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Contents

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The Business Situation

The economy made further good gains in the summer months, and the prospects for sustained strength in the fall and winter remain excellent. To be sure, the long-awaited labor settlement in the steel industry, which was preceded by many months of strike-hedge stockpiling by users of the metal, most probably signals the start of a readjustment toward lower and more normal steel inventories. But the dampening impact of a decline in inventories on over-all demand in the months ahead is likely to be offset, if not more than offset, by increases in consumer spending, business outlays for new plant and equipment, and expenditures by all levels of government. The latest surveys of consumer sentiment point to continued strength in this demand sector. Furthermore, the latest (August) Government survey of businessmen's actual and planned capital spending in 1965 points to a 13½ per cent increase this year, as against a 12½ per cent increase projected at the time of the May survey. The National Industrial Conference Board has reported that manufacturers' capital appropriations showed a very sizable further advance in the second quarter and that partial survey results point to another gain in the third quarter, confirming the present as well as future strength in capital spending. Moreover, private demand will be buoyed by the acceleration of defense spending. Indeed, the prospect of expanding demands for military hardware may tend to dampen the pace of the expected rundown of steel inventories.

To date, most estimates still suggest that defense spending in the current fiscal year will be only moderately greater than projected in the Federal budget last January. Yet, the expansion of the American military commitment in Vietnam may quite possibly intensify the upward pressures on prices that were already in evidence prior to the July decisions concerning the military buildup. On the other hand, the wage settlement in the steel industry appears to be about in line with the Council of Economic Advisers' guideposts, in contrast to earlier settlements in some other major industries.

The uptrend of the wholesale price index slowed in July, when industrial commodity prices remained stable on balance. Weekly data indicate that the advance of industrial prices was renewed in August, although offsetting price declines for farm products and foods may have left the over-all index for that month unchanged. The advance of consumer prices also moderated in July because the excise tax cuts effective that month led to price reductions for various nonfood commodities. These reductions very nearly offset the effects of further price increases for foods and services, and the over-all index rose by only 0.1 percentage point to 110.2 per cent of the 1957-59 average. Government estimates indicate that, in the absence of these reductions, the index would have risen to 110.4 per cent. While it is gratifying that the tax cuts have thus in large part been passed on in terms of lower consumer prices, they cannot of course be expected to have much, if any, further moderating effect on such prices. The economy is clearly vulnerable to inflationary pressures in the current circumstances of strong demand in markets for both labor and goods, although there is no present evidence that an inflationary spiral is actually under way.

PRODUCTION, ORDERS, AND EMPLOYMENT

The normal summer slowdown of industrial activity has been unusually mild this year, and producers in a broad range of industries report that customary vacation shutdowns have been curtailed or even omitted. The brisk pace of activity is reflected in the Federal Reserve Board's seasonally adjusted production index, which registered a further substantial gain in July, rising by 1.2 percentage points from the upward-revised June level to reach 143.6 per cent of the 1957-59 average. The July advance was centered in durable goods which, in turn, were paced by gains in the output of equipment and of industrial materials, particularly steel. Production of consumer goods, on the other hand, was unchanged in July, with automobile assemblies remaining at the high June rate of about 9½ million units annually.

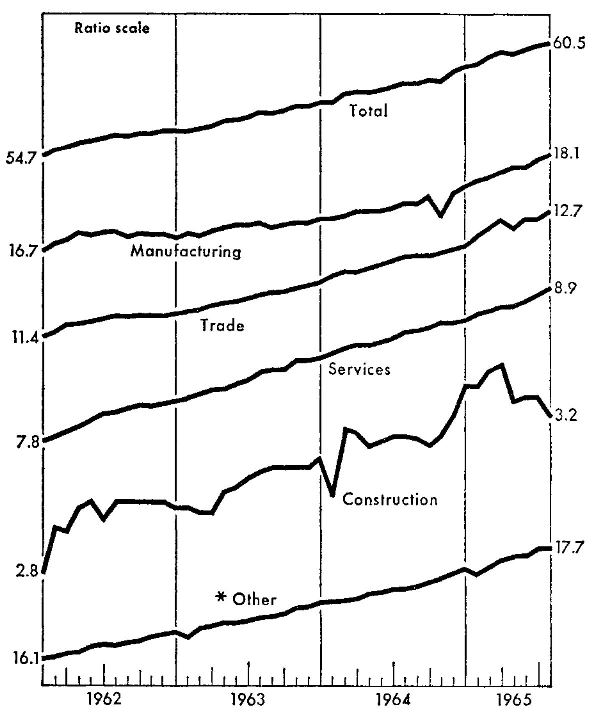
Fragmentary data suggest that over-all production rose again in August, even though steel output was cut back as both producers and users began to plan for the reduction of the inventories accumulated in anticipation of a possible strike. In the auto industry, August was marked by shutdowns for the changeover to production of 1966 models, and actual output was thus at a seasonal low. However, manufacturers were most anxious to provide dealers with adequate stocks prior to the introduction of the new models in early October. Therefore, shutdowns were shortened and new-model production begun as rapidly as possible and, after allowance for seasonal factors, the assembly rate in August was maintained at about the advanced June-July pace. Trade sources see a good chance that production, which was at a seasonally adjusted annual rate of 9.5 million units in the second quarter, will post a more than seasonal gain in the third quarter as a whole. Many observers are looking for total output in 1965 to be slightly over 9 million units, which would handily surpass the previous record of 7.9 million set in 1955.

The outlook for continued strength in durables production was further improved in July by an upsurge in new orders for such goods, which rose by 3 per cent to a volume only fractionally below the record set in April. It is noteworthy that the over-all advance was centered in industries oriented to civilian production, as defense orders edged up only slightly in July. Orders for machinery and equipment registered a particularly good advance of 6½ per cent, no doubt reflecting in good part the sustained growth of capital spending. While shipments of durables also rose—to a record volume—the backlog of unfilled orders on producers' books nevertheless expanded once again.

Chart I

RECENT DEVELOPMENTS IN NONFARM PAYROLL EMPLOYMENT

Millions of persons, seasonally adjusted



* Includes finance, government, mining, transportation, and public utilities.

Source: United States Bureau of Labor Statistics.

