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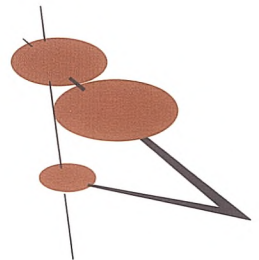
FEDERAL RESERVE BANK OF PHILADELPHIA

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In this issue

Financing the Inner City
Crisis in the State House
Crisis in the Household?



October 1969

Financing the Inner City

... Efforts to revitalize the inner city should be centered around the creation of more (and better) jobs and housing.

Crisis in the State House

... A fundamental disequilibrium exists between slow-growing state-government revenues and fast-growing expenditures.

Crisis in the Household?

... Household debt is enormous (\$420 billion) and rises almost 10 percent a year. Has it overstepped the limits of "safety"?

Editor: William Burke

Financing the Inner City

With a number of measures now before Congress, there has been no let up in the debate over the problems of the “inner city”—a term which increasingly has become synonymous with “ghetto” and a term which, in its human dimensions, increasingly has become synonymous with all the problems of the minority groups in the nation’s population. At all levels—national, state, and local—and in both the public and private sectors, more and more proposals have been designed to cope with and, hopefully, to eliminate, the many interrelated problems of the city: high rates of unemployment and underemployment, attendant low levels of income, inadequate housing, rising crime rates, a flight of capital, an eroding tax base, and a deteriorating social overhead (schools, hospitals, transportation facilities, and the like).

The nature and dimensions of these problems are recognized by the nation’s business community, including its financial institutions, and this recognition is being translated into positive programs aimed at providing jobs, housing, and the financing of “minority” businesses. This article will discuss some of these programs and assess a number of proposals designed to increase their effectiveness and to broaden thereby the attack on “ghetto” poverty.

Jobs . . . money . . . migration

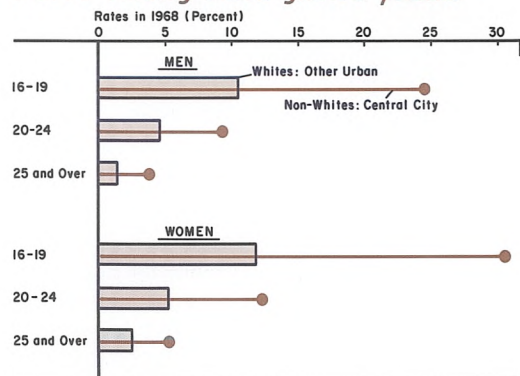
The problem of the inner city is, first and foremost, evident in high rates of unemployment and low levels of income among the growing minority population of the center city. “Minority population” means Blacks predominantly, but in many Western cities the term also encompasses large numbers of

Mexican-Americans, Orientals, and American Indians.

According to the National Commission on Urban Problems (the Douglas Commission), unemployment rates in ghetto areas consistently exceed, and by a significant margin, the unemployment rates of the metropolitan areas in which they are located. In the ghetto areas of Los Angeles, San Francisco, Oakland and Phoenix, for example, unemployed workers in 1966 accounted for 11 to 13 percent of the labor force—at least double the jobless rates in the corresponding metropolitan areas. Moreover, a recent Labor Department survey shows a 46-percent jobless rate for black teenagers in Los Angeles, as against a national unemployment rate of less than 3½ percent for all age categories.

Low incomes, a natural concomitant of unemployment, are still a basic characteristic of the ghettos, although the evidence indicates that the extent of poverty has declined significantly in recent years. (The basic measure is an annual family income of \$3,000 or less in terms of 1962 purchasing

Unemployment problem concentrated among black ghetto youths



power — almost \$3,600 in today's terms.) The number of persons subsisting at or below the poverty level dropped by one-third between 1959 and 1967, from 22 percent to 13 percent of the total population—quite truly “a remarkable but little noted achievement,” in the words of the Douglas Commission.

Even so, an estimated 18 million whites (10 percent of the total white population) and 7½ million non-whites (33 percent of the non-white population) still live in poverty today. These are not all city dwellers; in fact, one half of the poverty population, as against roughly one-third of the total population, live outside of the urban centers. But today's problem is intensified by the fact that increasing numbers of the white and non-white poor are migrating to the urban centers from the countryside.

In the West, the incidence of poverty is still relatively less than in other areas of the nation, as about 9 percent (just under 700,000) of the region's white families and 21 percent (or 146,000) of its non-white families live in poverty. But although the number of white families who live in poverty has fallen appreciably in recent years, the number of non-white families in the poverty group apparently has increased slightly. Generally, this reflects the fact that poverty-stricken non-whites (Blacks in particular) have accounted for a significant proportion of the net in-migration, and that the vast bulk of these migrants have made their new homes in urban areas.

In San Francisco, for example, the city's total population declined by about 26,000 (3 percent) between 1950 and 1968, due to a net out-migration of about 146,000 (21 percent) in the white population. The white population thus declined from 89 percent to 73 percent of the total population, in spite of a substantial increase in the number of Spanish-speaking white residents. But this

net reduction was accompanied by a 120,000 increase (147 percent) in the non-white population, which consequently rose from 12 percent to 27 percent of the total. Blacks accounted for two-thirds of this increase, and consequently increased their representation in the city's population from less than 3 percent in 1950 to at least 14 percent in 1968.

Throughout the West — which has relied upon in-migration for over 60 percent of its population growth since World War II—the number of Blacks and other minority groups with characteristically low incomes is likely to continue growing rapidly. By 1985, the non-white population in the West may approach 5 million—well over double the 1960 non-white population, although still only about 10 percent of the total population. By 1985, too, probably 90 percent or more of the non-white population will still reside in metropolitan areas—a 150-percent increase in actual numbers—and most of that increase will continue to take place in the inner cities, with all their problems of unemployment, low income and substandard housing.

Cause-effect: chicken-egg

But while the dimensions of urban poverty are easily discernible, and to some extent measurable as well, the precise chain of causality linking urban poverty with other manifestations of the “urban crisis” is very much a matter of dispute. This may help explain why the problem of the cities appears to be worsening rather than improving, in spite of the fact that the Federal government currently is spending 15 percent of its budget (\$28 billion) on various programs to ease the plight of the poor, while state-and-local governments are spending several billions more. It may also help explain why estimates of the cost of “rebuilding” the cities vary so considerably, ranging from \$65 billion to \$300 billion.

In analyzing the urban problem, some ob-

servers attribute most importance to the unavailability of credit to ghetto residents, or at least its unavailability at a "reasonable" cost and on "reasonable" terms. In particular, these observers argue that the failure of established financial institutions — commercial banks, savings-and-loan associations, and insurance companies—to make credit available in adequate amounts has placed the ghetto resident at the mercy of "gougers" and "loan sharks." Other observers, while recognizing the importance of the credit factor, place primary emphasis upon the ghettos' lack of a sound economic base—a base which may have been present at one time but which has since deteriorated for reasons only partly if at all related to the availability of credit.

The difficulty which ghetto residents have experienced in obtaining credit from institutional lenders obviously reflects the low and unstable levels of their incomes, and thus the difficulty they encounter in repaying debt. And when high levels of debt interact with low (and unstable) levels of income, the risk of delinquency and default naturally increases. Paradoxically too, the increased national concern for the plight of the ghetto poor sometimes tends to restrict even further the flow of credit to the ghetto, because of lenders' fears of the social opprobrium incurred whenever they are forced to "foreclose" or otherwise take legal recourse against minority borrowers who are in default. But whatever the reasons, ghetto residents typically have trouble obtaining credit when they want to buy a car, buy a house, or start a new business.

Credit scarcity

Consumer lending in the ghetto involves high risks. From the lender's viewpoint, consumer loans are costly, partly because of their small size and large overhead, and partly because of the banks' heavy loan-loss

experience with such loans. The typical financial institution, moreover, for public-relations reasons alone, might find it difficult to charge as high a rate as some minority-owned or interracial banks charge on their consumer loans. Furthermore, private financial institutions simply are not structured to take high risks; they do, after all, lend "other peoples' money," and must be concerned with the volume of high-risk loans they extend.

For much the same reasons, ghetto residents have found it difficult to obtain mortgage loans to purchase homes. The amount of money involved is vastly greater than for a consumer loan, and in addition, more evidence is required regarding permanency of employment, stability of income, and availability of sufficient savings for down-payments. But even where private lenders have been willing to make mortgage loans in high-risk ghetto areas, the Government itself (under Congressional mandate) has until recently pursued a policy of "redlining" economically depressed areas.

For much the same reasons, too, minority businessmen typically have found it difficult to obtain financing for new businesses from commercial lenders. The minority-owned firm typically lacks sufficient collateral and sufficient experience in handling business-loan applications—and, with all that, must deal with the difficult problem of operating in a small, uneconomic market. Quite understandably, minority groups own only about 2 percent of the nation's businesses, and generally not the more profitable ones, although they account for 15 percent of the nation's population.

