A COMMISSION REPORT

Countercyclical Aid and Economic Stabilization

ADVISORY
COMMISSION ON
INTERGOVERNMENTAL
RELATIONS
WASHINGTON, D.C. 20575
DECEMBER 1978.

A-69

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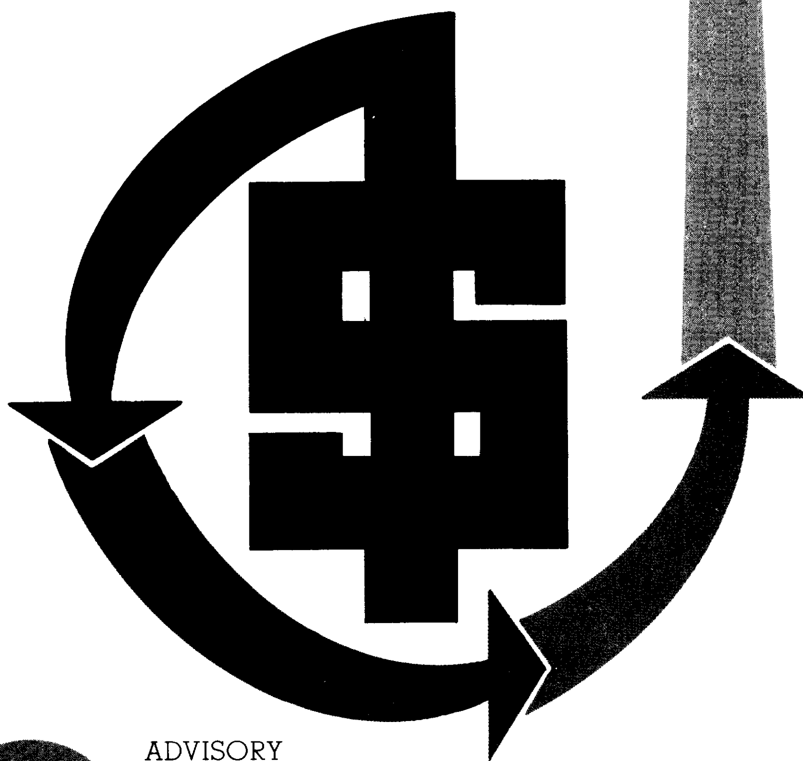

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Preface

In both the *Public Works Employment Act of 1976* (P.L. 94-396, Section 215(b)) and the *State and Local Fiscal Assistance Amendment of 1976* (P.L. 94-488, Section 145(a)) Congress asked the Advisory Commission on Intergovernmental Relations to examine the relationship between federal fiscal policy and state and local governments.

This report was prepared in response to those requests and attempts to answer two general questions: (1) how far should the federal government go in accelerating state and local government expenditures during periods of recession; and (2) how far should the federal government go in slowing down state and local government expenditures during periods of inflation? Special attention is focused on the substantial ($16.1 billion) economic stimulus package that was developed in 1976 and augmented in 1977. The Commission, however, looked at both sides of the business cycle and set forth policy recommendations dealing with state and local government involvement in national economic stabilization policy both in times of recession and inflation.

Abraham Beame
Chairman

Acknowledgements

This report was prepared by John P. Ross, senior academic resident in public finance, with the assistance of Susannah E. Calkins and Richard J. Reeder under the general supervision of John Shannon, assistant director for taxation and finance. Will Myers and Richard Gabler of the Commission staff provided editorial assistance and Lavinia B. Clarke typed the many drafts of the report. Ruth Phillips and Jean Ryan provided additional secretarial help.

The Commission and the staff benefited from the help of many individuals and organizations. Special gratitude is expressed for the comments and suggestions provided by participants at both the "thinkers' session" where the outline and study design were reviewed and the "critics' session" where the draft report and optional policy recommendations were discussed prior to consideration by the Commission. The participants were Stephen Barro, Herbert Becker, Carol Berenson, Dorothy Brodie, Arthur Corazzini, Peggy Cuciti, Martha Darling, Gene Dodaro, Dennis Dugan, John Duncan, Jeff Esser, John Fava, Aliceann Fritschler, Alvin From, Delphis Goldberg, David Greytak, Richard Gustely, Janet Hoffman, Jacob Jaffe, Lee Enfield Lockwood, James Martin, Richard Nathan, Leo Penny, John Peterson, George Peterson, Kent Peterson, David Puryear, Robert Rafuse, Robert Reischauer, Ralph Schlosstein, Jerry Shipley, Richard Viscount, and Charles Warren. Joan Wills and Lillian Saunders of the National Governors' Association also assisted us.

Full responsibility for the content and accuracy of the study rests, of course, with the Commission and its staff.

In the near future, the Commission will publish additional materials on the state and local role in federal economic stabilization policy. These materials will consist of more detailed staff findings dealing with the economic and program analysis.

Wayne F. Anderson
Executive Director

John Shannon
Assistant Director
Taxation and Finance

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Foreword

The U.S. economy recently experienced its worst recession since the great Depression of the 1930s. Technically this recession began in the fourth quarter of 1973 and did not hit bottom until the first quarter of 1975. During that period, real GNP actually declined from $1.24 trillion to $1.17 trillion or by 6%. The unemployment rate rose sharply—from 4.8% in the fourth quarter of 1973 to 8.7% by the second quarter of 1975. Inflation, already high from the rapid growth during the previous periods, increased from 9.6% to 12.6% by the fourth quarter of 1974.