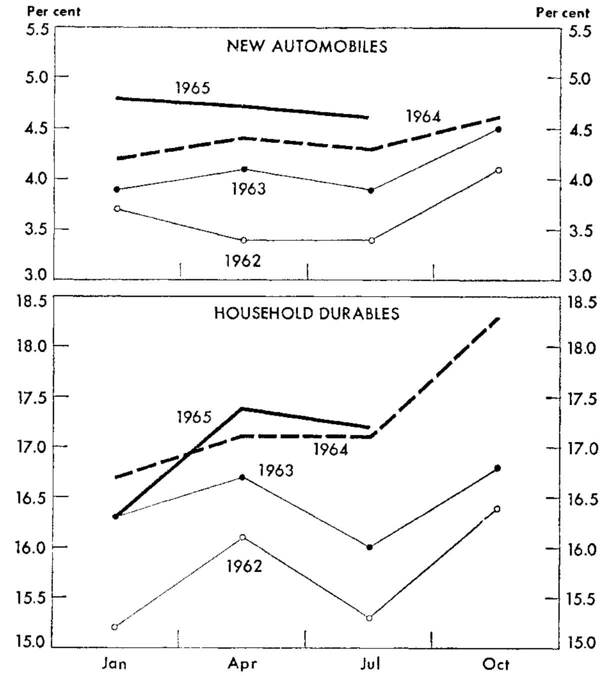
The brisk pace of economic activity in July was reflected in a further gain in nonfarm payroll employment (see Chart I). Employment in manufacturing industries increased by nearly 100,000 persons to 18.1 million persons, thus slightly exceeding the old record set in the middle of World War II. The fact that it took twenty-two years for this new record to be set reflects, of course, substantial gains in manufacturing productivity as well as the rapid reorientation of the economy toward service industries and public employment in the postwar decades. Nonfarm employment in sectors other than manufacturing has expanded by no less than 17.8 million persons during the intervening years, from 24.6 million in November 1943 to 42.4 million in July 1965. Since last winter, however, employment has been rising at a somewhat faster rate in manufacturing than in other major sectors. Manufacturing activity in a number of industries has been running at very high rates of capacity utilization and, in those industries experiencing particularly rapid demand expansion, producers are finding it increasingly difficult, at least in the short run, to expand output by the substitution of new capital equipment for the additional manpower that has so far been readily available. In August, both the total labor force and total employment declined, but since the reductions were about equal in size the over-all unemployment rate was unchanged from the July reading of 4.5 per cent. The stability of the over-all rate reflected offsetting developments for adults and teen-agers. While the unemployment rates for adult men and women both rose a bit, the teen-age employment situation showed a welcome further improvement and that group's rate dropped from 13.2 per cent in July to a three-year low of 12.4 per cent in August.

CONSTRUCTION SPENDING AND CONSUMER DEMAND

After staging a modest recovery during the first half of 1965, private nonfarm housing starts dropped off rather sharply in July and building permits also declined. It is true that both these indicators of future construction spending tend to be rather volatile, but the latest developments clearly give no ground for expecting any pronounced acceleration in home-building outlays over the near term. In fact, after trending slowly upward since the start of the year, such outlays declined in July and August. Nevertheless, industry analysts are cautiously estimating that the decline in starts has at last touched bottom, and that the rate of starts in the second half might equal or perhaps slightly exceed that of the first half. Such an outlook implies a continued slow growth of outlays, reflecting not only the rising costs of materials and labor but also the shift this year to the construction of somewhat more expensive types of housing units. On the other hand, outlays for commercial and industrial construction have been expanding this year more rapidly than most analysts had expected, with a good deal of the push coming from a renewed surge of office building. In large part, of course, the expansion of commercial and industrial construction activity is part of the growth of business capital spending. Another sizable advance in August brought seasonally adjusted expenditures for such construction in the first eight months of 1965 to a total about 15½ per cent above that for the same period last year. This component, however, accounts for only about 15 per cent of total construction spending, whereas private home building accounts for about 40 per cent of the total. (The remaining components of total construction activity—public construction and construction spending by utilities and institutions—have been virtually stable for some time.)

Chart II

CONSUMER INTENTIONS TO BUY NEW AUTOMOBILES AND HOUSEHOLD DURABLES WITHIN SIX MONTHS



Note: Buying plans are expressed as the ratio of the number of families who indicate they intend to buy to the total number of families in the survey.

Source: United States Department of Commerce, Bureau of the Census.

The latest Census Bureau survey of consumer buying intentions, taken in mid-July, points to continued strength in consumer demand (see Chart II). The proportion of families planning to purchase a new car within six months was well above the year-earlier reading, and the proportion planning to buy one or more of the seven household durable goods included in the survey was also higher than at the corresponding time a year ago. To be sure, buying plans in both categories contracted a bit between mid-April and mid-July, but such a movement is in line with the usual seasonal pattern shown in this survey. Thus, these midsummer results tend to bear out the findings of another survey of consumer sentiment taken in early June by the University of Michigan's Survey Research Center, which showed a high degree of consumer optimism over the prospects for continued general improvement in the economy as well as for the economic circumstances of the individual respondents.

Sales volume at retail outlets, after showing a slight dip in June, advanced strongly in July to a new high, with virtually all lines of trade sharing in the gains. Retail sales in July probably received some added impetus from the Federal excise tax reductions, and further stimulus is likely over the months ahead as consumers adjust to the fact that many previously taxed items now cost less. Government estimates indicate that, as of July, some 75 per cent of the total potential benefit of the tax cuts was being passed on to buyers in the form of lower retail prices. It had been expected, of course, that the number of new-car sales would benefit significantly from the excise reductions which, for autos, were retroactive to May 15. Unit sales, after declining from post-strike highs, did jump sharply in June and edged slightly higher in July to a seasonally adjusted annual rate of nine million cars, which was about equaled in August. However, the 1965 cars have enjoyed buyer enthusiasm throughout the model year, and it is virtually impossible to disentangle the specific effects of the tax cut. Industry sources forecast a strong October start for the 1966 cars.

REVISIONS OF GROSS NATIONAL PRODUCT ESTIMATES

The Commerce Department has released a revised set of gross national product estimates, incorporating changes back to 1929. The revisions are comprehensive, but it is noteworthy that the new figures show substantially the same quarter-to-quarter movements in GNP that had been indicated previously. In particular, the pattern of GNP growth during the current business expansion continues to look very much as it did prior to the revisions. For the earlier years of the postwar period, the net effect of the revisions has been to reduce GNP slightly, while for more recent years GNP has been increased moderately. Since the figure for 1964 has been scaled upward by about 1 per cent, from $622.6 billion to $628.7 billion, business analysts will find it desirable to make a similar upward revision in their forecasts for 1965 as a whole. For example, the frequently cited "standard" forecast has put GNP this year at $660 billion, up by 6 per cent from the unrevised figure for 1964. The same percentage increase, applied to the revised figure for 1964, implies a revised "standard" forecast for 1965 of roughly $667 billion.

One result of the revisions which is of particular interest is that the new figures show a slightly higher rate of growth of "real" GNP during recent years. Thus, the previous estimates showed GNP, measured in dollars of constant purchasing power, growing by an average of 4.1 per cent annually in the 1960-64 period, while the revised figures put the average annual growth at 4.3 per cent.

The regular summer revisions of GNP figures for the past few years have each reflected the use of more reliable data that become available only after some lapse of time. This year's revisions, however, are unusually extensive. They incorporate the results of using better data not only for the past few years but for earlier years as well, and they also reflect some changes in the definitions that determine which items are to be included in calculating the value of the economy's total output of goods and services. The last time the national income accounts were given such an extensive overhaul was in 1958. The largest of the "statistical" revisions — those reflecting the use of better data— is in the estimated value received by homeowners from the houses in which they live. This "imputed rent", which is classed in GNP as consumption spending for a service, has been increased because Government studies indicate that the nation's stock of housing in the postwar years has been of better quality than had previously been believed. Other "statistical" revisions resulted, among other changes, in increases in outlays for residential construction and producers' durables. With regard to the "definitional" revisions, the largest change is the removal from GNP of interest payments by consumers. These payments were formerly counted as personal consumption of a service but have now been excluded on the ground that they do not reflect any production. This and other definitional revisions generally reduced GNP below the levels previously estimated. For recent years, however, the definitional revisions were more than offset by the increases resulting from the use of better data.

The Money and Bond Markets in August

The money market was somewhat firmer during August, after having eased slightly in the latter part of July. Federal funds traded mainly at 4⅛ per cent, and the major reserve city banks were under reserve pressures as reserve distribution swung in favor of the "country" banks. Treasury bill rates moved higher in the early part of the month when professional offerings outweighed a rather modest investment demand. Subsequently, rates generally edged lower through midmonth. In the latter part of the month, demand tapered off—as often happens in August—and bill rates rose against a background of general market uncertainty.

