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A COMMISSION REPORT

FEDERAL APPROACHES TO AID STATE AND LOCAL CAPITAL FINANCING

ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D. C. 20575
SEPTEMBER 1970
A—37

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June 1970

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PREFACE

A decade ago the 86th Congress passed Public Law 380 establishing the Advisory Commission on Intergovernmental Relations. The Congress noted at that time the need in a federal form of government for the fullest cooperation and coordination of activities between the levels of government.

The Congress charged the Commission in the performance of its duties to encourage discussion and study at an early stage of emerging public problems that are likely to require intergovernmental cooperation. To fulfill this mandate the Commission from time to time singles out specific intergovernmental issues for study and develops recommendations which it believes will ameliorate the problems and enhance the effectiveness of the federal system of government as established by the Constitution.

At its September 1969 meeting the Commission identified the subject of Federal aid for State and local capital financing as an emerging intergovernmental issue. In the following report, the Advisory Commission examines the impact of NationalGovernment policies on State and local capital financing. The Commission's concern with this subject centers on the development of policy recommendations to (1) reduce and stabilize the costs of State and local borrowing, (2) increase to the extent possible the certainty of Federal financial participation in the State-local projects it aids, and (3) encourage State financial participation in federally-aided local capital projects where such participation is appropriate.

The Commission considered parts of the report at its meetings in December 1969 and April 1970 and approved it at the meeting on June 12, 1970.

Robert E. Merriam
Chairman

ACKNOWLEDGMENTS

L. Richard Gabler and Jacob M. Jaffe of the Taxation and Finance Section shared the responsibility for staff work on this paper. Their task would have been more arduous without the generous help they received from John Thompson, Paul Tracy, Frank Cavanaugh and Richard Simonson.

At various stages in its preparation the staff and the Commission also sought and received assistance from the following: Roy Bahl, George Bell, Gerard Brannon, Milton Brooks, Samuel Cohn, Maurice Criz, Arnold Diamond, Harvey Galper, Tom Graves, Peter Harkins, Robert King, I. M. Labovitz, Jerry Laughlin, Wilfred Lewis, Earl Mackey, Selma Mushkin, John Petersen, Neal Peterson, Donald Reeb, Edward Renshaw, William Robinson, Arlene Shadoan, Courtenay Slater, David Smith, Ralph Tabor, Anita Wells,* Gene Wilhelm, and Laurence Woodworth.

The Commission records its gratitude for the contribution of all these individuals. Full responsibility for content and accuracy remains, however, with the Commission and its staff.

*Deceased

John Shannon
Assistant Director
Taxation and Finance

Wm. R. MacDougall
Executive Director

THE COMMISSION AND ITS WORKING PROCEDURES

This statement of the procedures followed by the Advisory Commission on Intergovernmental Relations is intended to assist the reader's consideration of this report. The Commission, made up of busy public officials and private persons occupying positions of major responsibility, must deal with diverse and specialized subjects. It is important, therefore, in evaluating reports and recommendations of the Commission to know the processes of consultation, criticism, and review to which particular reports are subjected.

The duty of the Advisory Commission, under Public Law 86-380, is to give continuing attention to intergovernmental problems in Federal-State, Federal-local, and State-local, as well as interstate and interlocal relations. The Commission's approach to this broad area of responsibility is to select specific intergovernmental problems for analysis and policy recommendation. In some cases, matters proposed for study are introduced by individual members of the Commission; in other cases, public officials, professional organizations, or scholars propose projects. In still others, possible subjects are suggested by the staff. Frequently, two or more subjects compete for a single "slot" on the Commission's work program. In such instances selection is by majority vote.

Once a subject is placed on the work program, staff is assigned to it and a "thinkers session" is arranged to discuss the scope and content of the study with persons having technical competence in the subject matter area. In limited instances the study is contracted for with an expert in the field or a research organization. The staff's job is to assemble and analyze the facts, identify the differing points of view involved, and develop a range of possible, frequently alternative, policy considerations and recommendations which the Commission might wish to consider. This is all developed and set forth in a preliminary draft report containing (a) historical and factual background, (b) analysis of the issues, and (c) alternative solutions.

The preliminary draft is reviewed within the staff of the Commission and after revision is placed before an informal group of "critics" for searching review and criticism. In assembling these reviewers, care is taken to provide (a) expert knowledge and (b) a diversity of substantive and philosophical viewpoints. Additionally, representatives of the National League of Cities, Council of State Governments, National Association of Counties, U.S. Conference of Mayors, U.S. Bureau of the Budget and any Federal agencies directly concerned with the subject matter participate, along with the other "critics" in reviewing the draft. It should be emphasized that participation by an individual or organization in the review process does not imply in any way endorsement of the draft report. Criticisms and suggestions are presented; some may be adopted, others rejected by the Commission staff.

The draft report is then revised by the staff in light of criticism and comments received and transmitted to the members of the Commission at least three weeks in advance of the meeting at which it is to be considered.

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The Commission concludes that steadily growing inflationary pressures over the past several years have undermined investor confidence in fixed-income securities and thereby pushed to record highs interest rates on all forms of debt issues including tax-exempt "municipals." The Commission recommends therefore that policymakers at all levels of government support effective anti-inflationary action as the necessary first step in any program designed to reduce the cost of borrowed money and increase its availability.

Recommendation No. 2–Restricted Use of Debt Service Grants

The Commission concludes that while the debt service grant has been especially helpful in assisting local public housing authorities with low credit ratings obtain financing, extensive use of this installment method for the payment of Federal grants will place added pressure on an overburdened State and local bond market and introduce greater rigidity into the Federal budgetary process. The Commission recommends therefore that the Congress favor the lump sum payment approach as the instrument of choice for the financing of future Federal aid commitments.

Recommendation No. 3–An Environmental Financing "Pilot Operation"

The Commission concludes that it is necessary to test the ability of a federally subsidized lending operation to broaden State and local access to the capital market. The Commission recommends that the Congress authorize as a pilot operation the lending of funds to those jurisdictions that are unable to borrow at reasonable rates the necessary funds to cover their share of financing the construction of federally aided waste treatment works. The Commission further recommends that this lending operation be so designed as to supplement, not to supplant, the primary method for obtaining State and local funds–the tax exempt bond market.

Recommendation No. 4–Resolving the "Late Appropriations" Problem

The Commission concludes that Congressional delays in authorizing and appropriating funds are a major factor in the uncertainties experienced by Federal, State and local administrators of federally-aided capital facility programs. The Commission recommends therefore that the Congress establish and follow a specific timetable for processing annual authorizations and for acting on annual appropriations bills.

Recommendation No. 5–Gearing Federal Aid Flows to Countercyclical Actions

Because of the long-term nature of State and local capital construction projects and the inefficiencies and dislocations that result from sporadic funding, the Commission concludes that there are only limited possibilities for effective and timely gearing of State and local capital expenditures with national countercyclical policy. The Commission recommends therefore that rather than exclusively using Federal aid funds for State and local facilities as a vehicle for mandating expenditure cutbacks, the President, in cooperation with the Governors, establish procedures for voluntary State action designed to either cut back or accelerate State and local capital expenditures in accordance with mutually established priorities when such expenditure adjustments are needed to supplement Federal countercyclical policy.

Recommendation No. 6–Multi-Year Advance Budgeting

The Commission concludes that provision of advance budget authority stands out as the most promising approach for maximizing the certainty of Federal aid flows to States and localities while minimizing the loss of the President's and the appropriations committees' prerogatives with respect to the allocation of resources, the reordering of priorities and the conduct of economic stabilization policies. The Commission recommends therefore that for those State and local programs involving extensive long-term capital financing (e.g., highways, mass transportation, airport development, air and water pollution abatement facilities and higher education facilities) the Congress enact Federal aid legislation that:

(1) Provides the requisite authority for multi-year advance budgeting;

(2) Directs the President to include in his annual budget request a specific multi-year plan for each eligible program, to be reviewed periodically; and

(3) Provides for advance obligational authority and authority to liquidate contract obligations in appropriations acts for each of the years encompassed in the advance budget plan.

The Commission recognizes that there may be overriding national interests that would call for additional use of the trust fund method and recommends that such trust fund financing be applied where appropriate, within the context of the multi-year advance budget plan.

To facilitate the planning process, the Commission recommends further that the Congress allow adequate experience with a new program before it becomes eligible for multi-year advance budgeting.

Recommendation No. 7--State and Local Prefinancing of Federal Share of Capital Facility Programs

To permit State and local governments to plan and move ahead expeditiously in those capital program areas where there are multi-year Federal aid commitments, the Commission recommends that the Congress enact legislation authorizing Federal administrators of such programs to enter into prefinancing contracts with States or local governments under which the Federal Government would pledge to reimburse them for payments made in advance to cover the Federal share of the cost of constructing the project. To safeguard the budgetary and program interests of the National Government the Commission further recommends that such prefinancing contracts provide restrictions which would limit the prefinancing entitlement of any one State and provide for the conformance of such projects to the general program guidelines set forth in the substantive legislation and agency regulations.

Recommendation No. 8–Federal Financial Incentives for State Participation in Federal Grant Programs for Community Public Facilities

The Commission concludes that Federal aid programs for community public facilities would be strengthened and stabilized by State financial participation. The Commission recommends therefore that the Congress develop matching provisions for its various aid programs for community public facilities so as to increase the Federal aid contribution to those community development projects that are financed in part from State funds. The Commission recommends further that grant allocation formulas also be revised so as to complement the attainment of this incentive goal.

Chapter 1

Summary and Policy Recommendations

State and local government capital facility demands have shown a dramatic and sustained increase during the postwar period—an increase that shows no tendency to level off or diminish in the near future. Compared to State and local capital outlays of $20 billion in 1965, the current rate of spending exceeds $30 billion annually and by 1975 should be over the $40 billion mark. This changing price tag reflects not only a rising price level, but more importantly, the demands for capital facilities engendered by an increasingly affluent and mobile society.

State and local governments look to three sources for capital project financing. Current revenues—taxes and user charges—are generally assumed to account for between one-third and one-half of capital facility expenditures; they are a particularly important component of highway and bridge construction projects. The Federal Government presently provides about $8 billion in construction and debt service grants as well as about $2.0 billion—indirectly—by its tax-exempt treatment of the interest income from State and local government debt issues. Finally, perhaps most obviously, there is the municipal bond market.

State and local governments offered about $11.4 billion in new debt issues during 1969 despite extraordinarily tight credit conditions and the tax-reform scare. This was markedly lower than the $16.3 billion offered in 1968 and the estimated $17.0 billion to be offered in 1970.

At the close of 1969, total State and local securities outstanding stood at approximately $140.0 billion. At the close of World War II (1946), the amount outstanding was a mere $15.9 billion.

In this report, the Commission examines the impact of National Government policies on State and local capital financing. The Commission's concern with this subject centers on (1) reducing and stabilizing the costs of State and local borrowing, (2) increasing to the extent possible the certainty of Federal financial participation in State-local projects, and (3) encouraging State financial participation in federally-aided local capital projects where such participation is appropriate.

KEY ISSUES

When President Nixon signed the Tax Reform Act of 1969, a major chapter in Federal income tax history and legislation was closed. In the course of this legislation through Congress, one of the most heated debates centered on the House-passed version which would have subjected debt issues of State and local governments to an "indirect" Federal income tax.

The debate over the tax-exempt status of State and local bond issues—collectively referred to as "municipals"—has persisted for about half a century. Over the years, lines have been sharply drawn and the policy positions of interested parties have remained quite constant. Those leading the movement for Federal taxation of State and local bond interest both in the past and at present have been Treasury Secretaries and professional economists. Those opposing extension of the Federal income tax to State and local security issues are State-local government officials and representatives of financial houses that deal in these securities.

Attempts to abolish the tax free status of State and local securities generally have been most vigorous during times when Federal income tax rates were high or the volume of outstanding tax-exempt securities was large or both. These two conditions were fulfilled when the 1969 Tax Reform Act was taking shape. Yet despite this, the Tax Reform Bill as finally enacted, maintained the tax-exempt treatment of municipal bond interest income.

On this issue then, the Congress has recently spoken. It seems clear then that durable as the question of tax-exempt municipals has been, it nonetheless has been decided, certainly for the immediate future. The controversy surrounding the tax-exemption privilege is therefore not examined in this Report. Rather, the policy of tax-exemption is taken as the starting point of this study. Indeed, this is essential to placing in proper perspective the Commission's first three recommendations, relating to the reduction and stabilization of State and local government borrowing costs.

Reduction and Stabilization of State-Local Interest Costs

While 1969 may be long remembered as the year of the tax-exempt upheaval, it should also go down as a year of constructive development of ideas to aid States and localities in meeting their capital financing requirements. The special vulnerability of the State and local bond market to tight Federal money policies re-emphasized the necessity of reducing and stabilizing interest costs paid by the State-local sector.

The key policy question is: What mechanisms can be created to broaden the access of State and local governments to the capital markets thereby relieving pressures on an already overburdened municipal bond market?

The Federal Aid "Certainty" Issue

State and local officials must know well in advance the approximate amount of Federal aid they can count on both to plan effectively their capital facilities projects and to move ahead with dispatch. Yet their financial planning is often blighted by uncertainty. Under the annual Federal budgetary process, appropriation action is becoming increasingly tardy; furthermore, individual program appropriations often bear no relationship to the authorization figures spelled out earlier in the substantive legislation. Moreover, as it moves into the brick and mortar field, Federal aid takes on a sporadic character. It can expand quickly and then level off as expenditure outlays are adjusted to meet changes in both the national economy and in program priorities.

Ideally, the annual Federal budgetary process and Federal aid flows should be adapted to the need of State and local officials for a greater degree of certainty. Yet the realities of our intergovernmental system demand that this be viewed along side the keen Federal concern for budgetary flexibility. Surely, each new Congress and every new Administration are entitled to set their own spending priorities. Surely, the President must have the power to speed up or slow down expenditures as a means of countering economic fluctuations.

To accommodate the needs of our federal system, the question arises: How far should the Congress go in restricting the President and the appropriations committees in the exercise of their traditional budgetary prerogatives in order to accommodate State and local demands for greater certainty?

The issue, therefore, becomes one of reconciling competing national objectives. The national interest is served when State and local governments receive Federal aid on terms that facilitate efficient planning and construction of their major public works. It is also served by granting to the Federal fiscal generalists (the President and the appropriations committees) the authority needed to make timely adjustments in the spending levels for particular programs thereby promoting the overall fiscal and social objectives of the National Government.

As one session of Congress flows into the next, the need to come to grips with this issue becomes more apparent. For example, at the present time Congress is considering proposals for substantially increased Federal aid for airport construction, mass transit facilities and environmental control projects and in each case the same basic question is raised—that of striking an appropriate balance between the conflicting demand for Federal aid certainty and Federal budget flexibility.

State Financial Participation Issue

Closely related to the "certainty" issue is the question of the National Government's policy regarding State participation in Federal aid programs for local public facilities. Specifically, the State participation issue raises two questions:

1. Should the Federal Government provide a financial incentive for State assumption of part of the responsibility for financing federally-aided local projects?

2. In order to encourage State and local governments to construct as rapidly as possible public facilities of high national priority should Congress commit the National Government to reimburse those governments that prefinance the Federal share of the project cost?

These questions will assume increasing policy significance as the Federal Government steps up its aid for large scale local public facility programs–i.e., environmental control facilities, mass transit lines, airports and urban redevelopment. These issues have already surfaced in the Federal aid program for the construction of local waste treatment plants. In its 1966 aid legislation, the Federal Government assumed a moral if not a legal obligation to reimburse the States for prepayment of the Federal share of project costs of local waste treatment facilities. In the same legislation the Federal Government offered a financial carrot to those States that are willing to pay part of the project cost.

REDUCTION AND STABILIZATION OF STATE AND LOCAL GOVERNMENT BORROWING COSTS

Findings and Conclusions

The inability of the National Government over the past few years to hold inflationary forces in check has dealt a body blow to municipal bonds as well as to the entire fixed-income security market. In order to protect their purchasing power from the incursions of inflation, many investors–both individuals and institutions–have turned increasingly to the stock market and other investment outlets. As a result of the inflationary spiral, yields on all fixed-income securities have risen sharply: U.S. securities, from 4.21 percent in 1965 to 7.02 percent in early 1970; corporates, from 4.64 percent to 9.20 percent during the same interval; municipals from 3.34 percent to an historic high of more than 7 percent.

Because the tax-free municipal market attracts a relatively narrow band of investors–mainly high tax-bracket individuals and commercial banks–it experiences even further swings than other security markets and is especially vulnerable to restrictive Federal Reserve monetary policy. The experience of 1969–along with that of earlier tight-money years–underscores the fact that so long as the Federal government relies heavily on a restrictive monetary policy to fight inflation, the State and local bond market, along with the small business and housing sectors, will be one of the hardest hit areas of the economy.

The more rapid rise in municipal rates than in rates on either corporates or U.S. Government securities demonstrates the special vulnerability of the tax-free market to restrictive monetary policy. The precipitous departure of the commercial banks from the municipal bond market in 1969 and earlier periods of rising interest rates (commercial bank purchases fell from $9.0 billion in 1967 and $8.7 billion in 1968 to about $1.4 billion in 1969) further indicates the sensitivity of the municipal bond market to tight money policy. Soaring municipal rates coupled with unrealistic State and local ceilings on interest rates or "voluntary" deferrals and postponements were responsible for the sharp drop in volume of municipals–from $16.3 billion in 1968 to $11.4 billion in 1969.

Substantial evidence supports the view that the tax-free market difficulties of 1969 were more than a one-time abberation due, in whole or in part, to a tax-reform scare. A longer run view of the future municipal bond market reveals factors that signal increased competition for long-term money.

From their present $30 billion annual level, State and local capital facility requirements can be expected to rise further to the $40 to $50 billion level by 1975. At the same time, savings and investment projections indicate that a shortage of national savings will emerge. Taken together, States and localities will have to compete all the more intensively for capital funds. Yet, States and localities enter this competitive arena with several handicaps–they lack the "sweetener" devices available to corporations, including the deduction of interest costs from their tax liabilities, and without an equivalent Federal commitment such as that extended to the housing sector.

Issues and Recommendations

The dismal experience of the 1969 municipal bond market brought to the fore the necessity of instituting remedial procedures that will reduce and stabilize the interest costs paid by State and local governments. Three basic steps are required in this effort.

1. As a necessary first step, there should be strong support at all levels of government for an effective anti-inflationary policy. This will serve to restore investor confidence in all fixed-income securities–not just municipal issues–and to increase the flow of savings to the nation's long-term credit markets. Recommendation 1 urges officials at all levels of government to support the application of Federal controls capable of holding inflationary forces in check.

2. To reduce the need for State and local governments to incur debt, Recommendation 2 calls for the National Government to favor the

lump sum payment approach for financing its share of an aided State or local project. The Recommendation therefore also calls for highly restricted use of the installment-type payment executed under the debt service grant technique which necessitates State and local borrowing to cover not only their share of the project costs but part of the Federal portion as well.

3. As an additional method for easing pressures on the tax-exempt bond market, Recommendation 3 urges a federally subsidized authority to lend funds to those jurisdictions unable to borrow at reasonable rates the necessary funds to cover their share of federally aided waste treatment facilities. The Recommendation further suggests this authority as a pilot operation to test the efficacy of this approach toward supplementing–not supplanting–the tax-exempt bond market.

The Commission wishes to emphasize that the following recommendations are predicated on the assumption that the tax-exempt status of State and local bonds as reaffirmed by the Tax Reform Act of 1969 will continue to represent the policy of the Federal Government. The Commission further vigorously expresses its unalterable opposition to all efforts to tamper with the tax-exempt market because such action contributes to investor uncertainty and thereby erodes the municipal bond market. The Commission concludes that the following recommendations for reducing State and local borrowing costs cannot be fully effective unless the Federal Government makes it clear to the investment community that it will pursue a non-intervention policy with respect to the tax-exempt status of State and local securities.

Recommendation No. 1–The Necessary First Step: Controlling Inflation

The Commission concludes that steadily growing inflationary pressures over the past several years have undermined investor confidence in fixed-income securities and thereby pushed to record highs interest rates on all forms of debt issues including tax-exempt "municipals." The Commission recommends therefore that policymakers at all levels of government support effective anti-inflationary action as the necessary first step in any program designed to reduce the cost of borrowed money and increase its availability.

The municipal bond market has been and undoubtedly will continue to be basic to meeting the demands of State and local governments for long-term capital funds. While this market is more sensitive to pressures of anti-inflationary policies by the Federal Reserve, the crippling factor that has undermined all fixed-income security markets is inflation. Yields on long-term U.S. securities have risen steadily from 4.21 percent to 7.02 percent between 1965 and 1969; corporate rates have increased from 4.64 percent to 9.20 percent during the same interval while municipal rates have advanced from 3.34 percent to an historic high of more than 7 percent in early 1970.

There is no quarrel with the fact that the inflationary spiral of the recent past has been detrimental to raising long-term funds in the capital markets. The tendency for prices to drift or surge upwards has had the effect of making investments in equities–particularly stocks–a more attractive outlet for savings. This is true not only for the individual investor but for various institutions–public retirement funds, corporate pension funds and life insurance companies. It is the inflationary spiral which has led these groups to seek investments that offer greater protection against price increases in preference to fixed income securities. Nor can it be denied that unless and until the inflationary process is halted, States and localities will be hard-pressed to raise long-term funds at "reasonable" rates, regardless of the number of alternative channels of access they have to the capital markets.

The Commission has not tried to formulate a particular blend of fiscal, monetary, and other anti-inflationary devices that would be most appropriate to halt the price spiral. To do so, would go far beyond the intent or purpose of this study and enter into an area of widely different interpretations. Rather, the Commission's intent is to emphasize first things first–to call attention again to the simple and fundamental cause of difficulty faced by all fixed-income security markets, the process of inflation.

The Commission clearly recognizes that State and local governments have a role to play in the effort to curb inflation. Indeed, the Commission urges in this Report (Recommendation 5) that the President and the Governors establish procedures for voluntary curtailment or acceleration of State and local expenditures when such adjustments are needed to combat inflation or offset a developing recession.

This Recommendation underscores the fact that although States and localities are the prime providers of the nation's essential domestic public goods and services, States and localities can legitimately ask that the anti-inflation battle be broadened to include others, for if inflation is to be brought under control it will require the combined effort of government, the business community, and consumers.

Recommendation No. 2–Restricted Use of Debt Service Grants

The Commission concludes that while the debt service grant has been especially helpful in assisting local public housing authorities with low credit ratings obtain financing, extensive use of this installment method for the payment of Federal grants will place added pressure on an overburdened State and local bond market and introduce greater rigidity into the Federal budgetary process. The Commission recommends therefore that the Congress favor the lump sum payment approach as the instrument of choice for the financing of future Federal aid commitments.

The debt service grant has been especially helpful in developing public housing by making it possible for communities or public authorities with low credit ratings to obtain financing. Since the debt service grant, particularly when it covers a major part of the total cost, virtually constitutes a Federal guarantee, it makes it possible for housing authorities to sell their bonds at interest rates otherwise available only to communities with the highest credit ratings. Lacking such a Federal guarantee, most housing authorities would not be able to market their bonds at all.

There is a danger, however, in any attempt to go beyond this limited objective. Admittedly, there is real attractiveness in the proposal to extend the debt service grant across the entire State and local public facility spectrum. It appears to be the quick and easy way to achieve the most "bang" for the Federal "buck." However, this easy "installment payment plan" cranks additional rigidity into the Federal budgetary process. Growing use of this type of long-term Federal financial commitment makes the budgetary task of allocating resources and pursuing effective economic stabilization policies just that much more difficult.

Moreover, an overburdened State and local bond market is simply not in a position to carry the heavy additional load that expanded use of Federal debt service grants would generate. If a 1968 effort to provide debt service grants for water pollution control had been successful, it is likely that the annual net addition to outstanding State and local debt attributable to programs aided by Federal debt service grants would have increased substantially. The capacity of the municipal bond market to absorb issues would be severely tested if, as has been proposed, the National Government attempted to finance airport facilities, mass transit and waste treatment plants by means of this device.

Under the typical debt service grant contract, the Federal Government agrees to pay its share of the cost of a State or local capital facility in yearly installments of equal amounts over the life of the debt issue. This technique, then, requires States and localities to go into the bond market for funds sufficient to cover not only their own share of the project cost but also part of the Federal Government's share. Because it both eliminates the budgetary peaks and valleys created by lump-sum capital grants and reduces (at least in the short run) the annual drawdown on the Treasury, this debt service technique has acquired many friends in the Federal Government.

Until 1968, debt service grants were available only for public housing. In 1968, three new debt service grant programs were enacted to help State, local and private institutions of higher education and local vocational education agencies build academic and residential facilities. A further indication of Federal interest in this technique was the fact that the Administration that same year proposed conversion of the massive water pollution control facilities program from a lump-sum to a debt service grant. A bill to amend the Federal Water Pollution Control Act (S. 3206, 90th Congress) incorporated this "installment payment plan" idea and passed both the Senate and House. However, the bill was not enacted because of other differences in the Senate and House versions and the subsequent inability of the Conference Committee to iron out the differences before the close of the session.

To be sure, the debt service grant does more than just minimize the immediate drawdown on the Federal budget; it squeezes at least some additional financing for State and local projects into the Federal budget. On balance, however, these points are outweighed by the added rigidity introduced into the Federal budget, the lesser ability to pursue anti-inflationary policies and the extra pressure placed on the State and local government bond market.

Recommendation No. 3–An Environmental Financing "Pilot Operation"

The Commission concludes that it is necessary to test the ability of a federally subsidized lending operation to broaden State and local access to the capital market. The Commission recommends that the Congress authorize as a pilot operation the lending of funds to those jurisdictions that are unable to borrow at reasonable rates the necessary funds to cover their share of financing the construction of federally aided waste treatment works. The Commission further recommends that this lending operation be so designed as to supplement, not to supplant, the primary method for obtaining State and local funds–the tax exempt bond market.

While the municipal bond market undoubtedly will continue to be of great service to State and local governments, there are sufficient indications on the horizon to warrant the launching of a pilot operation designed to supplement the traditional tax-exempt bond market. In this regard, it seems particularly appropriate to test out the fiscal and administrative implications of a new approach in an area of high national priority—environmental control. Like the proposed Environmental Finance Agency of the Nixon Administration,[1] this Recommendation is restricted to the federally-aided waste treatment program.

The purpose of this pilot program is to assure that every community eligible to participate in the Federal waste treatment program will be able to sell bonds at reasonable interest rates. States and localities will decide whether the tax-exempt market or this federally subsidized lending operation offers the more attractive credit terms. Because this new lending operation is to be a financial mechanism only, no fears of added Federal controls need arise. Federal regulations have already been established in this on-going Federal-State-local program. This is, of course, a matter of highest concern to State and local officials.

The federally subsidized lending authority offers additional advantages beyond lower interest costs. The bond issues of smaller communities for example, can be packaged to overcome whatever cost disadvantages result from lack of investor awareness and knowledge about the financial strength of such communities. The existence of the authority as an alternative source of funds should contribute to a narrowing of the community-to-community variations in interest rates that show up most dramatically when money is tight. Thus, the new lending operation should be most helpful to lower-rated communities, particularly in tight money periods.

At a price, of course, the market has always been prepared to accept the bond issue of any community not barred by debt restrictions from paying the market determined going rate for money. This alternative would have the further effect of permitting other communities to go ahead with projects that otherwise might have been postponed or terminated awaiting lower interest costs in the tax-exempt market.

The financial operation of the proposed lending authority is relatively simple. It would issue its own taxable bonds and lend these funds to State and local governments at preferential rates of interest, the differential to be made up by congressional appropriations. If, for example, the authority borrowed $1 billion at 8½ percent and loaned at 6½ percent, the net would be a $1 billion increase in State-local waste treatment facilities at the cost of $20 million of Federal expenditure annually. Because of the preferential rate of interest at which it lends, interest rate savings are promised to State and local governments. The magnitude of such savings is difficult to quantify as it depends on the specific interest rate at which such loans are made. This will also determine the attractiveness of this financing alternative and the degree to which it is used.

It is also anticipated that this lending operation will be self-supporting, that is, the net gains and losses to the National Government will "wash." As operations progress beyond initial "start-up" costs, administrative expenses will be met by fees charged to borrowers. The annual appropriation to cover the differential in interest rates between the borrowing and lending costs of the proposed operation will be recouped via the tax payments on interest income for (a) securities issued by the authority and (b) somewhat higher interest income on all other taxable securities. The crucial factor in determining whether or not the operation "washes" is the marginal tax rate that is applicable to the holders of the new taxable instruments and to those who would otherwise have bought tax-exempt securities. The general consensus holds that any gains or losses that result will be small.

Careful attention will be required to define clearly what constitutes "inability to borrow at reasonable rates." This is admittedly a vague concept but one that is fairly common for water and sewer loans, and other programs administered by the Departments of Agriculture, Commerce and Housing and Urban Development. The criteria are likely to change along with interest rates. Indeed, a single statutory formula might defeat the purpose of the Recommendation because in periods of tight money, the tax-exempt bond market tends to fluctuate more widely than other long-term credit markets. In such times, this lending operation approach would offer a valuable "safety-valve" and prevent a community from having to halt its waste treatment program for lack of construction funds.

This proposal offers interest rate savings to State and local governments at no net cost to the Federal Government. It in no way infringes on the tax-exempt market but merely opens up an alternative mechanism designed to supplement this source of finance. It offers the opportunity of protecting a high priority Federal-State-local program from the possible delays, interruptions and postponements that might otherwise hamper waste treatment construction projects. The proposal is likely to provide the most assistance to smaller and less well known communities. The advantages of the pilot operation approach argue strongly for the opportunity to translate this potential into actual experience.

