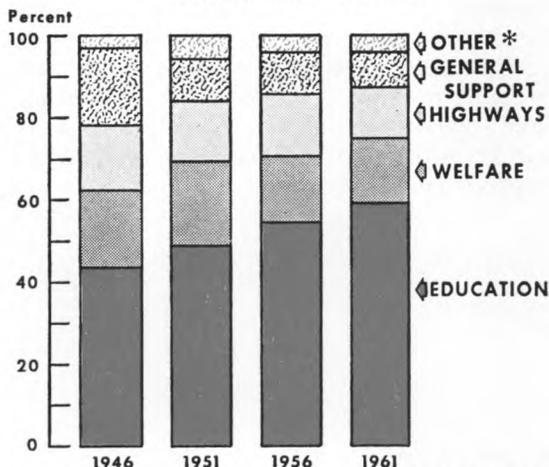
Proponents of stronger state government have suggested that Federal grants to states are unconstitutional because the controls connected with grants are an invasion of states' rights by the Federal government. Many of those who contend that Federal grants to states violate constitutional intent support the legality of state grants to local governments, however, on the basis that local governments were created by states and are agents of the state government.

### **State-Local Fiscal Relationships**

States have been aiding their local subdivisions for nearly as long as Federal grants to states have been in existence. State aid to local governments for education is an accepted public financial policy, and state aid to local governments for highways and welfare, in fact, preceded the Federal programs. Financial aid to local government, however, is limited primarily to education, highways,

## PAYMENTS by STATE GOVERNMENTS to LOCAL GOVERNMENTS, by FUNCTION

Percentage Distribution —  
Selected Fiscal Years



\* Includes payments mainly for public health, housing, safety, and recreation.

Source of data: U. S. Department of Commerce

and public welfare, with only a small amount given to local governments for general, unspecified purposes. (See the accompanying charts.)

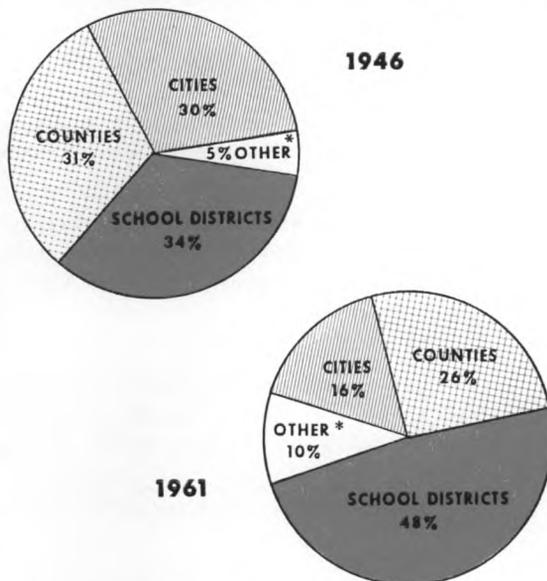
State aid to local education has increased markedly since the end of World War II, increasing from 44 percent of total aid in fiscal year 1946 to 59 percent in fiscal year 1961. Amounts transferred to local governments for highways and public welfare have decreased relatively since the end of the War. Highway aid made up 17 percent of total aid in 1946 but declined to 13 percent in 1961. Public welfare aid declined from 18 percent to 16 percent between 1946 and 1961; and funds for general purposes fell off sharply, decreasing from 18 percent to 8 percent over the same period.

The growth of total state aid to local governments can be attributed to two main factors. First, the states have a superior ability to tax and borrow than do local governments. The debt limits and available tax resources of local governments have been limited, in most cases, by the constitutions and laws of the various states. Many states have found it nec-

essary to meet, by state aid, the need for expansion of local services because of the fiscal limitations of local governments. A second factor has been the desire of states to raise and maintain standards of performance of certain functions. The states have sought, in many cases, to assure greater uniformity in the quality of local services to all citizens of the state.

In an attempt to attain this objective, states have extended aid to a variety of governmental units on the local level. In fiscal year 1961, school districts received the most aid, nearly 48 percent of total state aid. Counties received roughly 26 percent of the total, while cities obtained 17 percent. Townships and special districts also received limited amounts of aid. Distribution of these funds has changed markedly since the end of World War II. School districts have grown in importance, while state aid to cities has been cut, in percentage terms, almost in half. Counties in recent years have received slightly less than they did in fiscal year 1946. (See the accompanying chart.)