Since the first quarter of 1975, the economy has been in a period of recovery. By the third quarter of 1977, real GNP increased to $1.34 trillion, the unemployment rate dropped to 6.9% and the rate of inflation slowed to 4.2% per year. Since then unemployment has continued to fall, but the rate of inflation has risen significantly.

As a part of its attempt to bolster the sagging economic situation, Congress created in 1976 and expanded in 1977 three programs designed to stimulate the national economy and to stabilize state and local government financial systems. This economic stimulus package has three basic components: public works, antirecession general assistance, and public employment. The money involved is substantial—from November 1976, to March 31, 1978, almost $14.5 billion had been allocated to state and local governments.

Scope of Study

In two laws Congress asked the Advisory Commission on Intergovernmental Relations to examine the relationship between federal fiscal policy and state and local governments. Section 215(b) of the *Public Works Employment Act of 1976* (P.L. 94-369) called for the Congressional Budget Office (CBO) and the Advisory Commission on Intergovernmental Relations to

> . . . conduct a study to determine the most effective means by which the federal government can stabilize the national economy during periods of rapid economic growth and high inflation through programs directed toward state and local governments. Such study shall include a comparison of the effectiveness of alternative factors for triggering and measuring the extent of the fiscal coordination problem addressed by this program, and the effect of the recession on state and local expenditures.

Again in the *State and Local Fiscal Assistance Amendment of 1976* (P.L. 94-488) in Section 145(a) Congress asked the Advisory Commission on Intergovernmental Relations to evaluate

> . . . the effectiveness of federal government stabilization policies on state and local areas and the effects of state and local fiscal decisions on aggregate economic activity.

In order to coordinate our study with the work to be done by CBO, a division of labor was agreed upon that called on the CBO to concentrate on targeting, triggering, and evaluation of the aid mechanisms. The Advisory Commission on Intergovernmental Relations was to concentrate on the fiscal coordination problem and the effects of recession on state and local governments. Thus, ACIR's part of this study is to examine the advisability of using state and local governments as agents of national economic stabilization policy as well as the advisability of using federal grants-in-aid to stabilize state and local government finances during periods of severe economic fluctuations.

Given these two broad Congressional requests, the general purpose of this study is to examine:

1) the impact of state and local financial behavior on the national economy during the most recent recession;
2) the impact of the recession on state and local governments' financial positions;
3) the intergovernmental fiscal dimensions of this aid package including the advisability of placing state and local governments in a countercyclical role; and,
4) potential ways for slowing down state and

local government spending consistent with a national anti-inflation policy.

Examination of the intergovernmental dimensions of these aid programs raises some important, but difficult, issues concerning the reasons for having these programs at all. All three were originally passed and extended as antirecession tools having two related, but not necessarily identical purposes. The first purpose was economic stimulation. The additional aid would allow state and local governments to spend more, maintain or improve service levels, hire new employees, and, in the process, spur aggregate demand thereby aiding the entire recovery process. The second purpose was to provide fiscal support to those state and local governments whose finances were most severely disrupted by the recession. The result was a package of programs which provides a mix of economic stimulation for the national economy and special fiscal support for those state and local governments with high levels of unemployment.

As renewal time approaches and the economy improves, there is increasing scrutiny of the capacity of the three programs to help solve long-run (secular) economic problems as well as short-term (cyclical) financial troubles. This growing concern can also be traced to the way the funds are allocated—e.g., the relatively high unemployment cut-off of funds in the Antirecession Fiscal Assistance Program and the minimum floor for allocations to states in the Local Public Works Program.

Background

THE INTERGOVERNMENTAL SETTING

In considering the relationship between federal fiscal policy and state and local governments, three general trends in the intergovernmental finance system are important.

1. **While state and local governments are still a major growth industry, during the 1970s the rate of their own source expenditure growth relative to that of the national economy has substantially slowed. Federal aid to state and local governments is now a major factor in maintaining their relative growth position.**[1]

2. **Historically, the flow of federal aid funds to state and local governments has grown. There is no apparent, consistent pattern between the rate of that growth and the health of the national economy.**

3. **For two decades, federal aid has grown at a faster clip than own source state and local revenue. This is particularly true for local governments.**

These findings—the slowdown in relative growth of the state-local sector, the past lack of interest in using federal aid as a countercyclical tool, and the increasing dependency of state and local governments on federal aid—are important in considering a stabilization policy involving state and local governments. All three findings suggest the increased vulnerability of the state-local public sector to changes in federal aid policy.

Increased state and local government vulnerability, however, may be more apparent than real because rapid termination of federal aid programs is extremely difficult to achieve. The severe financial stress which many jurisdictions within the system would suffer from major cutbacks places an important political constraint upon reductions in federal aid. For example a federal decision to cut back Cleveland's direct federal aid to its fiscal year 1976 level would undoubtedly send the city government through its fiscal windshield.[2]

This fiscal fact of life introduces an element of "stickiness" into federal budget policies and suggests that significant changes in federal aid flows will usually be found on the increase rather than decline side of the budgetary ledger.