The apparent outflow of capital from the central city may be explained by the opportunity which lenders have of making less risky and more profitable investments elsewhere. Cheaper suburban land, cheaper transportation facilities, more highly skilled labor, lower

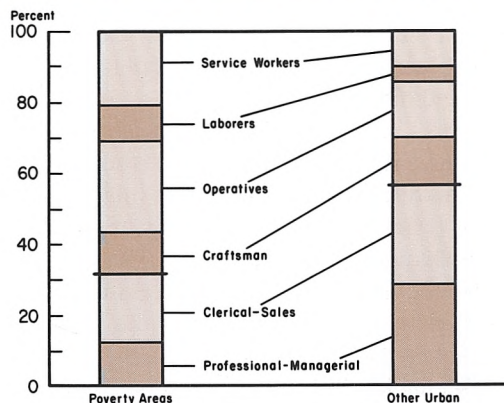
taxes, lower-cost insurance and, not least of all, rising incomes—all these ingredients of a viable economic base tend to enhance profit prospects and thereby enable the suburbs to attract a rapidly growing number of commercial, industrial, and service enterprises from the central cities.

Tax factors are crucially involved in these developments. Capital has tended to flow out of the central city, as noted above, because of the combination of higher taxes in the cities and generally lower taxes in the “ring” or suburban areas. In addition, ghetto slums and slumlordism tend to be perpetuated by local tax laws which penalize physical improvements and by the fast depreciation provisions of the Federal income tax laws. (The older and more decrepit the structure, the more rapid the depreciation.) The same end is served by the lack of income tax deductibility of special neighborhood assessments, which discourages improvements by home owners and, particularly in the ghettos, acts as one more impediment to home ownership.

Unresolved questions

On balance, therefore, a host of factors other than the availability of credit *per se* have contributed to the deterioration of the economic base of the inner cities. The exact causal relationships among these factors are not always clear, and it is precisely because of their complexity that remedial action is slow and difficult, particularly where this involves the changing of existing laws and social attitudes. Nevertheless, it is now generally recognized that neither the public nor the private sectors acting alone can do the job, and it is also clear that the revitalization of the cities requires more financing for the ghettos as well as more and better jobs for members of minority groups. But precisely what form the “partnership” between the public and private sectors should take, and

Poverty-area employment structure based on services, blue-collar jobs



the extent to which new financing arrangements should involve a modification of the constraints presently governing existing financial institutions — or the creation of entirely new institutions—are matters of considerable dispute.

How, specifically, can private, profit-oriented capital be lured back into the ghettos to provide more jobs, better housing, and more minority-owned businesses? Through subsidies? Guarantees? Tax incentives? Or through compulsion, with financial institutions required to allocate a given proportion of their funds to ghetto areas?

There remains, however, the basic issue of whether efforts to revitalize the ghettos should be integrationist or essentially segregationist. Should these efforts be aimed at improving mobility out of the ghettos? Or should they be aimed at subsidizing immobility within the ghettos in a deliberate effort to create a “separate but equal” environment in which minority groups can achieve their “identity,” but from which white capital will ultimately be excluded?

Solution: more and better jobs

In their capacity as employers, the various segments of the business community are attempting to provide some leverage with which

to attack the manifold problems of the ghetto. Thus, banks and other financial institutions have vigorously expanded their efforts to provide more jobs for minorities during the last several years. As one consequence, Blacks now account for about 10 percent of the commercial bank workforce, as against less than 2 percent in 1960, and a good part of the increase has occurred since 1966. (The proportion is somewhat higher—20 percent in some cases—in some of the large urban centers of the East.) These gains have been achieved in spite of banking's relatively stringent employment standards — standards which derive from the public-trust nature of banking activities—and in spite of the relatively high concentration of specialized “white collar” jobs in finance generally.

California commercial banks, particularly in Los Angeles and San Francisco, have recently developed a fairly large number of job opportunities for various minority groups. One large bank, for example, recorded an 11-percent increase in employment of minority personnel in 1968, as against a 2-percent gain in total employment; by mid-1969, therefore, Blacks accounted for 5 percent, and all other minority groups for 14 percent, of the bank's total workforce. Moreover, financial institutions have been relatively successful in providing jobs and on-the-job training for minority personnel once considered “hard-core” unemployables, as the turnover rate among these particular groups has been less than the average turnover for banks as a whole.

The urban investment program of the Life Insurance Association of America also attempts to provide expanded job opportunities in the inner city. Initiated in September 1967, the program has disbursed (or committed) over \$1 billion for housing and other job-creating projects in 227 separate cities in 42 states. In terms of jobs created and total funds disbursed, California ranks

first as a beneficiary of this program, but other Western states (especially Washington and Arizona) have also been major beneficiaries.

About three-quarters of the funds thus far disbursed have been used for the financing of low- and moderate-income housing and the remainder for various community services, such as a \$460,000 medical office building in the Watts area of Los Angeles. The industry believes, however, that a larger proportion of the program's second billion-dollar increment should be devoted to the difficult task of creating new jobs for core-area residents, on the grounds that the funds invested in job creation can produce significant “multiplier effects” which go far beyond the initial amounts invested.

Solution: more and better housing

The nature and dimensions of the inner city's housing problems have been amply documented by the reports of any number of public and privately sponsored commissions. According to the President's Committee on Urban Housing (headed by Western-builder Edgar Kaiser), almost 7 million housing units fail to meet minimum standards of health and decency—4 million have no indoor plumbing, while 3 million more are generally dilapidated. An additional 6 million units are overcrowded—seriously so in the rat-infested urban slums. Altogether, almost 8 million families need some form of housing assistance if they are to live in suitable housing and yet pay no more than one-fifth of their incomes for rent.

Moreover, according to the Douglas Commission, only about 500,000 public housing units have been produced over the last twenty years—despite the fact that Congress, in the Housing Act of 1949, called for the construction of over 800,000 units in a single six-year period. Over these two decades, in fact, demolition of substandard and dilapidated

housing by public action alone has destroyed more units than have been built under all Federally-aided programs.

But now, the Housing and Urban Development Act of 1968—far and away the most comprehensive legislation ever enacted in the field of housing—has called for the construction of 26 million housing units over the next ten years. This is nearly double the production of the previous decade. Furthermore, some 6 million of the new units are to involve some form of direct subsidy, such as supplemental rental payments, grants and loans for the rehabilitation of existing units, and below-market interest rates (as low as 1 percent, in some cases) on mortgage loans made to lower-income families.

Through the provision of below-market mortgage loans, the financial community has opened up one line of attack upon the inner city's housing problem. But it has opened up or expanded other avenues as well, so as to facilitate the flow of private credit into the financing of urban housing. FHA, for example, has considerably modified its restrictive practices to permit the insurance of mortgages in areas previously considered economically unsound, and last year's housing legislation called for the coverage of any losses which might result from the insuring of loans in such areas. However, Congress has not yet voted appropriations for this special-risk fund.

Government insurance is indeed critically important if private capital is to be lured into the rehabilitation of the urban slums, and many observers argue that an expansion of Government loan-insurance and loan-guarantee programs is the single most effective means of stepping up the flow of private capital into the ghettos. (New Jersey, for example, recently undertook a pilot program to guarantee personal loans made by private lenders to "disadvantaged" inner-city residents.) At the same time, some means will

have to be devised to simplify procedures for mortgage insurance and similar programs. In this regard, ways will have to be found to simplify local building codes, which now vary so widely from area to area as to hinder the application of uniform FHA insurance criteria. Then too, ways will have to be found to overcome artificial interest-rate ceilings, which have greatly restricted the flow of private credit into government-insured mortgages during the recent period of heavy credit demand.

Role of Western banks

Whatever the drawbacks, Western banks seem destined to play a major role in the financing of urban housing, simply because of their already active role in mortgage financing generally. At year-end 1968, Twelfth District banks allocated almost a third of their loan portfolios to mortgage loans and held almost a third of their mortgage loans in government-backed mortgages. In each case, the percentages were roughly double what they were at member banks elsewhere.

One major California bank — recognizing that "next to jobs, housing is the greatest need" — is now involved in making \$150 million in loans available to residents of economically depressed areas for the financing of single-family homes, multi-family units, and home improvements. To implement this objective, the bank has placed 100 specially trained officers in some 92 branch offices within "economically disadvantaged" areas, and has considerably modified the customary terms on which it makes these loans.

The bank will lend on single-family units with only two bedrooms, instead of three, as formerly, and with a total living space of only 750 square feet instead of the previously required 1,000 square feet. Besides, it is charging fewer "points" than are generally levied on such loans, and equally important, is making such loans on the basis of the pros-

pective buyer's current status rather than his past employment and credit records. But although the bank anticipates a 20-percent increase in staffing and supervision at the branches handling such loans, it still expects to make a profit on the overall operation.

The bank has solicited the services of some 100 organizations, including local neighborhood groups, to get prospective borrowers to apply for a loan, and has stepped-up its advertising through the media in Black, Spanish-speaking, and other minority communities. The program has been successful to date; in fact, the bank feels that the delinquency experience on these loans thus far has been "too low"—about one half the delinquency ratio on the bank's total mortgage portfolio.