THE QUEST FOR FEDERAL AID CERTAINTY

Findings and Conclusions

- Congress may be leaning more toward multi-year funding of Federal aid programs for State and local capital facilities:

  —The interstate highway program is underwritten with long-term Federal commitments and financed with dedicated funds (highway trust fund).

  —Recent congressional action provides advance appropriations (one year) for airport construction, urban renewal and urban mass transportation.

  —The widening authorization-appropriation gap has provided high-power ammunition for those urging Congress to build greater certainty into the funding of Federal aid programs. Between 1966 and 1970, program authorizations for 169 Federal aid programs rose from $14 billion to $24 billion while appropriations for these programs increased from $11.6 billion to $15.9 billion. This growing divergence between authorizations and appropriations left in its wake a dollar "gap" that increased steadily from $2.7 billion in 1966 to an estimated $8.5 billion by fiscal 1970.

- In most cases, a congressional decision to build advance funding into a Federal aid program also sharply alters the fiscal power relationship among the various committees within the Congress. Introducing long-term spending (obligational) authority into substantive legislation strips the relatively tough and cost conscious appropriations committees of their traditional right to recommend annually to the Congress the actual spending level for the program; it vests this power with the more sympathetic and program-oriented membership of the substantive committees.

  —In the highway program, long-term spending authority is specifically established in the substantive legislation and the appropriations committees are reduced to a ministerial role, that of authorizing the payment of bills incurred under the obligational authority set forth in the substantive legislation.

  —The 91st Congress has acted, or will act, on new proposals designed to expand the Federal aid outlay and build far greater certainty into Federal aid commitments for airports, mass transportation and environmental control facilities; specifically an $840 million, three-year airport program with trust fund financing (already enacted), a $5 billion, five-year urban mass transportation program, and a $4 billion, four-year waste treatment program.

- Three major factors have combined to strengthen the position of those groups seeking to build multi-year financing into Federal aid outlays for State and local public facilities:

  —The growing congressional acceptance of the proposition that State and local governments need considerable lead time to plan and adequately develop their major public facilities.

  —The mounting dissatisfaction with an appropriations process increasingly plagued by late action: only two out of 13 major appropriations bills had been enacted by the end of October 1969—four months after the beginning of the 1970 fiscal year. The last of the 1970 appropriations bills was finally passed in late January 1970, only to be vetoed by the President. A subsequent compromise was enacted on March 4, 1970.

  —The downgrading of the power of the appropriations committees is also apparent in the funding of debt service grants for public housing, college housing and academic facilities. As in the case of the highway aid, the spending decisions become an integral part of the substantive legislation. The proposed substantive legislation for expanding the mass transit and waste disposal facilities programs would also provide long-term obligational authority and annual spending ceilings. An airport development program, already enacted, provides for trust fund financing and provision of obligational authority in the authorizing legislation, thereby bypassing the expenditure control powers of the appropriations committees.

- The rising fiscal power of the substantive committees and the rigidities that flow from long-term Federal aid commitments also hobble the President. It becomes increasingly difficult for him to perform his "fiscal generalist" function, that of fitting the various spending programs into an overall annual budgetary plan for carrying out the Administration's fiscal and social objectives. On occasion these rigidities have forced the President to take negative action to hold back and "stretch out" Federal aid funds voted by the Congress by instructing the Federal Highway Administration, for example, to slow down the release of highway trust funds for obligation.

–Even this negative Presidential power can be exercised only with the tacit concurrence of the Congress. Mandatory statutory language could specifically enjoin the President from taking this type of "slow down" action. At the time it considered the proposed Highway Act of 1968, the Congress was urged by the champions of absolute certainty to adopt this protective strategy. Their appeal was rejected, however, and a less drastic approach adopted–a "sense of Congress" provision that clearly indicated congressional disapproval of any attempt on the part of the President to withhold highway aid funds.

–A recent opinion (December 1969) of the Attorney General held that the President cannot impound appropriated aid funds for certain formula grant programs, for example, Title I of the Elementary and Secondary Education Act of 1965, because the statutory allocation formula clearly mandates prompt distribution of such funds.

- The growing tendency to incorporate long-term spending authority into substantive legislation also promotes a kind of "functional feudalism" in our federal system; more specifically it strengthens "vertical functional autocracies" at the Federal, State and local levels. The complex of interests–program administrators at all governmental levels, and the pressure groups as typified in the Nation's highway program–coalesce around the real source of spending power, the substantive subcommittee and its chairman. The fiscal generalists on the other hand (the President, governors and mayors) find it increasingly difficult to exercise effective fiscal and administrative control over this vertical functional autocracy.

Issues and Recommendations

Any attempt to build greater certainty into Federal aid programs for State and local public facilities has two dimensions. The first is a quantitative or time dimension–the length of the Federal aid commitment. The second is qualitative in nature–an estimate of the resistance the President and Congress might be expected to encounter if they attempt to reduce or delay the flow of Federal aid funds to a particular program.

By introducing a specific timetable into the appropriations process, Recommendation 4 attempts to deal with one element of uncertainty–the chronic problem of late appropriations.

Recommendation 5 is addressed to the power of the President to slow up or accelerate Federal aid flows as a means for countering economic fluctuations. The Recommendation urges the creation of procedures for voluntary State action where expenditure adjustments are needed to supplement Federal countercyclical action, rather than unilateral action by the President.

Recommendation 6 proposes an advance multi-year budgeting system designed to provide a fairly substantial degree of future aid certainty for State and local governments while still preserving for the President and the appropriations committees a considerable degree of budgetary latitude over these aid programs. While recognizing that trust fund financing may be appropriate for some programs, the Commission would couple such financing with multi-year budgeting under the established budgetary and appropriations procedures.

Recommendation No. 4–Resolving the "Late Appropriations" Problem

The Commission concludes that congressional delays in authorizing and appropriating funds are a major factor in the uncertainties experienced by Federal, State and local administrators of federally-aided capital facility programs. The Commission recommends therefore that the Congress establish and follow a specific timetable for processing annual authorizations and for acting on annual appropriations bills.

The need for corrective action on the authorization and appropriations front has been recognized for some years by the leadership in Congress. We are convinced that the time is at hand for Congress to establish a rigid timetable for acting on appropriations bills and on the necessary authorizing legislation that precedes them. Palliatives such as shifting the fiscal year from the present July-June basis to a calendar year basis to allow more time for the appropriations process simply will not suffice. They will merely stretch out an already extended budget and appropriations cycle.

A number of alternatives have been suggested for pinning down the appropriations schedule. One plan, espoused by Senator Warren G. Magnuson, would require Congress to schedule its work in a more orderly fashion–specifically that it set aside a portion of its time early in the session to act on the necessary annual authorizations.

In addition, several resolutions have been introduced in the House recently that would virtually force early authorization action by the substantive committees. These proposals call for changes in the House rules–directives requiring authorization action to be completed by a specified date. Failure to meet this timetable would automatically transfer jurisdiction to the appropriations committees. Thus, under these extraordinary conditions, the appropriations committees would be empowered to act without substantive authorizations.

There is a demonstrable need to overhaul the budget and appropriations procedures of the largest single dispenser of funds in the nation. The late appropriations now force Federal agencies to operate far into the new fiscal year on the basis of a "continuing resolution"–an action that ordinarily permits Federal agencies to obligate funds at no more than the previous year's authorized level (or at lower levels in some instances). Thus, during the early months of the new fiscal year, Federal administrators are often "in the dark" as far as their ultimate program funding is concerned.

State and local administrators of federally-aided programs experience even greater uncertainty because they are less likely than their Federal counterparts to be privy to congressional intentions or their potential impacts upon particular projects. Planning and budgeting for both operating and capital programs is extremely difficult when the magnitude of a major revenue source (Federal aid) is unknown until well into the fiscal year. School systems are especially vulnerable as they have to contract with teachers far in advance of the school year. They are often faced with either sudden curtailment or sudden expansion of their programs when they are finally advised, late in the year, as to the exact amount of Federal aid to expect. Since they are required to set property tax levies early in the year these are often too low or too high depending on subsequent congressional action.

The President must transmit the budget to Congress early in January. To meet this requirement, the Bureau of the Budget begins to assemble the data it needs during the previous summer. The task of bringing together the vast amount of technical detail and preparing for the printer a massive document becomes doubly difficult when Congress has not finished shaping the *current* budget. In a letter to the congressional leadership on October 28, 1969, President Nixon noted that if Congress did not shortly complete its appropriations action for fiscal 1970, *"it may be impossible for me to transmit the 1971 budget in January."**

A variety of factors conspired to impede legislative action on the 1970 appropriations bills–only two were enacted by the end of October 1969. Authorization bills accounting for about one-third of the dollar volume of the 1970 budget required annual action by the substantive committees before the appropriations committees could act on these programs. The 1969 Presidential transition also caused some delay in submitting budget revisions to the Congress.

Although 1969 could perhaps be regarded as an abnormal year, appropriations tardiness has been chronic for at least a decade. Furthermore, use of the "continuing resolution" eases the pressure on Congress to act quickly on appropriations bills because it eliminates the most painful consequence of late appropriations–the "payless payday." In fact, some Congressmen take the position that the longer they can delay the appropriations process the more economy they can impose on the executive agencies. Still, the chronic tardiness in enacting appropriations distorts financial management of the Federal Government–indeed, the longer this phenomenon is allowed to continue the more aggravated this distortion will become.

In the Commission's judgment remedial action is essential. If the National Government's budget is to be responsive to rapid changes in both the economy and the demands of the body politic, this proposal should receive early and favorable consideration by the Congress.

Recommendation No. 5–Gearing Federal Aid Flows to Countercyclical Actions

Because of the long-term nature of State and local capital construction projects and the inefficiencies and dislocations that result from sporadic funding, the Commission concludes that there are only limited possibilities for effective and timely gearing of State and local capital expenditures with national countercyclical policy. The Commission recommends therefore that rather than exclusively using Federal aid funds for State and local facilities as a vehicle for mandating expenditure cutbacks, the President, in cooperation with the Governors, establish procedures for voluntary State action designed to either cut back or accelerate State

*The 1971 budget was submitted on February 2, 1970, even though final action was still pending on the fiscal 1970 Labor-HEW Appropriation Act (it had been passed late in January and vetoed; finally enacted on March 4).

and local capital expenditures in accordance with mutually established priorities when such expenditure adjustments are needed to supplement Federal countercyclical policy.

A decision to cut back on capital facilities programs can curtail projects still in the planning stage but not yet under construction contract. It will be less successful in stemming expenditures for projects under way. Moreover, where implementation of the cutback requires a reduction in Federal aid, the sheer mechanics involved further delay the impact of the decision to turn off the flow of funds. In such circumstances it is conceivable that by the time a cutback order is finally translated into reduced expenditures at the State and local levels, the economic situation might have been reversed (by credit restrictions or compensatory tax policies) and an expenditure *increase* might actually be indicated.

An Administration that seeks to curtail the flow of capital facility expenditure by reducing Federal aid is really trying to alter the individual spending decisions of 50 States and 80,000 municipalities, counties, townships, school districts and special districts. It is significant that most Presidential efforts to enforce cutbacks have been directed at the Governors due largely to the impracticability of dealing with tens of thousands of local governments.

Not only can the anti-inflationary impact of federally-imposed capital facilities cutbacks be too little and too late, it can also be argued that the State and local sector should not be expected always to be the first to bend the knee and bow the head when inflation threatens. States and localities are usually the first to be caught in the whiplash of anti-inflationary actions. When general interest rates rise, so do interest rates on State and local securities and they have the choice of either paying the higher rates (provided State constitutional or statutory rate limits allow it) or not going into the bond market (thus postponing capital projects, as many States and localities were forced to do in 1969); or—as some have done—borrowing on a short-term basis in the hope that the long-term market will stabilize.*

It is an ironic commentary on the Nation's value system that Las Vegas casino operators can move forward with their building programs while State and local governments cut back on construction of schools and hospitals because they cannot borrow at reasonable rates. High interest rates are not only "reining in" State and local capital financing currently (1969 and 1970), they have done so frequently in the past. Various studies have shown that the State and local government sector often bears a good deal of the brunt of the so-called general controls exerted by monetary policy. States and localities generally avoid accumulating financial reserves. They rely on the capital markets. As a consequence the State-local sector is peculiarly sensitive to the exercise of anti-inflationary monetary controls.

To go beyond the use of general monetary controls and to attempt to force cutbacks in federally-aided as well as non-aided projects is comparable to an exercise in double jeopardy. If States and localities find themselves relatively hard pressed by Federal tight money policies, what reason other than their vulnerability suggests the wisdom of additional cutbacks?

This does not mean that State and local governments should be immunized from participating in Federal countercyclical action when necessary and to the extent they are able. Indeed, the response of some States to President Nixon's pleas for voluntary capital expenditure cutbacks has been encouraging, and the Commission feels strongly that this type of Federal-State cooperation should be institutionalized.

Presidential power to accelerate State and local expenditure for public works could be a useful component of a comprehensive anti-recession program. Such acceleration could be made particularly effective if the President were armed with standby spending authority for this purpose and if plans were held in readiness to let public facilities contracts quickly. It will be recalled that States and localities were given advance planning loans soon after the end of World War II to develop shelves of blueprints that could be put to immediate use in the event of a down-turn in the economy. President Eisenhower established an agency in the Executive Office with specific concern for civil public works. That agency worked with States and localities to develop public works plans which could be put into effect quickly if the need should arise, as in the event of a substantial increase in unemployment. President Kennedy wanted to take more drastic action: in 1962 he asked Congress for standby authority to spend up to $2 billion for public works in the event of a threatened slowdown in the economy, but this request was denied.

Once project plans are made ready they will, of course, have to be updated as they await the propitious time to be put into effect; and surely mechanisms could be developed jointly by the Federal Government and the States to keep them up to date. In particular, plans

*The housing market is also among the first to be adversely affected by high interest rates. State-imposed interest rate limits on mortgages and on government bonds compound the problem. However, the Federal Government has taken specific steps to expand housing credit through FNMA, GNMA, the Federal Home Loan Banks and the Farmers Home Administration. Similar steps have not been taken to ease the pressures on the municipal bond market.

should be kept ready for projects that would start expenditure flows quickly—for example, for the purchase of new equipment and for the rehabilitation and modernization of existing equipment and structures.

The notion of maintaining a shelf of public works plans to be put into effect quickly to offset economic recessions might be expanded to cover a public works "reservoir." This would not be a static shelf of plans to be activated only to bolster lagging employment. Rather, it would consist of projects planned well in advance by States and localities with Federal technical and, perhaps, financial assistance, with a definite implementation timetable based upon State and local needs and priorities. As projects are withdrawn from the reservoir, new ones would take their place. Thus, whenever the need should arise to accelerate public works, this "live" reservoir would be available immediately. To the extent that long-term commitments are available for federally-aided projects (as called for in Recommendation 6), such projects could readily be included in the reservoir.

States now operate the employment security systems that could, if so attuned, monitor trends in construction employment. By gathering, analyzing, and publishing this information, State employment security offices could inform local governments and State agencies of "stress" and "ease" conditions in regional, and local labor markets. State and local government contracting might then be geared to counteract developing economic trends while simultaneously contributing to tighter competitive bidding on public facilities and hopefully lower construction costs.

The Commission has recommended that States establish an information system with respect to local fiscal needs and resources.[2] One very practical use of such a system would be the inauguration of a capital facilities counseling service. In conjunction with a system that would (1) analyze the State employment security information, (2) local government expectations as to capital outlay expenditures, and (3) trends in the financial markets, a State local affairs department or agency could give valuable guidance to local units of government on the best timing for their construction awards. This information system would entail additional State government costs, but the size of the capital outlay expenditures by the State and local governments makes prospects for savings quite favorable.

Recommendation No. 6—Multi-Year Advance Budgeting

The Commission concludes that provision of advance budget authority stands out as the most promising approach for maximizing the certainty of Federal aid flows to States and localities while minimizing the loss of the President's and the appropriations committees' prerogatives with respect to the allocation of resources, the reordering of priorities and the conduct of economic stabilization policies. The Commission recommends therefore that for those State and local programs involving extensive long-term capital financing (e.g., highways, mass transportation, airport development, air and water pollution abatement facilities and higher education facilities) the Congress enact Federal aid legislation that:

> **(1) Provides the requisite authority for multi-year advance budgeting;**
>
> **(2) Directs the President to include in his annual budget request a specific multi-year plan for each eligible program, to be reviewed periodically; and**
>
> **(3) Provides for advance obligational authority and authority to liquidate contract obligations in appropriations acts for each of the years encompassed in the advance budget plan.**

The Commission recognizes that there may be overriding national interests that would call for additional use of the trust fund method and recommends that such trust fund financing be applied where appropriate, within the context of the multi-year advance budget plan.

To facilitate the planning process, the Commission recommends further that the Congress allow adequate experience with a new program before it becomes eligible for multi-year advance budgeting.

This proposal for a multi-year advance budget plan steers a middle course between the great uncertainties generated by the present annual budgetary system and the rigidities inherent in establishing long-term financing in substantive legislation. It would retain the responsibility for making specific advance spending commitments in the hands of the President, the appropriations committees and, ultimately, the entire Congress, where it properly belongs. But it would also provide State and local officials with a fairly substantial degree of assurance that the promised Federal dollars would be forthcoming at the proper time by requiring the President and the appropriations committees of Congress to develop and propose for adoption in appropriations acts a specific advance spending plan for each of the nation's major public facility grant programs. The specific time frame covered by the advance budget plan might be as little as two years or as much as five years.

Unlike the large but "soft" dollar authorizations developed in the protective atmosphere of the substantive committees, this multi-year budget plan would produce far more realistic commitments hammered out in the competitive budgetary arena. Under this proposal each of the advance budget programs would be pitted against the other capital financial claimants and, for that matter, against all other competitors for Federal dollars.

Once this advance budget plan is ratified by the Congress, it would be difficult to make capricious changes in funding levels for the years encompassed in it. Thus, the periodic Presidential and appropriations committee review of each advance funding plan would ordinarily be limited to the request and justification for the period that must be added onto the previously approved commitments. The President and the Congress would still have the option of making changes in prior commitments, but political reality would necessarily limit such alterations to those that could be justified in terms of major shifts in program emphasis or by sharply altered economic circumstances.

While timely annual appropriations action by the Congress and Federal-State concerted action on countercyclical policies would go a long way toward reducing fiscal uncertainties, these two actions must be bolstered by this advance budget plan. These three steps taken together should be sufficient to provide State and local governments with predictable Federal fiscal commitments while at the same time safeguarding the legitimate need of the President and the Congress for budgetary flexibility.

Present budget and appropriations practice provides some precedent for the procedure recommended here. There are a number of instances where appropriations acts now provide obligational authority one year in advance (for example, airports, mass transportation, and education of deprived children), and the 1969 amendments to the Office of Economic Opportunity Act authorize similar advance funding. Moreover, for some years the Bureau of the Budget has required the program agencies to develop five-year plans for internal Budget Bureau use; and for the first time, the 1971 *Budget* contains some very summary projections to 1975 of major Federal revenue and expenditure totals.

It must be admitted that White House opposition to committing the Administration to programs for more than one year has created a formidable barrier for advance budgeting. Yet, unless the President and the appropriations committees act quickly to build a fairly substantial degree of certainty into Federal aid outlays for major State and local public facilities, the initiative for making long-term Federal aid commitments will be assumed increasingly by the various substantive (program) committees of the Congress, with the consequent and serious diminution in the budgetary influence of the fiscal generalists—the President and the members of the appropriations committees.

Inclusion in the annual budget of requests for multi-year obligational authority for major public facility programs would represent a move toward building long-term planning into the annual budget and appropriations process. More significantly, from a power standpoint, it would strengthen the leadership role of the "generalists" in the budgetary process—the President and the appropriations committees. By the same token, it would retain for substantive committees the traditional role of formulating the basic legislation that must precede the granting of long-term spending authority by the appropriations committees, although it would remove from the substantive committees the authority to propose specific advance funding plans.

This proposal for advance budgeting would be consistent with the current Federal aid requirements that call on State and local governments to make advance plans. Such requirements are now included in Federal aid programs for highway construction, hospital facilities, urban renewal and model cities, among others. Furthermore, a number of States and localities now develop five-year capital budgets as an integral part of their own planning procedures. An advance Federal budgeting and appropriations process would enhance such State and local planning, as well as Federal planning in the public facilities area.

The Commission recognizes the political realities that might under special circumstances necessitate the dedication of specified revenues to the funding of particular programs. However, unlike the situation in the Highway Trust Fund, our proposal would subject the actual spending decisions to the advance multi-year budgeting procedures called for here. In other words, whether or not a program were financed from earmarked trust fund revenues, the multi-year spending authority would be requested by the President in his budget for adoption in an appropriations act.

In order to give the Bureau of the Budget a body of information with which to develop multi-year plans, this recommendation suggests that no program be considered as a candidate for this advance budget treatment until it has been in operation for some time.

Urgency underpins this recommendation—the champions of mass transportation and airport development are pressing with great vigor their respective cases before Congress for a more drastic solution to the "uncertainty" problem—the rigid trust fund approach *coupled with the establishment of* *advance obligational authority in substantive legislation.* At the present time, $4.3 billion of the $8.1 billion of Federal aid to State and local facilities comes out of the Highway Trust Fund. Yet, it is conceivable that within a very few years the annual flow of such Federal aid may rise to $15 or $20 billion–with much of it tightly locked up in four or five special accounts. No matter how worthy the program, it should not be shielded completely from the rigorous but healthy competition of the budgetary arena.

If this development takes place, there will be a radical diminution in the ability of the President and the Congress both to allocate resources among competing programs and to carry out effective economic stabilization plans. The very "success" of the Highway Trust Fund counsels against more intensive use of this method for achieving major yet limited construction objectives. Money that might well have gone into educational facilities or mass transportation equipment becomes the exclusive province of the highway builders and their allies. Indeed, the fiscal generalists at the State and local level–the governors, mayors and legislative appropriations committees–in the long run stand to forfeit their own fiscal powers to the functional specialists when they press for a reduction of their' counterparts' power at the Federal level. Rigidifying the Federal budget and appropriations process through long-term commitments made by substantive committees will result inevitably in placing the fiscal power of government in the hands of a "vertical functional autocracy"–the program specialists at all levels of government.

Pressure from States and localities for *absolute* certainty, even assuming that such a goal *could* be achieved, would be self-defeating in the long run. If the President's power to apply expenditure reductions were eliminated, he would be left with only two alternatives to combat inflation. He could ask Congress to raise taxes–always a politically unpalatable act, and one which, unless Congress provides him with standby authority, inevitably involves lengthy deliberation. The other alternative, which *can* be applied quickly, is that of restricting credit–i.e., a tight money policy. Because such a policy immediately raises interest rates, including those on municipal bonds, States and localities are among the first to be caught in this credit crunch and are always adversely affected by it.

The multi-year advance budget and appropriations plan therefore stands out as the most feasible compromise for reconciling the competing demand of State and local policymakers for greater budgetary certainty and the Federal concern for a substantial measure of budgetary flexibility.

THE STATE FINANCIAL PARTICIPATION ISSUE

Findings and Conclusions

There is definite evidence of growing State involvement in urban problems generally and State funds are now beginning to flow into local program areas that until recently were virtually the exclusive aid preserve of the Federal Government.

–Half of the States have now established agencies to deal primarily with local community problems, with increasing emphasis on financial, program and coordination responsibilities as well as technical assistance, advisory and research functions.

–At least six States–Delaware, Maryland, Massachusetts, New Jersey, New York and Pennsylvania–now give substantial aid to urban areas for mass transportation facilities.

–In recent years a number of States authorized new and expanded housing and urban renewal programs–among them Connecticut, Delaware, Massachusetts, Michigan, New Jersey, New York, Pennsylvania, Vermont, West Virginia, and Wisconsin.

Local waste treatment construction projects now attract State aid dollars in a considerable number of States–a situation that can be explained in large part by the incentives for State financial participation to be found in the Clean Water Restoration Act of 1966.

–That 1966 aid legislation provided a Federal aid "bonus" if the State assumed a designated share of local project cost and at the same time created at least a moral obligation on the part of the Federal Government to reimburse any State for sums it advanced to cover the Federal share of the local project cost.

–Seven States have now prefinanced over $300 million of the Federal share of the cost of constructing local waste treatment facilities.

–Sixteen States (including the seven "prefinancing" States) have now qualified for the Federal bonus by "buying into" the financing of these local projects.

Recommendations

Recommendation 7 is calculated to encourage State participation in federally-aided local projects by calling on the Congress to provide a firm legal commitment to reimburse States and localities for sums they advance to cover the Federal share of the local project costs. Recommendation 8 would push the cause of State financial involvement further by providing a Federal aid bonus for those States that "buy-in" to a federally-aided local construction project.

Recommendation No. 7–State and Local Prefinancing of Federal Share of Capital Facility Programs

To permit State and local governments to plan and move ahead expeditiously in those capital program areas where there are multi-year Federal aid commitments, the Commission recommends that the Congress enact legislation authorizing Federal administrators of such programs to enter into prefinancing contracts with States or local governments under which the Federal Government would pledge to reimburse them for payments made in advance to cover the Federal share of the cost of constructing the project. To safeguard the budgetary and program interests of the National Government the Commission further recommends that such prefinancing contracts provide restrictions which would limit the prefinancing entitlement of any one State and provide for the conformance of such projects to the general program guidelines set forth in the substantive legislation and agency regulations.

Once the Congress has committed the Federal Government to multi-year advance funding for a particular program it should permit the States and localities to move ahead as quickly as possible by authorizing them to prefinance a substantial portion of the Federal share.

It must be emphasized that the Commission calls for prefinancing only those public facility programs that Congress deems of such high priority as to warrant some form of long-term Federal financing commitment (as called for in Recommendation No. 6). It is in the national interest for Congress to encourage States and localities with the most critical needs and the ability to raise the funds to move ahead on their high priority programs faster than the annual apportionments would allow. In this way the needed facilities will be available sooner, and in view of a general upward trend in construction costs, may save money in the long run (possibly subject, however, to offsetting higher interest costs) thus enhancing the total program.

Congress authorized prefinancing of the Federal share of sewage treatment facilities construction costs in the Clean Water Restoration Act of 1966. Seven States took advantage of this prefinancing authority, *despite the fact that they were not given unconditional assurance that the funds they advanced would ever be forthcoming.* By September 1969, those seven States* had advanced almost $300 million of anticipated Federal aid and additional amounts have been committed since. To do this and to provide their own share of the program, they had authorized financing–mainly bond issues–to the tune of $1.6 billion. Michigan, New Jersey, Washington and Wisconsin have recently authorized sizeable bond issues for the same purpose, and Maine increased its bond authorization considerably.

Given the opportunity and the fiscal ability, those States with the most urgent needs will make significant contributions to a national effort by taking the lead in implementing a national policy enunciated by Congress. Beyond this, experience with the water pollution control program has shown that a Federal grant program can induce the States to participate with statewide funds in local projects by offering an increase in the Federal share for such participation; but it is evident that this inducement becomes even stronger when it is coupled with prefinancing authority. The seven States that are prefinancing the Federal share of the cost of constructing sewage treatment plants are adding their own shares in substantial amounts.

The critical point to note is the imperative need to give the States *unconditional assurance* that the funds they advance in behalf of the Federal Government will be reimbursed on a timely basis. By taking this decisive action the National Government can mobilize substantial additional resources for an accelerated attack on many of the Nation's urgent domestic needs.

In a recent address to the Governors' Conference, President Nixon acknowledged the desirability of reimbursing the States that moved ahead on the water pollution control front:

> We believe that any State that went forward after the Clean Water Restoration Act of 1966 relying on what the Federal Government had indicated, went forward in its own program, should not be penalized because it took that initiative. As a matter of fact, it should be rewarded.

*Connecticut, Maine, Maryland, Massachusetts, New York, Pennsylvania and Vermont.

That is why 20 percent of all the funds that we have asked the Congress to appropriate in the field of water pollution will go through the Office of the Secretary of the Interior and the first priority on that 20 percent will now be to take care of approximately $320 million in the case of those States which between 1966 to the present time did go forward in their own programs and who have not been compensated for the Federal share from the Federal Government...

...But in no event will any State represented around this table be penalized when it relies on what the President of the United States indicates will be a Federal commitment.

We have made a commitment. If the States go along, we will see to it that you are reimbursed. That will be our program.[3]

Prefinancing authority is particularly important in program areas where—as in the case of water pollution control—the Federal legislation mandates statewide standards. Without prefinancing, some communities with sufficient resources of their own might well go ahead with federally-aided projects, but unless their neighboring, less affluent, communities could also participate, the statewide standards could not possibly be achieved. With prefinancing the State could assist all communities to construct the necessary facilities and thus comply with the mandated standards.

Such prefinancing arrangements, however, must protect National Government interests by building in proper safeguards. Where no limits are set as to the amount of prefinancing an individual State can undertake, some States will undoubtedly over-extend themselves with little hope, except a moral one, that they will eventually recoup. Furthermore, even with advance Federal funding, priorities may change—especially toward the latter part of the period for which such funding is provided.

Limiting safeguards are needed in connection with prefinancing authority because while technically it would be available to all States as are the benefits of most grant-in-aid programs, only a handful of States would ordinarily be able to take advantage of it. The States likely to use such authority are those with considerable fiscal resources of their own, with sufficient borrowing power, and with political leadership capable of convincing taxpayers of the need to approve such financing. For example, the three States—Connecticut, Maryland and New York—that account for 90 percent of the prefinanced Federal share of the cost of sewage treatment plant construction are among the top dozen in per capita personal income. Unfettered prefinancing could distort the intent of Congress to allocate funds among all the States in proportion to their needs and their ability to finance the program. To the extent that a prefinanced program involved equalization, this aspect could be diluted if a handful of high-income States were allowed to pre-empt more than the intended share of the Federal resources.