Prices of Treasury notes and bonds declined irregularly in August, with prices of some issues dipping to their lowest levels in five years. Market participants warily appraised the potential effects of recent international political and economic developments, including those in Vietnam, as well as the possible consequences for interest rates of the very strong summer performance of the economy. There was also some selling of long-term Government bonds by institutional investors who were switching into new corporate issues as the yield spread in favor of the latter remained relatively wide. A cautious atmosphere was also evident in the corporate bond market during most of the period. The volume of new issues was larger than usual for August and their yields rose above comparable July levels, while prices of recent issues were also marked lower. In the tax-exempt sector, where a better tone had emerged in July, bond prices edged higher in early August and then held steady until late in the month when a more cautious tone developed.

THE MONEY MARKET AND BANK RESERVES

Over-all net reserve availability fluctuated in a narrow range in August around the average level prevailing in the preceding several months, but the tone of the money market turned somewhat firmer than in the latter part of July. In part, this reflected the fact that available reserves were lodged at banks outside the main money centers during most of the period. The effective rate on Federal funds was more consistently at 4⅛ per cent during August than in earlier months. (See left-hand panel of the chart on page 185.) Offering rates for new time certificates of deposit issued by leading New York City banks tended to rise slightly, as did the range of rates at which such certificates traded in the secondary market. Rates posted by the major New York City banks on new call loans to Government securities dealers were generally in a 4¼ to 4½ per cent range, while rates on renewal call loans were most frequently quoted in a 4¼ to 4⅜ per cent range. Investor demand for bankers' acceptances absorbed a limited supply during most of the month at the lower rates prevailing since late July. However, when supply expanded sharply near the end of the month, dealers raised their rates by ⅛ of a percentage point, making the rate on ninety-day unendorsed acceptances 4⅜ per cent (bid) and 4¼ per cent (offered).

Table I

CHANGES IN FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, AUGUST 1965

In millions of dollars; (+) denotes increase, (—) decrease in excess reserves

Factors	Daily averages—week ended Aug. 4	Aug. 11	Aug. 18	Aug. 25	Net changes
"Market" factors					
Member bank required reserves*	— 125	+ 216	— 3	+ 71	+ 159
Operating transactions (subtotal)	— 271	— 504	+ 553	— 47	— 269
Federal Reserve float	— 234	+ 40	+ 290	— 78	+ 18
Treasury operations†	— 27	— 144	+ 194	— 57	— 34
Gold and foreign account	— 64	— 43	— 37	+ 17	— 127
Currency outside banks*	— 148	— 388	+ 99	+ 169	— 268
Other Federal Reserve accounts (net)‡	+ 200	+ 35	+ 5	— 100	+ 140
Total "market" factors	— 396	— 288	+ 550	+ 24	— 110
Direct Federal Reserve credit transactions					
Open market instruments					
Outright holdings:					
Government securities	+ 104	+ 356	— 222	— 66	+ 172
Bankers' acceptances	— 1	+ 1	— 1	+ 1	—
Repurchase agreements:					
Government securities	+ 283	— 105	— 293	+ 64	— 51
Bankers' acceptances	—	—	—	—	—
Member bank borrowings	+ 65	+ 72	— 125	+ 55	+ 67
Other loans, discounts, and advances	—	+ 3	— 1	— 1	+ 1
Total	+ 451	+ 328	— 642	+ 53	+ 190
Excess reserves*	+ 55	+ 40	— 92	+ 77	+ 80
Daily average level of member bank:					
Total reserves, including vault cash*	21,777	21,601	21,512	21,518	21,602§
Required reserves*	21,399	21,183	21,186	21,115	21,221§
Excess reserves*	378	418	326	403	381§
Borrowings	544	616	491	546	549§
Free reserves*	— 166	— 198	— 165	— 143	— 168§
Nonborrowed reserves*	21,233	20,985	21,021	20,972	21,053§

Note: Because of rounding, figures do not necessarily add to totals.
* These figures are estimated.
† Includes changes in Treasury currency and cash.
‡ Includes assets denominated in foreign currencies.
§ Average for four weeks ended August 25, 1965.

Table II

RESERVE POSITIONS OF MAJOR RESERVE CITY BANKS AUGUST 1965

In millions of dollars

Factors affecting basic reserve positions	Daily averages—week ended Aug. 4	Aug. 11	Aug. 18	Aug. 25	Average of four weeks ended Aug. 25
Eight banks in New York City					
Reserve excess or deficiency(—)*	11	9	13	5	10
Less borrowings from Reserve Banks	115	167	4	52	85
Less net interbank Federal funds purchases or sales(—)	— 78	6	239	— 45	31
Gross purchases	*753*	*773*	*857*	*668*	*763*
Gross sales	*831*	*767*	*618*	*713*	*732*
Equals net basic reserve surplus or deficit(—)	— 26	— 164	— 230	— 2	— 106
Net loans to Government securities dealers	684	372	531	459	512
Thirty-eight banks outside New York City					
Reserve excess or deficiency(—)*	23	20	18	22	21
Less borrowings from Reserve Banks	120	170	209	192	173
Less net interbank Federal funds purchases or sales(—)	516	548	441	433	485
Gross purchases	*1,250*	*1,204*	*1,194*	*1,085*	*1,183*
Gross sales	*734*	*657*	*754*	*652*	*699*
Equals net basic reserve surplus or deficit(—)	— 613	— 698	— 632	— 603	— 637
Net loans to Government securities dealers	251	172	190	203	204

Note: Because of rounding, figures do not necessarily add to totals.
* Reserves held after all adjustments applicable to the reporting period less required reserves and carry-over reserve deficiencies.

The money market had a firm tone during the first statement week of the month, which included the subscription period for the Treasury's August refunding.[1] System open market operations supplied a substantial volume of reserves (both through outright purchases and repurchase agreements), largely offsetting the reserve drains stemming from movements in "market" factors, and nationwide net reserve availability was little changed from the preceding week. However, the basic reserve positions of the major New York City banks swung from a sizable surplus the week before to a deficit when these banks met a large portion of the expanded loan requirements of Government securities dealers, businesses, and sales finance companies. These banks bid strongly for Federal funds, largely at 4⅛ per cent, and also stepped up their borrowings from the Federal Reserve Bank.

During the statement period ended August 11, reserve distribution increasingly favored the country banks at the start of their biweekly reserve computation period. A large unsatisfied demand for Federal funds led to heavy member bank borrowings from the Federal Reserve Banks over the weekend. Partly as a result of the excess reserves built up in this way, the supply of Federal funds became somewhat more ample in the latter part of the statement week. Subsequently, the money market readily accommodated the flows of money and securities associated with the August 13 settlement for the Treasury's August refunding. In addition, average member bank borrowings for the August 18 statement week declined when the availability of Federal funds increased toward the end of the period as the country banks worked down their excess reserves.

The money market remained quite firm over the rest of the month. Federal funds were in limited supply before the weekends beginning on August 20 and 27, and a modest volume of Federal funds traded at 4¼ per cent. While there was only a limited willingness to pay this rate, its appearance also seemed to impede the flow of Federal funds as it reduced the inclination to sell below the 4¼ per cent rate. This contributed to the tendency for borrowings from the Reserve Banks to increase over both weekends and for Federal funds to be more readily available thereafter.