Role of other lenders

The insurance companies, as noted previously, have allocated the vast bulk of their urban-investment funds to various housing programs. Generally, these funds have been placed in areas which the companies normally would not finance due to their poor location and high risk, but in no case have the loans carried a higher rate than is obtainable in less risky areas, and they have even carried below-market rates on many occasions.

To the greatest extent possible, the insurance companies work through minority brokers, and what is perhaps most important, they follow a policy of making funds available to inner-city residents for the purchase of homes outside of these areas. This policy facilitates a shift of populations from the inner city into the "transitional" areas and the suburbs, and thereby helps to break down the economic as well as the social delineations of the ghettos.

The nation's savings-and-loan associations, as well, have greatly expanded their efforts to provide financing for the "core areas" of the cities. From the national to the local level,

S&L trade organizations have widely publicized recent legislative programs to provide credit to lower- and middle-income groups. And, acting individually and in concert, growing numbers of S&L's have taken steps to help revitalize the inner city.

In the San Francisco Bay Area, the Bay Cities Savings and Loan League has formed a service corporation to originate loans within the core areas of the larger metropolitan complex. One fairly large association, besides participating in the service corporation, has also committed over \$3 million to help finance a several-hundred-unit middle-income rental and townhouse development in Oakland. Another medium-sized association, headquartered in a lower-middle income area of San Francisco with a heavy minority population, has handled the permanent financing of a project which involves the conversion of an old San Francisco hotel into a HUD-subsidized rental development for elderly persons. A Seattle savings-and-loan association meanwhile has undertaken both the interim and the permanent financing of a 150-unit inner-city development, which it will lease to local authorities with a purchase option. In addition, the Federal Home Loan Bank is now processing the first three "inner city" S&L applications—two of them for branches in Watts and a blighted area of East Los Angeles.

Projects such as these reflect the financial community's conviction that good housing, and particularly home ownership, is one of the most important factors needed to improve the quality of life for the economically disadvantaged. This conviction has translated itself into a number of specific proposals aimed at increasing the flow of private funds into housing generally, and into the inner city in particular.

One such proposal calls for private lending organizations to work together as a group in the Model Cities program, right down to

the neighborhood level, in order to avoid duplication or misdirection of effort. Group action—including action through “umbrella organizations” such as the National Alliance of Businessmen, the Urban Coalition, Urban America, or the National Urban League—may also make it possible to pool or coordinate specialized skills, such as loan packaging, with a considerable saving of time, effort, and hence expense.

Group action, of course, is not without its hazards. However good their intentions, the civic groups and non-profit organizations which have become increasingly active in ghetto programs are not always themselves able to offer the many and varied technical skills necessary for a successful solution of complex home-financing and home-building problems. The professional lender, moreover, to whom time itself is a precious (and expensive) commodity, and whose margin of tolerance for “bureaucratic” or “unbusinesslike” procedures is thin to begin with, may find it somewhat frustrating to deal with civic-minded but essentially unskilled organizations.

Expanding mortgage flows

At any rate, mortgage-lending institutions have recommended a number of changes in existing regulations to permit a greater flow of credit to the ghettos. One such proposal would increase their ability to take equity positions in urban projects, inasmuch as both banks and S&L's are now severely restricted in the extent to which they can directly engage in equity financing. (Federally-chartered S&L's, for example, may place only 2 percent of their assets in urban renewal areas). Another proposal would lengthen permissible loan maturities from 30 to perhaps 50 years, in order to reduce monthly payments and thus ease the burden of home financing on low-income groups.

Similar results would be achieved by an increase in permissible loan ratios—the ratio

of the loan to the value of the property financed—and by an increase in the (10 percent) limit on the proportion of assets which can be placed in apartment-house financing. For its part, the Home Loan Bank Board recently announced that it will make ten-year fixed-rate advances to member S&L's undertaking the financing of HUD-approved low- and moderate-income housing projects.

One proposal would involve placing public funds in institutions which are actively engaged in the financing of low- and moderate-income housing programs. Another proposal would involve placing U.S. Treasury tax and loan accounts with commercial banks engaged in urban financing, although these deposits fail to represent the stable longer-term funds which lending institutions typically commit to long-term investments. Yet another suggestion would permit banks in ghetto areas to pay higher-than-normal rates on savings deposits in order to attract loanable funds, even though this could distort the already high cost structures of many ghetto banks.

Private financial institutions almost unanimously support the Housing Act provision which calls for financial counseling and guidance of families who undertake the responsibilities of home ownership, including guidance and counseling in the important area of consumer borrowing. Spokesmen for every major institutional lender emphasize the desirability of such a program to assure the success of the other measures aimed at broadening home-ownership.

Still other proposals are quite controversial, including the increasing demands from a number of quarters that the Federal Reserve implement its Congressionally-conferred authority to “help housing” by purchasing the obligations of the Federal Home Loan Bank. However, the exercise of this authority at the present time would be inconsistent with the general policy of mone-

tary restraint and would tend to help one particular sector at the expense of other sectors of the economy.

More than that, such a move could well be self-defeating. The amount of support operations involved would have to be massive in order to prevent mortgage borrowing costs from rising, while the larger amount of off-setting Treasury issues which the Federal Reserve would have to sell in order to pursue its general restraint policy would be so great as to cause a sharp rise in Treasury yields. Investor funds would then tend to shift from thrift institutions—that is, mortgage-lending institutions—to those investments paying higher yields.

Finally, there remains the fundamental problem of providing more and better housing in the face of rapidly rising costs. Between 1961 and 1968, housing construction costs rose by almost 40 percent in the nation as a whole, while the price of land jumped even faster in areas of heavy population concentration. Altogether, the financing of the 26 million housing units called for in the 1968 Housing Act could require almost \$400 billion at today's prices, even with a mortgage loan of only \$15,000 per unit.

In view of the basic strength of housing demand, along with such recent developments as the rent-supplement and interest-rate subsidy programs, prices might rise sufficiently to offset the anticipated economies in home construction resulting from mass production of "factory-built" homes. For that reason, much may depend upon the success of HUD's recently launched "Operation Breakthrough," which is designed to stimulate private builders to develop industrial techniques appropriate for the volume production of low-cost housing.

Solution: more entrepreneurs

In another basic approach, financial institutions are trying to overcome the problem of

urban poverty by financing minority enterprises of one type or another. They frequently coordinate their efforts with the Small Business Administration's "Project Own," which has as its goal the formation of about 20,000 new minority-owned-and-operated businesses annually by the end of fiscal 1970. Under "Project Own"—recently renamed "Operation Business Mainstream"—the SBA guarantees, up to 90 percent, the loans extended to minority businessmen by commercial banks and other private lenders.

The SBA's "Minority Entrepreneurship Teams" offer managerial assistance to shepherd minority loan applicants through the "red tape" involved in the processing of loan applications, since applicants oftentimes have



little or no familiarity with such matters as basic accounting procedures or the provision of collateral. For their part, participating banks have managed to cut paperwork to a minimum, reducing the processing time for a typical minority loan to about ten days.

In fiscal 1969, SBA made or guaranteed over 4,300 minority loans, totaling \$101 million—triple the level of any earlier year. (California was typical in this regard, with 360 loans and \$8½ million in allocated funds.) To date, however, losses on "Project Own" loans have been fairly high (over 15 percent), and for this reason, SBA has generally avoided the financing of very small high-risk operations, such as the typical corner grocery, beauty parlor, or carry-out food store.

Increasing numbers of commercial banks have participated in SBA programs, and have also initiated their own programs to make more credit available to minority borrowers. In both San Francisco and Los Angeles, for example, the largest clearinghouse banks have set up non-profit organizations to make the type of minority loans which individual banks normally can not make because of the risks involved and the constraints imposed by bank-examination standards. Funds are obtained from participating banks at the prime rate, and are then re-lent to minority borrowers at a somewhat higher rate.

In some cases, the loans made by these organizations provide in effect the 15 percent "equity capital" which the borrowers are expected to put up in order to qualify for an SBA loan. Although these organizations will consider financing small-scale operations, such as a "Ma and Pa" grocery store, they hope to encourage the development of enterprises with generally brighter prospects — firms which will be capable of producing goods and services marketable in areas other than the ghetto.

These non-profit groups, like the SBA itself, place great stress upon their management-assistance and counseling functions, whereby they solicit the voluntary services of specialists in a number of different fields to help minority entrepreneurs set up new enterprises. In the future, these organizations plan to undertake regular training programs for people under 40 years of age who are interested in starting up their own businesses or in assuming managerial positions in existing firms. To do this, however, they will have to tap a much larger reservoir of loanable funds than is now available — perhaps through grants and loans from private and public agencies, or through sales of bonds supported by collateral in their own loan portfolios.

New banking approaches?

An expansion in the number of minority-owned commercial banks is yet another means of increasing the flow of credit into the ghettos. However, the overall performance of the 50 or so Negro banks in the nation is "not particularly promising," in the words of Federal Reserve Governor Brimmer. These banks as a group have failed to turn a profit (after taxes) in the last three years, faced as they are with severe staffing problems and difficult cost problems. Their costs reflect the small average size of their deposit and loan accounts, their high proportion of interest-bearing to total deposits, and their relatively high loan losses.