## PAYMENTS by STATE GOVERNMENTS to POLITICAL SUBDIVISIONS, by TYPE



\* Includes townships and special political subdivisions.

Source of data: U. S. Department of Commerce

*Local Intergovernmental Payments.* Not only do states provide financial support to local governments, but local governments also render payments to state governments. The amount transferred to states by local governments is small compared with other intergovernmental transactions, however, amounting to only \$.3 billion in fiscal year 1961, or just over 1 percent of aggregate state revenue.

Local payments to states are made for a

number of reasons. Some payments contribute to programs run by the state for the benefit of local governments. Other transfers represent payments on debt or similar transactions. In fiscal year 1961, 32 percent of local payments to states went to support highway programs, 22 percent to support health and hospital programs, 12 percent to education, and 8 percent to public welfare. The remaining 26 percent was allocated for other than support purposes.

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## *Around the Fourth District—*

At the end of July, *total deposits at country member banks* in the Fourth District were up 5 percent from a year earlier. Increases of approximately 7 percent were recorded by country banks located in Ohio, Kentucky, and West Virginia, but Pennsylvania country banks showed virtually no change. (Country banks are those located in places with less than 15,000 population.)

\* \* \*

*Cash receipts from farm marketings* during the first five months of this year were below year-ago levels in all Fourth District states, although a 2-percent increase was reported for the U. S. as a whole.

\* \* \*

*Total earning assets* of 26 weekly reporting member banks in the Fourth District rose sharply in the week ended August 15. The increase in total bank credit was the largest since mid-April, with both loans and investments sharing in the gain.

\* \* \*

In Cleveland, *unemployment* increased in the first half of August, largely because of temporary layoffs in the automotive industry during the switchover period while plants were being readied for production of 1963-model cars.

*(The above items are based on various series of District or local data, which are assembled by this bank and are available to the public in the form of printed releases.)*

# Business Borrowing Patterns At Banks

(Fourth District)

LOANS to business firms continue to represent the largest single category in commercial bank loan portfolios, despite the vigorous growth in the volume of consumer loans and real estate loans. In view of this, the Federal Reserve Bank of Cleveland, as part of a national study, conducts a weekly survey of the commercial and industrial loans outstanding at 21 weekly reporting member banks located in eight metropolitan centers in the Fourth Federal Reserve District. It is estimated that the reporting banks account for roughly three-quarters of total business loans made by all commercial banks in the Fourth District.

The primary objective of the weekly survey is to collect information on the total amount of business loans outstanding, by type of commercial or industrial borrower.<sup>(1)</sup> In addition, with the cooperation of the participating banks in the Fourth District, information is obtained on the volume of term loans outstanding, i.e., commercial and industrial loans with an original maturity in excess of one year.

The purpose of this article is to provide an analysis of commercial and industrial loan patterns in the Fourth District as of the close of the first half of 1962, and to indicate the differences in the types of business borrowers and the maturity of loans among banks located in four metropolitan centers. In addition, information published by the Federal Reserve Bank of New York is used to compare the differences and similarities in business loan experience at major New York City banks with that of reporting banks in the Fourth District.

(1) This information is transmitted by the Federal Reserve Bank of Cleveland to the Board of Governors of the Federal Reserve System in Washington, D. C., where information on net changes collected from the other Federal Reserve banks is collated and published on a national basis.

## Borrowing Patterns in the Fourth District

The predominance of heavy industry throughout most of the Fourth District is evidenced in the fact that the largest share, approximately 27 percent, of all business loans reported by the 21 banks at the close of June had been granted to *durable goods manufacturers*. Furthermore, within this category nearly three-quarters of the loans represented credit extended to firms engaged in the production of primary metals, machinery, or fabricated metal products. (See the chart on the next page.)

The second-largest category of business loans was *trade organizations*, which accounted for roughly 17 percent of the total. More than one-half of the loan volume in the trade classification represented credit extended to retail enterprises. The predominance of retail borrowing reflects in part the dependence of many small retail firms on local sources of short-term credit, as contrasted to other alternatives available to larger business borrowers.