Over the month as a whole, market factors absorbed $110 million of reserves, while System open market operations provided $121 million. The weekly average of System outright holdings of Government securities rose by $172 million from the final statement week in July through the last week in August, and average System holdings of Government securities under repurchase agreements decreased by $51 million. Average net System holdings of bankers' acceptances, both outright and under repurchase agreements, remained unchanged on balance during the month. From Wednesday, July 28, through Wednesday, August 25, System holdings of Government securities maturing in less than one year rose by $1,868 million, while holdings of issues maturing in more than one year declined by $1,899 million. This shift in the maturity structure of the System Account portfolio reflected primarily a movement of issues into the shorter maturity area with the passage of time. This effect was only partially offset by the August 13 exchange of Treasury refunding issues, which decreased the amount of shorter maturities while adding to the longer maturities in the System's portfolio.

THE GOVERNMENT SECURITIES MARKET

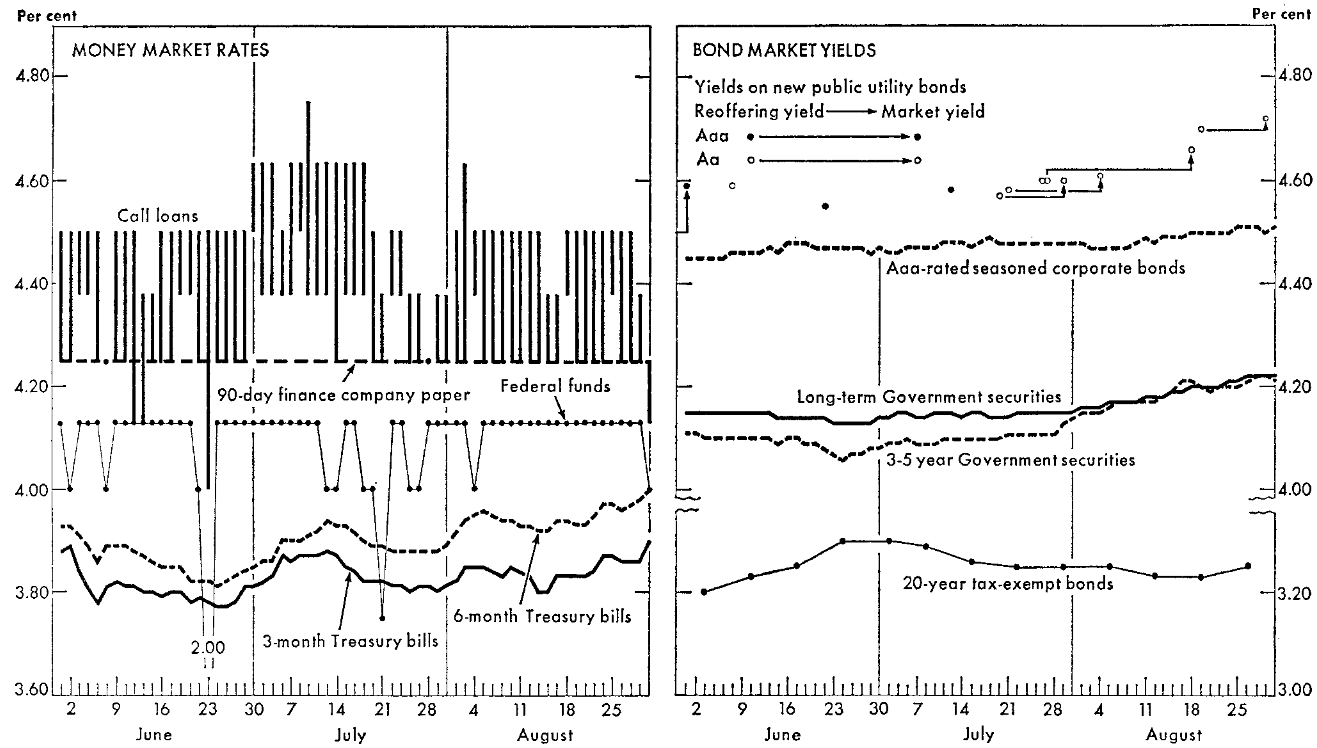
As the month opened, there was continuing disappointment among Government securities dealers with the limited reinvestment demand for bills arising from the Treasury's August refunding of coupon issues. Bill demand from other sources was also light and quite selective, and dealers sold at rising rates to reduce their bill positions. Announcement of a large Federal Home Loan Bank flotation of short-term notes also contributed to the cautious atmosphere, since these instruments were viewed as potentially competitive with Treasury bills. Against this background, bill rates edged irregularly upward through August 5. (See left-hand panel of the chart.) As higher rate levels emerged, a fairly good investment demand appeared —including some commercial bank and public fund buying, dealer offerings contracted, and the tone of the bill market gradually improved. Some scarcities developed, particularly in the shorter maturity areas, and bill rates moved downward from August 6 through midmonth. Subsequently, however, investment demand receded, as is often the case in August. Dealer concern over the future course of interest rates increased, professional offerings expanded, and bill rates edged irregularly upward during the remainder of the month.

At the last regular weekly auction of the month, held on August 30, average issuing rates were 3.886 per cent for the new three-month issue and 3.991 per cent for the new six-month bills, about 8 and 12 basis points respectively above the average rates at the last weekly auction in July. The August 24 auction of $1 billion of new one-year bills

[1] For the details of the refunding, see this *Review*, August 1965, p. 164.

SELECTED INTEREST RATES*

June-August 1965



Note: Data are shown for business days only.

* MONEY MARKET RATES QUOTED: Daily range of rates posted by major New York City banks on new call loans (in Federal funds) secured by United States Government securities (a point indicates the absence of any range); offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three- and six-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields of new Aaa- and Aa-rated public utility bonds are plotted around a line showing daily average yields of seasoned Aaa-rated corporate bonds (arrows point from underwriting syndicate reoffering yield of a given issue to market yield of the same issue immediately after it has been released from syndicate restrictions); daily averages of yields of long-term Government securities (bonds due or callable in ten years or more) and of Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields of twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

produced an average issuing rate of 4.006 per cent, as against 3.875 per cent on the comparable issue sold a month earlier. The newest outstanding three- and six-month bills closed the month at bid rates of 3.90 per cent and 4.00 per cent, respectively.

In the market for Treasury notes and bonds, a heavy atmosphere prevailed throughout the month. Prices of many outstanding issues slipped to their lowest levels of the year, and in some cases to new five-year lows. (The right-hand panel of the chart shows the rise in yields which accompanied this decline in bond prices.) Uncertainty over the viability of prevailing interest rate levels heightened, as market participants focused upon the Vietnamese situation, the related possibility of increased defense spending, the strong domestic economic outlook, and the status of the pound sterling. In addition, the persistence of a relatively wide yield spread between Treasury and corporate bonds restrained investment interest in longer term Government securities and led to some switching into corporate issues. In this environment dealers sought aggressively to reduce their considerable inventories and prices moved lower, especially in the long-term sector of the market. However, there was little selling by banks and other investors of intermediate issues until late in the month when some such selling did materialize. As the month progressed, the lower prices attracted some institutional buying which, together with official account buying, produced a significant decline in bond inventories over the course of the month.

Results of the Treasury's August refunding operation, announced after the close of business on August 6, indicated that about \$7.0 billion of the maturing Treasury notes eligible for exchange would be converted on the August 13 payment date into the two refunding issues offered by the Treasury. Subscriptions totaled about \$5.1 billion (including about \$2.1 billion from public subscribers) for the new 4 per cent notes of February 1967 and approximately \$1.9 billion (including about \$0.8 billion from public subscribers) for the reopened 4 per cent bonds of February 1969. Approximately 7.4 per cent of the maturing securities held by the public was not exchanged. Although the attrition was less than had been anticipated, the refunding results had virtually no effect on prices of outstanding coupon issues.