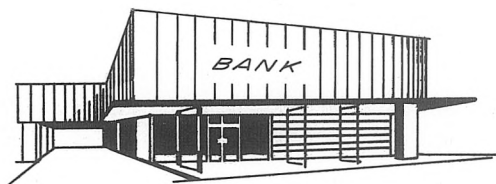
Ultimately of course, the problems of the minority banks reflect the problems of the economically depressed markets in which they are located, which helps explain why new minority-owned banks have experienced greater operating difficulty than new banks generally. But there are exceptions, including the two minority-owned banks — one Black, the other Mexican-American — presently operating in Los Angeles.

Given the high start-up costs of a new bank, the most efficient means of bringing credit into a ghetto community is probably through the vehicle of branching by existing banks. Indeed, in this respect, the large Western branch banks appear to provide distinctly better services than their unit counterparts elsewhere in the nation. (In Chicago, where branch banking is prohibited, some nine wards with an average population of 70,000 each are deprived of banking services, while another eleven wards are served by only one bank office each.) Unit banks, moreover, can not be net suppliers of funds to the areas which they serve because their deposits necessarily must exceed their loans. Unit banks — unlike individual branch offices — can not lend more than they receive in de-

posits, and even then, a substantial portion of their funds must be allocated to reserves and to investments, out of deference to liquidity requirements.

Another proposal in the field of ghetto financing would permit nationally chartered banks to invest in the stock of inner-city banks, while another would permit them to take equity positions in ghetto businesses, just as some banks now do abroad through so-called Edge-Act corporations. (As Governor Brimmer has asked, if banks can assist in the equity financing of businesses abroad, why not in the financing of domestic businesses as well?) Other proposals would extend Federal insurance to the note and debenture issues of ghetto banks, and perhaps also raise the present limit on deposits covered by insurance, to permit these institutions to compete more vigorously for funds. Still other proposals would provide tax credits to depositors who maintain their funds in ghetto banks, and would provide a wide range of tax incentives to banks and firms which set up operations in ghetto areas.

However, while tax incentives have the advantage of minimizing direct governmental intervention in the market, the difficulties of applying such incentives to those particular aspects of corporate operations which are conducted in a ghetto area may be quite formidable. Financial institutions, moreover, are not likely to allocate a given percentage of their funds to urban areas unless the prospective investments, in the last analysis, appear profitable.



New institutions?

In view of considerations such as these, many observers argue that new institutions are needed to increase the flow of credit into the ghettos. For example, Congress is now considering the creation of a National Development Bank, with resources of \$1 billion or more, to guarantee and make loans to local Community Development Banks, which in turn would work closely with local development corporations to finance minority-owned businesses and other enterprises in urban slum areas.

After their initial honeymoon period, however, new lending institutions would be faced with the problem of competing with established institutions, not only for a given aggregate supply of loanable funds, but also for the already scarce supply of personnel trained in specialized lending fields. In short, there is a very real question whether new institutions could raise funds for ghetto financing more cheaply and more easily than existing institutions, or whether they are more likely to reshuffle the existing supply of funds at a possibly higher net cost.

There would also be the problem of determining just which areas are to receive priority in setting up local development banks and corporations. Over 32 organizations, for example, are now involved in rehabilitating the Watts area of Los Angeles, and the problems attendant to this multiplicity of organizations help explain why some private businesses hesitate to involve themselves in the area. In addition, there would be the problem of determining the distribution of decision-making power among the interested parties at the national and local levels. This is exemplified by the difficulties encountered by the Office of Minority Business Opportunity, which has the task of coordinating the 116 economic-development programs currently being administered by some 21 Federal agencies.

Age-old solution: more jobs

In assessing the prospects for an expansion of minority enterprises, political and economic leaders must decide whether that objective is really as essential as others, such as the creation of new jobs. If, because of the high cost of land, inadequate transportation, high crime rates, high taxes, and so on, the inner-city area is basically less efficient and less viable than alternative locations, then funds spent in inducing firms to locate in ghetto areas might better be spent in training residents for jobs outside of the ghetto.

Job skills and an attendant earning power presumably are more important to the ghetto resident than the location of his job, and the mere injection of capital to create minority-owned businesses where there are no complementary resources is not likely to revitalize the urban slums on anything approaching a lasting basis. As NAACP head Roy Wilkins has observed, unless the ghettos are transformed from residential areas into industrial complexes (which may not be economically feasible), most of the jobs held by minority workers will of necessity have to be outside of the ghetto.

Consequently, many observers believe that measures to cope with the urban problem should concentrate first and foremost on jobs (including jobs outside of the ghetto) and secondly upon housing, rather than upon creating a new class of minority entrepreneurs. These individuals, like their non-minority counterparts, must increasingly deal with problems of technological change and economies of scale, which generally work to the advantage of the larger firms. In order to survive, the minority businessman must, above all, make profits, and making profits is a prerequisite to providing employment for

his minority neighbors. Otherwise, "Black Capitalism" could easily become synonymous with a situation of marginal profits, bankruptcy, and attendant disillusionment.

Even if the number of minority entrepreneurs were to be vastly expanded, moreover, the aggregate effect upon employment and income in the ghetto areas probably would not be very great. Indeed, a 2-percent increase in employment and wages of ghetto residents could well have a much greater effect upon the overall quality of urban life than would a 100 percent increase in the numbers, and the profits, of minority entrepreneurs.

To repeat, the efforts to revitalize the inner city may perhaps best be concentrated in the creation of more and better jobs and more and better housing and to a relatively lesser extent in the creation of a class of minority entrepreneurs. But an improved urban social overhead also is critically important — better schools (including trade schools), parks, transportation facilities, and so on. In this connection, the substantial dimensions of the municipal-bond portfolios of the nation's private financial institutions is clear evidence that these institutions will play a major role in financing the social overhead of a refurbished urban environment.

The problem is indeed critical, the outlook certainly not cause for unrelieved optimism. But in the words of Federal Reserve Governor Maisel, "any problem which has defied solution for over 100 years—and that is true of our cities' poverty areas—won't suddenly succumb to another try. Still, each new effort does move us closer to our ultimate goal. Progress is being made. The task we all must share is to further its momentum."

Verle Johnston

Crisis in the State House

“Governments must have revenues in increasing amounts, not because they are corrupt or inefficient, which can be remedied, but because the social needs of education, ethics, morality, art, liberty, protection of the weak, highways, health, and recreation grow faster in an improving civilization than do private needs for food, luxuries and private ostentation.”

—John R. Commons

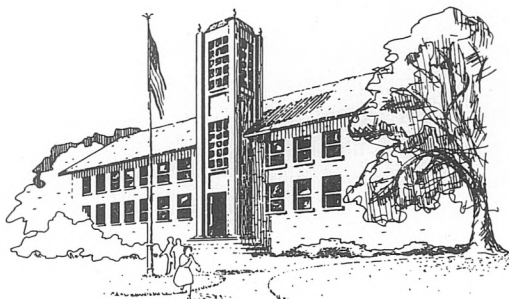
State expenditures for general government have increased almost fivefold over the past two decades, from \$10.4 billion in 1948 to \$60.4 billion in 1968. (General government encompasses all state revenues and expenditures except those arising from business-type enterprises, such as state-operated liquor stores and insurance trust funds.) This rapid growth in basic civil services has accompanied a 36-percent increase in U.S. population and a 166-percent growth in the nation's total production of goods and services. The upsurge in states' expenditures has helped the public sector as a whole to double its share of the national economy, as total state-and-local government purchases have jumped from 6 to almost 12 percent of GNP over this time-span.

Growth in state-government expenditures has been financed in three different ways: about one-third from prosperity-induced increases in the yield of traditional state-revenue sources, one-third from new taxes and increased rates on old taxes, and about one-third from very sharp increases in both state debt and Federal Government assistance. The increased importance of Washington's role in state-government finance can be seen from the fact that the U.S. Treasury provided 25 cents out of every dollar of state general government expenditures in 1968, compared to about 13 cents in 1948.

State budget planners have recognized for some time that an imbalance exists between growth in state general revenues and growth in state expenditure commitments. The dimensions of this imbalance are difficult to define with precision. In the absence of new taxes or higher rates on existing taxes, however, it appears that general revenues from the states' own revenue sources would grow only a little over half as fast as the states' expenditure commitments. Significant differences exist among the fifty states, and especially among the nine Western states, but fiscal imbalance in an important degree is virtually universal.

Sources of expenditure growth

Most of the expansion in state expenditures has occurred in traditional public functions rather than in new areas of governmental activity—notably in education, high-



ways and transport facilities, health and hospitals, protection, public welfare, and general administration. While the categories of civil functions have remained the same, their character and content have changed radically over the years, and in many instances the services offered today simply did not exist twenty years ago. Accelerated urbanization of an increasingly affluent and mobile population, a substantial (15-percent) increase in the relative size of the dependent population, and rapid changes in technology have spawned new human wants and needs which are reflected in the growing array of services now offered.