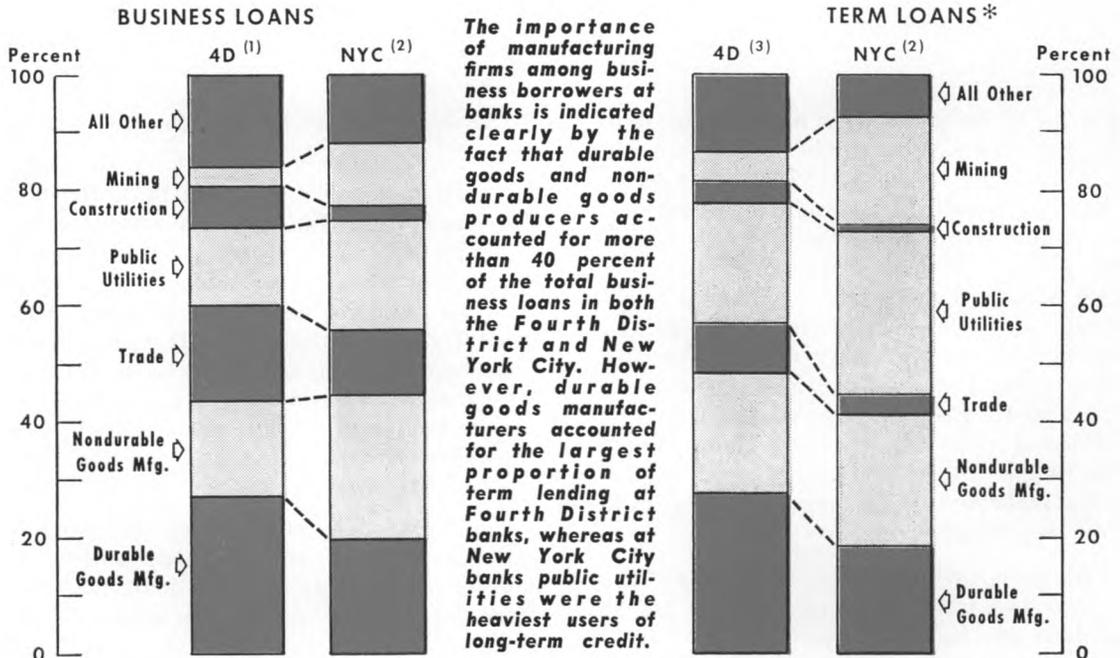
According to survey information, *nondurable goods manufacturers* nearly equaled trade organizations in the utilization of bank credit as of the close of the first half of 1962. Within the former classification, manufacturers of chemicals and rubber products accounted for approximately 30 percent of the loans, which reflects the importance of these industries in the economic base of the Fourth District.

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*Complete tabulations of the data upon which the discussion of business loans in the Fourth District is based are available upon request from the Research Department, Federal Reserve Bank of Cleveland.*

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## COMPOSITION OF BUSINESS LOANS, by INDUSTRY Fourth District and New York City as of June 27, 1962



\* Term loans are defined as any commercial or industrial loan with an original maturity in excess of one year.

(1) Figures are from 21 large member banks which report weekly to the Federal Reserve Bank of Cleveland.

(2) Figures are from large New York City banks which report weekly to the Federal Reserve Bank of New York.

(3) Figures are from 20 large member banks which report weekly to the Federal Reserve Bank of Cleveland.

Among the other classifications of business borrowers, the *public utilities* and *transportation* group held nearly 14 percent of the reporting bank business loans, while *construction firms* and *mining enterprises* accounted for 7 percent and 3 percent, respectively.

### New York City Banks Loans

In contrast to the pattern of business loans among Fourth District reporting banks, the largest proportion of commercial and industrial loans outstanding at large New York City banks at the end of June was granted to nondurable goods manufacturers. As in the Fourth District, however, the largest single category within this classification was chemical and rubber producers.

Durable goods manufacturing firms provided the second-largest class of business borrowers among New York City reporting banks. Unlike Fourth District bank experience, the producers of primary metals and fabricated metal products played a less important part in loan demand, as nearly 60 percent of the loans in the durable goods classification were utilized by machinery manufacturers and producers of transportation equipment.

Public utilities and transportation firms accounted for nearly one-fifth of total business loans at New York City banks, and trade firms and mining enterprises each held approximately 11 percent of the total. It is noteworthy that the largest users of bank

credit within the trade classification were wholesale firms, whereas in the Fourth District retail enterprises accounted for more than one-half of the total.

Construction firms made up the smallest group of business borrowers at New York City banks at close of June, accounting for less than 3 percent of total commercial and industrial loans outstanding.

### Term Lending

Term loans, as distinguished from other commercial bank loans, are generally recognized as business-purpose loans which bear an original maturity in excess of 12 months.