When a new grant-in-aid program is proposed and finally enacted, Congress and the Administration must leave open for themselves the option of reassessing it in the light of future developments. The need may arise, for example, to reallocate program resources somewhat differently from the way it was done under the original formula. New technological developments might call for a revision of standards and techniques with consequent changes in the focus of the program. In a dynamic society priorities change and programs must be adjustable to those new priorities. This element of budgetary flexibility is surely weakened, if not removed altogether, if a few States were allowed to cut drastically into the future resources available for the program.

If States were allowed unlimited prefinancing authority they could virtually tie the Federal budgetary hands. Such State action would make it impossible for Federal policymakers to cut a program back in later years even if subsequent experience indicated that original cost estimates were too high or there emerged the need to reallocate resources among more pressing needs. Nor would it be possible later on to revise the apportionment formula to redirect the funds to other States whose needs may not have been fully anticipated earlier. For this reason the recommendation calls for a limit on the prefinancing entitlement of any one State. The nature of the limitation would depend on the way grant funds are allocated among the State areas. Some public facility aid programs provide for the apportionment of all or part of the authorized funds among the States on a formula basis. For such formula grants the limitation could be specified as a percentage of each State's entitlement. For project grants where there is no specific allocation among the States, the amount authorized for prefinancing could be established as a set-aside from the total amount authorized for obligation.

To ensure that this prefinancing authority does not undermine national program requirements, at least one additional safeguard provision is warranted. Although it is the aim of prefinancing to allow States to move ahead quickly, Congress must require that their projects conform generally to its planning and program specifications. If this action is not taken the responsibility for implementing its programs will shift from the Federal to the State program administrators.

There should be at least preliminary Federal approval of projects before construction contracts are let by the States. The procedures for obtaining such preliminary approval should be streamlined by arranging for State officials to deal directly with Federal regional program administrators who would pass on certifications that proposed projects conform to general guidelines.

Without a requirement that States using the prefinancing authority conform to the general program guidelines, this device could significantly shift power and responsibility from the National to the State and local governments, for it would reduce the ability of Federal program administrators to harmonize individual projects into an overall program. States might plan and construct public facilities which vary significantly from the standards developed by the Federal program administrators in consultation with State, local and private program specialists. If the prefinancing States were permitted to move ahead without regard to the general program specifications laid down by Congress the result might be far from that envisaged by Congress when it enacted the program.

Recommendation No. 8–Federal Financial Incentives for State Participation in Federal Grant Programs for Community Public Facilities

The Commission concludes that Federal aid programs for community public facilities would be strengthened and stabilized by State financial participation. The Commission recommends therefore that the Congress develop matching provisions for its various aid programs for community public facilities so as to increase the Federal aid contribution to those community development projects that are financed in part from State funds. The Commission recommends further that grant allocation formulas also be revised so as to complement the attainment of this incentive goal.

Provision of the public facilities required by community growth and development has taken on an increasingly intergovernmental aspect, yet State participation in these matters remains the exception rather than the rule. Far greater State participation is now called for in the light of the financial difficulties in which many municipalities now find themselves and in the light of the limited funds the Federal Treasury is likely to make available to supplement local resources.

From an intergovernmental point of view, moreover, direct Federal-local grants ignore the spillover effects within regions and States in such program areas as environmental control, urban mass transportation and airport development. Thus, if a project is of more than local interest, it need not be viewed as strictly a local-Federal project; the States too must become financially active to bring costs and benefits of such projects into proper alignment.

The entry of State governments into Federal aid programs for urban development adds a vital political dimension. The mustering of State government support in behalf of larger and more stable Federal urban aid commitments would tend to build greater fiscal certainty in these intergovernmental fiscal arrangements. It is significant that the President of the United States went before the National Governors' Conference and promised that he would use all the power at his disposal to assure reimbursement to those States that prefinanced the Federal share of the cost of the waste treatment program. It is significant also that this is the only Federal aid program with both a prefinancing feature and a financial incentive for State participation.

In a 1964 study, the Commission recommended that:

> ...the States assume their proper responsibilities for assisting and facilitating urban development; to this end it is recommended that Federal grants-in-aid to local governments for urban development be channeled through the States in cases where a State (a) provides appropriate administrative machinery to carry out relevant responsibilities, and (b) provides significant financial contributions, and when appropriate, technical assistance to the local governments concerned.[4]

This ACIR recommendation, however, was silent on the question of a Federal financial incentive to induce the States to become administratively and financially involved in urban development.

Providing Federal financial incentives for State participation can hardly be viewed as a radical proposition. The idea was first translated into statutory language with the enactment of the Clean Water Restoration Act of 1966–a measure that extended Federal aid to localities for construction of waste treatment facilities.

Under that Act, the Federal share is increased by up to 20 percentage points if the State provides 25 or 30 percent of the project cost, depending upon certain circumstances. As of April 1970, 16 States were supplementing the Federal grant for construction of sewage treatment plants with State funds, covering 25 or 30 percent of the program costs. Three additional States provided some share of the cost of local projects.

It should be noted, however, that there is a serious flaw in the State participation incentive provisions of that Act in that they do not provide for increasing the *dollar amount* allocated to a participating State. Unless the allocation of Federal funds is increased to provide for the higher matching, the amount of Federal funds available to the State remains the same as before. In other words, the higher Federal share is available for particular projects that have already been approved, leaving less for other projects. If the Federal Government is to provide a true incentive for State participation it should provide *increased dollar grants as well as increased matching* for those States that put up the required non-Federal portion. This would require either an increase in the total amount appropriated for distribution to the States or a shift of Federal funds from nonparticipating States to participating ones. It would also require an aid formula that establishes a relationship between needs and allocations rather than one that relies simply on population as the allocation factor.

The case for Federal financial incentives for State participation becomes even more persuasive if the Congress authorizes States to prefinance the Federal share of the local project cost. As a precedent, albeit somewhat limited, we have in the Clean Water Act of 1966 not only a Federal financial incentive for State participation, but also a moral, if not a legal, commitment to reimburse those States that advanced the Federal share of the local project cost. Thus, State participation along with prefinancing represents a double-barreled force for firming up Federal aid commitments, and thereby promoting the national interest in areas of critically needed urban public facilities.

Although the offer of Federal carrots for State participation in urban projects will undoubtedly draw some States into such programs, opposition to such Federal incentives has been voiced.

It has been argued that, if the States are serious about assuming their proper responsibilities for urban development programs, the mere channeling of Federal funds should be sufficient reward. The fact is that most of the urbanized States are now becoming involved in urban programs—through their newly established community affairs departments and offices—without Federal incentives. Why, then, should a State be offered a Federal bonus for acting responsibly and responding to the critical needs of its urban areas?

The Federal incentive is needed to blur distinctions frequently made between clearly statewide interests—such as elementary, secondary and higher education, public assistance and air pollution control—and those, like urban mass transportation, which transcend the boundaries of individual communities yet do not have a statewide impact. Such regional-impact programs are at a disadvantage in the competition for State funds and it is precisely for such programs that the Federal incentive should prove most helpful in marshalling State legislative support.

Footnotes

[1]H.R. 15903, H.R. 16020, H.R. 16055, S. 3468; all of the 91st Congress, 2nd Session.

[2]ACIR, *State Aid to Local Government,* A-34 (Washington: April 1969) p. 24.

[3]Remarks of the President at the National Governors' Conference, Winter Session, February 25, 1970.

[4]ACIR, *Impact of Federal Urban Development Programs on Local Government Organization and Planning* (A-20), p. 30.

Chapter 2

State and Local Government Access to Capital Funds

Year-in and year-out, between 25 and 30 percent of State-local general and utility expenditure (excluding interest on debt) is devoted to capital facilities (see chart). Annual capital outlay, currently divided in roughly equal proportions between States and localities, passed the $20 billion mark in 1965 and will probably hit the $40-$50 billion range by 1975.

RELATIVE IMPORTANCE OF BORROWING FOR STATE-LOCAL CAPITAL FINANCING

States and localities have recourse to three revenue sources for acquiring land and existing structures, constructing new buildings and purchasing new equipment. They set aside current revenues from taxes and charges. They receive "outside" financial assistance from other governmental levels for categorically-aided capital expenditures. They issue debt instruments, mainly "municipal" bonds.

Surveys conducted by the Urban Institute for fiscal years 1969 and 1970 confirm the widely-held assumption that States and localities together finance between one-half and two-thirds of their capital outlays by borrowing. Roughly equal shares of the remainder are derived from current revenues and Federal funds. The relative importance of these sources, however, varies considerably between the State and local levels and among functions.

In 1969 and 1970, the States incurred debt to finance 38 percent of their total capital outlays, according to the surveys. State taxes and other current receipts provided the funds for 27 percent of total capital spending. Federal grants and loans accounted for the remaining 35 percent of these outlays.

Both cities and counties relied far more heavily on borrowing than did the States, obtaining 63 percent of their capital financing from debt issues. City taxes and other current receipts financed 20 percent of city capital outlays, and Federal grants and loans funded the remaining 17 percent. The comparable figures for county government were 22 percent from taxes and current receipts and 15 percent from Federal grants and loans.

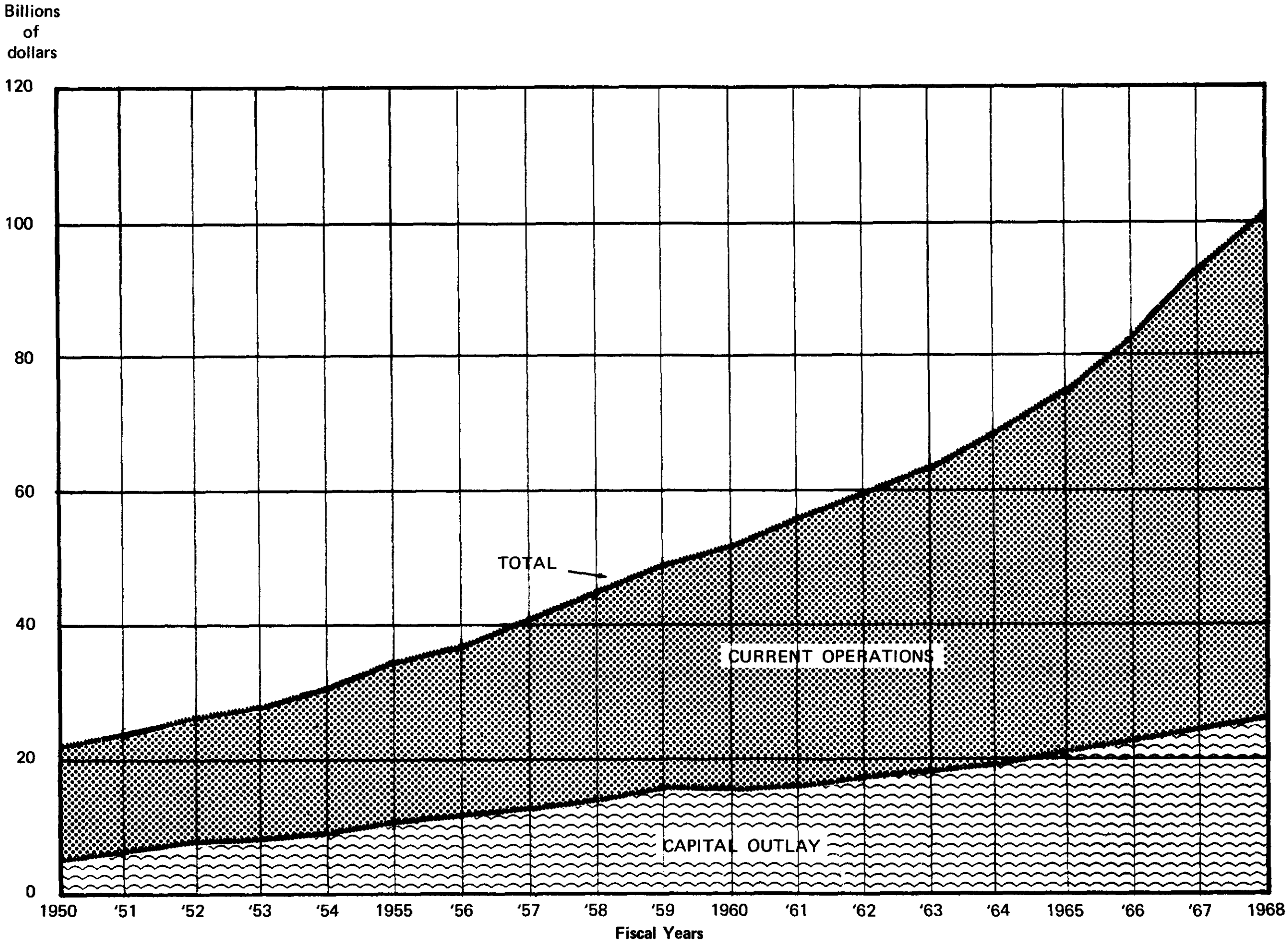
Relative emphasis on the three sources of financial support for capital outlay purposes reflects a variety of fiscal considerations. Bond issues, for example, have the desirable feature of spreading the cost of facilities over the course of their useful life and between present and future users. Nonetheless, some States and localities have made a conscious decision to follow the "pay-as-you-go" approach. Still other governments have been forced, in effect, to follow this latter approach by the presence of unrealistic State and local debt restrictions.[1] The Advisory Commission has recommended that debt restrictions, along with tax limitations, be removed or at least made less rigid.

Federal financial assistance in support of State and local capital expenditures takes two distinct forms. The direct form of aid is exemplified by construction grants under the Federal aid highway programs. Construction grants are estimated at $8.1 billion for fiscal 1971, of which $4.3 billion is for highways. States and localities receive indirect aid from the National Government via the tax-exempt status for Federal income tax purposes accorded interest income from State and local bonds. This type of aid is highly prized by State and local officials because of its blanket, automatic, unconditional, and open-ended character.

PROJECTED STATE-LOCAL CAPITAL OUTLAYS

In the financing of State and local capital outlays, the municipal bond market and the magnitude of capital spending by these governments interact as the foregoing

STATE AND LOCAL GENERAL AND UTILITY EXPENDITURE
FOR CURRENT OPERATIONS AND CAPITAL OUTLAY, 1950-1968
(Interest on Debt Excluded)



Source: U.S. Dept. of Commerce, Bureau of the Census, *Census of Governments.*

discussion indicates. Because of this interaction, it is not only difficult but hazardous to speculate about future developments in the municipal bond market. The underlying set of required assumptions for projecting State and local outlays encompasses a wide range of slippery subjects including construction and interest rate trends, type and magnitude of Federal financial assistance, and the degree of commercial bank participation in the purchase of municipal securities. Changes in any of these factors along with changes in citizen perception of public facility needs, in urban areas particularly, can have a sizeable impact on estimated capital outlay magnitudes and municipal bond market developments.

The most widely quoted projections of future outlays are those contained in a study completed by the Joint Economic Committee in 1966. The Committee estimated State and local capital expenditures would reach $40.7 billion in 1975, just over twice the actual 1965 figure (table 1). The Committee foresaw a ten-year total capital outlay of $327.8 billion by these governments, with transportation, education, and water and sewerage facilities exerting the major claims.

Construction prices, the Committee assumed, would grow at a rate of 2 percent per year. Had the Committee used a 3 percent price rise, which is still lower than the 3.4 percent increase that occurred during the 1950's and the 3.7 percent advance that marked the 1960's, the 1975 State and local outlays would total just over $50 billion.

The pressure that these new demands will exert on the municipal bond market can be gauged by using the simple average of $33.0 billion for each of the next 10 years (from the original JEC study) and making the

Table 1

STATE AND LOCAL ESTIMATED CAPITAL REQUIREMENTS, 1966-1975, AND ACTUAL CAPITAL OUTLAYS, 1965
(in billions of dollars)

Category	Actual 1965[1]	Estimated 1970	Estimated 1975	Estimated 1966-1975
Water and sewer	2.7	5.5	6.8	56.5
Electric and gas	0.8	1.3	1.4	12.8
Transportation	8.9	13.5	17.7	141.1
Education	4.9	5.9	7.8	62.0
Health	0.8	1.3	1.7	13.1
Recreation and cultural	1.5	3.4	4.4	35.0
Other public buildings	0.5[2]	0.7[3]	0.9[3]	7.3[3]
Total	20.1	31.6	40.7	327.8

[1] Adjusted to reflect facility categories where data are not available.
[2] Excludes publicly owned industrial plants.
[3] Includes police stations with estimated capital requirements assumed to be $1 billion during 1965-1975.

Source: State and Local Public Facility Needs and Financing, Joint Economic Committee, 89th Congress, 2nd Session, Volume 1, p. 14.

assumption that only one-half the capital outlays will be financed by new bond issues. This then yields an annual municipal bond offering of $16.5 billion—an amount just in excess of the record $16.3 billion issued in 1968.

VIEWS OF THE FUTURE MUNICIPAL BOND MARKET

The Joint Economic Committee's projection of total outlays and its implications for the municipal bond market have met with mixed reactions.

Optimistic View

Those holding to a more optimistic view of the municipal bond market conclude that it could absorb the projected level of capital facility demands based on the Joint Economic Committee study. To buttress this position, these "optimists" point out the basically constant relationship over the recent past between a State-local bond yield index and a comparable index for corporate securities (table 2). According to this viewpoint, the relative position of State and local issues has not deteriorated; the instability of the index in 1969 represented an aberration brought about when State-local bond interest was considered for possible inclusion in the Federal income tax base. Current problems in the municipal bond market are the same problems faced by all fixed-income security markets in this time of inflation, in the view of the optimists. Inflation upsets the market by necessitating ever higher interest rates to attract potential purchasers to fixed income securities.

Pessimistic View

Some analysts are highly skeptical of the Joint Economic Committee projections and therefore are "bearish" about the ability of the municipal bond market to absorb State and local debt issues. These critics foresee new and expanded public works programs in pollution control and other fields that could add as much as $30 to $50 billion over a period of 5 to 10 years. Such demands coupled with the tremendous backlog of credit needed for housing, other consumer purposes, and the normal expansion in corporate borrowing portend intense competition for capital funds. With a money market characterized by a wide variety of attractive investment opportunities, States and localities may not be able to count as heavily as they have in the past on high tax bracket individuals and commercial banks—traditional holders of municipals—to invest in State and local securities.

Table 2

STATE-LOCAL AND CORPORATE BOND YIELD INDICES, BY MONTH, 1965-1970 (June)

	Municipal Bond Yields (Bond Buyer "20 Bonds" Index)	Corporates (Moody's Aa Series)	Ratio		Municipal Bond Yields (Bond Buyer "20 Bonds" Index)	Corporates (Moody's Aa Series)	Ratio
1965 J	3.07	4.48	68.5	1967 N	4.27	6.23	68.5
F	3.04	4.46	68.2	D	4.45	6.35	70.1
M	3.20	4.48	71.4				
A	3.16	4.48	70.5	1968 J	4.38	6.29	69.6
M	3.15	4.49	70.2	F	4.16	6.27	66.3
J	3.20	4.52	70.8	M	4.49	6.28	71.5
J	3.30	4.56	72.4	A	4.31	6.38	67.6
A	3.25	4.59	70.8	M	4.44	6.48	68.5
S	3.29	4.63	71.1	J	4.51	6.50	69.4
O	3.41	4.66	73.2	J	4.48	6.45	69.5
N	3.44	4.69	73.3	A	4.11	6.25	65.8
D	3.50	4.80	72.9	S	4.44	6.23	71.3
				O	4.36	6.32	69.0
1966 J	3.53	4.83	73.1	N	4.56	6.45	70.7
F	3.54	4.90	72.2	D	4.76	6.66	71.5
M	3.83	5.05	75.8				
A	3.55	5.10	69.6	1969 J	4.85	6.73	72.1
M	3.63	5.10	71.2	F	4.96	6.77	73.3
J	3.78	5.16	73.3	M	5.19	6.95	74.7
J	3.92	5.25	74.7	A	5.25	7.02	74.8
A	3.99	5.38	74.2	M	5.10	6.96	73.3
S	4.24	5.58	76.0	J	5.73	7.12	80.5
O	4.00	5.50	72.7	J	5.68	7.24	78.5
N	3.74	5.46	68.5	A	5.80	7.23	80.2
D	4.02	5.48	73.4	S	6.37	7.36	86.5
				O	6.19	7.53	82.2
1967 J	3.76	5.30	70.9	N	6.11	7.58	80.6
F	3.40	5.18	65.6	D	6.72	7.93	84.7
M	3.60	5.23	68.8				
A	3.54	5.26	67.3	1970 J	6.61	8.15	81.1
M	3.79	5.42	69.9	F	6.54	8.13	80.4
J	3.96	5.63	70.3	M	6.00	8.06	74.4
J	4.07	5.72	71.2	A	6.11	8.03	76.1
A	3.91	5.76	67.9	M	6.89	8.24	83.6
S	4.07	5.87	69.3	J	6.92		
O	4.25	6.01	70.7				

Sources: The Weekly Bond Buyer and Department of Commerce, Office of Business Economics, *Survey of Current Business.*

Table 3

ESTATE TAX RETURNS FILED DURING 1966 BY SIZE OF ESTATE AND COMPOSITION OF ASSETS

Size of Total Estate (000 omitted)	Number of Returns	Total Estate (in millions)	Municipal Bonds: Amount Held (in millions)	Municipal Bonds: Percent of Estate Holdings	Municipal Bonds: Proportion of Total 1966 Municipal Holdings	Municipal Bonds: Average Amount Per Tax Return
$ 60 under $ 80	8,770	$ 631.2	$ .9	.14	0.17	$ 102.6
80 " 100	8,707	778.1	1.7	.21	0.33	195.2
100 " 150	15,919	1,980.5	5.4	.27	1.06	339.2
150 " 200	10,465	1,808.5	7.0	.38	1.38	668.9
200 " 300	9,712	2,354.7	16.8	.71	3.31	1,729.8
300 " 500	6,689	2,543.4	33.5	1.31	6.60	5,008.2
500 " 1,000	4,133	2,818.8	84.9	3.01	16.72	20,542.0
1,000 " 2,000	1,532	2,079.2	97.5	4.68	19.20	63,642.3
2,000 " 3,000	400	964.7	60.8	6.30	11.97	152,000.0
3,000 " 5,000	236	898.1	62.5	6.95	12.31	264,830.5
5,000 " 10,000	130	890.8	76.9	8.63	15.14	591,538.5
10,000 " 20,000	33	449.8	33.9	7.53	6.67	1,027,272.7
20,000 or more	19	599.9	26.1	4.35	5.14	1,373,684.2
Totals	66,745	$18,797.7	$507.9	2.70		

Note: Data presented here relate only to taxable estates. Total estate differs from gross estate by the inclusion of life insurance at face value (before deduction of outstanding loans), and the exclusion of gifts made during the decedent's life.

Source: Statistics of Income, 1965, Estate Tax Returns filed during calendar year 1966: United States Treasury Department, Internal Revenue Service, Washington, D.C., November 2, 1967, pp. 71-72.

Commercial Bank Position—

Meeting the credit needs of State and local governments is, at best, a tertiary investment activity of commercial banks. Their predilection to invest first in business and personal loans became quite clear in the extraordinary conditions of 1969 and previous tight money markets. Bank purchases of State and local issues dropped off sharply from rates of $9.0 billion and $8.7 billion in 1967 and 1968, respectively, to about $1.4 billion in 1969.

In the view of some observers, commercial bank demand for municipals will remain sluggish in both the near term and in the longer run. Both monetary and tax policy considerations are cited in support of this view. Until banks recover from their presently depressed liquidity position brought about by Federal Reserve policies to combat inflation, they will be precluded from making large scale purchases of State and local securities.[2]

To the extent that commercial banks are in the market to reduce their income tax liabilities, their participation is bound to level off as this goal is reached. Previous acquisitions motivated by tax considerations have already given commercial banks an established position for reducing their tax liabilities. Over the longer term, bank demand motivated by tax considerations may have been permanently reduced by the provision in the Tax Reform Act of 1969 which requires commercial banks to treat long-term gains from the sale of bonds (both U.S. securities and municipals) as ordinary income. This change will, in effect double income tax liabilities on such gains since they formerly were treated as capital gains and taxed accordingly.

High Tax Bracket Individuals—

Although individuals subject to high Federal income tax rates place relatively modest portions of their assets in State and local bond issues, it is nonetheless true that the vast majority of State and local bond issues held by individuals are held by those who find the tax-exempt feature attractive financially. An analysis of 1966 estate tax returns shows that State and local municipal bonds were less than 10 percent of the total estate for each of several size classifications (table 3). But, the same data on a per return basis revealed that the amount held in State and local bonds rises steadily as the size of estate increases. For example, State and local security holdings averaged only $103 in estates ranging from $60,000 to $80,000 while holdings averaged $1,373,684 in estates of $20 million or more. Similarly, 87.2 percent of the amount held in State and local bonds was held by those whose estates exceeded $500,000, a group that accounted for only 9.7 percent of 1966 estate tax returns.

High-bracket individuals who buy municipal bonds, whether motivated by tax or other investment considerations, will find the tax-exempt status of these bonds less attractive since the passage of the Tax Reform Act of 1969. Various provisions of this bill reduced individual income tax liabilities and thereby reduced the value of this privilege. This aspect of the bill may have little effect, however, on the municipal market because State and local bond issues remain untaxed while various alternative tax shelters have been made less attractive either directly by various reform provisions or indirectly via the minimum income tax provision.

Thus, those inclined to take a "bearish" view of the market predict that just when State-local bond offerings are likely to be at peak levels, commercial banks and high tax bracket individuals—the predominant sources of funds—appear likely to reduce their purchases. Unless new sources of demand are uncovered, the future, according to this view, will be one of particular difficulty in placing State and local bond issues.

GROWTH IN OUTSTANDING ISSUES

At the end of 1946, State and local governments had some $15.6 billion in interest bearing securities outstanding (table 4). This amount increased each year thereafter. By mid-1969, the total of State and local securities outstanding reached $132.5 billion, more than 8 times the 1946 level. Moreover, the 1969 amount was more than 5 times the total outstanding at the end of 1950 when the temporary effects of the pent-up demands of the war years had been pretty well absorbed. The same picture of dramatic increase in State and local bond issues is revealed by annual amounts offered for cash on the municipal bond market. Compared to a total of $1.2 billion offered in 1946 and $3.5 billion in 1950, some $16.3 billion was offered in 1968, though this tailed off to $11.4 billion during 1969.

Virtually all of the State-local government debt outstanding is long-term; nearly 95 percent is of this nature. Most of the long-term debt is backed by the full faith and credit of the issuing government but a sizeable amount, about 40 percent, is non-guaranteed. These latter State-local issues do not constitute a claim on the general revenues of the issuing governmental authority but are payable solely from pledged earnings of specific activities or facilities, from special assessments, or from specific nonproperty taxes.

COMPOSITION OF INVESTORS IN MUNICIPALS

The increase of more than $116 billion in State and local government securities outstanding during the postwar period has been absorbed by four institutional groups: savings institutions, business, government, and individuals. Those holding State and local bonds may also be classified into two broader groups, public or governmental and private, the latter being far and away the more important.

Public Investors

The Federal Government, and States and localities themselves, hold State and local securities through their trust, sinking, and investment funds. In the aggregate, their present holdings constitute less than 5 percent of the total issues outstanding (table 5). State and local funds invested in municipals totalled $4.6 billion in 1969, a smaller amount in this form of investment than in any year from 1959 through 1965.

By way of contrast, holdings of State and local securities in U.S. Government investment accounts have generally increased, from $0.3 billion in 1959 to $1.4 billion in 1969. The Federal Reserve System does not hold such securities though recent proposals have been made that would have this "quasi-public" institution participate in this market.[3]

Private Investors

Individuals, business and saving institutions comprise the private holders of State and local securities. Within this class, holdings are quite concentrated in the hands of commercial banks and individuals. Indeed, these two groups have consistently accounted for upwards of 70 percent of all private holdings of State and local securities in each postwar year and 76 percent in mid-1969. Fire and casualty insurance companies are a third significant holder of municipals, presently having about $17 billion or 11 percent of total private holdings.

The concentration of municipal holdings in the hands of a few classes of investors can be attributed to the tax-exempt status of these securities for Federal income tax purposes. As would be expected, tax-exempt income is of particular interest to those subject to high Federal income tax rates. Thus, individuals who would otherwise be subject to the higher marginal Federal income tax rates and commercial banks which are subject to corporate income taxes at the standard rates find municipals particularly attractive investments.

Table 4

STATE AND LOCAL GOVERNMENT SECURITIES OUTSTANDING (in millions of dollars)

June 30	States, counties, cities, etc.
1969	$132,500
1968	121,400
1967	113,300
1966	104,800
1965	99,200
1964	91,300
1963	85,900
1962	80,131
1961	71,730
1960	66,425
1959	61,675
1958	56,500
1957	51,840
1956	47,400
1955	42,600
1954	37,300
1953	32,200
1952	29,111
1951	26,592
1950	23,722
1949	20,481
1948	18,354
1947	16,529
1946	15,626

Information furnished by the Treasury Department.

While tax considerations are the motivating force behind most of the demand for State and local securities, other individuals and financial institutions who stand to gain only moderate tax savings nonetheless hold these securities, albeit, in limited amounts. Thus, other holdings of State and local government securities in mid-1969 were spread among nonfinancial corporations (4.7 percent), a group of miscellaneous investors* (1.9 percent), and mutual savings banks (0.1 percent).

*Comprises savings and loan associations, non-profit associations, corporate pension trust funds, dealers and brokers, and investments of foreign balances and international accounts in this country.