Children today are a larger proportion of our total population, and a larger percentage of them go to school, for more years, to receive instruction which requires more complex plant and equipment and more highly trained teachers. Thus, outlays for education, especially higher education, have risen sharply. Medical science has increased life expectancy and thereby the number of elderly people, and it has also expanded the range of medical services which can be provided. Moreover, the evolution of American values has elevated comprehensive medical care for the aged and the infirm to the level of a basic human right, and has helped shift the responsibility for insuring this right from private families to the public sector.

Affluence and the desire for greater mobility have created the "automobile society," and this society has called into existence a network of superhighways which bear little resemblance to the city streets or rural roads of twenty years ago. The transfer of a large portion of freight traffic from private rail to public road has further accelerated the demand for more, bigger, and more efficient highways. In turn, auto-generated congestion and pollution have created demands for new and expanded public-transit systems which are something more than the collection of fuming, rattling buses and the maze

of tracks and overhead trolley wires of the past.

Higher densities of a more affluent and leisure-oriented population have sparked popular demands for expanded public-recreation facilities, greater protection for property, and increased law-enforcement activity to settle the more frequent conflicts which arise from close human proximity. In addition, greater population density, together with higher standards of public health and new technology, have created demands for expanded (and in many cases altogether different) public-health services.

State governments share the responsibility for many of these functions with some 80,000 local governments which are often in even more severe financial straits than the states themselves. Ultimately, however, local-government fiscal problems are the responsibility of their parent states, because the state-local relationship is one between sovereign state governments and dependent local units. (This legal dependency, which is recognized in all fifty states, is called "Dillon's Rule" after the Iowa Supreme Court Justice who promulgated the doctrine a century ago.) In contrast, the federal-state relationship is one between sovereign governments with separate powers and responsibilities reserved to each under the U.S. Constitution.

Unless the states take seriously their powers over local governments, they surrender their major responsibilities for civil government, and with it, their most significant role in the American federal system. Hence, when we speak of "financial crisis in the state-house," we are really referring to fiscal problems associated with the broad range of civil functions.

Income elasticity

In evaluating the imbalance in state fiscal systems, it is convenient to examine the

growth of general revenues and expenditures in the context of growth in the overall level of economic activity. For this purpose, economists have devised the concept of "income elasticity."

The amount of revenue which any tax yields is determined first by the size of the base upon which the tax is levied, and second by the statutory tax rate applied to that base. In the absence of an increase in statutory tax rates or a broadening of the tax base, tax collections increase in a growing economy because of the expansion of the base, whether it be income, expenditures, or total wealth.

The rate at which the yield of a tax grows over time depends upon economic growth, of course, but also upon the responsiveness of the tax base to economic growth. (It depends, too, upon changes in efficiency of tax administration and upon the variable structure of the tax with respect to its base.) The responsiveness of tax yield to growth is called the income elasticity of tax revenue. A tax is said to be income-elastic or income-inelastic depending upon whether revenue increases by more than one percent, or by less than one percent, respectively, when income (GNP) increases by just one percent.

The relation between income (GNP) and government expenditures is not as direct and mechanical as the relation between income and government revenue, but it exists nonetheless. The expansion of most government services occurs in response to consumer demands which are directly related to income—for example, outlays for schools, highways, and the protection of property. A few other demands on government arise from the perception of income differences. In either case, it is meaningful to speak of the income elasticity of government expenditures and to contrast such figures with the analogous revenue relationships.

Elasticity of revenues

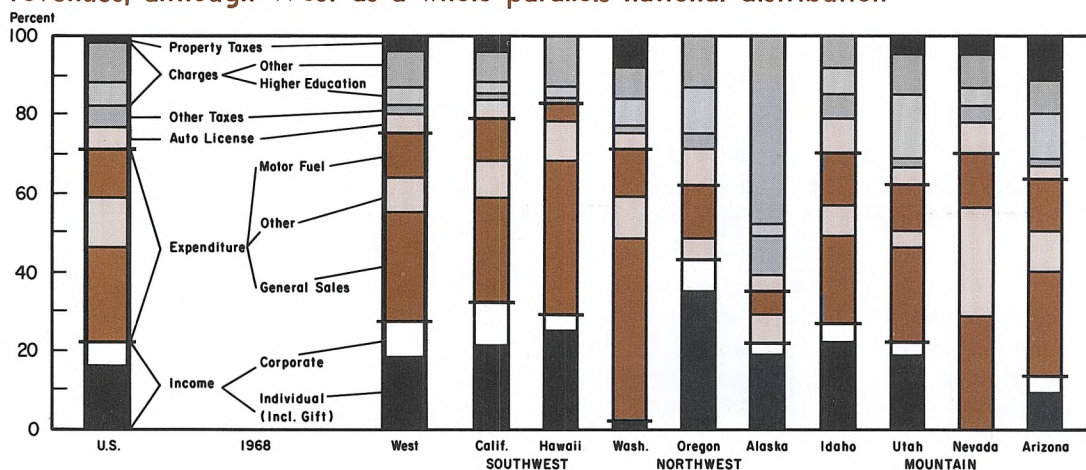
Income elasticities of individual revenue sources and expenditure commitments vary widely, and the relative weights of different items in a state's total fiscal structure thus determine the elasticity of its *total* expenditures and the elasticity of its *total* revenues. These elasticities ideally are approximately equal, so that economic growth automatically produces revenues to finance the required expansion in government services. In practice, however, some differences always do exist.

These differences cause little difficulty as long as minor rate adjustments will compensate for them. In the postwar period, however, most state governments have not found such adjustments to be sufficiently compensatory: existing revenue sources have consistently failed to yield adequate revenues to finance expanded services, and higher rates and new taxes have become necessary to make up the short-fall.

Rough estimates of total revenue elasticity in individual Western states can be calculated from national estimates of the elasticity of various revenue sources, developed from 1958-68 data compiled by the Advisory Commission on Intergovernmental Relations (ACIR), and from 1968 Census data showing the state-by-state distribution of income from different revenue sources. According to these computations, revenue elasticities in individual Western states invariably are close to unity, which suggests that the yield from existing revenue systems tends to increase at approximately the same rate as income (GNP).

Within the present structure of state revenue systems, the rigidity of inelastic revenue sources just about offsets the flexibility which otherwise would result from elastic revenue measures. Only about one-third of total state general revenues comes from revenue sources with an elasticity greater than

Individual state governments show wide differences in pattern of revenues, although West as a whole parallels national distribution



one, according to the ACIR's medium estimates of income elasticity. These sources include direct taxes on income (individual and corporation income taxes, and death and gift taxes) and certain user charges (higher education, hospital fees, and natural resources fees). On the other hand, about one-half of total general revenue comes from sources which are less responsive to income changes—ranging from the tobacco excise, with an elasticity of only 0.35, to the general sales tax, with an elasticity of roughly unity. This heavy reliance on revenue sources characterized by low elasticity is a structural handicap as the states attempt to provide more efficient and effective services.

Western variations

Individual Western states vary widely with respect to their reliance on specific revenue sources which, with the method of estimation used here, determine the value of their respective total revenue elasticities. Nevada and Washington had no individual or corporation income tax in 1968, and Arizona derived only 12 percent of its revenues from direct taxes on income, while Oregon obtained 40 percent of its total general revenues from these sources. In the remaining

Western states, taxes on income yielded one-fifth to one-third of general revenues.

Low income-tax states ordinarily rely heavily on expenditure taxes to finance general government. In 1968, Nevada and Washington both obtained over two-thirds of their general revenues from taxes on consumer outlays, while Oregon, with its highly productive income tax, obtained only one-fifth of its revenue from expenditure levies. Alaska meanwhile was in a class by itself. Its combined receipts from income and expenditure taxes totaled only 35 percent of internally generated revenues, but its charges and miscellaneous revenues (mostly rents and royalties) amounted to 50 percent of general revenues.

Elastic . . . inelastic

Direct taxes on income typically are income elastic, because they have an element of progressivity built into their rate structure. Even if statutory rates were proportional, exclusions from the taxable income base would insure at least mild progressivity in the *effective* rate structure. "Progressivity" means that persons with higher incomes not only pay more tax than persons with lower incomes, but they also pay a larger *percentage* of their

total income in tax than do lower-income taxpayers.

Therefore, a one-percent increase in national, state, or local income automatically yields more than a one-percent increase in revenue from progressive taxes as persons are shifted into higher tax brackets. This accounts for the enormous productivity of the Federal revenue structure, which derives about three-fourths of its total receipts (excluding trust funds) from direct taxes on income.

Taxes on general consumer expenditures (sales and use taxes), on the other hand, tend to be inelastic with respect to income growth, because the proportion of total income saved is greater at higher income levels. Taxes on specific consumer expenditures (excises) are frequently inelastic, because the demand for these items does not grow proportionately with an individual's income.

Moreover, many of the major excise taxes—those on motor fuels, tobacco products, and alcoholic beverages—are levied as a fixed amount per unit of purchase, rather than as a fixed percentage of the price of the purchase, and as a result their yields do not automatically increase with inflation as ad valorem taxes do.