FISCAL COORDINATION IN ECONOMIC STABILIZATION, 1957-77

In asking for this study, Congress requested answers to three specific questions. First, what is the effect of state and local fiscal decisions on the aggregate economy? Second, the other side of the coin, what is the effect of fluctuations in the aggregate economy on state and local government finances? Third, can an ideal

Table 1

STATE-LOCAL FISCAL BEHAVIOR: AVERAGE QUARTERLY RATES OF GROWTH OF EXPENDITURES, RECEIPTS, AND SURPLUSES 1957-77

During Recessions

Contraction[1] (peak-trough)	Expenditures[2] (average quarterly rate of growth in percent)	Receipts (average quarterly rate of growth in percent)	Surplus (average quarterly change: billions of dollars)
1957: III-1958: I	2.9%	1.7%	$-0.55
1960: I-1960: IV	2.1	1.9	-0.10
1969: III-1970: IV	3.2	2.8	-0.46
1973: IV-1975: I	3.3	2.6	-1.32

During Expansions

Expansion[1] (trough-peak)	Expenditures[2] (average quarterly rate of growth in percent)	Receipts (average quarterly rate of growth in percent)	Surplus (average quarterly change: billions of dollars)
1958: I-1960: I	1.5%	2.4%	$0.34
1960: IV-1969: III	2.4	2.5	0.08
1970: IV-1973: IV	2.5	2.9	0.80
1975: I-1977: I	1.8	2.9	2.95

[1]Peak and trough quarters used are for real GNP, as identified by the U.S. Department of Commerce, Bureau of Economic Analysis (BEA).

[2]Total expenditures, receipts, and surplus were used to compute the above, hence federal aid and trust fund amounts are included.

Source: ACIR staff computations, based on U.S. Department of Commerce, BEA, *Survey of Current Business,* various years.

countercyclical policy using programs directed toward state and local governments be designed? Policy conclusions set forth later in this report deal with the third question; findings on the first and second questions are presented below.

1. **During each economic downswing since World War II, state and local fiscal behavior was "correct" (countercyclical) because it added to aggregate demand. This finding holds whether we use the "traditional" yardstick—the national business cycle—or the newer measure—potential full employment. However, during the present economic upswing the contribution of state and local fiscal behavior is negligible. State and local governments are increasing their expenditures, but at a slower rate than they did during previous recoveries.**

The conclusion that state and local governments did not act as a drain on the economy by raising taxes and cutting expenditures during economic downswings rests on four general findings.

First, *Table 1* shows the average quarterly rates of change of state and local expenditures, receipts, and surpluses for each recession and expansion since 1957. For each of the recessions, expenditures grew more rapidly than receipts and surpluses fell. Thus, during each recession, state and local governments behaved in the "right" way—they added to the income stream thereby increasing aggregate demand. While these rates of change are only rough indications of the fiscal impact of state and local financial behavior, they do point to the conclusion that state and local governments have acted as a stabilizing force over these recessions.

Chart 1 shows state and local surpluses as a percent of GNP for the period. Again, during each recession, surpluses as a percent of GNP fell, indicating countercyclical behavior.

Table 2 examines the average annual rate of change in employment for each contraction and expansion. The major identifiable trend is that of growth in state and local employment regardless of the phase of the cycle. In each recession, however, the growth rate of state and local employment was slightly faster than in the next expansion, indicating at least some tendency toward countercyclical behavior.

Finally, using the concept of fiscal leverage, *Table 3* shows the real impact of state and local fiscal behavior on each recession and expansion for the period.[3] In the last recession, state and local government behavior added to real GNP. If federal aid is included, state and local governments retarded the recession by almost 17%. In other words, GNP would have fallen by 17% more than it actually did if it had not been for the stabilizing influence of state and local government tax and expenditure behavior.

How, during a recession, do state and local governments manage to increase their expenditures more rapidly than their revenues and in the process help to stimulate the economy? Apparently, state and local governments draw down their surpluses in order to maintain or increase expenditures.[4]

Since 1950 state and local governments' net operating balances have been in surplus only

Table 2

PRIVATE AND PUBLIC SECTOR EMPLOYMENT, 1957-76
(Full-Time Equivalent Employees)

During Recessions

Contraction[1] (peak-trough)	Private Sector (average annual growth in percent)	Public[2] Sector (average annual growth in percent)	Federal[2] (average annual growth in percent)	State-Local (average annual growth in percent)
1957-58	-4.0%	0.0%	-3.8%	5.1%
1960-61	-1.0	3.4	2.0	4.7
1969-70	-0.9	-0.3	-5.8	4.3
1973-75	-1.4	1.8	-0.6	3.1

During Expansions

Expansion (trough-peak)	Private Sector (average annual growth in percent)	Public[2] Sector (average annual growth in percent)	Federal[2] (average annual growth in percent)	State-Local (average annual growth in percent)
1958-60	2.4%	1.9%	-0.1%	3.9%
1961-69	2.9	3.7	2.9	4.4
1970-73	2.6	0.5	-4.7	4.3
1975-76	3.6	0.3	-1.0	1.0

[1]Calendar year peaks and troughs chosen to most closely reflect employment at peak and trough months as measured by BEA.
[2]Includes military.