Table 5

OWNERSHIP OF STATE AND MUNICIPAL SECURITIES
U.S. TREASURY DEPARTMENT ESTIMATES AS OF JUNE 30, 1959 THROUGH 1969
(000,000 omitted)

	1969	1968	1967	1966	1965	1964	1963	1962	1961	1960	1959
Total Amount Outstanding	$132,500	$121,400	$113,300	$104,800	$99,200	$91,300	$85,900	$80,131	$71,730	$66,425	$61,985
Held By—											
Individuals (includes partnerships and personal trust accounts)	41,800	39,200	39,800	38,200	36,000	33,700	31,700	30,700	28,300	27,200	24,600
Commercial Banks	58,500	52,800	45,600	40,300	36,600	31,500	27,900	23,200	18,800	16,800	17,000
Insurance Companies	17,300	16,500	15,500	14,400	15,200	15,000	14,500	13,700	12,600	11,100	9,500
State and Local Funds*	4,600	4,500	4,200	4,600	5,000	5,600	6,400	7,200	7,400	7,100	6,800
Corporation†	6,200	5,000	4,800	4,100	3,300	2,700	2,600	2,400	1,900	1,700	1,700
Miscellaneous Investors††	2,500	2,000	2,100	2,000	1,900	1,800	1,800	1,800	1,600	1,500	1,300
Mutual Savings Banks	200	200	300	300	400	400	500	600	700	700	700
U.S. Government Investment Accounts	1,400	1,200	1,000	900	800	600	600	500	400	300	300

*Comprises trust, sinking and investment funds of State and local governments, Territories and possessions.
†Exclusive of banks and insurance companies.
††Includes savings and loan associations, non-profit associations, corporate pension trust funds, dealers and brokers, and investments of foreign balances and international accounts in this country.
Figures are rounded and do not necessarily add up to the totals.
Information furnished by the Treasury Department.

FACTORS AFFECTING THE GROWTH OF STATE AND LOCAL BOND ISSUES

In the late 1940's and early 1950's, State and local governments turned to the bond market to (a) help meet the costs of capital facility projects delayed during World War II, (b) finance veterans' bonus payments, (c) catch up again on demands held in check during the Korean War. These governmental authorities also increased bond issues in response to economic development and change that has characterized the nation during the postwar period.

Population Growth

Pressure for additional public facilities stems most directly from growth in the population. Between 1946 and 1969, the nation's population grew from 141.4 million to 203.2 million, an increase of more than 40 percent. Yet, this understates the demand on States and localities to meet public facility needs of particular population segments and specific functions. For example, the number of school-age children (aged 5-19) increased at a rate nearly double that for the population as a whole, rising from 33.2 million in 1946 to 58.9 million in 1969, an increase of 80 percent.

School facility needs also changed as a result of the lengthening of the average term of a person's education and the higher standards required for new school buildings and facilities due, in part, to the greater usage of capital intensive teaching techniques made possible by technological advances. Thus, the recent expansion of the State-local educational plant and facilities reflected the compounding effects of population and other factors that are likely to continue in the years ahead.

The massive highway program of the past decade reflected a similar response to the compounding effects of population and associated growth factors. Car ownership became more widespread and more and more families grew accustomed to a second vehicle. Motor vehicle registrations, for example, jumped from 49.3 million in 1950 to 101.0 million in 1968, an increase of 105.8 percent. The ever-increasing automobile ownership and utilization of more and heavier trucks and buses resulted in the need for additional highways, including multi-tiered bridge facilities, as well as the repavement of extensive road mileage with improved surfaces.

While population growth stands out as a factor leading to additional State and local public facilities and bond issues, it is a "general" indicator at best. The real impact of population growth on the need for State and local bond issues can only be worked out by analyzing the components of population growth and associating them with simultaneous technological developments in the nation's economy.

Price Increases

A second pervasive influence affecting the growth in State and local bond issues has been the postwar advance in prices. Stated simply, it costs more to build the same public facility in 1969 than it did in 1946, after abstracting from quality improvements and the like. The E. H. Boeckh Associates, Inc. index for construction costs (an average of 20 cities), for example, has risen without interruption in the postwar period from 54.1 in 1946 to 75.9 in 1950 and to 155.6 in March 1970. Like the costs of all goods and services, the costs of building public facilities have increased sharply. Indeed, such costs have risen at more than twice the rate of increase in consumer prices; for the 1950-1969 period, public building costs rose 105 percent while consumer prices rose 52 percent.

Population Redistribution

The relentless movement of the nation's population from rural to urban areas has added to State and local spending for capital facilities. Moreover, the more densely populated the urban centers become, the more difficult and expensive it is to meet capital facility requirements. This is particularly evident in the urban transportation field, where facilities must meet "rush-hour" demands, even though they may stand relatively idle at other times of the day. Furthermore, the movement from city to suburb forces State and local authorities to replicate facilities in these newer areas of development without eliminating the need for facilities in the central city, where many of the suburbanites continue to work and shop.

While it is difficult to measure the precise impact that population growth, price increases, population shifts and the general rise in personal incomes have had on increased State and local government bond issues, the important point is that these forces are part and parcel of the economic growth that has been characteristic of the nation. As such, they can be expected to constitute operative forces in determining State and local capital facility needs and the associated financing requirements in the future as well.

"Tight Money"—The Interest Rate Effects

In addition to the influence of demands for new capital facilities, State and local government bond issues have also been affected by changes in interest rates. Indeed, the State-local sector seems particularly sensitive to changes in monetary policy which, by affecting the price that these governments must pay to attract funds, alters either the timing or magnitude of State and local bond offerings. Because of their heavy dependence on the bond markets, State and local governments—along with the housing sector and small business—are peculiarly vulnerable to monetary policies aimed at dampening down the inflationary pressures of the national economy. Thus, while monetary policy is frequently defended as a "general control" whose effects are spread over the various sectors of the economy, State and local governments, lacking a retained earnings cushion of large corporations for example, are particularly sensitive to an anti-inflationary monetary policy. The State-local sector, however, is not without its own protective mechanisms. While bond issues may be postponed or deferred because of tight money markets, spending on capital facilities can be maintained by drawing down liquid assets or borrowing short-term funds. Nonetheless while State and local governments retain some financial flexibility to tide them over short periods of stringency, this type of insulation is less effective the longer the stringency proceeds.

Interest rate changes affect not only the price that State and local officials must pay but also their expectations as to the future course of interest rates. Thus, a given interest rate may at one point in time cause a postponement or cancellation of a bond offering if it was not anticipated while the same rate—at a subsequent date—may not lead to any such change simply because it had been expected. It is the difference between the actual and expected rate of interest—not the actual rate itself—therefore that is crucial.

Empirical Evidence. Perhaps the most obvious effect of interest rates on the market—certainly in periods of very tight money such as the credit crunch of 1966 and 1969—is demonstrated when these rates exceed constitutional or statutory limitations at which State and local government authorities are permitted to borrow. Actually, State and local governments enter the capital market with an extraordinary number of such limitations (table 6) and despite recent actions by several States to suspend, ease, or permanently remove such restrictions, they remain a major barrier to placing State and local bond issues. According to the *Weekly Bond Buyer,* statutory rate ceilings have caused some $2.4 billion of State and local bond issues to be either postponed, have bids rejected or fail to receive bids during 1969.[4]

Recent studies have examined the specific influence of interest rates on State and local bond issues. These studies have shown that State governments as well as local governments,[5] both large and small,[6] were affected by interest rate changes. State governments apparently react more to the interest rate effect than local governments do. While one might attribute this reaction to financial weakness, State sensitivity to interest rates indicates financial strength. The diversity and size of State government financial operations tends to provide a larger cushion of financial assets to fall back on in times of need. In short, State governments simply have more flexibility in adjusting to interest rate changes than do local governments.

These studies also indicated that, while high and rising interest rates had a demonstrable impact on the issuance of State and local government bonds by causing the abandonment or postponement of debt issues, there was a far lesser reduction in actual capital outlays. This was particularly true for States and the larger units of local government, both of which were able to rely on their liquid asset holdings and short-term borrowing. Smaller local governments, while also relying on short-term borrowing, were more likely to have to reduce their current expenditures or to postpone their cash disbursements.

Despite high and rising interest rates during the credit crunch of 1966, State and local governments, large as well as small, went ahead with their borrowing intentions according to a Federal Reserve Board survey. The larger governmental units, for example, planned to borrow $7.6 billion in 1966 and actually borrowed $6.2 billion or 82 percent of their intentions.[7] Moreover, of the 493 larger governmental units that either borrowed or intended to, 371 experienced no change in plans at all; nonetheless, 69 did change their plans while an additional 53 jurisdictions that had intended to borrow in 1966 did not actually do so.[8] For the smaller governmental units, planned borrowing in 1966 totalled $4.0 billion with actual borrowing at 72 percent of that amount, or $2.9 billion, while one-fifth of the sampled governmental units that had some intention to borrow in 1966 were forced to make some downward adjustment of their initial plans.[9]

Federal Grants-in-Aid

Federal grants-in-aid and loans to State and local governments for construction projects are another influence that has pushed the debt issues of these governmental units upwards. For fiscal 1971 this assistance is estimated at $8.1 billion in grants and $337 million (net) in loans. Federal aid is provided either as a

Table 6

STATUTORY INTEREST RATE CEILINGS ON STATE AND LOCAL BONDS, 1970

	State GO (%)	State Revenue (%)	State Agency (%)	State Notes (%)	Local GO (%)	Local Revenue (%)	Local Agency (%)	Local Notes (%)	Urban Renewal Notes (%)	Low-Rent Housing Notes (%)
Alabama	8	8	8	8	V	V	V	V	O	O
Alaska	7	8	7	7	O	O	O	O	6	7
Arizona[15]	O	O	O	O	O	O	O	O	O	O
Arkansas[1]	V	U	V	O	V	V	V	O	8	8
California[8]	7	V	7	7	7	V	7	O	7	7
Colorado[2]	O	O	O	O	O	O	V	O	O	O
Connecticut	O	O	O	O	O	O	U	O	O	O
Delaware[3]	O	6	6	6	6	6	6	6	6	6
Florida	7½	7½	7½	7½	7½	7½	7½	7½	7½	7½
Georgia	O	O	O	O	O	9	9	O	8	8
Hawaii[19]	8	O	N	8	8	8	N	8	6	8
Idaho	7	U	U	U	O	O	U	U	O	O
Illinois[14]	O	N	V	N	7	7	V	V	6	7
Indiana	O	O	O	U	O	O	V	U	O	O
Iowa	7	7	U	U	7	7	7	7	7	7
Kansas[4]	5½	6	5½	U	5½	6	5½	U	8	8
Kentucky	O	O	O	O	O	O	O	N	O	O
Louisiana	O	O	O	O	6	6	6	O	6	6
Maine	O	O	V	O	O	O	V	O	6	6
Maryland	O	V	O	O	V	V	V	V	6	6
Massachusetts	O	O	O	O	O	O	O	O	O	O
Michigan[16]	6	8	8	8	8	8	8	8	8	8
Minnesota[5]	O	U	U	O	7	O	O	O	7	7
Mississippi	6	6	6	U	6	6	6	U	6	8
Missouri[18]	8	8	8	U	8	8	8	U	6	6
Montana	5½	5½	6	U	6	6	6	U	6	6
Nebraska[6]	O	O	O	O	O	O	O	O	7	O
Nevada	7	U	7	7	7	7	7	7	6	6
New Hampshire	O	O	O	O	O	O	O	O	6	6
New Jersey[7]	6	6	O	N	O	O	U	O	6	6
New Mexico	8	8	8	U	8	8	8	U	8	8
New York[9]	O	O	O	O	O	O	O	O	O	O
North Carolina	O	O	8	O	O	O	O	O	6	6
North Dakota[10]	U	6½	U	6½	6	6	N	6	6	6
Ohio	O	O	O	N	8	U	8	8	8	8
Oklahoma[11]	6	5	V	6	O	O	N	U	O	7½
Oregon	7	U	U	N	7	U	U	N	7	7
Pennsylvania[13]	O	7	7	O	7	7	7	7	6	6
Rhode Island	O	O	O	O	6	U	6	6	6	6
South Carolina	7	7	7	7	7	7	7	7	7	7
South Dakota	O	U	6	U	8	U	6	U	6	6
Tennessee	10	10	10	10	10	10	10	10	8	8
Texas	10	10	10	U	10	10	10	U	O	O
Utah	7	7	7	7	8	8	8	8	8	8
Vermont	O	U	O	O	O	O	U	O	O	O
Virginia[17]	O	O	O	O	O	O	O	O	6	6
Washington	O	O	O	U	8	8	8	U	O	O
West Virginia	O	7	7	O	8	7	7	O	6	6
Wisconsin[12]	O	U	O	U	8	8	8	7	6	6
Wyoming	O	O	O	O	O	O	O	O	6	N

See footnotes on following page.

Table 6

STATUTORY INTEREST RATE CEILINGS ON STATE AND LOCAL BONDS, 1970 (Cont'd)

O = none; U = none issued; N = none authorized; V = various.

[1] Arkansas: School district bonds, about 20 types of bonds for street and parking facilities, public building corporations formed to construct municipal facilities, municipally sponsored bonds for waterworks, sewer, drainage, parks, recreation agencies, convention centers, and construction and refunding bonds for eight State-sponsored colleges and universities, and county and municipal bonds for hospitals, nursing homes and rest homes may be issued at 8 per cent. County and municipal industrial development bonds, airport bonds for larger cities, countywide river port bonds and municipal port authority bonds may be issued at 10 per cent.

[2] Colorado: Maximum interest rate must be part of proposal submitted to voters along with amount of authorization.

[3] Delaware: State agency bond anticipation notes for school districts are limited to 6 per cent.

[4] Kansas: The ceiling on revenue bonds is 6 per cent.

[5] Minnesota: Highway bonds have constitutionally fixed ceiling of 5 per cent.

[6] Nebraska: No State public debt.

[7] New Jersey: 6 per cent ceilings suspended through June 30, 1971, for counties, municipalities, school districts, State agencies and other public authorities and agencies.

[8] California: Any rate permitted on specific issue approved by two-thirds vote of each house of Legislature and by the Governor.

[9] New York: 5 per cent ceilings suspended until June 30, 1971 except for issues by public authorities on which the ceiling is 8 per cent.

[10] North Dakota: Municipal refunding improvement bonds have 7 per cent ceiling.

[11] Oklahoma: Some State agencies such as Boards of Regents for Colleges have no interest rate ceiling.

[12] Wisconsin: Local notes can run for 10 years.

[13] Pennsylvania: Philadelphia does not come under Municipal Borrowing Act and thus has no ceiling on interest costs, except for 6 per cent limitation on port, transit and street bonds. The 7 per cent limitation is in effect only until mid-Oct., 1970, when by statute it reverts to 6 per cent. The 5 per cent limitation on State tax anticipation notes was removed through June, 1970.

[14] Illinois: Chicago GO bond limit of 6 per cent suspended until July 1, 1971. Park District (city corporation) GOs are limited to 7 per cent. Sanitary districts in State and City of Chicago and Chicago Board of Education authorized to issue GO notes of two-year duration not to exceed 7 per cent.

[15] Arizona: Maximum interest rate must be specified on ballot.

[16] Michigan: The 8 per cent ceiling is effective through Jan. 1, 1971, then drops to 7.5 per cent until July 1, 1971, and then returns to 6 per cent.

[17] Virginia: Ceiling reverts to 6 per cent after June 30, 1972.

[18] Missouri: Bonds must be sold not less than 95 per cent of par. Negotiated sales cannot exceed 6 per cent except industrial aid bonds which have 8 per cent ceiling.

[19] Hawaii: 8 per cent limitation for State effective until April, 1971, when it reverts to 6 per cent; 8 per cent limitation for counties effective until July, 1971, when it reverts to 6 per cent.

Source: Weekly Bond Buyer, July 13, 1970 fixed portion of the project costs or according to distribution formulas incorporating such factors as population and relative financial ability. By far the largest of these construction grants is for the several highway programs which total an estimated $4.3 billion for fiscal 1971.

Federal grants for construction programs to State and local governments have increased in each year during the 1960's. More significant, the expansion of programs in the areas of mass transportation, pollution control and public housing, for example, will probably induce even more State and local borrowing in the future, particularly if the debt service grant is used in place of the more traditional Federal lump-sum payments. Under the debt service grant, the Federal Government pays its portion in yearly installments of equal amounts over the life of the debt issue thereby avoiding an immediate, large dollar outlay and an increase in the Federal debt. States and localities are required to raise not only their share of the project costs but also a portion of the Federal share via the tax-exempt market.

At present, the debt service grant is used mainly in the public housing field and to a lesser extent for the construction of college and university facilities.* If the debt service grant is used as the financing vehicle for new and expanded Federal programs, it will further increase pressures on the municipal bond market. Congressional interest in this technique is indicated by the inclusion of Federal financing via debt service grants in both the House-and Senate-passed versions of the water and sewerage program in 1968. Because of unreconciled differences in the two measures, however, a bill was not enacted.

Summary

The economic growth and change of the nation during the postwar period has been a major factor leading to the need for additional and better public facilities. For very practical reasons State and local governments resort to the municipal bond markets to finance these facilities over their useful life. Their decisions to do so are affected by many factors but principally by interest rate changes, the availability of alternative liquid assets, and the amount and form (lump sum or debt service) of Federal financial assistance.

Recent experience indicates that interest rate changes have had a considerably stronger effect on the amount and timing of new debt issues than on the actual capital outlays. Governmental units have made a real effort to tide themselves over periods of tight money or unfavorable market conditions by making use of liquid asset holdings and short-term borrowing. Federal financial assistance has been more often than not a spur to further State and local borrowing. Many Federal grants are on a matching basis and induce State and local governments to issue bonds to put up their share of project costs. The use of debt service grants by the Federal Government as opposed to the lump-sum grants transfers the financing of such construction projects from the taxable market to the tax-exempt State and local market.

*For purposes of this report, urban renewal is classified as a debt service grant. Unlike Federal financial aid for public housing, however, urban renewal aid involves no contract for annual debt service payments. The Federal Government in providing its 2/3 or 3/4 share of the net urban renewal project costs provides a major portion of principal and interest cost upon completion of the local authority's participation in the project. In this sense therefore the Federal Government guarantees that the local urban renewal debt obligations will be discharged.

FACTORS AFFECTING THE DECISION TO PURCHASE MUNICIPAL BONDS

Tax-Exempt Status

Tax exemption stands at the head of the list of attractions that make State and local government securities desirable investments. The interest income derived from such securities is excludable in reporting income for Federal tax purposes. Conceptually, a dollar of tax-exempt interest income is clearly more valuable than a dollar of taxable income; how much more valuable depends on the marginal tax rate to which the holder is subject. Accordingly, if it were possible to find a municipal bond comparable in all other respects to a taxable bond, the municipal bond would carry a lower interest rate.

The value of these tax-exempt securities is fully appreciated by those who purchase them and is undoubtedly a major reason leading to this decision. Similarly, there is no doubt that the tax-exempt status of municipal bonds has meant lower interest costs to the issuing government than would result if such securities were made taxable. The prospect of obtaining tax-exempt income appeals most to individuals and commercial banks subject to high marginal Federal income tax rates. For this reason, State and local government issues are usually placed among this rather restricted group of market participants.

The decision to purchase such bond issues will be responsive not merely to current tax rates but to anticipated rates as well. While this is an admittedly subjective area, anticipations of higher future income tax rates would make such tax-exempt securities more attractive while the prospect of lower Federal income tax rates would reduce the incentive to purchase such securities.

It is, of course, impossible to predict the future revenue needs of the Federal Government since conflicting pressures are at work. Domestic demands for various public programs and the various components that comprise the urban fiscal crisis run head on with pressure for tax reform and tax reduction. As noted previously, several provisions of the Tax Reform Act of 1969 will tend to lower income tax liabilities.

Inflation

So long as prices continue to rise or are thought likely to increase, investment in fixed income securities, such as municipals, will be unattractive because the real purchasing power of the amounts invested will be smaller when the securities are sold or redeemed. The tendency for prices to creep or gallop upwards has had the effect of making equities, particularly growth stocks, a more favored investment. Both individual and institutional investors consider equities a better hedge against inflation than bonds. For example, public retirement funds now invest a portion of their funds in equities while continuing to make sizeable bond purchases. Corporate pension funds and life insurance companies have also stepped up equity purchases.

The impact of inflation on the municipal bond market has been to further constrict participation to the conservative investor whose objective is to preserve his wealth position rather than to enhance it. Over the long run this portends relative contraction in the supply of funds for municipals as the rate of savings of wealth-conserving units seems likely to be less than that of aggressive builders of an estate.

To the extent that inflation tends to narrow the appeal of municipals to those concerned with conserving wealth and taking advantage of the tax-exemption feature, it results in the municipal market being more vulnerable to shifts in investment preferences.

Alternative Tax Shelters

At any one time, taxpayers have a number of investment opportunities that, like tax-exempt municipals, constitute income tax shelters. Investment in assets that yield (a) capital gains rather than ordinary income or (b) favorable depreciation and depletion allowances, for example, reduce potential tax liabilities. Taxpayers can also make use of gift tax provisions to divert income out of their high marginal rate brackets. Provisions of the Tax Reform Act of 1969, however, will work to enhance the relative attractiveness of State and local bond issues as a tax shelter because the interest income derived from such securities remains wholly tax-exempt while all of the alternative tax shelters have to some extent been tightened up.

The Role of Commercial Banks

The privilege of tax exemption on State-local bonds undoubtedly has been a major factor in attracting commercial banks into the market. In a sense, the relationship between these financial institutions and the market for municipals has been one of "dual captivity." Municipals are the only form of tax shelter available to commercial banks. Unlike individuals, these banks cannot buy oil royalties or invest either in equities to avail themselves of the favored capital gains tax provisions, or in rental real estate properties to take advantage of accelerated depreciation schedules. Thus, tax-exempt municipal bonds have become a favored investment outlet for commercial banks.

The captive nature of bank participation in the municipal market is, however, a mixed blessing. Commercial banks are in business primarily to make business and individual loans. Hence, their demand for State and local securities is more of a residual activity. Further, commercial banks are a major channel by which the Federal Reserve Board exerts monetary controls. Hence, these institutions are irregular purchasers of State and local bonds, buying mainly in periods of easy money. Commercial banks purchased 85 percent of new municipal issues in 1967, and about 70 percent in 1968. But, in tight money periods they reduce purchases sharply. In 1966, commercial banks bought only 38 percent of new issues and in 1969 their purchases similarly tailed-off dramatically. Swings of this magnitude in bank purchases make the municipal bond market highly volatile, a characteristic fully appreciated by the market itself.

An admixture of sentiment and self-interest may further explain a portion of commercial bank purchases of municipals. Outside the financial centers, commercial banks are essentially local businesses and as such are tied by reasons of sentiment, if not pressure, to the support of State and local governments. Moreover, commercial banks that are willing to hold State and local securities are more than likely favored in securing the deposit balances of these governments. Indeed, governmental deposits often are conditioned on investment by the banks in selected governmental securities. Deposits, of course, are the stock-in-trade of the banking business. While knowledgeable State and local money managers have increasingly sought to place public funds in higher yielding, short-term investments rather than commercial bank deposits, a sort of customer relationship frequently prevails between local officials and local bankers. This working relationship may have contributed in the past to facilitating the issuance of smaller debt issues by some local governments. Some deterioration in this relationship may have been introduced by the change in the Federal income tax law which now requires commercial banks to treat gains on the sale of debt securities as ordinary income. This, in effect, reduces the attractiveness of long-term securities (Treasury as well as State-local bonds) to commercial banks and may reduce trading in municipals and thereby affect both the marketability and liquidity of municipal bonds.

Tax exemption then stands out as the prime factor swinging individuals and commercial banks investment decisions to municipal securities. When tax considerations are not an important motivating source, the combination of sentiment, patriotism and, in the case of commercial banks, self-interest also help to explain why institutions as well as individuals purchase these securities.

PROPOSALS TO BROADEN THE ACCESS OF STATES AND LOCALITIES TO CAPITAL FUNDS

To broaden the access of States and localities to the capital markets, several proposals have been advanced recently seeking on behalf of the States and localities to: (1) lower interest rates, (2) increase the funds available for building new capital facilities, (3) reduce the influence of bond ratings on interest rates, and (4) stabilize the municipal bond market. The proposals also seek to capitalize on the National Government's interest in reducing its so-called "tax expenditures" resulting from the sale of tax-exempt securities in the market. For convenience in distinguishing three essentially different approaches, these proposals can be grouped under the following headings.

1. A Federal subsidy only for the issuance of taxable State-local securities.

2. A Federal subsidy or broadened investment authority to induce purchase of tax exempts by institutions that presently do not find municipal securities attractive (because their tax free status is vitiated by the fact that the institutions themselves are tax exempt). These proposals deal with the tax-exempt question only to the extent that they are designed to reduce the flow of such securities to those seeking this form of tax shelter.

3. Nonsubsidy actions to make the existing municipal instrument more widely held without significantly altering the traditional sources of municipal bond financing.

Proposals Relating to Taxable Municipal Bond Issues

Environmental Finance Authority. The Environmental Finance Authority (EFA) has been proposed by President Nixon in connection with the financing of waste treatment facilities.[10] Proponents view EFA as a financial mechanism for assuring that every community can meet its responsibilities in this program area by being able to sell bonds at reasonable costs.

The mechanics of the EFA approach are relatively simple. The Authority would borrow money in the private market and use these funds to purchase obligations issued by States and localities to finance the non-Federal share of the cost of a waste treatment construction project. EFA could not purchase an issue unless the Secretary of Interior had certified that the seller is unable to obtain sufficient credit at reasonable interest rates and had guaranteed the principal and interest payments on the obligation. The Secretary of the Treasury would be directed to make annual payments to EFA sufficient to cover the difference in interest rates between EFA's own obligations *(which would be taxable)*, and the interest rates at which EFA lends to State and local governments. The source of funds to cover the interest subsidy aspect of the proposal would be a permanent indefinite appropriation by the Congress to the Treasury. The Secretary of the Treasury would also be authorized to advance up to $100 million of appropriated funds for EFA's initial administrative expenses as well as funds to finance obligations purchased by EFA but not yet financed by the issuance of its obligations.

The Environmental Finance Authority is thus purely a financial mechanism; judgments regarding environmental matters and the needs or the credit-worthiness of potential borrowers would be the province of the Secretary of the Interior. The Authority would be self-supporting aside from "start-up" costs. EFA's administrative expenses would be met from fees paid by borrowers while any loan default would be a cost of the Interior Department program. The payment to cover the interest rate differential would be recaptured through higher Federal income tax receipts.

EFA, as a new financial approach to an intergovernmental problem area, has already aroused some criticism. For example, its detractors question whether it is possible to define clearly what constitutes "inability to borrow at reasonable rates." This is admittedly a vague concept but one that is in use in water and sewer loan programs administered by the Departments of Agriculture, Commerce and Housing and Urban Development. The reasonableness of interest rates will no doubt vary with economic conditions. Accordingly, a single statutory formula is not likely to meet the congressional intent of assuring State and local outlays for waste treatment projects. In periods of tight money, for example, when the tax-exempt bond market tends to fluctuate more widely than other long-term credit markets, EFA hopefully would offer a valuable "safety-valve" to keep a community from having to halt its waste treatment program for lack of construction funds.

The EFA legislation follows earlier precedents on administrative matters. The Secretary of the Treasury would be responsible for determining the lending rate while the Federal program agency would set eligibility and other loan criteria. In EFA's case, the Treasury and Interior Secretaries share responsibilities. This sharing of responsibility may involve additional administrative complexity and bureaucratic procedures, but it permits individual departmental expertise on matters each is most familiar with. This seems far preferable to the alternative of centralizing all EFA functional responsibilities in one administrative agency.

Somewhat similar to EFA is a bill (H.R. 15979) pending in Congress to allow the Farmers Home Administration to purchase tax-exempt obligations issued for conservation, land use, water and other purposes and to resell them as taxable municipal bonds.

New Lending Institutions and Development Banks. Several proposals have called for the creation of new institutions that would issue their own taxable securities and use these funds to lend to State and local governments at preferential rates of interest. Perhaps the most familiar version of this proposal is the Urban Development Bank (Urbank)[11] which would set up a non-Federal corporation owned by States, localities and private investors who would buy the capital stock of this corporation. The differential between the interest rate at which Urbank borrows and lends would be made up by a subsidy in the form of an annual Federal appropriation. Obligations issued by the Urbank would not be guaranteed by the Federal Government but the Treasury would be authorized to purchase such securities to insure the integrity of the Urbank. In order to obtain a loan from the Urbank, States and localities would have to meet certain eligibility standards. This proposal would in no way interfere with the right of a State cr local government to obtain funds in the tax-free market.

In lieu of having EFA or Urbank deal with individual localities, it has been suggested that State or regional subunits of these lending institutions be established. Similarly, it has been suggested that Urbank work in conjunction with State or regional organizations of private firms (banks or insurance companies). The Federal subsidy under these alternative institutional approaches would broaden the market impact of the particular arrangements.

State and local officials tend to be critical of this approach because it raises the specter of Federal controls over State and local capital facility projects. Proponents of the proposal point out that if Federal infringements prove too severe, State and local officials retain access to the tax-exempt bond market. A more practical concern with this approach arises in connection with whether Urbank would have sufficient Federal financing to carry out its intended objectives. If not, the problem of credit rationing among projects and governments becomes critical.

Direct Taxable Municipals. To give States and localities access to the taxable market, proposals have been made that call for direct issuance of taxable State and local bonds with the added interest cost offset by a Federal subsidy.[12] The FederalGovernment would enter into a contractual agreement with the State or locality to pay a fixed percentage of the interest costs on these new taxable municipal issues. The intent of this proposal is to preserve, free of Federal review, State and local initiative in issuing all such securities.