The elasticity of revenues from user charges, the third major revenue category, varies considerably depending upon the income elasticity of demand for the particular service for which the charge is made—that is, upon whether the quantity of the service demanded increases more or less than in proportion to an increase in income. For example, the elasticity of auto-registration fees is low, while the elasticities of higher-education fees and hospital fees are relatively high. User charges with high income elasticities generally are associated with “economic luxuries”—that is, items which are relatively more important in the budgets of higher-income groups.

Altogether, the elasticity of state general revenues in the period covered in the foregoing analysis ranged downward from 1.14 and 1.10 in the high income-tax states of Oregon and Utah, respectively, to 0.87 and 0.82 in the low income-tax states of Washington and Nevada, respectively. The West as a whole recorded a total revenue elasticity of 1.00, compared with a national average of 0.96; in other words, the average Western state was in just about the same fiscal position as the average state elsewhere in the nation with respect to automatic revenue growth.

Elasticity of expenditures

On the expenditure side of the budget, the situation is quite different. Both regionally and nationally, state-government expenditures in the 1958-68 period were quite elastic with respect to income growth. For example, the elasticity of education expenditures was 2.82 for the nation and 2.33 for the West, and the corresponding figures for public-welfare expenditures were 1.96 and 3.13, respectively. (These two budget items account for over half of the average state's outlays for general government.) The elasticity of debt-interest expenditures was 2.41 for the nation and 5.62 for the West, reflecting the fact that the growth of general revenues has not kept pace with the growth of state expenditures.

INCOME ELASTICITIES—STATE GOVERNMENT REVENUES AND EXPENDITURES

Area	Revenue Elasticity	Expenditure Elasticity
United States	.96	1.90
Twelfth District	1.00	2.35
Alaska	.88	9.12
Arizona	.97	2.87
California	1.01	2.41
Hawaii	1.08	1.30
Idaho	.99	1.76
Nevada	.82	2.53
Oregon	1.14	1.93
Utah	1.10	2.95
Washington	.87	1.62

Source: Federal Reserve Bank of San Francisco

In almost every expenditure category, the average elasticity of expenditures was higher for the West than for the rest of the nation. In those Western states where highly elastic expenditure categories accounted for a disproportionately large share of total state expenditures, the elasticity of total expenditures was considerably above the national figure. This was true of Utah (2.95), Arizona (2.87) and California (2.41), which recorded figures well above the national average of 1.90.

Expenditure elasticities of course are merely illustrative of the behavior of state expenditures during the last decade. They describe behavioral tendencies, not automatic responses to increases in income. But they are useful, notwithstanding this limitation, because they add a quantitative dimension to our understanding of structural disequilibrium within the states' fiscal systems.

Response to disequilibrium: taxes

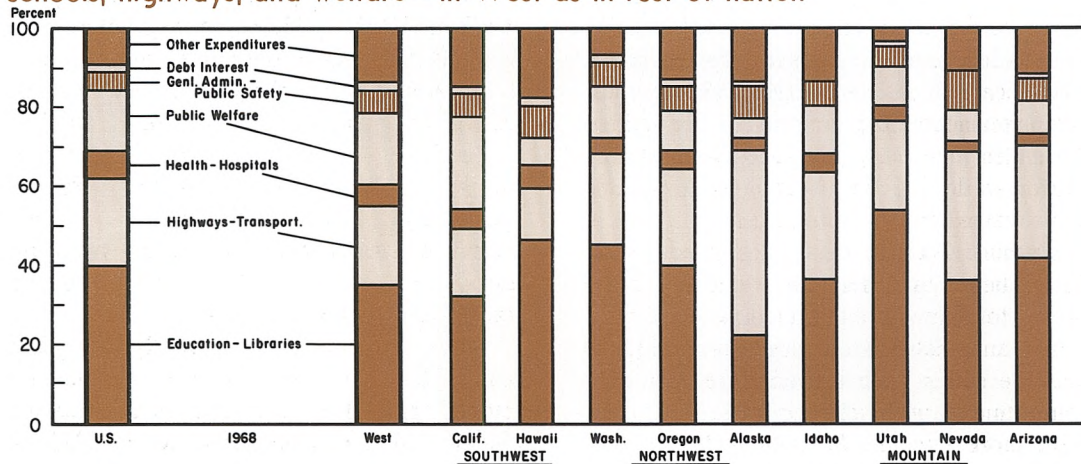
The states obviously could not continue indefinitely with general expenditures growing roughly twice as fast as general revenues. To fill the widening gap in their budgets, state legislators have (1) enacted new taxes and raised the rates on existing revenue

measures, (2) stepped up their demands on the Federal Treasury for assistance, and (3) resorted more often to deficit finance. The foregoing analysis suggests, however, that none of these responses has provided a long-run solution to the structural problem which created and helps perpetuate the budget gap.

State efforts to deal effectively with their fiscal problems through new tax legislation are caught in a cross fire between the voting public's steadily rising demands for new expenditures and its ever more strident complaints against high taxes. Attempts to overhaul the local revenue system often are hamstrung by state constitutional restrictions, by fears of interstate tax competition, and by the dubious notion that the Federal Government has pre-empted the most elastic and productive revenue source, the individual income tax.

Even though all taxes are ultimately paid out of income, there is strong political opposition to pyramiding direct income levies at various levels of government. As a result, even those states with a history of income taxation still apply relatively modest rates. Last year, for example, the effective income-tax rate in the nation as a whole was only

State-government budgets dominated by fast-growing sectors—schools, highways, and welfare—in West as in rest of nation



1.7 percent at the state level — as against 10.4 percent at the Federal level — for a family of four with \$10,000 annual income.

Failure to exploit more elastic tax sources has meant greater pressure on regressive tax levies on real property and consumer expenditures — that is, levies that tend to take a less-than-proportional bite out of income as income rises. Thus, over the past decade, the various state legislatures passed 252 separate rate increases in general sales taxes, motor-fuel taxes, or liquor and cigarette excises, but posted only 38 rate increases in individual and corporate income taxes. (The cigarette excise alone, whose estimated elasticity is only 0.35, went up 99 separate times during this period.) In 1959, 22 states levied general sales taxes, but in no case was the rate higher than 3 percent. By 1969, however, 45 states levied sales taxes—20 of them at rates of 4 percent or more, and 6 of them at rates of 5 percent or more.

In the absence of new legislation, elastic revenue sources would automatically assume a greater importance in the states' total revenue structure by virtue of the fact that their yield increases more rapidly than that of less elastic revenue sources. But with the almost continual introduction of new low-elasticity taxes and the increases in the rates on existing ones, the importance of inelastic revenue sources has remained almost stable over the past decade. In 1968 as in 1958, expenditure taxes accounted for roughly one-half of the states' internally generated general revenues, while individual and corporate income taxes, which should have grown in importance because of their high elasticity, did no better than maintain a one-fifth share of the total in both years. This stability of elastic and inelastic revenue shares suggests that the states have met rising expenditure commitments with stop-gap measures which yield more revenue, but which do not pro-

vide permanent solutions to the basic problem of fiscal imbalance.

Response to disequilibrium: grants

The second line of attack on the budget gap, increased Federal assistance, has not been any more successful than increased taxation in solving the states' long-run fiscal problems. Federal assistance is provided in the form of individual grants-in-aid for specific projects or governmental functions. To date, it has not addressed the more generalized need for automatic revenue growth at the state and local levels.

Grants are subject to a variety of conditions set forth in statutory authorizations, and they typically require matching funds from the recipient jurisdictions on a fixed or variable basis. Although administering agencies may attempt some interjurisdictional equalization by adjusting for population growth, per capita income, or local fiscal effort when calculating variable Federal-state funding ratios, the priority which Congress assigns to the particular activity in question ultimately determines the overall limits of the Federal subsidy.

These characteristics of Federal grant assistance have been accentuated in recent years by the accelerated proliferation and categorization of programs. According to 1967 ACIR data, 379 separate grant authorizations were then operating, administered by groups with such widely varied interests as the Department of Agriculture, the Department of the Army, and the Department of Health, Education and Welfare. Project grants have grown in preference to functional grants, further contributing to the increase in the total number of programs and the variety of matching ratios.

State governments frequently complain about the "strings" attached to Federal money, and also about the impact exerted on allocation of state resources by Federal

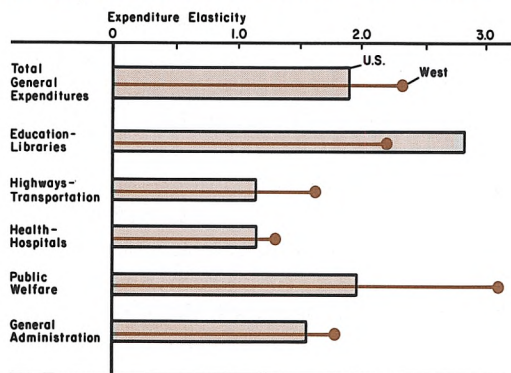
selection of specific functions for funding and by differences in the Federal-state funding ratio. This aspect of the grant system has given rise to a controversy between those who regard Federal involvement in state-and-local budget decisions as a threat to the dispersion of political power, and others who see it as a desirable step toward uniformly higher local standards for civil functions.