Source: ACIR staff computations, based on U.S. Department of Commerce, BEA, *Survey of Current Business*, various years.

Table 3

STATE-LOCAL TAX AND SPENDING POLICIES: ESTIMATES OF THEIR EFFECTS ON THE ECONOMY DURING PERIODS OF RECESSION AND EXPANSION 1948-77

During Recessions

Contaction[1] (peak-trough)	Change in State and Local Leverage[2] (billions of 1972 dollars) Including Federal Aid	Excluding Federal Aid	Percent Contraction Reduced by State and Local Financial Behavior Including Federal Aid	Excluding Federal Aid
1948 IV-1949 IV	$ 8.7	$ 7.9	55.9%	53.7%
1953 II-1954 III	6.0	6.6	22.7	24.2
1957 III-1958 I	4.7	3.4	17.5	13.3
1960 I-1960 IV	4.0	4.2	32.5	33.3
1969 III-1970 IV	11.9	5.2	49.8	30.2
1973 IV-1975 I	14.7	12.1	16.8	14.4

During Expansions

Expansion (trough-peak)	Change in State and Local Leverage[2] (billions of 1972 dollars) Including Federal Aid	Excluding Federal Aid	Percent Expansion Intensified or Slowed Down (-) by State and Local Financial Behavior Including Federal Aid	Excluding Federal Aid
1949 IV-1953 II	$ 4.7	$ 3.6	3.5%	2.7%
1954 II-1957 III	15.0	12.2	23.2	18.1
1958 I-1960 I	6.5	1.4	9.2	1.9
1960 IV-1969 III	69.0	44.6	24.4	14.5
1970 IV-1973 IV	19.4	0.1	12.8	0.1
1975 I-1977 II	–0.5	-11.4	–0.3	–6.6

[1]Peak and trough quarters are for real GNP, as measured by BEA.

[2]This form of leverage is adjusted for inflation and includes lag effects, thus the change in leverage represents the addition to real GNP due to present and past state and local fiscal behavior.

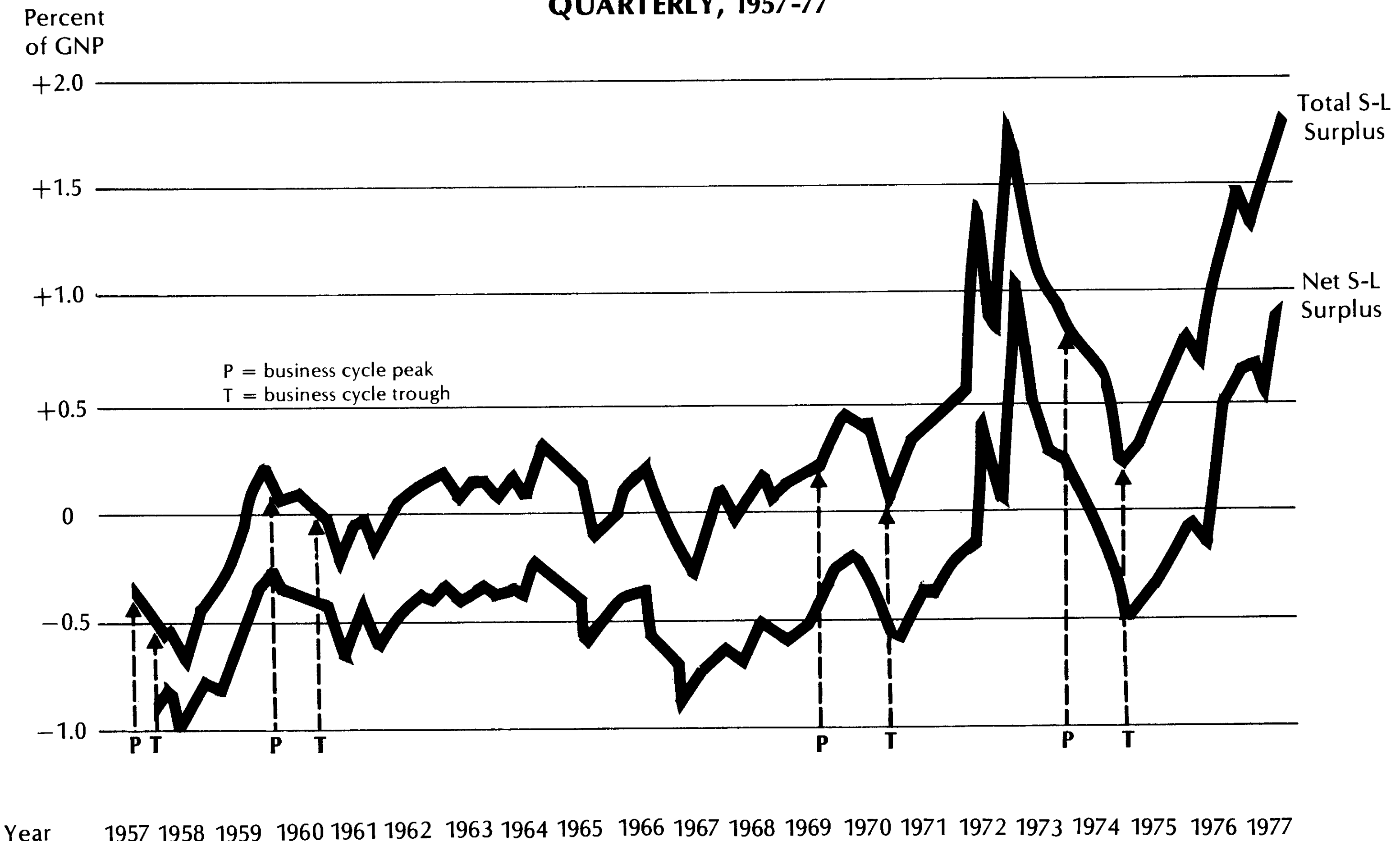
Source: ACIR computation, based on U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business,* various years.