Bond prices steadied temporarily on August 10, when reports that the British trade gap had narrowed in July encouraged the market and sparked limited professional short covering. Investment demand did not expand significantly, however, and a cautious tone quickly reappeared. The market was also adversely affected by the cancellation of a large scheduled tax-exempt flotation, the proceeds of which were to have been reinvested in Treasury bonds, and by the increase in the German Federal Bank's discount rate from 3½ per cent to 4 per cent. Thus, prices resumed their downward trend from August 11 through August 17.

Market sentiment improved slightly over the next several days. The Government's August 17 announcement of a small surplus in the United States balance of payments during the second quarter of 1965 — the first quarterly surplus since 1957 — was favorably received. Market participants also began to recognize that measures undertaken by the United Kingdom to defend the pound sterling were beginning to take effect. Investment demand for coupon issues expanded moderately, some professional short covering took place, and offerings were more readily absorbed. A weaker tone reappeared in the latter part of the month, however, and prices again moved lower in response to expanded offerings from professional and investment sources.

OTHER SECURITIES MARKETS

Caution was also the watchword in the corporate bond market in August. The volume of new flotations was fairly large for a month that is normally very quiet, and yields on new issues rose above the levels available on comparable securities in July. Prices of seasoned corporate bonds declined irregularly in response to many of the same factors affecting the Government securities market. Several slow-moving recent issues were released from syndicate price restrictions and adjusted upward in yield by approximately 3 to 7 basis points. (See right-hand panel of the chart.) Over the month as a whole, the average yield on Moody's seasoned Aaa-rated corporate bonds rose by 3 basis points to 4.51 per cent.

In the tax-exempt sector, on the other hand, the steady tone which had emerged in the latter part of July carried over into early August. Prices of tax-exempt bonds were unchanged to slightly higher, and dealers made some further headway in cutting the volume of unsold bonds on their shelves in the early part of the month. Later in the month an easier undertone began to appear when commercial banks reportedly became less active buyers and when participants contemplated a fairly heavy calendar of high-grade issues scheduled to be marketed in September. Over the month as a whole, the average yield on *The Weekly Bond Buyer's* series for twenty seasoned tax-exempt issues (carrying ratings ranging from Aaa to Baa) remained unchanged at 3.25 per cent. (See right-hand panel of the chart.)

The volume of new corporate bonds publicly floated in August amounted to an estimated \$410 million, compared with \$535 million in July 1965 and only \$175 million in August 1964. The largest publicly offered new corporate bond issue of the month consisted of \$75 million of A-rated utility company convertible debentures maturing in 1980. The debentures were reoffered to yield 2.89 per cent and were accorded only a fair reception. The syndicate marketing this issue terminated late in the month, and the price subsequently declined about 2 points —increasing the yield to about 3.08 per cent. New tax-exempt flotations totaled about \$645 million, as against \$980 million in July 1965 and \$705 million in August 1964. The Blue List of tax-exempt securities advertised for sale closed the month at \$768 million, compared with the revised level of \$746 million at the end of July. The largest new tax-exempt bond flotation during the month consisted of \$132 million of Aaa-rated housing authority bonds. The bonds were reoffered to yield from 2.30 per cent in 1966 to 3.40 per cent in 2006 and were accorded a good reception. Other new corporate and tax-exempt bonds publicly offered during the period were accorded mixed investor receptions.

The Financing of State and Local Government Activities in the Postwar Period *

The term "government" in this country is probably most commonly associated with the activities of the Federal Government. But it is a fact that there are also fifty state governments and some 91,000 county, city, and other local governments, which carry out a myriad of functions, from building major highways and providing schools for our young people to collecting refuse. These governments have been one of the most rapid growth sectors in the economy during the postwar period. Indeed, with a population growing both in numbers and in complexity of needs over this period, state and local governments have registered about a sixfold increase in their expenditures and a twofold rise in the number of persons they employ. At the same time, these governments have found it increasingly difficult to finance their additional responsibilities. Although their tax revenues have grown substantially since 1946, state and local governments have had to rely to an increasing extent on obtaining funds through debt operations and from Federal grants-in-aid. Without the Federal grants-in-aid, it is highly likely that many of the new services and facilities provided by state and local governments in the past several years would have been long delayed if not completely forestalled. Since the forces making for additional state and local government services can be expected to continue to operate in the future, further revenue problems seem virtually assured for the state and local government sector in the years ahead. Additional financial support from the Federal Government also seems a reasonable expectation—certainly for the immediate future—as the Administration's legislative program and recent legislation foreshadow a sizable expansion in this direction.

This article summarizes the growing role that state and local governments have played in the postwar years, outlines the major forces which have spurred the increased activities by this sector, examines the revenue problems which state and local authorities face, and describes the variety of techniques by which Federal grants-in-aid have been made available to these governments. Such a broad summary, of course, must necessarily be built on generalizations and cannot adequately describe either the knotty problems of individual states and communities or the ways in which these problems have been tackled.

THE GROWTH IN STATE AND LOCAL GOVERNMENT EXPENDITURES

In the aggregate, state and local governments constitute an increasingly important sector of the national economy. Purchases of goods and services by such governments currently run at an estimated annual rate of nearly $67 billion, and in fiscal 1964—the latest year for which such data are available—an additional $20 billion was spent for such items as interest on debt, transfer payments, and insurance trust systems as well as the public operation of utilities and liquor stores (measured on a gross basis). Present total budgetary expenditures by state and local authorities are thus probably in excess of $87 billion, of which about $10 billion comes from the Federal Government. In contrast, fiscal 1965 cash expenditures of the Federal Government, *excluding* the cost of national defense, amounted to $66 billion. The inclusion of defense outlays—which are, of course, a predominantly national function—raised expenditures by the Federal sector to $122 billion.[1]

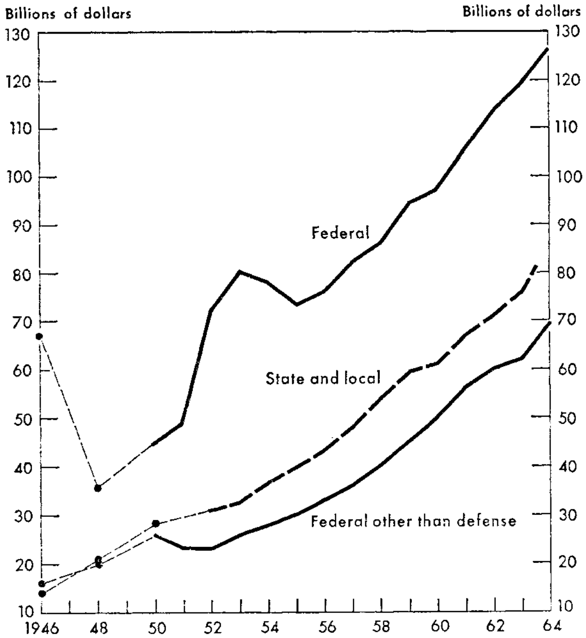
The post-World War II rise of state and local expenditures has been the continuation of a long and generally steady trend (see Chart I). Between 1946 and 1964, total expenditures by these governments multiplied nearly six

* L. Richard Gabler, Economist, had primary responsibility for the preparation of this article.