At the present time, both the Federal Reserve Bank of Cleveland and the Federal Reserve Bank of New York collect information on the volume and pattern of term lending at reporting member banks within the respective Districts.

The need for information on the volume and pattern of term lending is clearly demonstrated by the fact that, as of the end of June, 45 percent of the total commercial and industrial loans outstanding at Fourth District reporting banks were classified as term loans. Furthermore, the pattern of term lending has differed considerably from short-term business loans.

Reflecting the predominance of heavy industry, the largest volume of term loans at Fourth District reporting banks was concentrated in the durable goods manufacturing classification. Unlike the total business loan pattern, however, public utilities and transportation firms constituted the second-largest category of terms loans, accounting for 21 percent of the total. Nondurable goods manufacturers were the third-largest group of term-loan holders.

On the other hand, trade firms were far less important in term-lending activity. Although commodity dealers, wholesalers, and retailers accounted for 17 percent of total business loans, they accounted for less than 9 percent of the term loans outstanding.

The importance of *term lending at New York City banks* is evidenced by the fact that, at the end of June, more than half, or roughly 56 percent, of total business loans were classified as long-term. The higher ratio of term loans to total business loans at New York City banks may reflect both the nature and size of their customers. A relatively few large corporate customers located throughout the U. S. account for a substantial share of the business of the larger New York City banks, and many of these firms have a continuous need for long-term funds. Thus, the New York City banks may have more opportunity and may experience stronger demand to extend long-term business loans. Furthermore, the New York City banks extend smaller proportions of other types of long-term credit which are not included in the business loan category (i.e., real estate loans and consumer loans) than do banks outside of New York City. Therefore, they may actively seek a larger proportion of term loans in their business loan portfolios in an attempt to improve aggregate earnings.<sup>(2)</sup>

Public utilities and transportation firms, which held 29 percent of the term loans granted by the larger New York City banks, constituted the largest category of long-term business borrowers. The second-largest classification was nondurable goods manufacturers, followed by durable goods producers, mining enterprises, trade organizations, and construction firms.

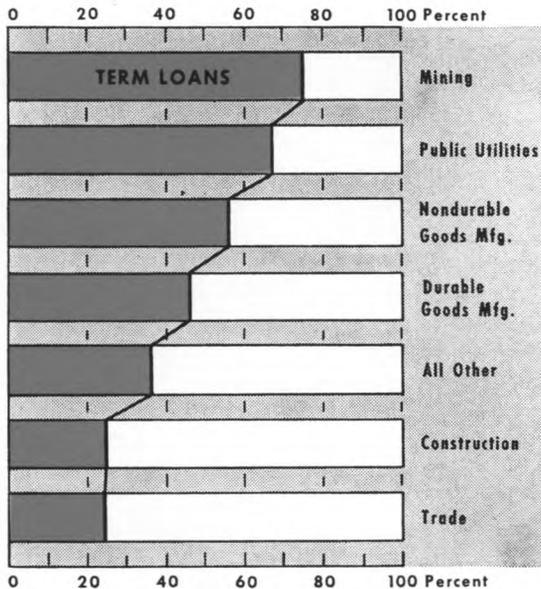
### Term Loans as a Proportion of Total Loans

In addition to providing information concerning the distribution of total term loans among various business borrowers, the weekly survey furnishes data on the ratio of term loans to total loans for each of the business classifications. (See the chart on the next page.)

Among both Fourth District and New York City reporting banks, mining firms held, as of the end of June, the largest proportion of

<sup>(2)</sup> See "Term Lending by New York City Banks", *Monthly Review*, Federal Reserve Bank of New York, February 1961.

**TERM LOANS as PERCENT of  
BUSINESS LOANS, by INDUSTRY  
Fourth District Banks<sup>(1)</sup>  
as of June 27, 1962**



(1) Figures are from 20 large member banks which report weekly to the Federal Reserve Bank of Cleveland.

term loans to total loans outstanding. At Fourth District banks, 75 percent of the dollar volume of loans granted to mining firms were classified as term loans, while 95 percent of those granted at New York banks had original maturities in excess of one year.

Ranking second at both Fourth District and New York banks was the public utilities and transportation group. About 69 percent of the total loans in this category were long-term loans at Fourth District banks; however, at New York City banks nearly 86 percent of the loans to public utilities carried maturities extending beyond 12 months. The relatively heavy use of term loans by public utilities reflects in part the recurring need for additional capital for extended periods, a somewhat greater willingness to utilize external sources of capital, and the relatively high credit rating enjoyed by many public utilities.