Different views on this issue are largely a matter of personal political persuasion, and hence, a moot question here. More relevant to the present discussion is whether the grants-in-aid system is the most sensible way for the Federal Government to assist the states in rectifying the imbalance in their fiscal structures. The answer to this question may well be, no.

Programs which often lack uniform standards and purpose, and which depend for funding on the fluctuating outlook for the Federal budget, do not seem to provide a viable long-run solution to basic fiscal imbalance at the state level. Indeed, the present system of Federal grants-in-aid was not designed for this purpose, and if there is a role for the Federal Government to play in attacking this fiscal issue, a new approach will likely be required.

Increased debt, the third measure used to fill the revenue gap in state-government budgets, has been the natural consequence of heavy investments in capital projects, such as highways and educational facilities during the last two decades. (For the fifty states as a whole, outstanding debt jumped from \$3.6 billion to \$35.7 billion over this period.) Deficit financing is appropriate for capital outlays which can be amortized over the entire useful life of a project, but it has obvious limitations as a substitute for current operating revenues. Hence, debt is not a viable solution to the current-account imbalance under consideration here.

West shows higher elasticity of expenditures than rest of nation



Whither state government?

Relatively few attempts have been made to project the long-run course of state revenues and expenditures, but several recent studies covering the overall fiscal situation agree that state-and-local government expenditures will continue to rise sharply over the next decade. The Congressional Joint Economic Committee and the National Planning Association both anticipate at least a 45-percent rise in state-and-local government *expenditures* by 1975, while the Tax Foundation projects a 30-percent increase in state-and-local tax *revenues* by 1975.

Our survey gives little cause for optimism as the states enter another decade of heavy fiscal commitments. State revenue structures are still largely inelastic, the demands from hard-pressed local governments will likely increase, and Federal assistance has yet to focus on the basic structural problem. There are, however, some hopeful signs. Various ACIR studies have helped the public to recognize that fiscal imbalance at the state-and-local levels of government is a dynamic problem which cannot be solved by simply finding revenues to meet funding requirements on a year-to-year basis. These studies hence have stimulated budget planners to give more attention to the growth potential of prospective revenue sources.

The states themselves are beginning to rework their fiscal systems. In the West, California restructured its revenue code in 1968 to double the yield of its highly elastic individual income tax, and the State of Washington submitted its first income tax to the electorate in 1969. Oregon already derives about 40 percent of its revenues from elastic direct taxes on income, and in two other Western states, Hawaii and Idaho, the income-tax take is more than one-quarter of total internally generated revenues. Similar developments are afoot across the nation.

At the same time, various official proposals have been advanced to make Federal revenue available to the states on a more automatic and dependable basis. President Nixon's recently unveiled revenue-sharing plan, for example, would channel one percent of Federal individual income-tax collections to the states by the mid-1970's. The initial ante is low, only half a billion dollars in 1971, but the amount would increase because it is tied to an elastic revenue source.

Regardless of the relative merits of individual measures of this sort, the trend in thinking is encouraging, because it reflects a growing appreciation of the states' basic fiscal problem which was not present only a few years ago.

Two decades of experience have demonstrated that there are certain basic social needs like education, protection, health, highways and welfare, which are the legitimate children of affluence; that these needs grow faster than the overall level of economic activity in a rich and improving society such as ours; and that, if the existing distribution of civil functions is to be maintained, state-and-local governments must be equipped with elastic revenue structures, or must find politically acceptable and practicable ways to tap the elastic Federal revenue system. To a large extent, the future role of "grass roots" civil government in our society depends upon the types of solutions to these problems which will be forthcoming within the next few years.

Kent Sims

California's Individual Income Tax

The squeeze imposed by elastic expenditures and inelastic revenues has produced mounting deficits for state and local governments throughout the postwar period. These governments, unlike the Federal Government, obtain their revenues primarily from inelastic taxes on consumption and real property, whereas their major expenditure commitments include items (such as education and transportation) which are extremely elastic with respect to economic growth. Consequently, fiscal experts in recent years have turned their attention to increasing the yield of elastic revenue sources, such as the individual income tax.

In a study prepared by Kent O. Sims, "Estimates of the Elasticity of California's Individual Income Tax," an attempt is made to measure precisely the elasticity of this major revenue source. The tax's elasticity is measured with respect to California's personal income, population growth, and changes in the structural definition of the tax base, in terms of individual income brackets. (Scholars interested in the study's detailed appendix can obtain the data on punch cards from this bank's Research Department.)

Copies of this study are available upon request from the Administrative Service Department, Federal Reserve Bank of San Francisco, 400 Sansome Street, San Francisco, California 94120.

Crisis in the Household?

Since the end of the Korean War, the nation's total public and private debt has increased more than one and one-half times, reaching an astronomical \$1.6 trillion by year-end 1968. This spectacular expansion has been propelled, in very large part, by the persistently strong credit demands of individual consumers. Household debt — the liabilities of consumers and nonprofit organizations—has grown at a 9.6-percent average annual rate since 1953, and thus has outpaced the growth of both corporate and government debt. By 1968, household debt amounted to \$420 billion and comprised more than one-quarter of the nation's total debt, up from \$107 billion or less than one-fifth of the total in 1953.

The debt of households can be broken down into three components: 1) mortgage debt on one-to-four-family houses; 2) consumer credit; and 3) a relatively small miscellaneous category including debt owed to brokers, debt owed to life-insurance companies by policyholders, and debt owed to commercial banks by securities purchasers. (The relatively minor debt of nonprofit organizations is ignored in this analysis.)

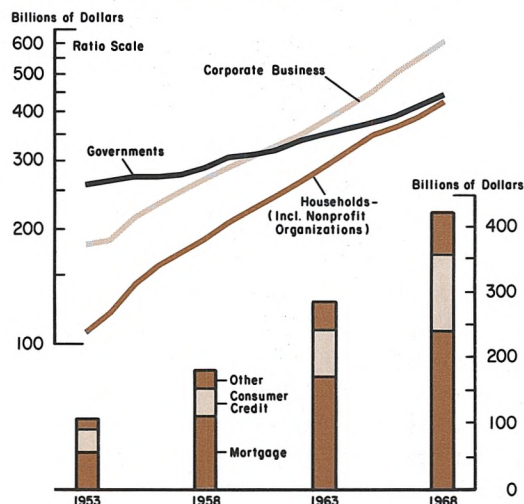
Mortgage credit, the long-term portion of household debt, accounts for six out of every ten dollars of consumer indebtedness. Growing without interruption since 1953 at an imposing 9.9-percent annual rate, consumer-mortgage debt has quadrupled in volume, reaching \$242 billion by 1968. Still, the rate of growth has tapered off somewhat in recent

years, reflecting the growing trend away from home ownership toward tenancy and, perhaps even more, the restraining influence of tight money on home financing.

Consumer credit, which represents the short- and medium-term portion of household debt, contributes roughly two and one-half out of every ten dollars of household indebtedness. Although rising steadily, from \$31 billion in 1953 to \$113 billion in 1968, it has grown at a slightly less exuberant pace than mortgage credit over this period.

Significant shifts have occurred over the years in the relative importance of the major components of consumer credit. First, instalment credit has grown considerably faster than noninstalment credit, increasing its

Household debt, after rapid rise, comprises one-fourth of total debt



share of total consumer credit from 73 percent in 1953 to 79 percent in 1968. And within the instalment-credit category, personal loans have advanced decidedly faster than all other components, reflecting the growing number of purposes for which personal-loan financing is now being used. (The personal-loan share of outstanding instalment credit spurted from 21 percent to 30 percent between 1953 and 1968, while all other classifications exhibited a declining share.) Automobile credit still accounted for the largest share of the total in 1968 (38 percent), but this share lagged behind its record-high figure of 47 percent recorded in 1955.

Cycle sensitive?

Changes in instalment credit (especially for goods purchases) and changes in economic conditions tend to move in tandem, with credit advancing relatively briskly during business expansions and growing relatively sluggishly or declining during business slowdowns. Consumers' willingness to incur new debt, after all, depends on their confidence that current and future income levels will be sufficiently large to cover the required repayments without undue strain. At the same time, the spending of stepped-up borrowings tends to generate higher levels of income.

Thus, during the recessions of 1954, 1958, and 1961 (and the 1967 mini-recession), instalment credit for autos and other consumer goods either declined or else advanced at a more subdued rate than previously. Likewise, in each of the subsequent recovery years, when consumers had reason to become optimistic about future economic conditions, instalment credit in these categories perked up sharply and helped feed the expansion. On the other hand, the personal-loan category remained relatively immune to the dampening effects of declines in business activity over this time-span.

Some industries are particularly sensitive to purchases made with borrowed funds. The availability of new credit for housing and for certain consumer goods, for example, has helped to bolster the volume of consumer expenditures for these items. Thus the growth in mortgage credit for one-to-four-family housing has generally paralleled the movement of new nonfarm residential construction. Residential construction activity has flourished and reached cyclical peaks whenever new mortgage credit has flowed plentifully into the economy. Similarly, auto sales have moved in tandem with new auto credit over the years, with the ratio of new credit to new sales remaining fairly stable at around 90 percent.