for two years. These two years, 1972 and 1973, are also the years when general revenue sharing was introduced into the system. However, those two years of surplus did place state and local governments in a particularly strong position to face the recent recession. Operating balances began to fall in late 1972 and continued to decline until the trough of the cycle was reached in the first quarter of 1975 (*Chart 1*). Since that quarter, state and local governments have been in the process of rebuilding their surplus position.

While the actions of state and local governments did help the economy out of its recent crisis, their behavior was not ideal. As recovery started, state and local governments began to slow their rates of expenditure increase and rebuild their balances thereby reducing their leverage (*Chart 2*). The recovery would undoubtedly have been stronger had they continued to increase spending at a more rapid rate. It can be argued that since the economy is still a long way from full employment, state and local government spending should

Chart 1

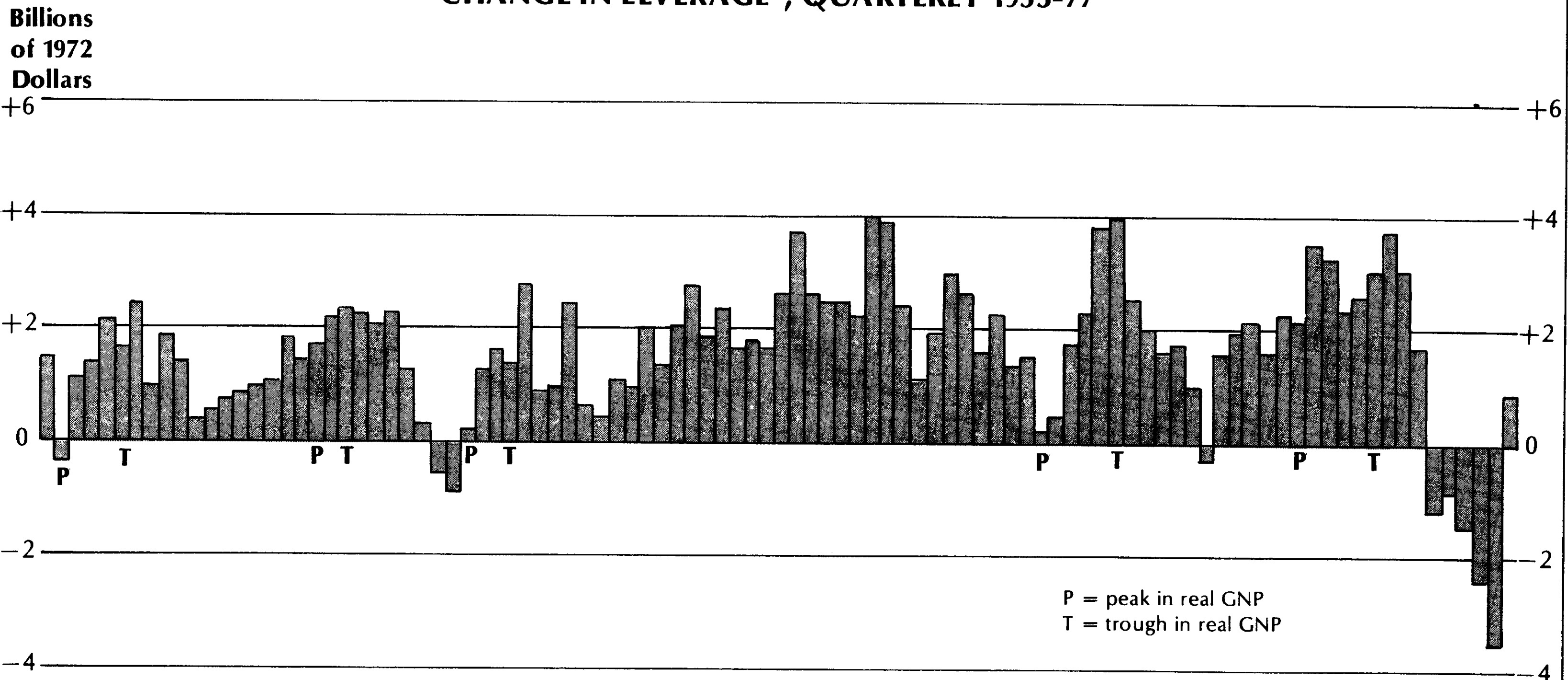
STATE AND LOCAL SURPLUS AS PERCENT OF GNP: TOTAL AND NET OF SOCIAL INSURANCE FUNDS QUARTERLY, 1957-77



Source: ACIR computations based on U.S. Department of Commerce, BEA, *Survey of Current Business*, various years.