Under this proposal, the discipline of the market would be retained because the fixed percentage subsidy would be applied to market-determined rates of interest. Furthermore, no new borrowing "bureaucracy" would be created at any level of government.

Taxable bonds, however, entail decisive changes in the traditional sources of State and local bond-holdings. Once the tax-exempt feature is removed, new classes of buyers would have to be found. It is quite clear, for example, that those who purchase tax-exempt securities to reduce their tax payments will not be equally willing to hold comparable amounts of securities on which they must pay taxes. Moreover this approach would seem to invite another attack on tax-exemption, perhaps serving to disrupt the municipal bond market and disturb investor confidence.

Proposals to Attract Existing Institutions to the Purchase of Municipals

A second basic approach to broadening the access of States and localities to the capital markets would induce institutions that presently do not find the tax-exempt status of municipal bonds attractive to purchase tax free municipals by supplementing their yield with a Federal subsidy or by broadening their investment authority or both. Proposals in this category offer the subsidy only to specific institutions compared to the general Federal subsidy that is envisioned in the indirect or direct local taxable bond approaches. By way of further contrast, proposals under the second approach deal only indirectly with the issue of tax-exemption. To the extent that particular institutions are induced to purchase municipals, the flow of tax-exempt securities to private holders is reduced.

The Urban Institute has advanced two such proposals. It suggests a Federal subsidy to State and local retirement funds that purchase municipal bonds as well as broadened investment authority for and a Federal subsidy to the Unemployment Trust Fund. Professors Reeb and Renshaw suggest a third instance for broadening institutional participation in the market. They would authorize the Federal Reserve Board to invest in municipal securities, an action which does not require a Federal subsidy. The common feature of each of these proposals is their objective of altering the yield on municipal securities in such a way that an existing pool of financial resources will be re-oriented to the municipal bond market.

The special difficulty of this approach is to build a case for restricting the special treatment to certain claimants. Once special consideration is given for the purchase of particular securities, additional special purpose claims are bound to emerge. When broadened investment authority is extended to certain institutions or the purchase of municipal bonds is induced by means of a subsidy, this would seemingly invite comparable claims from other institutions. It might also warrant extension of the idea to more wide-ranging purposes than the purchase of State and local bonds.

Proposals of this nature also raise the question of whether the purchase of municipal securities by particular institutions is consistent with the other objectives they must pursue. For example, could the Federal Reserve Board reconcile purchases of municipals with its duties and responsibilities for pursuing countercyclical monetary policies? Answers to questions such as this would depend upon the amount of resources committed to municipals by the institutions. The market impact of these proposals would depend upon the rate and predictability of the growth of institutional resources.

Proposals to Enhance the Attractiveness of Municipal Bonds

Guarantees of Municipal Securities. Guarantees of municipals have been proposed as yet another way to give States and localities access to a broader capital market. By reducing risks, guarantees are intended to attract more investors whose interest lies in conserving rather than enhancing their wealth. Guarantees could be provided either by the Federal Government, by the States, by both, or by some nongovernmental organization; they could be restricted solely to taxable municipal securities or extended to tax-exempt State and local issues as well.

The Municipal Capital Market Expansion Act of 1969 (S. 398, 91st Congress, 1st Session) specifically provides a guarantee plan along with interest reduction grants to be financed by Federal appropriations. The guarantee, for which a fee is charged, has the effect of reducing the risk of municipal issues and lowering their interest rates. The interest income of the State and local bond issues covered under the guarantee and interest reduction grant provisions would be subject to the Federal income tax. The bill's guarantee provision contemplates a degree of Federal review of the eligible issues.

Mutual Fund Regulation Change. To attract the small and middle income investor to the municipal bond market, an amendment to the Internal Revenue Code has been proposed that would permit mutual funds to buy and sell the debt issues of State and local governments and to pass interest income from the securities through to the shareholder without incurring a tax liability. In effect, this proposal would make municipals and their tax-exempt feature available to groups who presently find the typical denominations of such securities ($5,000 or $1,000) too steep a financial commitment. Thus, through the use of a financial intermediary, the savings of a new investor group could be tapped for State and local capital projects. This proposal would have the further advantage of allowing individuals to rely on the management expertise of mutual funds to evaluate State and local bonds and enable States and localities to avoid the higher costs of administration involved in using smaller denomination bonds to attract this class of investor.

The standard arguments against the tax-exempt feature–its effect on the progressivity and equity of the Federal income tax–are of course, applicable to this proposal which would extend its coverage. Because of the small investor's lack of familiarity with the tax advantage of municipals, his response to this proposal is quite unpredictable. Indeed, the attraction of this proposal to mutual fund managers is not entirely clear because experience may indicate that the costs of administering this type of investment may be excessive even for a financial intermediary geared to deal with numerous small investors.

Footnotes

[1]See U.S. Congress, House Committee on Government Operations, Subcommittee on Intergovernmental Operations. *Unshackling Local Government: A Survey of Proposals by the Advisory Commission on Intergovernmental Relations.* Washington, D.C. 1969.

[2]Tilford Gaines, "Federal Reserve Policy Review," *Manufacturers Hanover Economic Report,* November 1969.

[3]Donald J. Reeb, "The State-Local Bond Market: Another Urban Problem and a Solution," *Congressional Record,* p. E 1028.

[4]*Weekly Bond Buyer,* December 29, 1969, p. 62.

[5]Michael Tanzar, "State and Local Government Debt in the Postwar Period," *Review of Economics and Statistics,* Vol. XLVI (August, 1964) pp. 237-244.

[6]Paul F. McGouldrick and John E. Petersen, "Monetary Restraint and Borrowing and Capital Spending by Large State and Local Governments in 1966," *Federal Reserve Bulletin,* July 1968, pp. 552-581; John E. Petersen and Paul F. McGouldrick, "Monetary Restraint, Borrowing and Capital Spending by Small Local Governments and State Colleges in 1966," *Federal Reserve Bulletin,* December 1968, pp. 953-982.

[7]Paul F. McGouldrick and John E. Petersen, "Monetary Restraint and Borrowing Capital Spending by Large State and Local Governments in 1966," *Federal Reserve Bulletin,* July 1968, p. 556.

[8]*Ibid.*

[9]John E. Petersen and Paul F. McGouldrick, "Monetary Restraint, Borrowing and Capital Spending by Small Local Governments and State Colleges in 1966," *Federal Reserve Bulletin,* December 1968, pp. 958-960.

[10]H.R. 15903, H.R. 16020, H.R. 16055, S. 3468; all of the 91st Congress, 2nd Session.

[11]S. 409, 91st Congress, 1st Session.

[12]This approach was discussed by Congressman Ullman and Governor Tieman in testimony on the Tax Reform Act of 1969. See part 6 of the *Hearings before the Committee on Ways and Means on the Subject of Tax Reform.* March 10 and 11 1969, pp. 2185 ff.

Chapter 3

The Financing of Federally-Aided Capital Facilities: Long-Term Commitment Versus Federal Budgetary Flexibility

State and local officials must know well in advance the approximate amount of Federal aid they can count on in order to both plan their capital facilities projects effectively and to move ahead with dispatch. Yet their financial planning is often blighted by uncertainty in the funding of Federal aid programs. Under the annual Federal budgetary process, appropriation action is becoming increasingly tardy; furthermore, individual program appropriations often bear no necessary relationship to the dollar amounts spelled out in the substantive legislation, which provides the authority to appropriate funds, often for three to five years in advance. Moreover, as it moves into the brick and mortar field, Federal aid takes on a sporadic character; it can expand quickly and then level off as expenditure outlays are adjusted to meet changes in both the national economy and in program priorities.

THE CERTAINTY ISSUE

The desirability of building some degree of certainty into Federal grants for State and local public facilities is only partially supported by the fact that almost one-third of all Federal aid in fiscal 1971 is for public facilities—$8.1 billion of an estimated $26 billion. Of the capital facilities grants, about $6.4 billion are in the form of lump-sum grants and another $1.6 billion are for debt service grants (mainly public housing and urban renewal).* In addition, the Federal Government is extending gross loans of $1.4 billion at subsidized interest rates for such programs as public housing and urban renewal, higher education facilities, and general public facilities (table 7). Still, the current annual volume of public facilities grants is dominated by the Federal-aid highway program ($4.3 billion of the $8.1 billion total)—a program in which Congress already provides firm financing commitments.

It is the future extension of present vagaries in the Federal budgetary process that gives rise to State-local concern in the capital financing field. Tens of billions of Federal dollars will be required over the next decade for air and water pollution control, mass transportation and airport development. Other massive Federally aided building programs will be expanded or proposed: elementary, secondary and higher education facilities; hospitals and other health facilities; rebuilding old cities and building new ones; and more. The orderly placement of these public investments is not likely to occur if the flow of funds surges and ebbs from time to time.

Thus, State and local officials and public interest groups intensify their quest for certainty by demanding long-term Federal commitments, both in the form of advance appropriations and as advance spending (obligational) authority in the program (substantive) legislation. Attempts to obtain authority for States and localities to prefinance the Federal share of project costs and the pressures for debt service grants represent ancillary parts of the certainty issue. The quest for greater fiscal certainty has sparked a conflict between the functional specialists, on the one hand, and the fiscal generalists (the President and the appropriations committees of Congress), on the other.

Those pressing for more certainty via the long-term commitment route voice two primary yet related concerns. They shudder at the prospect that an applicant for a public facility grant will be unable to complete an approved yet only partially funded project because of a Federal aid cutback. Secondly, they express misgivings about the national commitment to any Federal grant program that depends on the annual appropriations process. Will the program be financed on the scale that will meet national needs as originally envisioned by the program specialists and the substantive committees of

*See footnote on page 30.

Table 7

FEDERAL OUTLAYS FOR PUBLIC FACILITY GRANTS AND LOANS TO STATE AND LOCAL GOVERNMENTS, FISCAL YEARS 1969-1971
(in millions of dollars)

Program and Agency	1969 Actual	1970 Estimate	1971 Estimate
Lump-sum Grants			
Funds Appropriated to the President:			
Appalachian regional development programs	138	204	222
Public works acceleration	2	4	....
Department of Agriculture:			
Flood prevention and watershed protection	64	76	80
Rural water and sewer systems	24	34	31
Resource conservation and development	3	4	4
Farm labor housing	3	6	6
Department of Commerce:			
Development facilities grants	126	136	156
Department of the Army: (Corps of Engineers)			
Flood control, etc.	15	20	8
Department of Health, Education & Welfare:			
Mental health centers	14	16	16
Medical facilities	104	115	114
Health, educational research, etc. (NIH)	53	127	130
Schools in federally affected areas	20	33	27
Higher educational facilities	247	244	237
Community education facilities	22	23	12
Department of Housing and Urban Development:			
Neighborhood facilities	11	26	38
Water and sewer facilities	80	119	146
New community development	....	1	2
Department of the Interior:			
Outdoor recreational facilities	27	40	38
Waste treatment works (FWPCA)	139	166	367
Department of Transportation:			
Airport construction	104	92	139
Federal aid highways[1]	4,068	4,336	4,252
Urban mass transportation facilities	136	127	254
Department of Justice, Law Enforcement Assistance Administration	....	2	11
Other civil public works	12	28	137
Department of Defense	13	12	14
Total lump-sum grants	5,425	5,991	6,441

(Continued on next page)

Table 7

FEDERAL OUTLAYS FOR PUBLIC FACILITY GRANTS AND LOANS TO STATE AND LOCAL GOVERNMENTS, FISCAL YEARS 1969-1971 (Cont'd.)
(in millions of dollars)

Program and Agency	1969 Actual	1970 Estimate	1971 Estimate
Debt Service Grants			
Urban renewal	512[2]	1,004[2]	972[2]
Low rent public housing	343	461	638
Higher education academic facilities	....	12	25
College housing	....	3	3
Total debt service grants	855	1,480	1,638
Loans (gross disbursements)			
Agriculture and agricultural assistance	65	72	54
Natural resources	7	7	6
Commerce and transportation	19	83	58
Renewal and housing assistance	513	993	885
Metropolitan development	53	49	44
Education and manpower	146	126	113
General government	118	168	214
Total loans	921	1,498	1,374

[1]Excludes forest and public land highways.
[2]Excludes grants for code enforcement. See footnote on page 30 for an explanation of the classification of urban renewal aid as a "debt service" grant.

Source: *Budget of the United States, Fiscal Year 1971,* Special Analyses O and P and Appendix.

Congress? Or will the originally conceived priorities be changed by the fiscal generalists and the Congress as social, political and economic conditions shift, and budgetary priorities are reordered?

This chapter reviews the recent trend toward multi-year financing in Federal public facilities grants, assesses the reasons for this movement and attempts to establish a basis for resolving the conflict between the "functionalists" and the "fiscal generalists."

THE TREND TOWARD MULTI-YEAR FINANCING

The quest for fiscal certainty in Federal capital facility aid programs has taken two basic forms. Regular appropriation acts include language to provide advance spending authority. This technique is of fairly recent origin and operates through the regular budget and appropriations procedures. Program (substantive) legislation provides specific spending (obligational) authority. This technique is calculated to furnish a high degree of funding certainty, in effect bypassing the annual budget and appropriations process.

Advance Appropriations

The Congress has recognized the desirability of advance funding in providing contract authorization or appropriations (generally one or two years in advance) for a number of major capital facilities grant programs. Specifically, advance funding has been made available for one year beyond the current budget year for airports, urban mass transportation and urban renewal. Congress has also provided that funds appropriated for these programs shall be available until expended in recognition of the lead time required to carry out these capital investments. Thus, obligational authority in this case, as in the case of most direct Federal capital facilities programs, does not expire at the end of the fiscal year for which the appropriation is made.[1]

A 1966 Act extending the authorization for airport aid provides a typical example of substantive legislation required to authorize advance appropriations.

> For the purpose of carrying out this chapter (Federal Aid for Airport Development) in the several States, in addition to other amounts authorized by this chapter, appropriations amounting in the aggregate to $199,500,000 are hereby authorized to be made to the Administration over a period of three fiscal years, beginning with the fiscal year ending June 30, 1968. Of amounts appropriated under this paragraph, $66,500,000 shall become available for obligation, by the execution of grant agreements pursuant to section 1111 of this title, beginning July 1 of each of the fiscal years ending June 30, 1968, June 30, 1969, and June 30, 1970, and shall continue to be so available until expended.[2]

The budget request for this program has generally been for one year in advance (i.e., the 1969 *Budget* requested an appropriation for fiscal 1970) and the appropriations have been made on this basis.

Appropriations for the urban renewal program are also requested (and granted by Congress) for one year in advance. In the 1968 *Budget*, the narrative introducing the 1968 appropriation request for that year states "to assure continuity an advance appropriation of $750 million for 1969 is proposed to cover contract authority already enacted."[3] The 1970 *Budget* requested an appropriation of $250 million for fiscal 1970 (in addition to the amount appropriated in 1969 for fiscal 1970), plus $1.25 billion for 1971.

Since the enactment of the urban renewal program, Congress has provided contract authority totalling $9.6 billion (through July 1, 1969). This authority is based on substantive legislation that reads as follows:

> "The faith of the United States is solemnly pledged to the payment of all grants contracted for under this subchapter, and there are authorized to be appropriated, out of any money in the Treasury not otherwise appropriated, the amounts necessary to provide for such payments...."[4]

The language indicates a strong congressional commitment to provide the necessary funds to pay contractual obligations as they fall due. This mandate leaves the appropriations committees little choice other than to appropriate amounts necessary to liquidate such obligations.

The urban mass transportation act lacks the type of long-term commitment written into the urban renewal legislation, but the appropriations committees have recognized the necessity for planning and construction lead-time inherent in the development of sound mass transportation facilities and have therefore provided advance funding—even if only for one year ahead.

Another facet to the multi-year funding trend became apparent when Congress extended the life of the Office of Economic Opportunity for two years beyond July 1 1969. In presenting his plan for changing the focus of OEO to that of experimentation and innovation, the President stressed the need for assurance that the agency's program would be continued for at least the two-year period:

> A two-year extension will have a number of advantages. From a management standpoint, by allowing longer-range planning it will make possible a more orderly and efficient allocation of funds. From a recruiting standpoint, it will guarantee to those whose talents are needed that the Nation's commitment is a continuing one. Furthermore, an innovative agency has a special need for both continuity and flexibility. It is in the nature of experiments that some succeed, and some fail; *a two-year extension will give greater assurance to those whose function it is to experiment that even though a particular program may fail, the lessons learned will be put to use, and that the larger effort of which it is a part will continue.*[5]

In accordance with this statement, the bill introduced in the Senate at the request of the Administration carried a specific advance funding provision. As finally enacted, this provision reads as follows:

> For the purpose of affording adequate notice of funding available under this Act, appropriations for grants, contracts, or other payments under this Act are authorized to be included in the appropriation Act for the fiscal year preceding the fiscal year for which they are available for obligation.
>
> (b) In order to effect a transition to the advance funding method of timing appropriation action, the amendment made by subsection (a) shall apply notwithstanding that its initial application will result in the enactment in the same year (whether in the same appropriation Act or otherwise) of two separate appropriations, one for the then current fiscal year and one for the succeeding fiscal year.[6]

Congress in 1968 granted authority to the Office of Education to request advance appropriations for the programs under its jurisdiction.[7] The reasoning behind this grant of authority for advance funding was that, "to plan effectively and hire personnel for the fall school programs, school officials need to know in the spring the amount of funds they can count on for operations in the fall."[8] In the 1969 *Budget* the Administration requested, and was granted, an advance appropriation for fiscal 1970 to fund Title I of the Elementary and Secondary Education Act of 1965. A similar advance appropriation was requested for fiscal 1971 in the 1970 *Budget,* but it was deleted by Congress because the legislative authorizations for 1971 had not yet been enacted by the time the 1970 Appropriation Act was enacted (March 4, 1970).

Long-Term Commitments in Substantive Legislation

The 1956 act calling for the development of our interstate highway network is the prototype for the recent pressures on Congress to establish long-term commitments to finance other large-scale public facility grant programs. With the help of assured financing through the Highway Trust Fund, the Federal aid highway program has built an impressive interstate highway network. Legislation pending before the second session of the 91st Congress (1970) would provide similar Federal commitments for airports, urban mass transportation and waste treatment plants. Governors, mayors, county officials and other proponents of the two other major transportation modes, drawing on the highway experience, pressed for similar financing for air transportation and urban mass transportation. Projected needs in both areas run into the tens of billions of dollars. The direct user benefit aspects of air transportation—both as to passengers and suppliers—are particularly intriguing to those who advocate dedicating user charges to the construction of facilities. The relationship between users and benefits is less clear cut for mass transportation and water pollution control programs. For this reason, proposed financing arrangements for these functions include advance obligational authority in the program (substantive) legislation along with general fund financing (table 8).

Highway Trust Fund. When the Federal Government embarked, in 1956, on the development of the interstate highway system it decided that (1) the entire program had to be laid out in advance, (2) an assured source of funding was essential to completion of the program, and (3) the revenue to finance the program should come from those who benefit from it—the highway users. Accordingly, the Congress authorized a thirteen-year Federal aid highway program for the fiscal years 1957 through 1969 to complete a 41,000 mile highway network. As the program progressed it became clear that changes were needed. Construction costs rose; automobile ownership grew by leaps and bounds; more emphasis was needed on the urban areas; in short, more expensive roads were required. These changing conditions led Congress to increase the original spending authority on several occasions and provide additional spending authority through fiscal 1974.

Congress assured the financing of the interstate system by setting up a trust fund for certain highway-user taxes, mainly the gasoline tax. This most productive of the excise taxes was increased from two to three cents per gallon on July 1, 1956 and to four cents on October 1, 1959. Net motor fuel taxes transferred to the trust fund in fiscal 1969 amounted to $3.0 billion and the other excise taxes, including those on trucks and buses, tires, truck use, lubricating oil, and truck and bus parts netted another $1.6 billion.

The establishment of the Highway Trust Fund did not, however, remove this program from congressional scrutiny. The Secretary of the Treasury reports annually to Congress on the status of the highway fund. The Congress periodically revises the program, frequently to update the highway plan and occasionally to rearrange its financing. The Congress makes annual appropriations from the trust fund. The appropriations are closely tied to the current requirements to make payments as projects move toward completion; that is, appropriations are for "liquidation of contract authority." The 1969 Appropriation Act for Federal-aid highways reads as follows:

> For carrying out the provisions of title 23, United States Code, which are attributable to Federal aid highways, to remain available until expended, $4,155,370,000, *or so much thereof as may be available in and derived from the "Highway trust fund";* which sum is composed of $587,218,731, the balance of the amount authorized for the fiscal year 1967, and $3,552,518,466 (or so much thereof as may be available in and derived from the "Highway trust fund"), a part of the amount authorized to be appropriated for the fiscal year 1968, $15,499,136 for reimbursement of the sum expended for the repair or reconstruction of highways and bridges which have been damaged or destroyed by floods, hurricanes, or landslides, as provided by title 23, United States Code, section 125, and $133,667 for reimbursement of the sums expended for the design and construction of bridges upon and across dams, as provided by title 23, United States Code, section 320.[9]

Table 8

LEGISLATION PENDING IN 91st CONGRESS PROVIDING LONG-TERM FEDERAL FINANCING COMMITMENTS: AIRPORT DEVELOPMENT, URBAN MASS TRANSPORTATION AND WATER POLLUTION CONTROL, AS OF JUNE 30, 1970

Item	Airport Development (Trust Fund)	Urban Mass Transportation (General Fund)	Water Pollution Control (Const. of Waste Treatment Plants) (General Fund)
1a Relevant bills, 91st Congress	1b H.R. 14465; S. 3108, Enacted as P.L. 91-258	1c S. 3154; H.R. 13422, 13463, 14953, 15468, 18185	1d S. 3472; H.R. 15904, 16035
2a Status of legislation	2b Enacted, 5/21/70.	2c Passed by Senate. Reported out by House Banking and Currency Committee on 6/30/70 (H.R. 18185).	2d Introduced 2/16/70 and 2/18/70 and referred to Committees on Public Works. Senate Public Works Committee held hearings in April, 1970.
3a Financing provisions	3b Authorizes $840 million advance obligational authority with cumulative annual spending ceilings over a 3-year period, subject to annual appropriations to liquidate contractual obligations.	3c Authorizes $3.1 billion advance obligational authority with cumulative annual spending ceilings over a 5-year period, subject to annual appropriations to liquidate contractual obligations (S. 3154). As reported out by the House Banking and Currency Committee, obligational authority is increased to $5 billion.	3d Authorizes advance obligational authority of $1 billion for each of the 4 fiscal years beginning with FY 1971 subject to annual appropriations to liquidate contractual obligations.
4a Presidential position	4b Radically reduced—President left with pro forma task, that of requesting annual appropriations to liquidate contract obligations.	4c Some diminution—President is authorized to recommend to the substantive committee the specific amounts of additional obligational authority for program funding at 2-year intervals.	4d Some diminution—Must recommend specific amounts for additional contract authority to substantive committee according to a specified timetable.
5a Position of appropriations committees	5b Radically reduced—left with pro forma task of authorizing appropriations to liquidate contract obligations.	5c Radically reduced—left with pro forma task of authorizing appropriations to liquidate contract obligations.	5d Same as 5c
6a Position of substantive committees	6b Greatly enhanced—they recommend for congressional approval the specific amounts of obligational authority for the program.	6c Greatly enhanced—they recommend for congressional approval the specific amounts of obligational authority for the program.	6d Same as 6c.

On the basis of estimates and certain program formulae in the substantive legislation, the Secretary of Transportation "apportions" funds to the States for the interstate system two years in advance of the fiscal year to which such apportionments apply, thus providing contract authorization in advance of the appropriation. An element of uncertainty nevertheless persists. The Secretary of the Treasury, in consultation with the Secretary of Transportation, is required to reduce amounts apportioned to States for obligation if he estimates that insufficient revenue will be available in the trust fund at any future time to liquidate contractual obligations as they come due. This provision, the so-called, "Byrd Amendment," was included in the Act establishing the trust fund to ensure that expenditures would always be balanced by revenues.[10] Increases in trust fund revenues do not, however, become available for obligation automatically. Thus, financially speaking, the Highway Trust Fund has only a one-way stretch.

The likelihood that trust fund outlays in any fiscal year will exceed the available revenue is further minimized by administrative factors that usually reduce actual obligations below the congressionally authorized spending limit. Grants for specific projects are subject to approval by the Secretary of Transportation and funds are withheld when he disapproves of particular projects. At times, local controversy over the location of a particular strip of road will delay a State request for funds, and thus delay the obligation of Federal aid funds.

The President's general power to withhold (or impound) funds for which spending authority has been granted by Congress has traditionally been regarded as a further safeguard against over commitment of Federal highway funds. Controversy has developed on this point in recent years.

When President Johnson decided in 1966 and 1967 to reduce budget expenditures as a countercyclical measure he used the authority granted him by the Anti-Deficiency Act of 1906 and the Budget and Accounting Act of 1921 to apportion appropriated funds. His action also included temporary impounding of highway funds—an action which caused considerable furor among State highway officials, highway users, and some congressmen. In a letter to the Secretary of Transportation, Attorney General Ramsey Clark reasoned that obligational authority provided by Congress "...places an upper limit and not a lower limit on expenditures" and that, "As a limitation on the sums which may be spent under the Federal-aid highway legislation, the (Highway Trust) Fund is functionally akin to the conventional appropriation and, as such, it constitutes an authority rather than a mandate."[11] The Attorney General concluded that "the recent limitation on the Federal-aid highway funds which may be obligated during the current year was a valid exercise of Executive authority."

Senator Warren G. Magnuson disagreed with this opinion, stating that as a "trust" the highway funds are, in effect, not the funds of the Government and they must be spent in accordance with the mandate (obligational authority and apportionment among the States) in the highway acts. Indeed, the Congress included in the Highway Act of 1969 a "sense of Congress" provision prohibiting the President to "impound or withhold" funds authorized to be expended from the Highway Trust Fund.[12] A "sense of Congress" provision is widely regarded as a form of congressional guidance but not a directive to the Executive. To date, the President's power to withhold expenditure from the Highway Trust Fund is unchallenged in the courts.

Congress has made several changes since 1956 in the revenue aspects of the Highway Trust Fund. It increased the rates of some user taxes initially dedicated for the fund. It also dedicated some additional taxes into the fund several years after it was established. It even moved one revenue source from the Highway Trust Fund to the Land and Water Conservation Fund—the tax on motor fuel used in motor boats (some $30 million annually).

Because the trust fund revenues are inviolate they cannot be used for other purposes even if the trust fund builds up a surplus. At the close of fiscal 1969, the Highway Trust Fund had a balance of about $1.5 billion (largely the result of prior-year program cutbacks), invested in special Treasury certificates of indebtedness and drawing interest. The balance is expected to grow to $3.8 billion by the end of fiscal 1972 (table 9).

In no small measure, the success of the Federal Aid Highway Program can be attributed to the ability of highway officials at all governmental levels to plan ahead with the certainty that the necessary funds would be forthcoming when needed.

Airport Trust Fund. Growth in the use of air transportation for the movement of passengers and cargo by the commercial airlines and by a growing body of private and corporate owners of airplanes has given renewed interest to the idea of financing of airways and airport development either through a trust fund or a dedicated account in the Treasury.

In June 1969, President Nixon proposed a greatly expanded program of airways and airport facilities development calling for the expenditure of $5 billion over a ten-year period to include direct Federal expenditures as well as grants-in-aid. To finance this program, the President proposed a schedule of increased

Table 9

STATUS OF HIGHWAY TRUST FUND, ACTUAL FISCAL YEARS 1957-69 AND ESTIMATES 1970-73, UNDER EXISTING LEGISLATION
(in millions of dollars)

Fiscal year	Receipts									Expenditures							Balance in the fund
	Gross excise taxes	Deductions		Net excise taxes	Interest (net)	General fund advances	Repayment of advances (deduct)	Reimbursements from general fund[2]	Total	Interstate highways		Primary, secondary and urban[3]	Rural[3]	TOPICS[3]	Other[4]	Total	
		Transfers[1]	Refunds							Authorized	Authorizations withheld from apportionments (deduct)						
Actual																	
1957	1,479	. . .	. . . .	1,479	3	. . .	. . .	. . .	1,482	208	. . . .	743	. . .	. . .	15	966	516
1958	2,116	. . .	90	2,026	18	. . .	. . .	. . .	2,044	675	. . . .	809	. . .	. . .	27	1,511	1,049
1959	2,171	. . .	97	2,074	13	. . .	. . .	. . .	2,087	1,501	. . . .	839	. . .	. . .	273	2,613	523
1960	2,642	. . .	103	2,539	[5] –3	359	359	. . .	2,536	1,801	. . . .	879	. . .	. . .	200	2,940	119
1961	2,923	. . .	126	2,798	[5] 1	60	60	. . .	2,799	1,719	. . . .	877	. . .	. . .	23	2,619	299
1962	3,080	. . .	131	2,949	7	. . .	. . .	. . .	2,955	1,914	. . . .	860	. . .	. . .	10	2,784	471
1963	3,405	. . .	126	3,279	14	. . .	. . .	. . .	3,293	2,109	. . . .	906	. . .	. . .	2	3,017	747
1964	3,646	. . .	127	3,519	20	. . .	. . .	. . .	3,540	2,635	. . . .	1,004	. . .	. . .	6	3,645	641
1965	3,786	4	123	3,659	11	. . .	. . .	. . .	3,670	3,016	. . . .	990	. . .	. . .	20	4,026	285
1966	4,065	28	120	3,917	[5] 7	70	70	. . .	3,924	2,978	. . . .	937	. . .	. . .	50	3,965	244
1967	4,684	31	212	4,441	14	. . .	. . .	. . .	4,455	2,976	. . . .	954	. . .	. . .	44	3,973	725
1968	4,523	30	114	4,379	34	. . .	. . .	15	4,427	3,207	. . . .	947	. . .	. . .	17	4,171	982
1969	4,889	28	224	4,637	53	. . .	. . .	. . .	4,690	3,149	. . . .	984	. . .	. . .	18	4,151	1,521
Estimate:																	
1970	5,136	28	34	5,074	102	. . .	. . .	. . .	5,176	3,330	. . . .	1,029	29	7	72	4,467	2,230
1971	5,376	28	132	5,216	145	. . .	. . .	. . .	5,361	2,944	. . . .	1,124	89	143	95	4,395	3,196
1972	5,569	28	134	5,407	190	. . .	. . .	47	5,644	3,366	. . . .	1,106	105	173	269	5,019	3,821
1973[6] . . .	[7] 1,985	10	171	1,804	. . .	. . .	. . .	4	1,808	[8] 13,052	7,829	313	32	52	9	5,629	. . . .
Total . .	61,475	215	2,064	59,197	629	489	489	66	59,892	50,640	7,829	15,301	255	375	1,150	59,892	. . . .