[1] Federal grants-in-aid to state and local governments are included in the above figures on Federal cash outlays. These cash figures quoted from budgetary accounts are on a somewhat different basis from the Census figures used in Chart I.

Chart I

EXPENDITURES BY FEDERAL AND STATE PLUS LOCAL GOVERNMENTS SINCE 1946



Note: Federal data are for fiscal years ended June 30. State and local data are on calendar-year basis except for 1964 when fiscal-year total is used. Dashed lines for early postwar period are used to indicate that data for some years are unavailable in a form comparable to that of later years.

Sources: United States Department of Commerce, Bureau of the Census: 1962 Census of Governments, Vol. VI, No. 4, and Governmental Finances in 1963-64.

acterized the nation itself. In the main, these factors include the growth in population and its continuing mobility, particularly to urban and suburban communities, the expanding requirements generated by increased automobile ownership, technological advances, rising incomes and standards of living, and the increased responsibilities undertaken by governmental authorities.

All types of spending have been affected in one way or another by these various forces, but the rates of increase over the postwar period, measured both in terms of total amounts and on a per capita basis, differ among the several categories (see Table I for the per capita figures). Expenditures for education—the fastest growing component of over-all state and local government spending—currently account for nearly 40 per cent of total expenditures. Such expenditures have been sharply stimulated by the rise in the number of children of school age and by the lengthening of the average term of a person's education. At the same time, teacher pay scales have risen and there has been an upgrading of educational services including higher qualifications for the teaching staff and higher standards for school buildings and facilities. Most basically, the nation is recognizing more clearly the need for, and the value of, education.

Highway construction is a second category of state and

times, from \$14.1 billion to \$80.6 billion.[2] In comparison, Federal expenditures for programs other than defense increased less than five times. State and local expenditures for goods and services presently absorb about 10 per cent of total gross national product, compared with a 4.8 per cent share in 1946. Furthermore, these governments presently employ approximately 10 per cent of the nation's civilian labor force, as against only 5.8 per cent in 1946.

There are many reasons underlying this rapid rise in the economic significance of state and local governments. Like most of the civilian sector of the economy, state and local governments entered the postwar years with a large backlog of expenditures. At the same time, there have been other forces at work, all associated with the economic development and change that have char-

Table I

STATE AND LOCAL GOVERNMENT EXPENDITURES PER CAPITA, BY FUNCTIONAL PURPOSE

Calendar 1946 and Fiscal 1964

At prevailing prices

Purpose	1946	1964	Percentage increase 1946 to 1964
Education	\$23.74	\$138.67	484
Highways	11.83	60.96	415
Public health, housing, and recreation*	10.01	46.56	365
Police, fire, and sanitation	8.09	30.57	278
Public welfare	9.97	30.13	202
Interest on public debt	2.98	12.31	313
General control and financial administration	4.97	13.40	170
All other	6.44	29.55	359
Total	\$78.00	\$362.20	364

Note: Total excludes expenditures for government utilities, liquor stores, and insurance trusts. Because of rounding, figures do not necessarily add to totals.

* Includes health, hospitals, local parks and recreation, housing and urban renewal, and natural resources.

Sources: United States Department of Commerce, Bureau of the Census, *1962 Census of Governments*, Vol. VI, No. 4, and *Governmental Finances in 1963-64.*

[2] Throughout this article, state and local data for 1946 are on a calendar-year basis while 1964 figures relate to the fiscal year ended June 30, 1964.

local government spending which has shown a sharp rise over the postwar period, and it is a field in which Federal assistance to the states and Federal-state cooperation have been of particular importance. The need for highway expenditures is, of course, directly related to ever-increasing automobile ownership and the utilization of more and of heavier trucks — developments which have necessitated the provision of additional highways, including multi-tiered bridge facilities, as well as the repavement of extensive mileage of roadways with improved surfaces. The increase in traffic density and the proliferation of other problems associated with "urban sprawl" have stimulated state and local governments to create community and regional planning agencies, which directly or indirectly have further enlarged the activities of state and local governments.

Urbanization has been mentioned as another force in the growth of state and local government spending. Continuing migration from the farm to the city has accelerated the need for additional police and fire protection as well as for added water and sewerage facilities. And the more densely populated the urban centers become, the more complicated and expensive it is to provide these services. Furthermore, the recent acceleration in movement from city to suburban communities has forced state and local authorities to meet comparable needs in these newly developed areas, without eliminating the need for services in the center city where the population is by and large also still rising.

These major pressures have operated throughout the country, though the degree of the pressure and the response of state and local authorities have varied from one area to another. Thus, there continues to be a wide variation among the different states in amounts spent per capita in any given year. In 1964, for example, total budgeted state and local expenditures per capita in the various states ranged from a high of $576 in Nevada to a low of $217 in South Carolina[3] (see Table II). Education expenditures per capita — the single most important functional category—varied from $201 in Utah to $91, again in South Carolina. Although a small part of the variations among states can be attributed to differences in price levels, it is nonetheless true that the dollar spread also reflects wide variations in the quantity, and probably the quality, of public services provided.

What explains this wide range in per capita spending among the various states? A number of studies have suggested that some part of the disparity in expenditures per capita can be attributed to demographic differences among states, such as the degree of urbanization, population density, and rate of population increase. But it has also been found that an even more significant factor is the difference in fiscal capacity—as represented by per capita income—among the various states. It might be argued that this explanation begs the question: state and local government spending itself can increase local per capita income—through its direct income effects on local residents as well as by improving productivity in the private sector. Therefore, a relatively high level of per capita spending by such governments may contribute to, and a low level detract from, fiscal capacity. Quite possibly, the different political histories and institutions of the various states—factors that are not readily quantifiable—also have a bearing on the willingness to tax residents and hence on expenditures. It is nevertheless clear that over the short term these considerations are small solace to those state and local executives and legislators who, in addition to having the virtually universal revenue problems discussed in the next section, are forced to deal with these problems in areas which have presently low per capita income.

Table II

HIGHEST, AVERAGE, AND LOWEST AMOUNTS SPENT PER CAPITA IN THE VARIOUS STATES BY STATE AND LOCAL GOVERNMENTS

Fiscal 1964

Purpose	High	United States average	Low
Education	$201	$139	$ 91
Highways	192	61	38
Public health and recreation*	59	31	14
Police, fire, and sanitation	51	31	11
Public welfare	64	30	12
General control	14	7	3
Total expenditures	$576	$362	$217

Note: Figures exclude Alaska, Hawaii, and the District of Columbia.
* Includes health and hospitals and local parks and recreation.
Source: United States Department of Commerce, Bureau of the Census, *Governmental Finances in 1963-64.*

INTERNAL SOURCES OF FINANCE: TAX AND DEBT OPERATIONS

Financing the rising volume of expenditures has posed serious difficulties. Although the growth in over-all economic activity during the postwar period has, of course, increased the traditional tax base of state and local govern-

[3] Figures exclude Alaska, Hawaii, and the District of Columbia.

ments, these authorities have repeatedly been forced both to impose new levies and to increase tax rates on existing revenue sources. State governments, which can tap a wider variety of revenue sources than do local authorities, have been active in using these sources. Between 1946 and 1963, no less than fourteen states instituted a tax on cigarettes, while general sales taxes were added as a source of funds by thirteen states. At the same time, four states added an individual income tax to their sources of revenue and five adopted a corporate income tax. The list would be very much longer indeed if it did not exclude those cases in which states increased rates on previously tapped tax sources.[4]

The financing of local government expenditures has been a problem of at least similar difficulty. These governments rely almost exclusively upon property taxes — in 1964 such taxes provided about 90 per cent of all local tax revenues. While the postwar increase in property valuations has swelled the property tax base, there has still been a steady need to raise the property tax rates themselves. Residents of newly developed suburban communities have been particularly affected by such tax increases, as they often have seen the taxes on their property double after the first few years of occupancy and then double again.