Chart 2

CHANGE IN LEVERAGE*, QUARTERLY 1953-77



*Leverage includes federal aid, excludes social insurance transactions, is adjusted for inflation and time lags.

Source: ACIR staff compilations

still be growing at a rapid rate to add even more to the recovery process.

From a national point of view, state and local governments could have been asked to do more to help the economy during the last recession. For example, during the 1969-70 recession, their relative impact on slowing the recession was more than twice as much as it was in the 1973-75 recession (30% as compared to 14%, see *Table 3*).

2. State and local fiscal behavior has not been a major driving force in increasing the present rate of inflation.

This finding rests upon both the impact of state and local governments on aggregate demand and the distribution of state-local purchases. As with any growth sector, one would expect state and local governments to be increasing aggregate demand and, in those cases where inflation is caused by excessive demand, adding to the fires of inflation. However, the evidence for state and local governments on this point is mixed. During each expansion, receipts grew more rapidly than expenditures and surpluses rose. The leverage measures in *Table 3* indicate that, excluding federal aid, state and local fiscal behavior only added 0.1% to the 1970-73 expansion. They are actually slowing the present expansion and therefore not substantially increasing aggregate demand.

In addition, most would agree that the present inflation is due largely to structural imbalances in the economy rather than excessive demand. Certain kinds of commodities are in short supply and their rising prices have escalated the rate of inflation. State and local governments spend at least half of their tax dollars for personnel—a factor which, given the recent rates of unemployment, was not in short supply. Moreover, even the rate of wage increases in the public sector has been less than in the private sector. Thus, at least in immediate impact, state and local government purchases are not a major inflationary force.

The next finding examines the other side of the coin—the effect of national economic fluctuations on state and local governments.

3. The combination of inflation and recession led to an erosion of the financial position of state and local governments in the aggregate. While the net effect was not devastating, at the margin it was sufficient to cause real financial distress for those places with high unemployment.

The amount a state or local government loses due to a recession or gains due to an inflation depends upon the income elasticity of its various revenue sources. The more sensitive its revenue sources are to changes in income, the more it will lose or gain. In other words, those units of government heavily dependent upon a personal income tax will be much more severely affected by a recession than those governments dependent upon a property tax.

Table 4 presents estimates of the impact of inflation on state and local governments indicating that in the aggregate, state and local governments gained slightly because inflation pushed up revenues at a faster rate than the cost of goods and services.

Table 5 measures the net impact of both recession and inflation. In fiscal year 1976, state and local governments "lost" about $11 billion due to the combination of recession and inflation. That loss amounted to about 5% of total own source revenue. While not excessive in the aggregate, to a state or local government already under a great deal of financial stress that 5% could have been very important.[5]

For example, testimony presented before the Senate Subcommittee on Intergovernmental Relations of the Committee on Government Operations identified some of the recession-related financial impacts on places already suffering fiscal stress. It was reported that the recession had cost New York City $150 million in revenues in six months. The City of Detroit had to reduce its work force by 25% and the recession has been a factor in precipitating two property tax increases in two years in the City of Newark.[6]

At the state level Edward G. Hofgesang, budget director for the State of New Jersey, blamed the recession, combined with the inflation, for a reduction in appropriations during fiscal year 1976 of 3% below fiscal year 1975 levels, as well as for $210 million newly enacted taxes.[7]

To put these findings into perspective, the Council of Economic Advisers has estimated that state and local government revenues would have been increased by $17.2 billion had the

economy been at full employment in 1976.[8] This compares with the $16.4 billion loss due to recession reported in *Table 5*.

On the inflation side, David Greytak and Bernard Jump have estimated the purchasing power loss due to inflation by level of government.[9] Prior to 1972, they found net gains from inflation. Between 1972 and 1974, inflation increased expenditures by about 25% for all levels of government and added only 13% to 15% to revenues. The net result was an inflation induced loss in purchasing power for state and local governments. However, just as our estimates show only small gains, their estimates show small losses. In neither case is the net impact severe in the aggregate.

Table 4

ESTIMATED IMPACT OF INFLATION ON STATE AND LOCAL REVENUES[1] FISCAL YEARS 1973-76

Fiscal Years	Inflationary[2] Increase in Revenues		Inflationary[3] Loss in Purchasing Power		Net Gain[4] From Inflation	
	Billions of Dollars	Percent of Revenues	Billions of Dollars	Percent of Revenue	Billions of Dollars	Percent of Revenues
Total State-Local						
1973	$10.3	6.8%	$ 9.4	6.3%	$ 0.9	0.6%
1974	18.9	11.4	12.4	7.5	6.5	3.9
1975	28.4	15.7	18.5	10.2	9.9	5.5
1976	19.5	9.7	13.8	6.9	5.7	2.9
State						
1973	6.2	7.7	5.0	6.3	1.1	1.4
1974	11.3	12.7	6.7	7.5	4.6	5.2
1975	17.0	17.5	9.9	10.2	7.1	7.3
1976	11.6	10.8	7.4	6.9	4.3	4.0
Local						
1973	4.2	5.9	4.4	6.3	−0.2	−0.4
1974	7.6	9.9	5.8	7.5	1.9	2.4
1975	11.4	13.6	8.6	10.2	2.8	3.4
1976	7.8	8.4	6.4	6.9	1.5	1.6

[1]Own source general revenue.
[2]Based on regression analysis.
[3]Based on percent increase in implicit price deflator for state and local purchases of goods and services.
[4]Net gain equals inflationary increase in revenue minus inflationary loss in purchasing power, expressed in nominal dollars.