[1] Transfers to the land and water conservation fund in accordance with Public Law 88-578, approved Sept. 3, 1964 (78 Stat. 897).

[2] Reimbursements to the fund for emergency fund expenditures authorized by the 1964 amendments to the Alaska Omnibus Act, the Pacific Northwest Disaster Relief Act of 1965, and the Federal-Aid Highway Act of 1966. (See footnote 4.)

[3] Assuming authorizations will be extended for fiscal years 1972-73 at the annual rate of $1,100,000,000 for the primary, secondary, and urban program; $125,000,000 for the rural program; and $200,000,000 for the TOPICS program.

[4] Includes emergency relief funds; bridge and dam design and construction funds; advances to States; special $400,000,000 of primary, secondary, and urban funds authorized by sec. 2(a) of the Federal-Aid Highway Act of 1958; and $300,000,000 transfer to the right-of-way revolving fund authorized by sec. 7(c) of the Federal-Aid Highway Act of 1968. Beginning fiscal 1966 also includes emergency fund expenditures for which the fund will be reimbursed from the general fund of the Treasury in accordance with Public Law 88-451, approved Aug. 19, 1964 (78 Stat. 505), and Public Law 89-41, approved June 17, 1965 (79 Stat. 131). Also includes emergency fund expenditures for authorizations beginning fiscal 1967 for which the fund will be reimbursed from the general fund of the Treasury in accordance with the Federal-Aid Highway Act of 1966. (See footnote 2.) Pursuant to sec. 9(c) of the Federal-Aid Highway Act of 1966, appropriations for emergency fund expenditures resulting from authorizations beginning July 1, 1966, are authorized from the highway trust fund for 60 percent of such expenditures and from the general fund of the Treasury for 40 percent.

[5] Receipts of interest on investments netted by payments of interest on general fund advances of $5,000,000 in 1960, $1,000,000 in 1961, and $1,000,000 in 1966.

[6] Through Sept. 30, 1972.

[7] Includes receipts on tax liabilities accrued prior to Oct. 1, 1972, but collected thereafter.

[8] Includes expenditures estimated to occur after Sept. 30, 1972.

Source: The Secretary of the Treasury; *Highway Trust Fund-Fourteenth Annual Report,* House Document No. 91-265, 91st Cong. 2d Sess. (Washington: U.S. Government Printing Office, March 2, 1970), p. 9.

and new user taxes, the revenues to be placed in a "Designated Account" in the Treasury.[13] Bills were introduced in the 91st Congress to implement the Administration program (S.2437 and H.R. 12374). The financing provisions of these bills and a number of others are summarized in table 10.

The Administration's proposal to place airway-user taxes into a "designated account" had three objectives:* (1) to obtain the necessary revenue from those who benefit from air transportation; (2) to provide an adequate source of revenue; and (3) to provide assured revenue for the duration of the program. As to the last point, the Administration recognized that the user taxes would not yield the required revenue immediately and proposed, therefore, that appropriated funds be transferred (at least for the first few years of the program) from the general fund to the dedicated account to make up the difference.

The House of Representatives passed the "Aviation Facilities Expansion Act of 1969" on November 6, 1969. This bill (H.R. 14465) dedicated certain user revenues to a trust fund but provided that obligations against the fund are subject to annual appropriations. It authorized to be appropriated for airport grants $175 million for fiscal 1970, $205 million for fiscal 1971, and $265 million for 1972, but it did not provide advance contract authorization. The authorization language reads: "...the Secretary is authorized, *within the limits established in appropriation Acts* to make grants...in aggregate amounts not to exceed the following:..."[14] Several members of the Committee pointed out, in a separate view attached to the Committee Report, that the financing provision did not give the States and localities the long-term financing they need for airport planning and construction.[15]

When the Senate took up the bill, it adopted a long-term commitment provision which provided $1.5 billion of contract authority to be available for grants immediately upon enactment, but with a ceiling for each of the five fiscal years through July 1, 1975 as to the amounts that might be authorized to be appropriated for liquidation of contractual obligations. The ceiling was cumulative: not to exceed $300 million prior to June 30, 1971; $600 million prior to June 30, 1972; $900 million prior to June 30, 1973; $1,200 million prior to June 30, 1974; and $1,500 million prior to June 30, 1975. The Senate version of a long-term commitment prevailed in P.L. 91-258 which contains three-year advance obligational authority for a total of $840 million.

Urban Mass Transportation. Considerable pressure has built up behind the idea of trust fund financing for mass transit—particularly from mayors and urban county officials who experience at first hand the exigencies of the annual appropriation process as it applies to Federal grant programs for public facilities. A number of bills were introduced in the 91st Congress that would provide long-term Federal aid commitments and trust fund financing. One such bill, S. 1032, introduced by Senator Harrison A. Williams on February 17, 1969, would extend the auto excise tax at the 3 percent level to which it is scheduled to drop (from the present 7 percent) and transfer to a trust fund increasing proportions of the collections from this source each year through 1974.* On this basis it was estimated that the trust fund take would be about $300 million for fiscal 1971 and rise to $600 million in fiscal 1974.[16]

The pleas for a mass transit trust fund drew a sympathetic response from top officials in the U.S. Department of Transportation, including Secretary Volpe; but there was opposition from the White House, and particularly from the Bureau of the Budget, allegedly because trust-fund financing would be "a restriction of the President's fiscal flexibility."[17] Accordingly, the Administration-sponsored bill (S. 2821) called for a twelve-year program with a "Federal commitment to the expenditure of at least $10 billion." The bill provided general fund financing and contract authority for each of five years.

In his statement before the Senate Committee on Banking and Currency, Secretary Volpe pointed out that the Administration bill "provides the necessary assurance to the local jurisdictions that the assistance authorized will in fact be forthcoming."[18] If enacted as proposed, the Congress would provide specific contract authority for each of five years—a total of $3.1 billion—but subject to annual appropriations for liquidation of obligations. Additional contract authority would be sought from Congress biennially.

*There is some difference between a "designated account" and a "trust fund." When asked during the hearings on H.R. 12374 before the House Committee on Interstate and Foreign Commerce whether the user taxes would go to a trust fund or the Treasury, Secretary Volpe responded, "The funds that would be collected from the source of revenue indicated in the measure would be placed into a designated account. Call it a trust fund, call it what you will, but it is a separate account. The money in the designated account could be used only for the purposes enumerated in the bill" (p. 89). When asked later in the hearing what the difference is between a "designated account" and a "trust fund," the response was that the main difference is that the assets of a designated account cannot be invested and therefore, it does not receive interest (p. 110). The Bureau of the Budget and the Treasury have expressed a preference for the designated account, according to the testimony.

*Under present law the auto excise tax is scheduled to be phased out by 1972.

Table 10

SUMMARY OF PENDING LEGISLATIVE PROPOSALS FOR THE FINANCING OF AIRWAYS AND AIRPORTS
(1970 Estimates in Millions)

Proposed Legislation	FUEL TAX				TICKET TAX			DEPARTURE TAX		
	Amount		Proceeds to		Amt.	Proceeds to		Amt.	Proceeds to	
	SAC	GA	Airports	Airways		Airports	Airways		Airports	Airways
Present Law[1]	4-2¢	4-2¢	– $10.8 –		5%	– $287.5 –				
Senate Commerce Committee Report on S. 3641 (1968) and S. 1637 and H.R. 3668 (1969)[2]		7¢	– $42.7 –		8%	– $460 –				
Administration-Boyd Proposal in 1969[3]		8-10¢	– $48.8@8¢ –		7%	– $402.5 –				
Administration-Volpe Proposal in 1969 – S. 2437 and H.R. 12374		9¢	– $54.9 –		8%	– $460 –		$3 Intntl.	– $24.6 –	
S. 1265–Javits Bill (1969)[4]	2¢	5¢	$201.9		2%	$115				
H.R. 1064–Dingell Bill (1969)[5]	6¢	6¢	$550.8							
H.R. 9325–Pickel Bill (1969)[6]	2¢	8¢	– $220.2 –		Now 5%	– $287.5 –				
H.R. 12780–Staggers Bill (1969)[7]					No Amt.	XX		No Amt.	XX	
H.R. 14465 (FY 1971 estimates)[8]		7¢	– $47.2 –		8%[9]	– $526.2 –		$3	– $28.4 –	

See footnotes at end of table.

Table 10

SUMMARY OF PENDING LEGISLATIVE PROPOSALS FOR THE FINANCING OF AIRWAYS AND AIRPORTS (Cont'd)
(1970 Estimates in Millions)

Proposed Legislation	CARGO TAX			Est. Total Receipts FY 1970	TRUST FUND		
	Amt.	Proceeds to Airports	Proceeds to Airways		Joint	Airports	Airways
Present Law[1]				$298.3			
Senate Commerce Committee Report on S. 3641 (1968) and S. 1637 and H.R. 3668 (1969)[2]	5%	– $29 –		$531.7	$531.7		
Administration-Boyd Proposal in 1969[3]	3%	– $17.4 –		$468.7			
Administration-Volpe Proposal in 1969— S. 2437 and H.R. 12374	5%	– $29 –		$568.5	$569		
S. 1265—Javits Bill (1969)[4]				$316.9		$316.9	
H.R. 1064—Dingell Bill (1969)[5]				$550.8	$550.8		
H.R. 9325—Pickel Bill (1969)[6]	3%	– $17.4 –		$525.1	$525.1		
H.R. 12780—Staggers Bill (1969)[7]				No Amt.		XX	
H.R. 14465 (FY 1971 estimates)[8]	5%	– $37.4 –		$665.8[10]	$665.8		

See footnotes on following page.

Table 10

SUMMARY OF PENDING LEGISLATIVE PROPOSALS FOR THE FINANCING OF AIRWAYS AND AIRPORTS (Concl'd)

NOTE: The "Proceeds" shown in the table are based on latest Federal Aviation Administration estimates of unit receipts by tax category for fiscal year 1970. Amounts of "Proceeds" overlap the Airports/Airways columns in instances where separate amounts have not been recommended for airports or for airways. "SAC" refers to scheduled air carriers. "GA" refers to general aviation.

[1] Existing Federal fuel tax is 4¢ per gallon on gasoline only, with 2¢ refunded on application. The remaining 2¢ as well as uncollected refunds, are placed in Highway Trust Fund. Ticket tax collections are placed in the general fund.

[2] Amounts of taxes shown were recommended by the Senate Commerce Committee to the House Ways and Means Committee in July 1968, per Senate Report No. 1355, p. 25. Of the estimated receipts in amount of $531.7 million, $150 million would be allocated for airports and $250 million for airways use, and the balance for R&D, etc. The bill also contemplated a cost allocation study to determine proportion of expenditures to be paid by general tax revenues; the extension of the FAAP (Federal Airport Aid Program) to Hawaii, Puerto Rico, and Virgin Islands; and Federal loan guarantees to a maximum of $1 billion for debt service on airfield and terminal area investment.

[3] Former DOT Secretary Boyd sent legislation to Congress on January 16, 1969. While a "Trust Fund" was not recommended the legislation did propose the establishment of a "separate fund in the Treasury" for the purpose of financing an airport loan program. Also, the Secretary of the Treasury, during fiscal years 1970 through 1974, would be directed to credit to a "Reliever Airport Fund" $30 million received during each fiscal year from taxes imposed on aircraft fuels and the transportation of persons and property by air. General aviation fuel taxes would start at 8¢ in 1970, go to 9¢ in 1971, and to 10¢ in 1972.

[4] The Javits bill (S. 1265) relates only to airport financing. The annual collections of $293 million would be deposited in an "Airport Development Trust Fund."

[5] The Dingell bill would establish an "Airport and Airways Trust Fund" into which the proceeds from a 6¢ per gallon tax on gasoline and other aviation fuel would be deposited. Such funds would be utilized 50% for FAAP, 35% for airways, and 15% for R&D. Of the FAAP portion, $9 million would be expended in Hawaii, Puerto Rico and the Virgin Islands, $399 million in the other States, and $42 million for general aviation airports in the states.

[6] The Pickel Bill would establish an "Airport and Airways Trust Fund" into which would be deposited the proceeds from (1) aviation fuel taxes on commercial aviation (2¢ per gallon) and general aviation (8¢ per gallon), (2) the 5% ticket tax, and (3) a new 3% cargo waybill tax. In addition, up to $300 million of general tax revenues would be so deposited. Such funds would be allocated (1) $150 million to FAAP, (2) $250 million to airways, (3) grants for state aviation programs equal to half of the general aviation fuel tax collections, (4) grants for scheduled air carrier airports operations expense equal to half of the commercial aviation fuel tax collections, and (5) the balance to R&D and administrative expense. Federal loan guarantees to a maximum of $1 billion for debt service on airfield and terminal area investment would be provided.

[7] The Staggers bill, introduced on July 10, 1969 is supported by ATA, AOPA, AOCI, and several aircraft manufacturers. The bill provides for financial assistance for "an adequate system of airports and airport terminal facilities." An "Airport Development Fund" would be created into which would be deposited unspecified amounts of passenger ticket tax and departure tax receipts. Such fund would be composed of two accounts, the "direct airport account" and the "discretionary account," into which appropriated revenues would be credited in equal amounts. Direct airport account funds would be apportioned for airport projects on the basis of a passenger enplanement ratio. Discretionary account funds would be apportioned (1) 62% for large air traffic hub airports, (2) 18% for medium hubs, (3) 10% for small hubs, and (4) 10% for nonhubs. Such funds would be used to pay debt service principal costs over a fixed period up to 30 years. The bill also provides for the annual appropriation for 10 years of $50 million available by grant agreement for development of airports used by general aviation and subsidized air carriers.

[8] Passed by both House and Senate in somewhat differing versions; enacted as PL 91-258, 5/21/70. See *Congressional Record,* May 13, 1970, p. H.R. 4311.

[9] On gross receipts of airlines.

[10] In addition to the amounts shown, includes proceeds from an aircraft registration tax ($23.6 million) and a tax on aircraft tires and tubes ($3.0 million).

Source: Transportation Association of America, *Financing the National Airways and Airport Systems* (Washington: July 1969) p. 20, except as indicated in footnote 8.

Although the provision of contract authority in substantive legislation provides some measure of certainty that funds will be available to carry out a program, many, including Senator Williams and representatives of the cities and counties, remain unconvinced that anything short of a trust fund will do the job. In the *New York Times* article cited above, Secretary Volpe is quoted as being amenable to a compromise that would provide still further assurance:

> We would be willing to work with your committee (Secretary Volpe told Senator Williams) on a five-year contract authorization, as long as there is a schedule for orderly spending of the money. I am sure we can arrange to assure the long-term availability of these funds.

A "compromise" was worked out, embodied in a bill that was introduced by Senator Williams on November 19, 1969.[19] This legislation has "widespread" support from mayors, governors, the Administration and members of Congress, according to Senator Williams.[20] It commits the Federal Government to spend $3.1 billion for mass transportation facilities over a 5-year period but, unlike the earlier bill, the total would be available for obligation immediately. A ceiling on the amounts that may be authorized to be appropriated for liquidation of contractual obligations, however, would be established. As in the airport facilities legislation it is a cumulative spending ceiling. The aggregate amount authorized to be appropriated for liquidation of obligations may not exceed $80 million prior to July 1, 1971; increased to $310 million prior to July 1, 1972; $710 million prior to July 1, 1973; $1,260 million prior to July 1, 1974; $1,860 million prior to July 1, 1975; and $3,100 million thereafter. Thus, the maximum annual spending authority is set in substantive legislation and not by action of the appropriations committees. The Secretary of Transportation is directed to request additional authorizations for two year periods from 1976 through 1982, the first request to be submitted by February 1, 1972. He is also required to submit recommendations for any necessary adjustments in the schedule for liquidation of obligations.*

Water Pollution Control. Federal aid for construction of waste treatment plants is characterized by an absence of long-term commitments. A proposal to introduce debt service grants into this program in 1968 failed.* More recently, President Nixon proposed a long-term commitment for water pollution control facilities similar to that for urban mass transit. This suggestion was made in the President's February 10, 1970 message on environmental control:

> I propose a Clean Waters Act with $4 billion to be authorized immediately, for Fiscal 1971, to cover the full Federal share of the total $10 billion cost on a matching fund basis. This would be allocated at a rate of $1 billion a year for the next four years, with a reassessment in 1973 of needs for 1975 and subsequent years.
>
> By thus assuring communities of full Federal support, we can enable planning to begin now for all needed facilities and construction to proceed at an accelerated rate.[21]

The legislation subsequently introduced to implement this proposal provides obligational authority of $1 billion for each of the four fiscal years 1971-1974 and authorizes annual appropriations to liquidate contractual obligations.** The President is to report to Congress by January 10, 1973 as to the need for additional contract authority for fiscal years 1975-1979. Thus, a firm long-term spending commitment is embedded in the substantive legislation, again bypassing the appropriations committees.

FACTORS PROMOTING LONG-TERM COMMITMENTS

The Congress ordinarily provides spending authority to the program agencies through the annual appropriations process. With few exceptions, as noted above, spending authority (known as new obligational authority—NOA—or loan authority—LA) is provided for one year at a time and can take one of three forms: (1) a straight appropriation; (2) contract authority; or (3) authority to spend debt receipts. Contract authority is followed up in subsequent years with annual appropriations for "liquidation of contract authority;" i.e., funds are provided annually to make progress payments as the contract work is put in place.

*The House Committee on Banking and Currency on June 30, 1970 reported out a bill with almost identical provisions (H.R.18185) but with $5 billion of obligational authority.

*The debt service grant is a long-term commitment in the sense that once a debt service contract is made for a particular project, it is binding until the debt is liquidated.

**S. 3472, H.R. 15904 and H.R. 16035, 91st Congress. Hearings were started by the Senate Committee on Public Works, April 20, 1970.

The inability of Congress to deal in a timely manner with the Federal budget causes consternation among governors, mayors and other State and local officials. The growing gap between the amounts of Federal aid authorized to be appropriated and the amounts actually appropriated have become a growing source of disenchantment at the State and local levels. Planning, engineering and building a large-scale public facility requires considerable lead time—two or three years for a moderate-size school building or hospital; ten or 15 years from inception to completion of a municipal mass transit system. Where the Federal Government offers to share in the cost of such projects, the State and local planners are immediately faced with the question: how much assurance do we have that Federal funds will be forthcoming in the promised amounts when they are needed? The answer to this question is crucial, for both the scale of the project and the nature of the planning depend upon it.

Uncertainty of Federal aid commitments is perhaps most disruptive at the local governmental level. State constitutions and statutes frequently limit the amount of bonded debt local governments may incur. If the scale of a project is overstated on the basis of Federal aid which may or may not be forthcoming, or which may be drastically reduced after the project has been started, difficult adjustments to local debt limits must be made.

The State-Local Cost of Uncertainty

The costs to States and localities of uncertainty in the funding and timing of Federal aid programs are hard to calculate. There is little doubt, however, that significant costs can be incurred in the form of wasted personnel time, incomplete projects, and additional borrowing and construction (labor and material) costs. A few examples, gleaned from a recent report of the Council of State Governments, illustrate the inconvenience, wasted effort and costs experienced by States as they try to cope with these uncertainties.[22]

- As reported by New York, "specific 'cost' of delays are rarely documented....what does turn up, however, are administrative frustrations resulting from such uncertainties and the undoubtedly costly but intangible expenses of discoordinated planning of programs and projects. Also, of course, there remains the 'social costs' to which no price tag can be readily attached, which result from failure to be able to either initiate or expand worthy undertakings at the time planned."

- South Dakota reported specific costs involved because of Federal funding delays. "The construction of a dining hall at Southern State College was delayed for approximately one year. The increased cost resulting from this delay was approximately 10% or approximately $30,000. The delay in authorization for construction and advertisement for bids for a dormitory at Southern State College was approximately 14 months which resulted in an increase of $55,000 to the total costs of the building."

- "Financially it costs the State of Connecticut between $110.00 and $140.00 [interest] per million dollars for each day Federal funds are delayed."

- New Jersey states that the inability to anticipate Federal funds has created the possibility of under or over-matching of State funds. For example, the State appropriated $28,596,611 for highways and the beautification program for 1966-67, but subsequently received an apportionment which required matching funds of only $26,776,735.

Representative Brock Adams submitted the following statement at the March 1970 hearing of the Subcommittee on Housing of the House Committee on Banking and Currency:

> "Long-term guaranteed financial assistance is necessary before mass transit will gain the necessary support from the community to commit local funds to begin the planning and construction of such a long-range project. Support will not be forthcoming now for the development of mass transit unless future assistance is going to be available. Delays by the Federal Government in providing funds only delay the development and increase the cost, perhaps as much as 10% per year in construction costs alone."

Tardiness of Annual Appropriations

There has been a tendency in recent years for Congress to complete appropriation action well after the start of the fiscal year to which the appropriations apply. Only two of the thirteen major appropriation bills for fiscal 1970 had been enacted by the end of October 1969—four months after the beginning of the fiscal year. The last appropriation act, that for Labor-HEW, was finally passed at the end of January 1970, but was vetoed by the President.*

*The veto was upheld by Congress and a compromise was not finally adopted until March 4.

The appropriations committees bear only part of the responsibility for this lag. Fully one-third of the dollar amount included in the budget must await annual authorizations from the substantive committees. Furthermore, the pressure on Congress to act expeditiously on appropriations has been eased by the "continuing resolution"–a device that allows the agencies to continue obligating funds at the previous year's rate pending final enactment of the new appropriation. This device removes the fear of "payless paydays," leaving Congress free to concentrate on matters other than enacting appropriations.

To be sure the tardiness of action on fiscal 1970 appropriations was more extreme than it has been in most years. For one thing, 1969 was a presidential transition year in which the executive reins were transferred from one political party to another. The new administration experienced understandable delay in preparing and submitting its version of the Federal budget to Congress. Still, the situation is not unique (tardy appropriation action has been chronic for at least a decade) and there is considerable concern both on the part of the President and the congressional leadership. Moreover, if late appropriations portend a "crisis in the handling of the Nation's financial affairs," as noted recently by President Nixon in a letter to the House and Senate leadership,[23] how much more gnawing is the problem to State and local administrators of federally aided programs who are even less privy to congressional thinking?

The problems encountered by States and localities from delays in congressional authorizations and appropriations have been well documented.[24] Planning and budgeting for both operating and capital programs is extremely difficult when the magnitude of a major revenue source (Federal aid) is unknown until well into the fiscal year. School systems are especially vulnerable as they have to contract with teachers well in advance of the school year–they are often faced with either sudden curtailment or sudden expansion of their programs when they are finally advised, late in the year, as to the exact amount of Federal aid to expect. Since they are required to set property tax levies early in the year these are often out of phase with subsequent congressional action.

Unquestionably, steps need to be taken by Congress to correct the situation. A number of suggestions have been made, including a shift from the present fiscal year to a calendar year basis and more orderly scheduling of congressional action on authorization and appropriation bills.

Bills have been introduced in the House of Representatives to shift the Federal fiscal year to a calendar basis. Also, individual Members of Congress have expressed concern as to the scheduling of authorization action. Senator Warren G. Magnuson has proposed a "timetable" approach, a specific block of time early in the session to be set aside to act on the necessary annual authorizations. House resolutions have been introduced (especially in the 91st Congress) to put teeth in the timetable approach. The resolutions call for completion of authorization action by a specified date, after which the appropriations committees could take matters into their own hands.*

The Gap Between Congressional Authorizations and Appropriations

The widening gap between dollar amounts authorized in substantive legislation to be appropriated and amounts actually appropriated for particular Federal grant programs dramatizes the frustrated expectations of governors and mayors. For the period 1966-1970, program *authorizations* for 169 Federal aid programs with fixed dollar authorizations rose from $14 billion to $24 billion while appropriations for these programs increased from $11.6 billion to $15.9 billion. This growing divergence between authorizations and appropriations left in its wake a dollar "gap" that increased steadily from $2.7 billion in 1966 to an estimated $8.5 billion by fiscal 1970. Expressed in percentage terms, Federal aid appropriations fell from approximately 80 percent of authorizations in 1966 to an estimated 65 percent by 1970.[25]

For public facilities grant programs, the dollar gap tripled, from $1.1 billion to $3.4 billion; that is, appropriations as a percentage of authorizations fell from 87 percent in 1966 to 69 percent in 1970 (table 11). The gap for operating grant programs, which was considerably higher relative to authorizations than for capital grants in 1966, grew even more.

Significantly, *both* the authorizations and appropriations for the Highway Trust Fund maintained a fairly steady upward pace. To a significant extent this reflects the high degree of certainty afforded by long-term financial commitments coupled with the built-in political pressure that has developed with the

*An excellent article on the tardiness of the appropriation process by Arlen J. Large, entitled "Clogging the Federal Money Market" appeared in the November 25, 1969 *Wall Street Journal*. The article appears at the end of the chapter.

Table 11

AUTHORIZATIONS AND APPROPRIATIONS FOR PUBLIC FACILITIES AND OPERATING PROGRAMS, FY 1966-1970

(Programs with fixed authorization only)

(In millions of dollars)

Agency and function	1966				1967				1968			
	Auth.	Approp.	Gap		Auth.	Approp.	Gap		Auth.	Approp.	Gap	
			Amt.	%[1]			Amt.	%[1]			Amt.	%[1]
All programs	14,246	11,561	2,685	18.8	15,192	12,171	3,021	19.9	17,775	12,916	4,859	27.3
Public Facilities Programs	8,086	7,031	1,055	13.0	8,157	6,940	1,217	14.9	8,682	6,752	1,930	22.2
Highway Trust Fund	4,050	3,898	152	3.8	4,450	3,968	482	10.8	4,850	4,171	679	14.0
Debt Service Grants[2]	722	722	–	–	772	772	–	–	797	797	–	–
HEW	1,308	1,175	133	10.2	2,063	1,620	443	21.5	1,786	1,023	763	42.7
All other	2,006	1,236	770	38.4	872	580	292	33.5	1,249	761	488	39.1
Operating Programs	6,160	4,530	1,630	26.5	7,035	5,231	1,804	25.6	9,093	6,164	2,929	32.2
HEW	3,235	2,502	733	22.7	3,995	3,057	938	23.5	5,558	3,626	1,932	34.8
OEO	1,785	1,500	285	16.0	1,750	1,613	137	7.8	1,980	1,773	207	10.5
All Other	1,140	528	612	53.7	1,290	561	729	56.5	1,555	765	790	50.8

(Continued on next page)

[1] Percent of authorizations.

[2] Consists of public housing, urban renewal (excluding that portion of the model cities program related to urban renewal projects), and interest reduction grants for college housing, vocational education residential facilities and higher education facilities.

Table 11

AUTHORIZATIONS AND APPROPRIATIONS FOR PUBLIC FACILITIES AND OPERATING PROGRAMS, FY 1966-1970

(Programs with fixed authorization only)

(In millions of dollars) (Cont'd)

Agency and function	1969				1970			
	Auth.	Approp.	Gap		Auth.	Approp.	Gap	
			Amt.	%[1]			Amt.	%[1]
All programs	21,204	13,337	7,867	37.1	24,381	15,928	8,453	34.7
Public Facilities Programs	10,318	6,756	3,562	34.5	10,846	7,463	3,383	31.2
Highway Trust Fund	5,475	4,155	1,320	24.1	5,475	4,419	1,056	19.3
Debt Service Grants[2]	913	901	12	1.3	924	739	185	20.0
HEW	1,868	574	1,294	69.3	2,239	619	1,620	72.4
All Other	2,062	1,126	936	45.4	2,208	1,686	522	23.6
Operating Programs	10,886	6,581	4,305	39.5	13,535	8,465	5,070	37.5
HEW	7,106	3,840	3,266	46.0	8,510	4,792	3,718	43.7
OEO	2,180	1,948	232	10.6	2,196	1,948	248	11.3
All Other	1,600	793	807	50.2	2,829	1,725	1,104	39.0

[1] Percent of authorizations.

[2] Consists of public housing, urban renewal (excluding that portion of the model cities program related to urban renewal projects), and interest reduction grants for college housing, vocational education residential facilities and higher education facilities.

Source: ACIR, *The Gap Between Federal Aid Authorizations and Appropriations, Fiscal Years 1966-1970* (Report M-52) June 1970.

dedication of highway-user revenues to the trust fund.* In short, congressional promise and performance match quite well for highway aid.

Enlarged legislative authorizations for many new programs that were enacted during 1964-1966 period under the banner of the "Great Society," have competed with the need to finance the Vietnam conflict, thus giving rise to a large portion of the authorization-appropriations gap. While the promises in the form of escalating authorizations remained on the statute books, appropriations had to be contained to fit the budgetary cloth.