The importance of long-term credit to both durable and nondurable goods manufacturing firms is shown in the fact that approximately one-half of the loans reported in these two broad groups by both Fourth District and New York City banks were classified as term loans. Within the two groups, petroleum firms accounted for the highest ratio of term loans to total loans.

As would be expected, trade firms carried a much smaller proportion of their total loans as long-term obligations. Among Fourth District banks only one-quarter of the loans to the trade group were term loans, and the New York City banks reported less than one-fifth of the loans in this classification as long term. This situation reflects in part the purpose for which most trade enterprises rely on commercial bank credit. Loans granted to commodity dealers, wholesalers, and retailers are used most frequently to meet seasonal working-capital needs, with the working-capital cycle usually of short enough duration to permit repayment in less than 12 months.

**Loan Patterns in Selected Metropolitan Areas in the Fourth District<sup>3</sup>**

The analysis of total business loans and term loans in selected metropolitan areas in the Fourth District is confined here to Cincinnati, Cleveland, Columbus, and Toledo. In Cleveland, the data are from five reporting banks. In Cincinnati, four banks report loan figures weekly, and in both Columbus and Toledo the data are from three reporting banks. (See the chart on opposite page.)

Business loan patterns in each of the metropolitan areas are influenced heavily by the economic or industrial base of the particular area. For example, approximately one-third of total business loans reported by the five Cleveland banks at the end of June were granted to durable goods manufacturers, with

(3) To assure that information on the business loans of any single participating bank is not disclosed, it has been necessary to limit the analysis of business loans within selected metropolitan areas to those areas which contain three or more reporting banks. As a result, information from Akron, Dayton, Pittsburgh, and Youngstown banks is not separated out by area, although the business loans reported by these banks are included in the Fourth District totals.

nearly three-fifths of these loans accounted for by producers of primary metals and machinery. In contrast, the data gathered from reporting banks in Cincinnati and Toledo indicate that the largest proportion of outstanding business loans in each of those communities was to trade firms. In further contrast, Columbus banks reported other business firms, mainly service organizations, as the largest category of business borrowers.

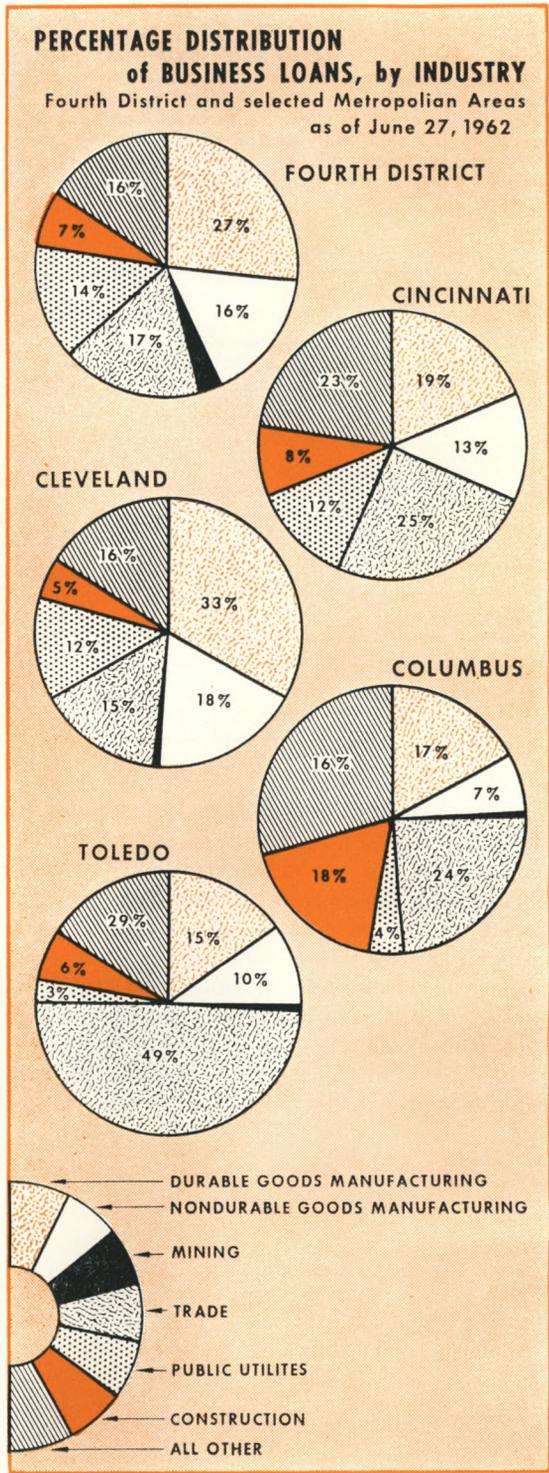
Loans to durable goods manufacturers accounted for less than one-fifth of total business loans in each of the metropolitan areas with the exception of Cleveland. Loans extended to nondurable goods producers ranged down from 18 percent of total business loans in Cleveland to 7.2 percent in Columbus.