Time series regression analysis was computed for each level of government using fiscal year data for the period 1957-76. The model was specified as follows:
$\triangle R = \alpha + B_1 \triangle GAP + B_2 \triangle DEFL$.

$\triangle R$ = Change in own source general revenues.
$\triangle GAP$ = Change in the nominal GNP GAP.
$\triangle DEFL$ = Change in the implicit price deflator for GNP.

Regression Results

	Coefficient estimated for: Constant	$\triangle$GAP	$\triangle$DEFL	R^2	Durban Watson
Total	1.15	−0.12	236.42	.883	1.35
		(5.54)	(11.28)		
State	0.33	−0.08	141.21	.857	2.01
		(5.91)	(10.31)		
Local	0.82	−0.04	95.21	.859	0.99
		(3.53)	(9.59)		

(T values are in parentheses.)

Source: ACIR staff compilation.

Table 5

SEPARATING THE IMPACT OF INFLATION AND RECESSION ON STATE AND LOCAL OWN SOURCE GENERAL REVENUES, FISCAL YEARS 1973-76

Fiscal Years	Net[1] Revenue Gain From Inflation: Billions of Dollars	Percent of Revenues	Net[2] Revenue Change Due to Recession: Billions of Dollars	Percent of Revenue	Net Revenue Loss (–) or Gain (+) From Inflation and Recession: Billions of Dollars	Percent of Revenues
Total State and Local						
1973	$0.9	0.6%	$+0.3	+0.2%	$+1.2	+0.8%
1974	6.5	3.9	–2.5	–1.5	+3.9	+2.4
1975	9.9	5.5	–16.0	–8.8	–6.1	-3.6
1976	5.7	2.9	–16.4	–8.2	–10.6	-5.3
State						
1973	1.1	1.4	+0.2	+0.2	+1.3	+1.7
1974	4.6	5.2	–1.8	–2.0	+2.8	+3.2
1975	7.1	7.3	–11.2	–11.6	–4.1	–4.2
1976	4.3	4.0	–11.4	–10.6	–7.1	-6.7
Local						
1973	–0.2	–0.4	+0.1	+0.1	–0.2	–0.2
1974	1.9	2.4	–0.8	–1.0	+1.1	+1.4
1975	2.8	3.4	–4.8	–5.7	–2.0	–2.4
1976	1.5	1.6	–4.9	–5.3	–3.5	-3.7

[1]Net revenue gain due to inflation is equal to estimated inflation-related revenue increases minus the loss of purchasing power of revenues (see *Table 4*). NOTE: This refers only to own source general revenue.

[2]Net revenue loss due to recession is the revenue shortfall state and local governments do not cover with tax rate increases.

Source: ACIR staff compilations.

FOOTNOTES

[1]While state and local government own source expenditures have been falling in relation to GNP, own source revenues have been holding steady or rising in relation to GNP during the last two years, resulting in increased surpluses.

[2]It is estimated that direct federal aid to Cleveland will rise from about 23% of own source general revenue in 1976 to about 68% in 1978.

[3]Leverage is an index of fiscal performance. For this table, we used the formula.

$$L = 2\left[\frac{G}{P_2} + \frac{aR}{P_2} - \frac{bT}{P_2}\right] + CF$$

Where
L = leverage.
G = government expenditures.
R = transfer payments to persons.
T = tax collections.
P_1 = implicit price deflator for state-local purchases.
P_2 = implicit price deflator for personal consumption.
CF = correction factor for differential inflation rates.
a = .7.
b = .5.

$$CF = \frac{G}{P_1} - \frac{G}{P_2}$$

The lagged leverage measure for quarter t is determined as follows:
Lagged leverage = $(1/2)L_t + (1/2)^2L_{t-1} + \ldots + (1/2)^5L_{t-4}$
The change in lagged leverage for the period is then estimated. While changing either the lag structure or the assumed multipliers within reasonable ranges changes the magnitude of the leverage estimates, it does not affect the direction of the impact. For a discussion of this concept see, R. A. Musgrave, "On Measuring Fiscal Performance," *Review of Economics and Statistics*, Vol. 46, May 1964, pp. 213-20; and Robert W. Rafuse, "Cyclical Behavior of

State-Local Finances," *Essays in Fiscal Federalism*, Richard A. Musgrave, ed., Washington, DC, The Brookings Institution, 1965, pp. 63-121.

[4]All of the above evidence indicates the *overall* impact of state and local fiscal behavior on the national economy. That overall behavior can be broken down into two types. It consists of automatic changes—those changes that occur automatically in response to changes in income—and discretionary changes—those changes resulting from direct decisions made by state and local government policymakers. An example of a discretionary change would be an increase in property tax rates.