While rising state and local government taxes have almost become a fact of life in the postwar period, such increases have not been easy to effect. Earlier increases in tax rates have made further levies all the more difficult. Moreover, interstate competition to attract new industry, and similar competition among localities, has undoubtedly hampered efforts to add to current revenues, particularly in the case of corporate taxes. States and localities generally offer some form of inducement to attract new corporations to their areas, with the long-range view toward creating new job opportunities and increasing the over-all tax base, and this competition imposes a constraint on tax rates which neighboring state or local authorities can levy. Disregard of the level of taxation in nearby communities in any given community's decision might repel, rather than attract, new industry and thus prove self-defeating.

Although the property tax is also the largest single source of the combined total of state and local tax revenues, its relative share has declined a bit over the postwar period. In 1964, these levies accounted for some $21.2 billion, or 36.3 per cent, of state and local general revenues (see Table III). Second in importance as a source of revenue were the sales and gross receipts taxes, which provided an additional $15.8 billion. Since there is neither a national sales nor a national property tax, state and local government levies on these sources do not overlap with the Federal tax structure. State and local authorities make far less use of the personal income and corporate profits taxes, and these taxes of course constitute the major source of Federal revenues.

Table III

INTERNAL GENERAL REVENUE SOURCES FOR STATE AND LOCAL GOVERNMENTS

Calendar 1946 and Fiscal 1964

In billions of dollars

Sources	1946		1964	
	Amount	Percentage of total	Amount	Percentage of total
Individual income taxes	$ 0.4	3.5	$ 3.8	6.5
Corporate income taxes	0.4	3.5	1.7	2.9
Sales and gross receipts taxes	3.0	26.1	15.8	27.1
Property taxes	5.0	43.5	21.2	36.3
Other taxes	1.3	11.3	5.3	9.1
Charges and miscellaneous	1.4	12.2	10.7	18.3
Total	$11.5	100.0	$58.4	100.0

Note: Excludes revenues from government utilities, liquor stores, and insurance trusts as well as from Federal grants-in-aid. Because of rounding, figures do not necessarily add to totals.
Sources: United States Department of Commerce, Bureau of the Census, *Historical Summary of Governmental Finances in the United States, 1957 Census of Governments,* Vol. IV, No. 3, and *Governmental Finances in 1963-64.*

State and local governments have also made extensive use of debt operations as a source of finance. For the most part, however, the funds obtained by borrowing have not gone into the general revenue pool but rather have been used almost exclusively for the expansion of capital facilities, such as the building of new schools and roads. (Many state and local authorities are barred by law or Constitutional restriction from borrowing for any other purpose.) The positive association between the volume of new debt issues by state and local governments and total capital spending by these authorities has been particularly strong in the years since 1953. Prior to that time, the relationship was obscured by the substantial amount of debt that had to be issued in the 1946-50 period to finance bonus payments to World War II veterans and

[4] A partial list of current state government fiscal efforts shows that these pressures have continued in the first six months of 1965. During this period, two states (including New York) added the sales tax, while nine increased existing rates; one state added the cigarette tax, while twenty advanced previous rates.

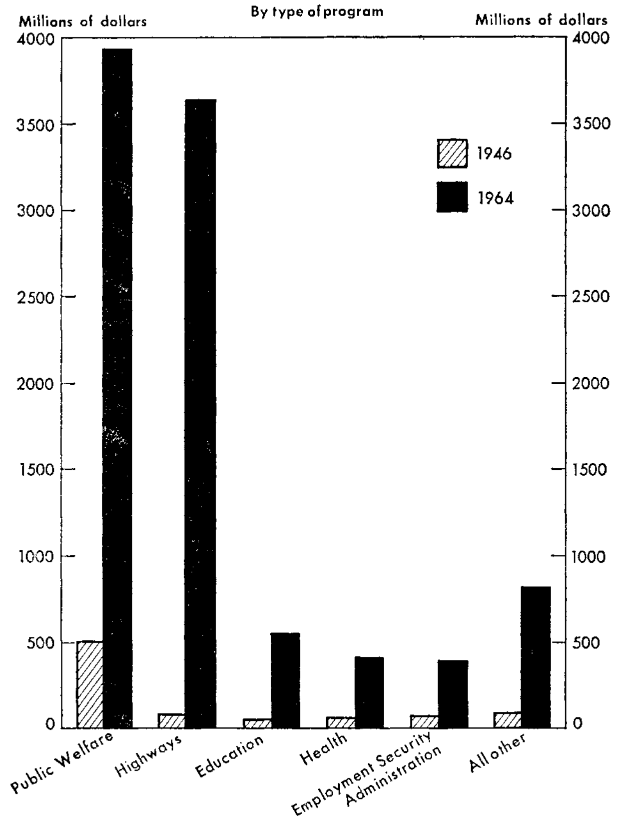
then by the restrictions on the issuance of new state debt that was imposed during the Korean war years.

In the aggregate, state and local government borrowing provided some $7.2 billion in funds during 1964, equivalent to about 12 per cent of the amount raised by taxation and other general revenues. In 1946, on the other hand, state and local governments reduced their outstanding debt. On a net basis, some amount has been borrowed by these governments in at least every other year of the postwar period, so that the rise in total state and local government debt outstanding since the end of World War II has been quite steady. Indeed, the amount of such debt has multiplied by almost six times, from $15.9 billion in 1946 to $92.2 billion in 1964. Interestingly, virtually all the debt incurred by state and local governments is long term. Short-term debt amounted to only 5 per cent of the total outstanding at the end of 1964.

Chart II

FEDERAL GRANTS-IN-AID TO STATE AND LOCAL GOVERNMENTS, FISCAL YEARS 1946 AND 1964

By type of program



Sources: United States Department of Health, Education, and Welfare, Trends (1964 Edition, Part I); Social Security Bulletin, June 1965.

FEDERAL GRANTS-IN-AID

In the face of the heavy demands placed upon state and local governments, the increase in their taxes and borrowing has been insufficient to prevent them from becoming gradually more dependent upon financial assistance from the Federal Government. The bulk of Federal assistance is provided by means of so-called "grants-in-aid" programs. These grants have been designed both to help implement programs of a general or national interest and also to provide relief for hard-pressed state and local governments. The amount of such grants has grown from a total of $844 million in 1946 to approximately $9.8 billion in 1964. In the latter year, this represented approximately 16.7 per cent of total taxes and other general revenues raised by state and local governments, compared with only 7.3 per cent in 1946. Grants to help support public welfare programs and to help build public roads and highways have shown the sharpest increase over the postwar years (see Chart II). These two types of grants together amounted to some $7.5 billion in 1964.

Financing available under present Federal grants-in-aid programs can generally be distinguished from one another with respect to two broad criteria—the way in which the actual Federal payments are allocated among states or localities, and the amount (if any) of "matching" funds which the state or local unit must agree to put with the Federal grants in order to carry out the over-all program. Allocation formulae are generally based on some index of "program need", with need typically measured by various population totals or subtotals of the state concerned. In some instances, the size of the Federal allocation is inversely related (at least in part) to the fiscal capacity of the state. As regards the matching of grants, the majority of current Federal programs require the same proportion of matching funds (typically 50 per cent) from each state or area, though there are some programs which permit poor states or areas to provide a smaller share than rich states.