Conversely, credit extended to trade organizations represented more than one-fifth in each of the communities except Cleveland. In Toledo, nearly one-half of the loans were granted to trade firms, with the largest proportion within the group accounted for by commodity dealers.

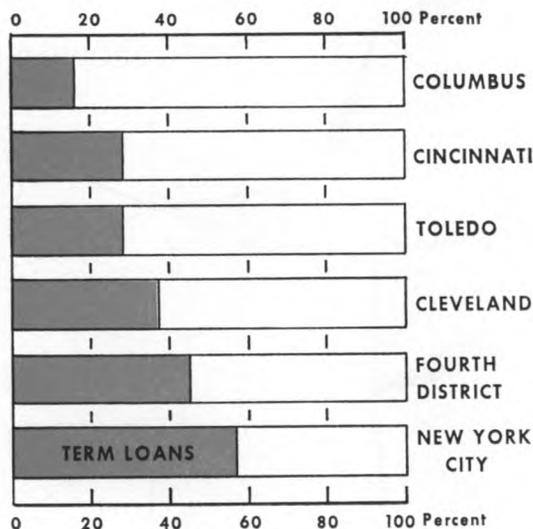
Public utilities and construction firms held nearly one-eighth of the total business loans in both Cincinnati and Cleveland; however, in Columbus and Toledo they accounted for less than 5 percent of the aggregate. Loans to construction firms provided less than 10 percent of the total in each of the communities except Columbus, where such loans represented nearly one-fifth of the total.

### Term Lending in the Four Metropolitan Areas

The proportion of term loans to total loans also varied widely among the four metropolitan areas. In Cleveland, nearly 37 percent of total business loans outstanding carried original maturities in excess of one year, while Columbus banks reported only 16 percent of their business loans as term loans. Term lending in Cincinnati and Toledo represented approximately 29 percent of total business loans. (See the accompanying chart.)



**Among four metropolitan areas in the Fourth District, banks in Cleveland held the largest proportion of term loans to total business loans, while Columbus banks reported the smallest share. The proportion of term loans to total business loans in each of the four metropolitan areas, however, was well below that for 21 reporting banks in the Fourth District and for large banks in New York City (June 27, 1962).**



The variations in term lending among the four metropolitan areas is explained in part by the composition of business loan portfolios in each of the communities. For example, nearly 70 percent of total business loans at reporting banks in Cleveland at the close of June were extended to manufacturing firms, public utilities and mining enterprises, all heavy users of long-term bank credit. On the other hand, in Columbus more than one-half of the aggregate business loans were granted

to trade firms and other business organizations which exercise a relatively light demand for other than short-term credit.

The distribution of term loans among the various classifications of business borrowers in each of the metropolitan areas was quite similar to the pattern of total business loans. This accounts in part for the variation in the ratio of term loans to total loans among the four Ohio communities.

Term loans to producers of durable goods represented more than one-third of total long-term loans at Cleveland banks; however, in the three remaining metropolitan areas, durable goods manufacturers held less than one-fifth of term loans outstanding. In addition, term loans extended to nondurable goods producers ranged down from 18 percent of the total in Cleveland to 3 percent in Columbus. In contrast, Columbus reporting banks granted 23 percent of their term loans to construction firms, as compared with 3 percent at Cleveland banks.

The proportion of term loans accounted for by trade organizations ranged from 28 percent in Toledo to 7.5 percent in Cleveland.

It is also noteworthy, as indicated in the accompanying chart, that the ratio of term loans to total business loans in each of the four metropolitan areas was below the average for all reporting banks in the Fourth District. This is explained by the relatively large proportion of term loans held by reporting banks other than those located in the four metropolitan areas under review.