The point must be emphasized, however, that the present system for funding Federal programs is virtually guaranteed to produce a gap between program authorizations and subsequent appropriations. This hiatus can be traced to the differing responsibilities of the authorizing (substantive) committees on the one hand and the appropriations committees on the other. This division of labor was succinctly described on the floor of the Congress a number of years ago:

> The legislative committee goes through the hearings, evaluates the evidence before it, and tries to determine the amount of money which is the ceiling that the committee could possibly justify as far as the activity is concerned. Then it is up to the appropriations committee to determine how much of the money can be spent in that particular year, and that is the amount which is made available....Each committee works for a different objective. The objective of the legislative committee is and ought to be to establish a ceiling for a program. The objective of the appropriations committee is and ought to be to establish the proper sum of money which can or should be spent by law in any given year.[26]

This dualism is designed to accommodate and to harmonize the national interest in promoting particular program interests, on the one hand, while still making ends meet on the other. Thus, the so-called gap at any time represents the difference between what the various substantive committees of the Congress regard as potentially feasible over the next 3 to 5 years and what the appropriation committees are willing to pay for immediately. Representative Jamie Whitten emphasized this point on October 8, 1969, during the debate on the sewage treatment facilities appropriation:

> If this House ever adopts the view that an authorization is a commitment by the Congress to carry out fully in the shortest possible time we are going to have the bitterest fights every time there is an authorization bill, because if that is where the decision is going to be made on immediate spending there will be precious few authorizations that go through the Congress without the greatest amount of difficulty, since it will be necessary to match the authorization against income, and it will be necessary to match it all along the way with other problems.
>
> It is wise, I believe, to have an authorization much higher than the funding which may be required at the moment. It actually allows us to have advanced planning. It allows us to have plans on the shelf, for the time when we can get out of this Vietnamese war. Authorizations on the shelf are fine for the operation of this country in season and out of season.[27]

It must be emphasized that a congressional authorization to appropriate funds is *not* a commitment. The authorization is generally a congressional judgment as to the ultimate magnitude of a program—without any particular concern for budgetary priorities or fiscal realities. The figure is generally arrived at in committee as a result of testimony presented at hearings by representatives of interest groups and special pleaders—both Federal and State—in the particular functional area. Often it is "what should be" not necessarily "what can be" in the light of budgetary and economic considerations which cannot be anticipated at the time the substantive legislation is being considered. Thus the substantive authorization, when a dollar amount is set forth in the enabling Act, is intended as a ceiling which spending authority may not exceed. By no means should it be considered a spending floor.

Nevertheless, when the substantive or parent committees send forth their new programs into the budgetary arena, they often arm their offspring with specific dollar authorizations—clubs which can then be held over the heads of the President and the membership of the appropriations committees. Thus, if the generalists in the appropriations process fail to fund the new program at the level prescribed by the substantive committee, they become vulnerable to the charge of shortchanging a program of high national interest.

The recent history of authorizations and appropriations for the sewage treatment facilities program illustrates well the political "leverage" effect of escalating authorizations. This program—a key element in the effort to combat water pollution—was expanded considerably by 1965 and 1966 legislation. The expanded program began modestly with authorizations of $150 million each for 1966 and 1967 and the

*See above p. 40, ff. for a discussion of the Highway Trust Fund.

appropriation for fiscal 1967 matched the promise. Beginning with fiscal 1968 the legislative promise (contained in the Clean Water Restoration Act of 1966) escalated—with authorizations of $450 million for that year, $700 million for 1969, $1 billion for 1970 and $1¼ billion for 1971.

In submitting the budget for fiscal 1968 the President was concerned with the inflationary impact of a swollen defense budget and recommended holding the line on most domestic programs. The sewage treatment plant program was no exception. Thus, $203 million was appropriated for fiscal 1968 (less than half the authorized amount) and $214 million for fiscal 1969 (less than one-third the amount authorized). The 1970 budget proposed the same amount—$214 million—but when Congress began to consider the appropriation, public interest pressures reached the boiling point, with demands for "full funding" (at $1 billion). After considerable debate, the House of Representatives approved an appropriation of $600 million and the Senate opted for full funding. The conference committee split the difference and, as finally enacted, the appropriation for fiscal 1970 stood at $800 million or 80 percent of the amount authorized.

Perhaps the most significant policy effect of the growing disparity between authorizations and appropriations is to be found in the high-powered ammunition that this development has provided proponents of firm long-term commitments in Federal grants for public facilities. Repeatedly, they have cited the growing authorization-appropriation lag as an argument for building greater certainty into the Federal aid process, particularly for urban mass transit and airport construction. Thus, they argue that only by establishing long-term spending (obligational) authority in substantive legislation can congressional promise and performance be kept in reasonable alignment. And, if this can be coupled with trust fund financing, so much the better!

Power Shift Considerations

The financing provisions of the 1970 Mass Transportation and Airport Development legislation represent a significant power shift from the appropriations committees to the program committees. If enacted, the same conclusion can be drawn from the Administration's legislative proposal for financing waste treatment disposal facilities. In all three cases, the long-term commitment (obligational authority) is set forth in the authorizing legislation prepared by the substantive committees. Thus, the appropriations committees would be left with the pro forma task of appropriating funds to liquidate contractual obligations as they fall due.* This fiscal power shift would appear to be more significant in the case of the House of Representatives. Unlike their Senate colleagues, members of the House Committee on Appropriations do not also serve on major substantive committees (table 12).

The evolution of the "Aviation Facilities Expansion Act of 1969" illustrates the potential fiscal power shift that occurs with the attempt to introduce long-term financial commitments.** The House-passed version (H.R. 14465), while it contained a trust-fund feature, also retained for the appropriations committees their prerogative of establishing annual spending authority in appropriation acts. The Senate amended the financing provision when it passed the same bill, substituting specific contract authority for authorization to appropriate funds. The Senate version prevailed, as finally enacted.

At least one Senator recognized the power shift inherent in the Airport Facilities Act (P.L. 91-258). During the floor debate Senator William Proxmire (a member of the Senate Committee on Appropriations) commented:

> The bill before us would segregate $600 million in Federal tax revenue for airport construction and for airport facilities. I am sure that in many cases, airports are good investments and the money should be spent. But in a tight budget year, when we are trying to fight inflation, does it make sense to go full speed ahead with building airports and cut back on more socially urgent programs such as housing? Does it make sense to tie the hands of the executive branch and the Congress when we should be reassessing all our national needs? Does it make sense to continue to whittle away at the power of Congress to control spending, when Congress must ultimately answer to the American people on the level and distribution of Federal expenditures?
>
> I think Congress needs to take notice that it is undermining its own authority when it bypasses the regular appropriations procedure. I realize that it is too late to completely restructure the financing methods contained in this bill. Nonetheless, as a member of the Appropriations

*See table 8, p. 41.

**See above p. 42 ff.

Table 12

OVERLAPPING MEMBERSHIP BETWEEN MAJOR SUBSTANTIVE COMMITTEES AND RELATED SUBCOMMITTEES OF THE SENATE COMMITTEE ON APPROPRIATIONS 91st CONGRESS

Major substantive committee	No. of members on Appropriations Committee	No. of members on related subcommittee of the Appropriations Committee	Percent overlap
Aeronautics & Space	6	5	83
Agriculture & Forestry	2	1	50
Armed Services	4	4	100
Banking & Currency	1	-	–
Commerce	4	3	75
District of Columbia	1	-	–
Foreign Relations	4	3	75
Interior & Insular Affairs	2	1	50
Judiciary	4	2	50
Labor & Public Welfare	1	-	–
Public Works	3	-	–
Total	32*	19	60

*Includes membership on more than one substantive committee. There are 24 members on the Senate Committee on Appropriations.

Source: Compiled by ACIR staff.

Committee, I feel a duty to point out to the Congress that by approving trust fund financing for airport construction, it is starting down a dangerous road.[28]

FACTORS RESISTING LONG-TERM COMMITMENTS

The budgetary powers of the President as well as those of the appropriations committees are diminished by building long-term commitments into Federal aid legislation. Slowly but surely, this movement reduces the ability of the President to propose and to urge upon the Congress a spending plan to carry out a Federal program which, in his best judgment, will offer the necessary governmental services most effectively. It also undercuts the effectiveness with which he can manipulate Federal expenditures–now accounting for one-fifth of the Nation's gross product*–when countercyclical measures are indicated. Every new trust fund with long-term obligational authority, every formula grant with mandatory expenditure provisions, every new "open-ended" grant program, adds to the amount of expenditure that is moved out of the President's control. The Bureau of the Budget estimates that fully 69

*On the basis of national income and product accounts, total Federal expenditure amounted to $181.5 billion in calendar 1968, with a GNP of $865.7 billion.

percent of the budget outlays for fiscal 1971 are "relatively uncontrollable"–up from 64 percent in fiscal 1969 and 66 percent in fiscal 1970.[29]

The "controllable" items in the Federal budget tend to be limited to the defense appropriations on the one hand and the "soft" domestic programs on the other–the poverty-oriented items such as education of children from low income families and community action and manpower training programs. Major domestic research and development programs, particularly those in the health field, are also vulnerable to budgetary pruning. Thus, the more massive the shield thrown around the "brick and mortar" programs, the more certain becomes the fate of the "soft" programs in time of budgetary constriction. Unlike their capital facility competitors, the people-related programs especially in the poverty field lack powerful champions in the budgetary arena.

Because of their sheer magnitude, Federal expenditures have a profound influence on both the shape of the Nation's domestic program and on the national economy. Therefore, Federal policymakers are increasingly using budgetary policy as a tool for economic stabilization, as well as for its traditional role of allocating and reallocating resources among alternative requirements. Each new President and every new Congress have their own notions, bolstered by political pressure groups, as to the kinds of public programs the Federal Government can best stimulate, support and conduct. The volatility of international relationships underscores the urgency of being able to shift Federal resources quickly from domestic to foreign commitments. The volatility of a domestic scene charged with racial and other sociological tensions makes it equally essential to be able to redirect Federal efforts as new circumstances arise.

Responsibility for focusing on the total program and economic impact of the Federal budget is lodged in the Office of the President. It is not surprising, then, that much of the pressure for budgetary flexibility has come from that office. And, as was noted above, similar pressure has come from the appropriations committees–especially the House Committee on Appropriations–which must also consider the total budgetary impact. For, just as surely as the President's budgetary flexibility is curtailed by long-term commitments in substantive legislation, so is that of the appropriations committees. The extent to which the President can apply the expenditure brakes quickly or, conversely, accelerate expenditures to counteract cyclical movements of the economy, depends to a large degree on the amount of flexibility the budget process gives him.

Recent presidential actions illustrate the application of budgetary policy to counteract economic trends or to reorder national priorities. In August 1969, President Nixon began to cut back Federal construction expenditure in an effort to dampen inflationary pressures. President Johnson ordered similar cutbacks in 1966 and 1967, when he found it necessary to reduce domestic expenditures to bolster the Vietnam effort. On the other hand, when private demands for consumption and investment goods are weak, threatening an increase in unemployment and idle plant capacity, it makes economic sense to increase Federal expenditures and the budget deficit to help restore overall demand to full employment levels.

Following World War II there was considerable concern that in converting from a war to a peace economy the Nation would be faced with periods of unemployment, and steps were taken to meet such eventualities. President Truman requested and obtained authority in 1950 for loans to enable States and localities to make ready a shelf of public works plans in the event of a recession. President Eisenhower established an agency in the Executive Office with specific concern for civil public works. That agency worked with States and localities to develop a shelf of public works plans which could be put into effect quickly if the need should arise. Later in the 1950's the concern shifted from that of general unemployment to the problem of surplus labor areas. This concern eventually culminated in the enactment of the Area Redevelopment Act (subsequently changed to the Economic Development Act) with provision for an accelerated public works program to be directed at areas with a high rate of unemployment. Soon after he took office, President Kennedy saw the need for standby authority in order to act quickly when the need should arise to stimulate the economy. Specifically, he asked Congress to authorize him to reduce individual income tax rates temporarily to head off a recession and also to provide $2 billion in obligational authority for public works projects.[30] Congress turned down this request.

MESHING STATE AND LOCAL CAPITAL FACILITY PROGRAMS WITH FEDERAL COUNTERCYCLICAL MEASURES

Under our federal system it is essential that the Federal Government and the State and local governments take seriously their roles as partners in the financing and delivery of domestic public services. In fact, Federal fiscal policy can have only a partial effect without supportive efforts by States and localities. State and local expenditures, bolstered by steadily growing

Federal grants-in-aid, have been expanding since the end of World War II at a considerably faster rate than the economy. States and localities now pay for over half of all government purchases of goods and services. It is apparent, therefore, that Federal expenditure cutbacks can have only a limited effect in dampening an inflationary trend without like action on the part of States and localities.

Presidential Power to Withhold Grant Funds

The President can, of course, try to force States and localities to slow down capital projects by withholding grant-in-aid funds. His authority to withhold the spending of appropriated funds stems from the Anti-Deficiency Act of 1906 and the Budget and Accounting Act of 1921. The Anti-Deficiency Act was intended as an executive tool to cut back spending when the President saw opportunities to effect economies during a particular fiscal year. When this is done, he can subsequently propose to Congress the recision of portions of appropriations. Under the Budget and Accounting Act, the President, through the Bureau of the Budget, is authorized to establish quarterly apportionments of appropriated funds, primarily to avoid overspending in the early quarters of a fiscal year, thus avoiding later requests for supplemental appropriations.

President Johnson used this authority when he ordered a slowdown of Federal construction in 1966. In doing so, he required the agencies administering construction grants, including the Federal Highway Administration, to do likewise.* There were immediate protests from State highway officials and governors to the effect that the cutbacks would wreck their programs. Furthermore, they argued, the Highway Trust Fund was inviolable and the President had no authority to withhold funds from it. Congress tended to agree with them. Senator Warren G. Magnuson, Chairman of the Senate Commerce Committee, stated:

> ...the fact that this is a trust fund is true. The words literally mean "trust." We intended it to be a trust fund. These funds are not the funds of the Federal Government in the sense that they are deposited in the Treasury to be used according to the policymakers on the budget of Government expenditures or reflected in what should be done about Government taxes. These funds were deposited in the Treasury for trust keeping. In a sense they are not Government funds. They are funds of the people.[31]

The Highway Act of 1968 included a "sense of Congress" provision prohibiting the President to "impound or withhold" funds authorized to be expended from the Highway Trust Fund.[32] It is generally agreed, however, that a "sense of Congress" provision is intended only as guidance to the President; in fact it is an indication to the President that he may be called to account by the Congress if he does not follow such a suggestion. Still it is not a *mandate.*

Congress does, of course, have the power to require the President to spend every penny that it appropriates and such action has been proposed on various occasions. It was considered in connection with the 1968 Highway Act but the softer "sense of Congress" provision was adopted instead. Hearings were held in 1958 on a number of bills to forbid the Executive Branch to "withhold or impound or otherwise prevent any moneys appropriated by the Congress from being promptly used or applied by contract or otherwise for the purpose designated in the Act appropriating the same."[33] This provision was never enacted into law. During the hearings it was pointed out on several occasions that "Congress has never adopted the philosophy that an appropriation should be considered as a mandate to spend."[34]

More recently, on the occasion of President Nixon's veto of the Labor-HEW appropriation for fiscal 1970, the Attorney General rendered several opinions to the effect that the legislative language for a number of formula grants administered by HEW prevents the President from impounding such funds once they are appropriated.[35] The President gave this as one of the reasons for vetoing the bill, pointing out that because there were only five months left in fiscal 1970, Congress would be forcing the Administration to spend the increased appropriations hurriedly and unwisely.*

*Attorney General Clark upheld the President's action in withholding highway aid expenditure. In his opinion the spending authority in the Federal-aid highway legislation constitutes a limitation and, he pointed out, "the (Trust) Fund is functionally akin to the conventional appropriation and, as such constitutes an authority rather than a mandate," (National Highway Users Conference, *The Highway Trust Fund,* Washington: 1967, p. 20). See above p. 42 ff. for a fuller discussion of the President's authority to impound highway funds.

*The vetoed bill would have increased appropriations for certain HEW items by about $1 billion over the budget request for fiscal 1970.

Voluntary Expenditure Reductions by States and Localities

Faced with a continued spiralling inflation, President Nixon in August 1969 ordered a 75 percent cutback in direct Federal construction expenditure. However, he announced to the National Governors Conference that he would not withhold construction *grant* funds at that time, although he did not guarantee that such a step would not be taken later. Instead, he urged the States to cut back voluntarily their expenditures for capital projects. This Presidential exhortation had some effect, as the States announced the withholding of about $1 billion in highway contracts and a similar cutback on other public facility programs.*

As an anti-inflationary measure the use of Federal grants to cut back State and local construction expenditures quickly is a blunt instrument at best. Even if the States and localities were to act quickly in response to a Presidential request, they could hardly stop construction projects that were already underway; they could only delay letting new contracts. Thus, by the time a cutback in State and local projects is reflected in their expenditure flows, the need for the reduction might have passed as a result of other fiscal or monetary action taken by the National Government.

Indeed, the imposition of credit restrictions and income tax increases is far more effective than trying to mesh State and local construction cutbacks with Federal anti-inflationary policy. An income tax increase shows up almost instantly through the withholding system; while the Federal Reserve System and other Federal credit instrumentalities can tighten private credit quickly and thus restrict private capital outlays. Furthermore, as a tight credit policy raises interest rates on the municipal bond market, States and localities withhold their borrowing and construction plans voluntarily (as occurred during the 1969 credit crunch).

When the need arises to stimulate the economy, the ability to accelerate expenditures—both Federal and State-local—can be an effective tool. With Federal assistance, States and localities would need little encouragement to step up their construction and equipment purchases in the light of their tremendous need for capital facilities.

*"Many States 'Agree' to Cut Road Building on White House Threat of Mandatory Curb," *Wall Street Journal,* Feb. 4, 1970. The suggestion that States and localities voluntarily defer construction was implemented by Bureau of the Budget Bulletin No. 70-5, dated September 12, 1969. This request for voluntary deferral was withdrawn on March 17, 1970.

Admittedly, harnessing the expenditure decisions of 50 States and 80,000 local governments to a unified national fiscal policy poses some formidable problems. The innumerable restrictions on State and local taxing and borrowing powers alone reduce the ability of those governments to participate fully in countercyclical actions. The Advisory Commission has previously pointed up the built-in State-local inflexibility resulting from such restrictions and has recommended that they be eased or eliminated. Yet, in view of the growing importance of the State-local sector in the economy, techniques need to be worked out that will bring State-local and Federal fiscal policy together to constitute a complementary fiscal policy for our federal system.

Advance budgetary planning on the part of the Federal Government, at least in connection with major Federal grant programs for capital facilities, can provide the beginning of a system of Federal-State-local priorities for fiscal policy purposes. To the extent the Federal Government is willing to provide certainty of funding for specified programs, the States and their localities should be willing to work in conjunction with the Federal Government to develop a system of program priorities which would be available to accelerate Federal-State-local expenditure efforts when the economy needs bolstering or to retard such efforts when a slow-down is indicated.

The idea of developing a system of priorities is not new. Thirty years ago the National Resources Planning Board called for a national planning policy, but it was well ahead of its time. "Planning" is no longer a dirty word and many recent Acts of Congress call for comprehensive planning on a State or regional basis in connection with Federal aid programs.

As Federal aid becomes a steadily growing factor in intergovernmental relations (in fiscal 1970 it ran at $24 billion annually and can be expected to reach $40 or $50 billion in the not too distant future, especially if a revenue sharing program is enacted), both the Federal leverage for advance planning and the State-local demand for more funding certainty will increase. Still, the development and maintenance of program priorities should be arrived at jointly by all three governmental levels. State governments are becoming more concerned with the need to deal with urban problems and to plan for their solution together with local governments. Given the opportunity, they can participate in implementing national domestic fiscal policy.

RESOLVING THE ISSUES

In this Chapter we have noted some conflicting tendencies in the financing of Federal programs to aid States and localities build capital facilities. On the one hand there has been a growing uncertainty in the traditional annual budget and appropriations process that has stemmed from congressional tardiness in enacting appropriations acts and from an ever-increasing gap between authorizations and appropriations for grant programs. On the other hand there is growing sentiment on the part of Congress to provide long-term Federal aid commitments by means of trust fund financing and by the establishment of advance spending authority in substantive legislation. Allowed to continue and to proliferate these congressional actions will tend more and more to hobble the efforts of the fiscal generalists (the President and the appropriations committees) to apply executive and legislative direction to the budgetary process and to the orderly development of the economy.

Granted that State and local governments are entitled to a strong measure of assurance that Federal aid funds for needed capital projects will be forthcoming in accordance with the promises made by Congress and by the Administration, surely those responsible for conducting the fiscal affairs of the Federal Government must be able to retain their flexibility. How can this conflict between the proponents of Federal aid certainty and the fiscal generalists be resolved?

One remedial step can be taken by Congress itself. It can and must establish a specific timetable for processing annual authorizations and for acting on annual appropriations. Only by doing this can it enact appropriations prior to the time they go into effect, thus eliminating one element of uncertainty that plagues Federal administrators and State and local beneficiaries alike.

Although the President should and does have the power to withhold appropriated funds when this is necessary to dampen inflation, the use of this power to mandate State and local expenditure cutbacks without prior consultation is a major source of intergovernmental friction. Nevertheless, while the possibilities for gearing State and local capital expenditure with national countercyclical policy are limited, the potential of voluntary State action should not be overlooked. Procedures should be established by the President, in cooperation with the Governors, that would provide a vehicle for the States and localities to cut back or accelerate their capital expenditures when such adjustments are needed to supplement Federal countercyclical policy.

The long-term commitment issue can and should be resolved without completely undercutting the budgetary flexibility of the President and the appropriations committees. Rather than establishing long-term financing (obligational authority) in substantive legislation, the Congress should provide for a system of multi-year advance budgeting thus building the long-term commitment (for specified capital facility programs) into the regular budget and appropriations process. Building a long-term plan into the annual budget for consideration by the appropriations committees and ultimately by the entire Congress would assure that the programs are initially pitted against other claimants for the Federal dollar. Commitments thus hammered out in the competitive budgetary arena would be far more realistic than the dollar authorizations developed in the protective atmosphere of the substantive committees and therefore much more likely to be honored when they fall due. The advance budget plan would thus steer a middle course between the uncertainties generated by the present annual budget and appropriations system and the rigidities inherent in establishing long-term financing in substantive legislation.

Footnotes

[1]It should be noted, however, that multi-year or no-year authority for Federal agencies simply allows them to hold their books open until the authorized funds are obligated. It does not provide advance spending authority.

[2]49 USCA 1104 (d) (7), added by PL 89-647.

[3]1968 *Budget,* Appendix, p. 518.

[4]42 USCA 1453 (b).

[5]*Congressional Record,* October 13, 1969, p. S 12449 (italics added).

[6]91st Congress, S. 3016 (Economic Opportunity Amendments of 1969), Sec. 5, enacted as Sec. 111, PL 91-177, Dec. 30, 1969.

[7]Elementary and Secondary Education Amendments of 1967 (PL 90-247, Jan. 2, 1968).

[8]U.S. Senate, 91st Congress, 1st Session, *Hearings Before the Committee on Appropriations, Departments of Labor, and Health, Education and Welfare Appropriations, FY 1970,* Pt. 4, p. 2221.

[9]PL 90-464, August 8, 1969 (An Act making appropriations for the Department of Transportation for the fiscal year ending June 30, 1969, and for other purposes) (italics added).

[10]Highway Finance Act of 1956, Sec. 209 (g).

[11]Opinion of the Attorney General, Feb. 25, 1967 (Washington: U.S. Government Printing Office).

[12]23 USCA 101 (c).

[13]Presidential Message to the Congress on Airports and Air Transportation, June 16, 1969.

[14]H.R. 14465, Title 1, Sec. 14 (italics added).

[15]House of Representatives, 91st Congress, 1st Session, *Aviation Facilities Expansion and Improvement* (Report No. 91-601, October 27, 1969), p. 93.

[16]"Transit Trust Fund Bills are Introduced," *Engineering News-Record,* February 27, 1969, p. 12.

[17]"Volpe Compromises on Long-Term Transit Financing," *New York Times,* October 15, 1969.

[18]Statement of John A. Volpe, Secretary, Department of Transportation before the Senate Committee on Banking and Currency regarding Public Transportation Assistance (S. 2821), Tuesday, October 14, 1969 (mimeographed) p. 3.

[19]S. 3154, 91st Congress, passed by the Senate on February 3, 1970.

[20]*Congressional Record,* November 19, 1969, p. S 14603. It should be noted, however, that considerable sentiment was expressed in favor of trust fund financing in hearings held during March 1970 by the Subcommittee on Housing of the House Committee on Banking and Currency--notably by the National Association of Counties.

[21]*Congressional Record,* February 10, 1970, p. H 744.

[22]The Council of State Governments, *Cost to States Resulting from Delays in Authorization or Appropriation of Federal Grants-in-Aid* (Chicago: May 1967).

[23]*Congressional Record,* October 29, 1969, p. S 13393.

[24]The Council of State Governments, *op cit.*

[25]ACIR, *The Gap Between Federal Aid Authorizations and Appropriations, Fiscal Years 1966-1970,* (Report M-52), June 1970.

[26]Quoted from the *Congressional Record,* Daily Edition, Sept. 5, 1961, p. 17022, in Fenno, Richard F., Jr., *The Power of the Purse--Appropriations Politics in Congress* (Boston: Little, Brown and Company, 1966), p. 114.

[27]*Congressional Record,* October 8, 1969 p. H9234.

[28]*Congressional Record,* Feb. 25, 1970, p. S 2364.

[29]*The Budget of the United States Government, Fiscal Year 1971,* (U.S. Government Printing Office, Washington: 1970), p. 42.

[30]*Economic Report of the President,* (Washington: U.S. Government Printing Office, January 20, 1962).

[31]National Highway Users Conference, *The Highway Trust Fund* (Washington: 1967), p. 21.

[32]23 USCA 101 (c).

[33]H.R. 11441, H.R. 11541 and H.R. 11682, 85th Congress, 2d session.

[34]U.S. Congress, House, *Prohibiting, Withholding or Impoundment of Appropriations and Amending the Antideficiency Act,* Hearing Before a Subcommittee of the Committee on Government Operation, May 20, 1958 (Washington: U.S. Government Printing Office, 1958) p. 3.

[35]*Congressional Record,* January 20, 1970, p. S 158ff.

Appendix to Chapter 3

CLOGGING THE FEDERAL MONEY MACHINE

The Wall Street Journal, Tuesday, November 25, 1969

By Arlen J. Large

WASHINGTON—The Congressional habit of passing everything twice is causing increasing chaos in Uncle Sam's moneybags.

Readers of newspaper stories about Congress recognize the mysterious phrasing: "Congress gave final approval today to a sweeping $1 billion program of Federal aid to canners of strawberry jam. The actual money, however, must be appropriated in separate legislation."

But if that first bill hasn't passed until late in the year, it can hold up enactment of the appropriation bill that will nourish not only the sub-bureau in charge of strawberry jam but several whole Cabinet departments as well. In recent years this has been happening often, and this year is the worst.

The Government's fiscal year started last July 1, a date by which Congress legally should have passed every departmental appropriation. Yet the first of the 13 annual appropriation bills wasn't finally enacted until Sept. 29, and to date—in the waning days of this session—only three more have made it. Much of the Government is running on a "continuing resolution," a stopgap bill by which the tardy Congress, generally speaking, lets a department keep spending at last year's rate.

Wasting Money

The appropriations delay causes more than just inconvenience for bureaucrats. Until a department's appropriation is passed, it's impossible for officials to plan changes and improvements from the status quo. The resulting uncertainty and wheel-spinning waste a lot of money.

The appropriations mess has triggered an exchange of cheap political accusations. Democrats in Congress complain the bills are late because President Nixon dawdled in submitting his budget. Republicans say the Democrat-controlled Congress is dragging its feet and trying to sabotage the President.

There is barely enough truth in both charges to keep the argument going. The real culprit is the system in Congress itself, traditional procedures dating back to the 1920s when the entire Government budget ran less than $3 billion annually. Today the Atomic Energy Commission alone consumes almost that much, and today the Congressional system of handling the purse is strangling itself.

On paper the system makes sense. Congress legislates on the warp and woof of its committees—a division of parliamentary labor essential to the screening of the thousands of bills on hand. There are House and Senate committees in charge of matters relating to agriculture, space, defense, taxes, banking, foreign relations and other broad topics. These "legislative" committees can hold hearings on affairs under their jurisdiction, check how well a department is doing its job, recommend changes in the law governing old programs or draft bills setting up new ones. They are, in short, Congressional policymakers.

When such a committee votes to "authorize" a new Federal program, it also makes policy by saying how much money the program should have. "There is authorized to be appropriated from the general fund of the Treasury the sum of $1,000,000,000" would be the stock language in a Strawberry Jam Act.

An authorizing committee may assert some say over the amount it wants appropriated, but it's the powerful appropriations committees in each house that actually set the amount in separate bills (subject, of course, to full House and Senate approval—which usually, but not always, is granted). Thus the system is bound to produce tension and power struggles. On one side are legislative committees seeking to fatten programs under their jurisdictions. On the other are the appropriations committees, which claim the duty of rationing out the total Federal budget in the context of overall national priorities.

Though this split function was established in 1920, for years most of the control over funds remained with the appropriations committees. But the Government kept getting bigger, and authorizing committees kept creating more new programs in which they have a prestige stake. Thus began a trend that has contributed significantly to the current mess: A requirement for annual authorization bills for long-established programs. These bills, which typically inflate spending targets, seek to set itemized policy for the program in question.

During the '50s the armed services committees got both houses to agree that Pentagon hardware procurement must receive an authorization each year; it was the way these military-minded panels hoped to grab more influence over Pentagon weapons decisions. The task of first authorizing and then appropriating Pentagon money didn't work too badly; in the Senate, Georgia's powerful Richard Russell for years headed a cozy interlocking directorate of Senators who—wearing different committee hats—handled both bills.