While some type of allocation and matching funds formula applies to almost every one of the Federal grants-in-aid programs presently in operation, the exact combination of formulae associated with any particular program has been varied depending on the goals which the program is designed to achieve. Two types of goals are generally distinguished:

(1) **ATTEMPTS TO STIMULATE STATE AND LOCAL UNITS TO UNDERTAKE NEW, OR EXPAND EXISTING, SERVICES.** An example of this type of grant is the Federal Highway Program for the so-called "ABC System". This program under

which states can apply for assistance on building or rebuilding all their more important roads (and which should be distinguished from the Interstate Highway System) generally requires the states to raise matching funds equal to 50 per cent of the total cost of the roads to be constructed.[5] The allocation formulae, on the other hand, vary with the type of road built. Aid for primary roads, the most heavily traveled facilities, is based on a combination of three factors—the number of square miles, the population of the state, and the existing number of miles of rural postal routes in the state. Aid for secondary roads —somewhat more local ones—is based on an essentially similar three-criteria formula, while Federal grants for urban road extension projects, which take the primary and secondary systems into urban areas, are based entirely on urban population figures. Grants under the Highway Program thus take no account of the relative fiscal capacity of the area in which the roads are being built.

(2) ATTEMPTS TO EQUALIZE THE BENEFITS AND BURDENS OF PUBLIC EXPENDITURES AMONG STATES. Programs aimed at this goal are intended to help assure that a governmental function achieves a national minimum level, regardless of the limitations of any state or local area in its ability to finance such programs. This is accomplished either by gearing the Federal allocation inversely to some selected measure of a state's fiscal capacity or by requiring smaller matching funds in states which have only limited tax and fiscal resources. In either case, the "poor" states receive a proportionately larger share of Federal financial support for any given program. The fact that such a program incorporates an equalization feature, however, does not preclude the simultaneous use of other measures of program need in the distribution scheme. In such cases, the allocation formula might be rather complex, with the amount of funds granted varying directly with an index of program needs and inversely with an index of fiscal capacity. As an example, Federal grants for construction of waste treatment facilities are allotted to states according to the following formula: one half according to population, and one half according to per capita income.[6]

Equalization features of one sort or another have been incorporated in approximately one third of the Federal grants-in-aid programs enacted in recent years (the Education Bill of 1965 is an example). In aggregate amount, however, they still do not bulk large in the total of Federal grant programs, and they have generally been combined in any single program with an allocation scheme based on measures of program need. As of 1962, twenty-three of sixty Federal programs incorporated some equalization provision, while in dollar terms only 18.6 per cent of the total Federal grants was based on this concept.[7] Moreover, the concept itself continues to generate considerable Congressional debate. As stated by the Advisory Commission on Intergovernmental Relations:[8]

> . . . the question of equalization touches some of the more sensitive and debated issues involved in the operation of a federal system. This governmental system leaves primary responsibility for most civil functions of government with the States and, to the extent each determines, with local governments. However, since the adequacy of the job done by each State in the critical functions affects every other State and thus the Nation, the inability of some to do an adequate job in a key functional area is generally accepted as warrant for national concern and intercession. By the same token, the greater the relative deficiency in required fiscal resources, the greater should be the relative amount of national aid. However, while American philosophy of government recognizes national concern with the adequacy of State and local performance in services affecting the national strength and welfare, it also cherishes the concept of the independence of the State. It wants to defend each State's right to set its own expenditure program levels and to minimize State dependence on Federal aid. Inequalities in program levels among the States, even when dictated by unequal fiscal resources rather than free choice, tend to be treasured as a hallmark of local self-determination in operation.

Since a consensus has not been reached in favor of any particular form of Federal grant, it seems reasonable to expect that the present diversity in techniques will remain a feature of future Federal programs.

[5] States in which public land areas exceed 5 per cent of the total land area receive relatively larger Federal grants.

[6] A third possible category might be mentioned, namely, programs in which the Federal Government assumes the entire cost of a particular program. An example would be disaster relief from flood or storm damage. In dollar size, these programs are the smallest of the classifications.

[7] Advisory Commission on Intergovernmental Relations, *The Role of Equalization in Federal Grants* (January 1964), pp. 42-43.

[8] *Ibid.* p. 9.

THE FEDERAL TAX SHARING PROPOSAL

One of the more recent proposals concerning Federal grants to assist state and local governments in coping with their present unmet needs suggests that a portion of individual income tax receipts, presently collected by the Federal Government, be specifically earmarked and returned to the states. Unlike existing Federal programs, these funds would not be restricted to a specific function but distributed with no strings attached. Since Federal income tax receipts are more responsive to increases in aggregate economic activity than the sales and property taxes, which are the main sources of state and local revenues, this proposal makes it possible for the states to share more fully in the process of national economic growth than has been possible with their present sources of taxation. The case for the plan has been put as follows by a leading advocate, Walter W. Heller, former Chairman of the Council of Economic Advisers: "The supply of readily available federal revenue is rising faster than the demands on the federal purse, but the state-local situation is reversed—expenditure demands are rising faster than the readily available revenue supply."[9] While the immediate outlook for the adoption of this plan is problematical, it has been widely discussed and has attracted a great deal of interest on the part of state and local officials.

No firm figures have ever been mentioned publicly as to the amount of Federal funds that might be redistributed to the states under the Tax Sharing Proposal. One of the more significant features of the proposal is that the states would not be required to "match" the Federal grants and hence no additional pressures would be placed on presently strained state and local tax sources.

It was originally suggested that the Federal revenue be distributed among states according to population. Yet, because of the variety of allocation formulae currently used, ample precedent for any one of several possible distribution schemes might be cited, and some compromise arrangement may prove necessary to satisfy divergent state interests. Indeed, each of the features of this proposal—the amount to be apportioned among states, the basis of the distribution, and the "no strings" provision—is likely to pose problems difficult to resolve.

OUTLOOK FOR THE FUTURE

Regardless of the future of the Federal Tax Sharing Proposal, it seems reasonable to expect the Federal Government to continue, and probably to expand, its present participation in meeting certain costs of state and local government activities. A number of the programs associated with the "Great Society"—aid to education, the war on poverty, housing, and community redevelopment—already point in that direction. Despite their achievements to date, state and local governments will continue to face a wide variety of additional public needs. Obviously, problems of water and air pollution, overcrowded schools, and substandard recreation and housing facilities, as well as inadequate health care and hospital space, persist. In our vast and diversified country, these services can often be most efficiently provided only through programs run at the state and local level. Additional fiscal efforts by state and local authorities will certainly be required. Nonetheless, state and local tax structures appear inadequate now and in the future to provide fully for the range and quality of public goods and services demanded. Thus, the present challenge is to develop intergovernmental relationships that will enable state and local governments to carry out their vital role. Clearly, innovation and experimentation will be needed in future Federal-state cooperation and in planning and budgeting public programs if aggregate outlays on such programs are to result in maximum social benefit per dollar spent.

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[9] Walter W. Heller, "The Future of Our Fiscal System", *The Journal of Business* (July 1965), p. 240. A similar statement was made by Governor Anderson of Kansas in the *Saturday Review*, January 9, 1965, pp. 31-32.

Publications of the Federal Reserve Bank of New York

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