How burdensome?

The enormous and rising volume of household debt has understandably aroused considerable concern. Has the volume of debt indeed overstepped the limits of "safety?" Answering this question is difficult; there simply are no unambiguous standards by which to determine whether current debt levels have, in fact, passed over the threshold of prudence into the danger zone.

The debt-carrying capacity of individuals ultimately depends on the magnitude of personal income—particularly disposable income, that is, after-tax personal income. Since 1953, both household debt and disposable income have leaped ahead, but the former has advanced at a far more rapid pace than the latter—9.6 percent as against 5.8 percent annually. Consequently, the ratio of household debt to disposable personal income has grown from 42 percent in 1953 to 71 percent in 1968.

The debt-income ratio has increased in every year of the period except 1966 and 1967. The first of those two years was of course a year of extraordinarily tight credit markets and limited credit availability. The

FEDERAL RESERVE BANK OF SAN FRANCISCO

second of those years (1967) was one of generally available credit, but it was also a year of sluggish consumer spending and therefore sluggish demand for personal credit.

Another important measure of the household-debt burden is the relationship between the volume of debt currently due—debt repayment—and disposable income. After all, debt becomes a problem only when individuals are unable to meet their repayment schedules, and these schedules are affected by wide variations in down payments and maturity terms. Unfortunately, little can be said on this subject because comprehensive data are available only for repayments of consumer credit, and not for mortgage-debt repayments. Even so, we should note the

7.9-percent annual growth rate in consumer-credit repayments since 1953, compared with a 5.8 percent annual growth for disposable income, which means a rise in the repayment-income ratio from 11.1 percent in 1953 to 15.0 percent in 1968.

Nevertheless, it can neither be said that the debt-to-income ratio in 1953 was too small to involve any problems, nor that last year's much higher rate necessarily portends disaster. After all, in comparing a stock of debt against a flow of income, there can be no definite criterion in determining which time period—past, present, or future—of income flows is relevant. The meaning of the debt-repayment measure is even more obscure, since terms of lending have not been

The 1969 Scene

A glance at the record for first-half 1969 reveals a mixed picture. While there are recognizable signs of a slowdown in consumer-credit growth, household-mortgage debt has shown increasing strength.

Outstanding consumer instalment credit advanced somewhat less during the first six months of 1969 than during the final six months of 1968—\$9.0 billion as against \$10.1 billion, at an annual rate. This relatively sluggish growth stems largely from a rather strong rise in auto- and personal-loan repayments and a relatively slow advance in new credit extensions.

At the same time, household-mortgage debt on one-to-four family homes advanced at a \$17.2-billion annual rate in the first half of the year, exceeding the 1968 rise of \$15.1 billion. This represents a 7-percent increase, the largest percentage gain since 1965. Thus, home-mortgage debt expansion was surprisingly strong in the first half of 1969, in spite of record-high mortgage-loan rates—and in spite of the weakening outlook for the housing industry.

Overall, total household liabilities grew at a \$25.2-billion (6.0 percent) annual rate during the first half of 1969. This of course is somewhat less than the 9.6-percent annual growth rate of the 1953-68 period. But while households were reducing their debt accumulation, they were reducing their asset accumulation even more.

Additions to liquid assets amounted to only \$19.0 billion, or 3.6 percent at an annual rate—the smallest percentage increase since 1953—and the debt-liquid asset ratio thus advanced to 82 percent by mid-'69, up from 80 percent last year.

Disposable income, on the other hand, grew at a 5.6 percent annual rate in the January-June period, virtually in line with the growth of household indebtedness. Consequently, the debt-income ratio inched up only slightly over this period.

constant over the fifteen-year period. Moreover, aggregate figures tend to conceal the maldistribution of incomes and debt among individual households. With even the smallest ratio of total household debt to aggregate disposable income, thousands of people conceivably could be on the verge of bankruptcy, because their particular shares of total income were insufficient to cover their much higher shares of total indebtedness.

Assets, liquid and nonliquid

Furthermore, although debt and debt repayments have made deeper and deeper inroads into personal income, individuals still have recourse to other sources of funds to meet impending debt obligations, namely, their liquid assets—currency, demand and time deposits, U.S. savings bonds, other sound securities near maturity, and various other assets for which a good market exists. When a person's income falls and his debt-repayment capacity becomes impaired, these asset holdings, at least, can be readily converted into cash. The most liquid household assets (currency, deposits, and savings bonds) have risen at a 6.7-percent annual growth rate, from \$199 billion in 1953 to \$525 billion in 1968. Although this buildup has been outstripped by the upswing in household debt, the total of such outstanding debt is still exceeded by the value of household assets available as a second line of defense.

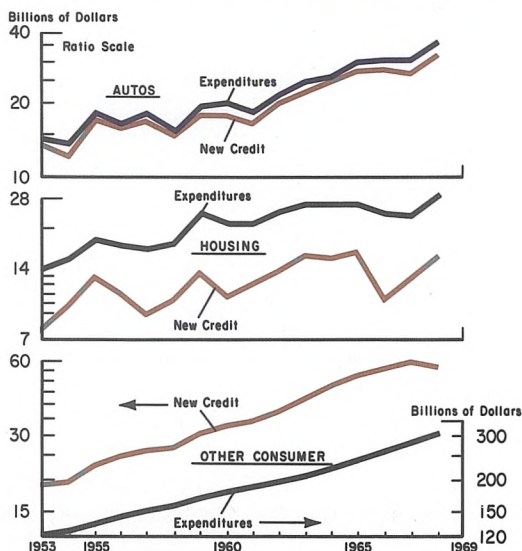
The ratio of household debt to household assets hence has grown substantially, from 54 percent in 1953 to 80 percent fifteen years later. However, practically all of the deterioration in the ratio occurred in the first half of the fifteen-year period.

Between 1953 and 1960, asset accumulation amounted to only one-third the amount of debt accumulation, but in the 1960-68 period, liquid assets grew slightly faster than

household debt. Indeed, in all but one of the last eight years, households have added more to their stock of liquid assets than they have to their debt liabilities—just the reverse of the situation in the preceding period. The contrast is most striking when comparing two years such as 1967 and 1955: debt accumulation was roughly equal in both years (\$22.1 billion in 1967 as against \$20.7 billion in 1955) but asset accumulation was five times greater in the more recent year (\$46.1 billion as against \$9.5 billion).

Yet, as already indicated, aggregate figures tell only a partial story. The households which have been adding to their holdings of liquid assets may not be the identical families who have been increasing their debt obligations. For example, the Federal Reserve's *Survey of Financial Characteristics of Consumers* reveals that about 63 percent of households-in-debt or 31 percent of all households did not have a sufficient supply of liquid assets to cover their outstanding debts during the survey year (1962).

Credit availability helps bolster spending for housing, durable goods



This should not be surprising. If a household is surveyed shortly after a borrowing, the family would be likely to have insufficient assets to meet the newly incurred obligation; otherwise, there would have been little incentive to incur the debt. Moreover, since the bulk of this debt is in mortgages, a survey taken a few years after the purchase of the house would still tend to show liquid assets less than the remaining liability on this large borrowing.

But what would happen if business activity should contract, incomes decline, and families become unable to meet debt repayments out of current income or out of readily liquidated assets? Individuals might then cash in their nonliquid financial assets—primarily credit- and equity-market instruments—or might, if necessary, cash in their physical assets.

Nonliquid assets of households have kept pace with the growth in household debt since 1953, and the ratio of nonliquid assets to debt consequently has moved horizontally over time. More important, the additions to consumers' total (liquid and nonliquid) financial assets have consistently been larger than the increases in household liabilities. Nevertheless, if an income decline were fairly widespread throughout the economy, and if a vast number of households were forced to cash in their nonliquid assets, markets for these assets would weaken, and the economic repercussions accompanying the inevitable decline in asset prices could be serious indeed.

In the final analysis, when no further financial resources are available to meet debt repayments, individuals simply become delinquent in repaying their debts. A marked

increase in delinquencies—or in bankruptcies—would therefore suggest that there has been some overextension of debt. But the record on this point is also inconclusive. Over the past fifteen years, the dollar value of personal bankruptcies has risen sharply, albeit from a very low starting point, but delinquency rates on bank instalment loans have moved sideways, showing little visible change since 1953.

Long-term burden

The foregoing evidence indicates that household debt has significantly outpaced income and financial assets over the 1953-68 period as a whole. This fact, although warranting some concern, is certainly not *prima facie* evidence that consumers have overburdened themselves with debt. Without definitive criteria for determining at what precise level debt becomes intolerable and an economic threat, nothing conclusive can really be said.

Then, too, it should be remembered that certain institutional developments over the years have affected the relationship between consumers' debt, assets, and income. The household sector's auxiliary assets—health and other insurance, unemployment compensation, pension funds, and the like—have grown considerably. In the event that household income temporarily declines, these security-providing secondary assets will alleviate some of the accompanying financial strains and thus free households' liquid assets for other purposes, including repayment of debt should this become necessary. The debt-carrying capacity of households is thereby enlarged.

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