A Breakdown in Delivery

But the system's seeming smoothness was due mainly to a lack of much controversy about Pentagon spending. When this year's dispute over the ABM and other weapons exploded, the system broke down—at least in terms of timely delivery of military cash. The Senate spent all summer debating the once-routine authorization bill. Though there was quick House passage, a long conference over differences in the two versions delayed enactment of the bill until Nov. 6 (compared with Sept. 11 last year and May 23 in 1967). Only then did it become legal for the House Appropriations Committee to start moving the actual money bill through the pipeline, and the ABM argument must start all over again.

Dissatisfied with the sums being appropriated for Coast Guard ships, the House Merchant Marine Committee and the Senate Commerce Committee in 1963 engineered a requirement for an annual Coast Guard authorization bill. Decrying stingy appropriations for merchant marine subsidies, the same panels in 1967 won approval of a requirement for annual authorization of this money. Merchant marine boosters dismissed complaints that officials running the program would have to testify before four separate committees instead of just two. "The terrible plight of the American merchant marine cries out for a solution!" exclaimed Republican Rep. Jack Edwards of Alabama. "If it means an added burden on the legislative process, so be it."

The "burden on the legislative process" is magnified by the tradition of lumping together in one bill the money for two or three separate departments. This year's appropriation for the Departments of State, Justice and Commerce languishes in a House-Senate conference while Attorney General John Mitchell darkly accuses Congress of sitting on his funds for police training and other anti-crime efforts. Yet lawmakers of every stripe are quite eager to cast this vote against crime; the main hang-up was the Commerce Department's merchant marine subsidy, which didn't get its annual authorization until Sept. 25.

Last year it was the National Science Foundation's turn to begin needing an annual authorization in advance of its yearly appropriation. Science-minded lawmakers wanted more say in the way the foundation distributes money for basic research; the chairman of the Senate subcommittee in charge of the NSF authorization this year lectured officials on the need to bend research toward more immediate solutions to social problems.

The NSF bill emerged from the Senate committee on July 2, but not until Sept. 18 did it pass the Senate. One reason for the delay: The chairman in charge was Sen. Edward Kennedy, whose July 19 accident at Chappaquiddick interrupted his legislative chores. The stalled NSF authorization in turn helped delay progress of the grab-bag "independent offices" appropriation bill, which provides funds for a score of scattered agencies.

Legacies from the Great Society program factory of the mid-'60s also cropped up this year to choke the system. One example: The Appalachia regional uplift program, enacted in 1965. Its authorization needed to be extended this year, and that bill didn't pass until this month. The delay was another reason for the lag in the independent offices appropriation.

The seniority system enables a key individual to climb to chairmanships in both the authorizing and appropriating pipelines; if he vanishes, work stalls all along the line. A Far East junket kept Sen. Warren Magnuson of Washington away for an extended time after the official August vacation of Congress. He's chairman of the appropriations subcommittee that handles the Health, Education and Welfare Department money, which now is late. Mr. Magnuson also is chairman of the Commerce Committee, which for months has sat on a needed re-authorization of the 1966 auto safety law, and this in turn has helped delay the Transportation Department's money bill.

But Sen. Magnuson himself has a plan intended to "help unscramble the present situation of hesitancy, confusion and uncertainty" over the Federal budget. The Congressional calendar would be split into legislative and appropriations sessions, as with many state legislatures. The authorizing committees would work until November, then stop. All appropriations would be held back for forced-draft passage in November and December. The reform also would change the Government's present July-to-June fiscal year to coincide with the calendar year.

Sen. Magnuson has been urging his plan for several years, but until lately it has had few takers. One objection: By keeping Congress in session during November and December of even-numbered election years, some of the voting would be done by defeated "lame duck" lawmakers whose terms officially don't expire until January.

A variation of the Magnuson plan, being touted by Rep. Louis Wyman of New Hampshire would avoid the lame duck problem. Legislative committees would have until June 1 each year to pass authorization bills. After that, it would be legal for the appropriations committees to start moving their measures whether anything has been authorized or not.

Some relief from the appropriations mess also may come by bending the custom of handling money bills in such huge multi-departmental chunks. Providing that a slow-moving re-authorization of Federal school aid can be passed early next year, House Appropriations Committee Chairman George Mahon of Texas has talked of splitting education money off from the traditional huge Labor-HEW appropriation and passing it in the spring. This would give school administrators time to plan for the school year starting in September—something the appropriations mess now prevents.

A Leadership Problem?

But some veteran students of Congressional folkways think such structural reforms are less needed than tough, whip-cracking leadership in both the House and Senate. Speaker John McCormack is showing declining vigor. Senate Democratic Leader Mike Mansfield occasionally cracks the whip, but he's a gentle fellow who is reluctant to constantly push, push, push the senior autocrats who head the Senate's legislative committees.

The legislative rank-and-file should share some blame for this year's acute appropriations breakdown, too. The atmosphere on Capitol Hill for most of the year has been relaxed. President Nixon hasn't proposed much, certainly not requiring the frenzied output of the L.B.J. era. This was to be the year the lawmakers could just attend to "routine" housekeeping amid their foreign junkets and visits home, but it's the "routine" that now threatens to overwhelm them.

Chapter 4

Intergovernmental Responsibilities: Federal Encouragement of State Financial Participation in Federally-Aided Capital Facility Projects

Economic theorists have developed a well rounded conceptual framework for a Federal-State-local partnership in financing public expenditures that is applicable both to current spending and capital outlays. Stated simply, this partnership assigns financial responsibility commensurate to the benefits that accrue to each jurisdiction. Yet in actual practice, this parcelling out of financial responsibilities is difficult to achieve–the division of benefits is at best a rough rule of justice and jurisdictional lines rarely coincide with the benefit ratios. To better capture the within-State benefit flows, many have argued for areawide or metropolitan governments capable of encompassing these spillover effects. Experience indicates, however, that creation of new jurisdictional boundaries moves at a glacial pace. For this reason, there has been increased attention devoted to the State sector which–with the few exceptions of certain metro areas that cross State lines–contain these benefits within an already existing jurisdictional boundary system.

The disturbing feature about current State-local fiscal relations is that some States have seen fit to remain largely aloof from participation in this balancing process. Yet, State governments have ultimate program responsibility as well as access to a broader financing base than do local communities. For this reason, States legitimately can be expected to participate fully in the financing of federally-aided projects, particularly those for which long-term Federal commitments are now being sought–airports, urban mass transportation, and water pollution control.

The following sections discuss two ways in which the Federal Government has attempted to encourage State participation in federally-aided public facility financing; namely by (1) authorizing States to prefinance the Federal share of the cost, and (2) providing a financial incentive for States to participate in a Federal-local program.

AUTHORITY FOR PREFINANCING FEDERAL AID

Three Federal programs contain provisions that authorize the States to advance from their own funds the Federal share of the cost of Federally-aided capital facilities. Two of these "prefinancing" provisions apply to the Federal-aid highway program as might be expected where Federal financial support is assured by the Highway Trust Fund. The other prefinancing opportunity is included in the water pollution control legislation–specifically those sections dealing with the construction of waste treatment plants.

Authority in the highway statutes to prefinance is quite broad: when a State has obligated all the Federal funds specifically apportioned to it, it may go ahead with its own funds on projects that have been approved for inclusion in the Federal-aid system; the Secretary of Transportation is authorized to reimburse the State for such advance expenditure as future apportionments become available.[1] In practice, this provision has been little used, probably because congressional funding commitments have generally been met. A number of States have, however, taken advantage of the indirect prefinancing authorization in the highway statutes, by using a portion of the Federal highway aid funds apportioned to them to retire the principal of bonds the proceeds of which were used to construct federally-aided highways.[2]

Interest in prefinancing took a sharp upswing with the advent of the Federal aid program for construction of waste treatment facilities. The Federal Government began to recognize water pollution as a national problem in 1956 when it enacted a small program of grants to States and localities for the construction of waste treatment works. With continued urbanization and population growth the problem of maintaining clean water for human consumption and for recreational purposes became increasingly acute. In 1965 and 1966, the Congress enacted three legislative landmarks: the Water Resources Planning Act of 1965; the Water Quality Act of 1965; and the Clean Water Restoration Act of 1966. The latter focused heavily on the waste treatment plant program authorizing total grants of $3.4 billion (in addition to the $300 million previously authorized in the Water Quality Act for fiscal years 1965 and 1966).

Specific authority for State prefinancing of the Federal share of sewage treatment plant construction costs was included in the Clean Water Restoration Act of 1966. It spells out conditions under which any sewage treatment project started after July 1, 1966 without Federal funding can be made eligible for future allotments of Federal aid up to the amount States or localities would have been entitled to if adequate funds had been available:* (1) The appropriate State water pollution control agency must have approved the project; and (2) the Secretary of the Interior must have certified that the project meets Federal requirements. But, the same section of the Act contains the following statement: *"Neither a finding by the Secretary that a project meets the requirements of this subsection, nor any other provision of this subsection, shall be construed to constitute a commitment or obligation of the United States to provide funds to make or pay any grant for such project."*

This statement, in effect, spells out the well established caveat that a dollar authorization in substantive legislation to appropriate funds is not a commitment on the part of Congress to provide the funds. Not until funds are appropriated does the commitment become a reality. Nevertheless, certain States have been willing to take the risk in order to meet urgent needs and have gone ahead with their anti-pollution programs.

Governor Rockefeller first broached the proposition of prefinancing in a letter to President Johnson dated December 30, 1964. The Governor was anxious for New York State to embark upon a massive water pollution control program without delay. To stretch the proceeds of a State bond issue as far as possible, the Governor proposed to prefinance the full anticipated Federal share of New York's program through 1970. The New York State Legislature authorized a billion dollar bond issue to provide grants to local governments for the construction of waste treatment plants which was approved by the voters in November 1965. Half of this amount provided the State's 30 percent share and the other half prefinanced the anticipated Federal share (at that time, 30 percent); 40 percent of the total project costs remained for local governments to finance.* In the aggregate, this amounted to a waste treatment facilities program of some $1.7 billion for New York State.

Six States subsequently followed New York's lead in tapping their own resources to move ahead with comprehensive water pollution control programs and prefinanced the Federal share in the hope that Congress would eventually supply the funds to reimburse them. As indicated in table 13, the seven States had, by September 1969, advanced almost $300 million on the basis of congressional authorizations but which the Congress might or might not appropriate in the future. The total commitment of the seven States to provide their own shares and to prefinance the Federal portion of projects amounted to almost $1.6 billion, much of which was to be obtained by the issuance of bonds.

The full picture of State participation in the financing of waste treatment facilities would be incomplete without mention of the bond authorizations approved by voters in a number of other States. The voters of Michigan and Washington in 1968 approved bond authorizations of $285 million and $25 million, respectively, for this purpose. On November 4, 1969 the New Jersey electorate approved a $271 million water conservation bond issue, including $248 million for waste treatment facilities, and the Maine electorate approved a $50 million bond issue for water pollution control. In January 1970, Wisconsin enacted a $144 million bond authorization to supply the State's share of a 10-year waste treatment facilities program.

It is clear from table 13, that if only the $214 million requested in the 1970 *Budget* were appropriated, Vermont would be the sole State completely reimbursed for its prefinancing expenditures. The House-approved figure of $600 million, meanwhile, would permit Maine, Massachusetts and Pennsylvania also to be reimbursed completely for their advances. Even if the House had gone along with the full $1 billion approved by the Senate, far from enough would be available to repay

*33 USCA 466 e (c). It should be noted that the Act increased the Federal share from 30 to 40 percent for those States agreeing to pay at least 30 percent of the project cost from State funds. All the States prefinancing the Federal share are meeting this percentage requirement as are a number of others. A further provision of the Act increases the Federal share to 50 percent if the State agrees to pay at least 25 percent of the project cost *and* if enforceable water quality standards have been established for the waters into which the project discharges.

*It should be noted that this New York "prefinancing" program antedated the Federal Clean Water Restoration Act of 1966 by about a year.

Table 13

STATE PREFINANCING OF ANTICIPATED FEDERAL SHARE OF EXPENDITURE FOR CONSTRUCTION OF SEWAGE TREATMENT PLANTS, AS OF SEPTEMBER 1969
(in thousands)

State	State bond issues or other financing authorized	Expenditures for prefinancing	Allocations fiscal year 1970			
			at $214 million level[1]	at $600 million level[2]	at $800 million level[3]	at $1 billion level[4]
Connecticut	$150,000	$60,900	$2,942	$8,326	$11,118	$13,905
Maine	25,000	3,500	1,853	3,911	4,982	6,044
Maryland	150,000	52,957	3,552	10,137	13,551	16,960
Massachusetts	150,000	8,500	5,383	16,316	21,984	27,646
New York	1,000,000	150,315	15,833	51,470	69,938	88,401
Pennsylvania	100,000	16,095	11,030	35,067	47,524	59,975
Vermont	11,800	677	1,282	2,110	2,542	2,986
Total	$1,586,800	$292,944	$41,875	$127,337	$171,640	$200,647

[1] Total requested in 1970 *Budget* for all States.
[2] Appropriation passed by House of Representatives, October 8, 1969.
[3] As finally appropriated for fiscal 1970.
[4] As authorized in substantive legislation and included in an appropriation that was passed by the Senate on November 12, 1969.

Source: Federal Water Pollution Control Administration.

Connecticut, Maryland and New York for their outlays.* As finally enacted, $800 million was appropriated for fiscal 1970.

An attempt was made by Senator Joseph Tydings to ensure reimbursement of the prefinanced amounts when he proposed an amendment to the Water Quality Improvement Act of 1969 (S 7) on the Senate floor. His amendment would have pre-empted the first $300 million in excess of $100 million appropriated by Congress for fiscal 1970 and subsequent years for such reimbursement.[3] Senator Jacob Javits proposed a substitute amendment that would simply authorize the Secretary of the Interior to use any appropriated but unspent funds for sewage construction grants (that is, funds subject to reallotment) to reimburse amounts prefinanced by either States or localities. The Javits substitute amendment was adopted.[4]

A number of lessons flow from the "prefinancing experience" of the water pollution control program. For one thing, it has become clear that, given encouragement, at least the more aggressive and resourceful States will participate in implementing a national policy enunciated by Congress. By moving ahead of the National Government they may even save

*It should be made clear that in prefinancing the Federal share of waste treatment plant construction costs the States did not expect reimbursement in any one year. These figures are cited here as illustrative only.

the Nation money in the long run, considering the constant rise in construction costs.* Beyond this, experience with the program has shown that a Federal offer to increase the Federal share of a grant program in return for State participation with statewide funds in local projects can succeed. This inducement evidently becomes even stronger when it is coupled with prefinancing authority. The seven States that are prefinancing the Federal share are adding their own shares in substantial amounts.

Despite obvious merits, prefinancing has its drawbacks when extended without limit. In a letter to Governor Rockefeller on March 27, 1967, President Johnson expressed three reservations in response to the Governor's proposal for extension of prefinancing authority to programs other than sewage disposal facilities. The President cautioned against "overcommitting the Federal Government." He stated that "financing of projects in States which had obtained prefinancing might conceivably exhaust the available appropriations, leaving none for other States." In addition, he pointed out that "unforeseen changes in economic and fiscal conditions might dictate a lower level of appropriations in some future years than would be consistent with prior years' prefinancing commitments." Therefore, President Johnson concluded, consideration of prefinancing arrangements should be restricted to a framework of "predetermined amounts in a selected number of programs."

In a sense, prefinancing on a large scale is tantamount to providing a debt service grant.** If and when New York is reimbursed for the half billion dollars worth of expenditure it will have advanced in anticipation of receiving Federal funds, it might well use that money (or money that it replaces) to retire the bonds it sold on the tax-exempt market to obtain the funds in the first place. Most of the other States that have indulged in considerable prefinancing for their antipollution programs have also issued tax-exempt bonds for this purpose. The $1½ billion of borrowing authorized by the seven "prefinancing" States plus the $750 million borrowed (or to be borrowed) by Maine, Michigan, New Jersey, Washington and Wisconsin will undoubtedly add to the price pressure on the municipal bond market.

*This point was made by Senator Edmund S. Muskie during the 1966 Water Pollution hearings; see *Congressional Record*, October 7, 1969, p. S 12058. However, if funds are borrowed in a tight money market there may be offsetting additional interest costs.

**See chapter 2 for a discussion of "debt service grants.

FEDERAL INCENTIVES FOR STATE FINANCIAL PARTICIPATION IN FEDERALLY-AIDED PROJECTS

We have noted that, in addition to prefinancing, the grant for construction of sewage treatment plants provides for an increase in the Federal share of 10 to 20 percentage points (depending upon circumstances) if a State participates financially to the extent of at least 25 percent. Sixteen States, including the seven prefinancing the Federal share, were taking advantage of this incentive provision as of April 1970, according to the Federal Water Pollution Control Administration.*

In a 1964 study, this Commission recommended that...."the States assume their proper responsibilities for assisting and facilitating urban development; to this end it is recommended that Federal grants-in-aid to local governments for urban development be channeled through the States in cases where a State (a) provides appropriate administrative machinery to carry out relevant responsibilities, and (b) provides significant financial contributions, and when appropriate, technical assistance to the local governments concerned."[5]

Developments to date indicate a mixed response on the part of the States. State payments to local governments for selected urban functions in 1967 were $141.1 million. This total covered housing and urban renewal ($67.0 million), water and sewers ($26.3 million), and urban mass transportation ($47.8 million), with the State payments for each functional area being highly concentrated among a few States.[6] Legislative sessions in 1968, 1969, and 1970 have provided hopeful signs of State actions for support of mass transit, water pollution control, air pollution abatement and, as noted, sewage treatment plant construction.

The marked increase in State participation in sewage treatment projects was in good measure a response to the special incentive provision of the Clean Water Restoration Act of 1966. If, as appears to be the case, States do respond to the financial incentive offered by

*The participating States are: Conn., Ind., Me., Md., Mass., Mich., Mo., N.H., N.J., N.M., N.Y., Pa., R.I., Tenn., Vt., and Wisc. In addition, Del., Ore., and Wash., provide some share of local project costs.

the Federal Government, the time would seem propitious for extending such "incentive financing" to other areas such as health, hospitals, transportation and education, where the interdependence or spillover effects are significant and where intergovernmental financial responsibilities have thus far been inadequately recognized.

A recent report of the National League of Cities–U.S. Conference of Mayors noted a flaw in the incentive feature of the waste treatment plant construction program: there is no provision in the allocation formula (basically a per capita distribution) for increasing the amount allocated to a State when it puts up State funds to obtain the higher Federal matching ratio. As a result, while the Federal matching is increased for particular projects, this cuts into the amount of Federal aid that would be available for other projects. When the entire State's allocation is already committed without State participation, no *additional* Federal funds could be made available should the State put up its share, ostensibly to obtain increased Federal matching. Oregon actually discontinued its participation in the program for this reason, according to the NLC-USCM report.[7]

If a Federal incentive in the form of increased matching for State participation is to be effective the allocation formula should take the higher Federal matching into account. In addition, while population may be a reasonable measure of need for some programs, it is a poor one for others. Specific need measures should be developed as a basis for the allocation of Federal aid funds; this will become particularly important as more State-participation incentive grants are established.

State Involvement in Federal-Local Grant Programs–Some Recent Findings

In order to obtain a more recent indication of the extent of State participation in grant programs affecting urban areas, the Advisory Commission on Intergovernmental Relations recently conducted a survey of State Offices of Community Affairs or their counterparts in each of the fifty States.[8] Each respondent was asked to: (1) specify in dollar amounts the financial aid contributed by the State in fiscal 1969 as the non-Federal share to match with Federal funds for use by local governments in selected urban programs; (2) indicate any State administrative involvement in such programs, including channeling or disbursement of Federal funds to localities through State agencies, review and comment, as well as application approval; and (3) describe any State technical assistance functions associated with the programs.

Table 14 summarizes the findings on the basis of responses from 37 States regarding 12 selected urban development programs. Of these, 34 made some State aid contribution to one or more of the programs. Only Nebraska, Kansas and South Dakota failed to "buy in." To a certain extent the lack of a more complete response somewhat distorts the overall picture of State financial participation in the urban programs examined. Several of the more "urban" States with developing roles in assisting local communities–including Illinois, Maryland, Pennsylvania and Rhode Island–and some with respectable reputations in local affairs are not included in the overall tabulations because of their failure to reply. Similarly, even though New Jersey has a broad range of programs to assist local communities, it is only counted in one program–Model Cities–because the State's financial involvement is concentrated in urban programs that are not federally funded.

Magnitude of "buying in." Fiscal 1969 payments to local governments for a dozen selected urban development programs covered in the survey totalled more than $230 million for the 37 responding States. Of this total, New York holds the commanding position with a significant contribution of over $123 million in State funds distributed among 11 separate programs. In descending order, following New York, the top five States in total contributions made were: Texas, $23 million; Connecticut, $21 million; Massachusetts, $19 million; and California, $11 million. These States contributed a total of over $197 million, or approximately 85 percent of the total among States reporting.

The single largest amount of State contribution was in the Aid for Educationally Deprived Children program, totalling nearly $90 million. But, only three reporting States participated–New York, Texas, and California. For each of these States, financial support for this grant program was their single largest expenditure among any of the 12 functional program categories examined. The program receiving the second largest amount of State outlays was Waste Treatment Facilities, amounting to over $45 million distributed among 11 States. Low Rent Public Housing accounted for the third highest total expenditure ($35 million), but New York and Alaska were the only States involved. New York was responsible for most of the total spending here.

The greatest involvement in terms of number of participant States was in HUD's Urban Planning Assistance Program where 21 States were "buying in." However, the total dollar amount was slightly less than $2.6 million, or about 1.2 percent of the State support for all 12 of the selected urban grant programs. Airport development attracted the second highest number of contributing States, with 17 making available about $8.8

Table 14

STATE INVOLVEMENT IN FEDERALLY AIDED URBAN DEVELOPMENT PROGRAMS, 1969
(number of States participating)

Federal urban development program	Make financial contribution ("Buy In")	Amount of State funds (000)	Require channeling of Federal funds	Require review and comment on local applications	Approve local applications	Provide technical assistance
Urban Renewal	4	$17,099	1	5	2	5
Urban Mass Transportation	5	17,711	1	5	2	2
Waste Treatment Facilities...	11	45,627	20	25	27	19
Urban Planning Assistance	21	2,562	22	23	20	23
Model Cities	4	1,130	.3	16	7	13
Airport Development	17	8,837	14	18	15	17
Air Pollution Control	8	2,323	10	17	12	14
Aid for Educationally Deprived Children	3	89,709	27	26	29	25
Community Action Program	8	9,039	4	27	18	25
Solid Waste Disposal	13	816	11	14	11	18
Juvenile Delinquency Prevention & Control ...	12	237	14	16	12	16
Low Rent Public Housing ...	2	35,617	3	7	4	6
Total	xxx	230,707	xxx	xxx	xxx	xxx

Source: Survey by Advisory Commission on Intergovernmental Relations; based on returns from 37 States. See text.

million, or just less than four percent of the total reported. The Solid Waste Disposal program, followed by the Juvenile Delinquency Prevention and Control program (with 13 and 12 States involved, respectively) received numerically, at least, the next highest levels of State involvement. But, the combined sum for both these programs was only a little over one million dollars, or less than one percent of overall State financial involvement.

State administrative involvement. Another feature highlighted by the results of the survey was the extensive amount of State administrative involvement in these 12 grant programs that was not accompanied by "buying in." In each program area, with the single exception of urban mass transportation, the number of States that have assumed administrative responsibilities exceeds the number assuming a financial role. State administrative involvement consists of conditions on grants to local government, such as: (a) channeling of Federal funds through a State agency; (b) State level review and comment on local applications; and (c) approval of local applications by State officials.

The most popular form of administrative involvement in the programs surveyed was the review and comment function. On the average, 17 States assumed this role while 11 required channeling of Federal funds and 13 approved local applications. On an individual program basis, a good example of the different types of State role is the Aid for Educationally Deprived Children program. Only three States are presently "buying-in" financially here, but in terms of carrying out the administrative side of the program operation, some 27 States are requiring the responsibilities of the program to be shared with them. Similarly, although only 11 States are involved financially in the Waste Treatment Facilities program, more than twice as many are engaged in the administrative side of program operation. Less dramatic, but nevertheless significant differences exist in the Community Action, Air Pollution Control, Model Cities and Low Rent Public Housing Programs. On the other hand, in the Urban Planning Assistance program 21 States are "buying in" and these same States plus only a few others have assumed administrative responsibilities.

State technical assistance. Another type of State participation examined in the survey was the provision of technical assistance to local units of government. The types of such assistance for each of the programs varied from State to State. The most frequently mentioned, however, included some form of help involving "consultation," "advice," "review," or "coordination," during stages of the application process. It might be concluded that the States' heavy interaction with local governments during the application phase serves as a means of monitoring or pre-evaluating the program prior to the State's formal approval or disapproval of local applications. In all the programs surveyed except two, the number of States providing technical assistance equaled or exceeded the number of States requiring approval of local applications. Only in the Waste Treatment Facilities and the Aid for Educationally Deprived Children programs was the approval requirement not accompanied in a comparable number of instances with State technical aid.

As expected, more specific kinds of technical assistance were listed by the States in the physical construction and development programs. This contrasts with the more general types of assistance rendered in the planning and more policy oriented programs. The facility type programs benefited from such technical assistance as project planning, engineering design, site selection and overall coordination. A few States listed some forms of regulation enforcement as technical assistance activities, most noticeably in the Air Pollution Control and the Juvenile Delinquency Prevention and Control programs.

In sum, the information supplied in response to the questionnaire leads to the conclusion that although most States are not "buying into" the various urban development programs, this has not barred a significant administrative role in these same program areas. At the same time, the States have supplemented their administrative involvement—and their relative lack of major financial investment—with varying types of technical assistance.

Hurdles to "Buying In"

Why have many States been hesitant to "buy in" to Federal-local grant programs? A number of possible reasons can be advanced.

Lack of Federal incentives. The failure of some States to "buy in" to urban programs on a massive scale may be partially due to only limited encouragement from the Federal level. The ACIR survey findings show that several States allocated their dollars ($45.6 million) to sewage treatment projects—a situation that can be explained in large part by the special incentives for State financial participation offered by the Federal Government in the Clean Water Restoration Act of 1966.* That legislation provided a Federal aid "bonus" if a State assumed a designated share of the local project cost.

If, as appears to be the case, States do respond to financial "carrots" offered by the Federal Government, it would seem logical to assume that extending such "incentive financing" to other areas in the urban development field would not go unheeded by the States.

"Irresponsibility" of Federal management of urban programs. Another possible reason for the marginal showing of many States in "buying in" to selected urban grant programs might be the "management mess" involved in handling narrow categorical grants. "Buying in" to "block grants" covering broad functional areas might be more attractive to the States. With the exception of the Model Cities program, the remainder of the urban programs examined in the survey are largely of a narrow-purpose nature and some of these, it is charged, tend to be administratively inflexible and cumbersome. Administrative and planning requirements, eligibility standards, and matching formulas vary widely among programs and even more so among agencies. At best, it is a bewildering exercise just to try to keep up with the administrative and procedural requirements of even those programs channeled to the States. Moreover, serious doubts exist concerning whether all of the Federal-local programs are really relevant to State planning and programming. All too often, then, Federal regulations and guidelines drawn up for particular categorical programs do not encourage State initiative and response. In light of these bureaucratic difficulties, some States undoubtedly prefer to let their local units deal directly with Federal agencies rather than to be bogged down in an administrative morass having minimal political and program payoffs.

State priorities. Another factor to be considered is that State investment as a back-stop to local efforts has not received unconditional acceptance by various State agencies competing for the scarce State budget dollar. Some agencies believe that State general fund revenues should be targeted primarily on pressing statewide needs and secondarily on the problems and programs of individual counties and cities. Vigorous competition exists at the State level for alleviating outdated State facilities and providing new services. Such basic

*Sixteen States are presently taking advantage of this incentive provision. See above, p. 67.

institutions as jails, mental institutions, and hospitals—to name a few—presently are competing with urban programs for State funding. This view, can curb a "massive" urban development commitment.

Fiscal inadequacies. Of all of the possible explanations that have been advanced in defense of the marginal showing of State governments in not "buying in" to Federal-local programs for urban development, the one that dwarfs all the others is the inadequacy of the States' own fiscal systems. The financial pressure placed on States, as well as on local governments, since the early 1960's by a growing and urbanizing population in need of better public services has been unrelenting. Direct State expenditures for such primary functional needs as education, highways, public welfare, hospitals, and health facilities have spiraled. While attempting to keep pace with new expenditure demands, the budgets of State governments have been growing every year just to maintain their traditional functional responsibilities. Consequently, most State governments, handicapped by a revenue system unresponsive to economic growth, have had to raise tax rates and impose new taxes again and again in order to keep abreast of burgeoning domestic expenditures. Thus, the ability of the States to meet recent public service needs has, to a certain extent, been subject to the same major fiscal restraints that confront local governments—namely the fiscal imbalance in the American federal system.

Footnotes

[1]23 USCA 115.

[2]23USCA 122.

[3]*Congressional Record,* October 7, 1969, p. S 12055.

[4]*Ibid.,* p. S 12066.

[5]ACIR, *Impact of Federal Urban Development Programs on Local Government Organization and Planning* (A-20), p. 30.

[6]ACIR, *State Aid to Local Government* (A-34), April 1969, p. 98.

[7]NLC-USCM, *Clean Water in the '70's!* (Washington: 1970), p. 13.

[8]ACIR, *A State Response to Urban Problems: Recent Experience Under the "Buying In" Approach* (M-54) October 1970.

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