It may be argued that in examining the question of fiscal coordination, attention should be paid only to discretionary changes rather than overall impact. For the most recent recession, it is difficult to argue that the discretionary behavior of state and local governments was substantially perverse. The *Survey of Current Business* reported that none of the increase in own source receipts was due to tax changes in 1974—the most severe year of recession. U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Vol. 56, #2, Feb. 1976, p. 5. The ACIR survey of major state tax sources found that for FY 75 only 10% of the increase in revenues was due to political action—well within the normal range for other years. ACIR, *Significant Features of Fiscal Federalism, 1976-77*, Vol. II, M-110, Washington, DC, U.S. Government Printing Office, March 1977, p. 50.

As another way of examining discretionary behavior, fiscal leverage was again calculated using estimated full employment revenue. The result was to reduce the stimulative impact of state and local governments; however, that impact remained countercyclical in character.

[5]Care is required in interpreting the relative state vs. local loss estimates provided in the table. Because of the estimating procedures used, local government gains from inflation may be overestimated. As a result their net losses would be underestimated. Hence, the actual state vs. local percentage loss numbers may be much closer than they appear in the table.

[6]U.S. Senate, *Intergovernmental Antirecession Assistance Act of 1975*, Hearings before the Subcommittee on Intergovernmental Relations of the Committee on Government Operations, 94th Congress, 1st Sess., on S. 1359, Washington, DC, U.S. Government Printing Office, p. 120.

[7]U.S. House of Representatives, *Intergovernmental Antirecession Assistance Act of 1977*, Hearings before a Subcommittee of the Committee on Government Operations, 95th Congress, 1st Sess., Washington, DC, U.S. Government Printing Office, March 1, 2, and 8, 1977, p. 144.

[8]*Economic Report of the President*, Washington, DC, U.S. Government Printing Office, Jan. 1977, p. 76.

[9]David Greytak and Bernard Jump, *The Effect of Inflation on State and Local Government Finances, 1967-1979*, Occasional Paper No. 25, Metropolitan Studies Program, Maxwell School of Citizenship and Public Affairs, Syracuse University, Syracuse, NY, 1975, p. 34.

The 1976-78 Economic Stimulus Programs

PURPOSES

During periods of recession there are at least two—not necessarily consistent—objectives of providing additional aid to state and local governments. The first objective is to counter the recession by using federal aid to make state and local governments agents of national stabilization policy. State and local governments are encouraged to accelerate their spending in order to hasten economic recovery.

The second objective of federal countercyclical aid is to provide fiscal support partially replacing the state and local revenue loss caused by the recession. Severe economic recessions have differential impacts on state and local jurisdictions. The degree of these differential impacts depends upon the geographic area occupied by the jurisdiction, the sensitivity of the jurisdiction's revenues and expenditures to changes in income, and the economic position of the jurisdiction prior to the recession. For example, a place already experiencing secular decline will often be more severely hurt by a recession than a place which is experiencing rapid secular growth. In this case, the purpose of the aid is to balance the impact of the recession across jurisdictions, cushioning those which would otherwise be most adversely affected.

These two purposes are not mutually exclusive and, therefore, can be blended into a mixed policy which includes both economic stabilization and fiscal support. To the extent that these objectives are compatible, the mix approach provides a workable political compromise for involving state and local governments in national stabilization policy while at the same time providing insurance against economic distress for state and local governments.

The present economic stimulus package embodies the goal of national economic stimulation and state and local government fiscal stability. The Local Public Works Program attempts to make sure that the federal aid supplements rather than supplants state and local funds while the antirecession assistance program provides the clearest example of the use of federal funds to maintain fiscal balance within the system. The CETA program is somewhere between these two extremes.

DESCRIPTION OF THE PROGRAMS

The current economic stimulus package consists of three programs: (1) Local Public Works; (2) Antirecession Fiscal Assistance; and (3) CETA Titles II and VI. The amounts involved are shown in *Table 6*.

The Local Public Works Program

The Local Public Works Program was authorized by Title I of the *Public Works Employment Act of 1976*, enacted on July 22, 1976.

Table 6

ECONOMIC STIMULUS PROGRAM AUTHORIZATIONS AND ALLOCATIONS TO STATE AND LOCAL GOVERNMENTS FY 1977 AND FY 1978

	Authorizations FY 1977 and FY 1978 (billions)	Allocations to State and Local Governments by March 31, 1978 (billions)[1]
Local Public Works Program	$ 6.0[2]	$ 5.7
Antirecession Fiscal Assistance	3.5	2.5
CETA Titles II and VI	6.6	6.3
Total	16.1	14.5

[1]Excludes funds for Puerto Rico and island territories.

[2]The Local Public Works Program authorization was for Fiscal Year 1977 only.

Under the legislation, the Economic Development Administration selected in December 1976, state and local capital project applications totaling $2 billion. The program was extended and expanded as part of President Carter's economic stimulus program by legislation enacted May 13, 1977, making available an additional $4 billion to state and local governments for public works projects which could begin within 90 days of project approval. Round II funds were allocated to states by a formula which distributed 65% of the funds on the basis of the total number of unemployed in the state and 35% to states with an average unemployment rate (over the 12-month period ending February 28, 1977) in excess of 6.5%, on the basis of the state's share of the national excess unemployment. No state could receive a total allocation of less than $40 million under the combined programs.

State allocations were divided among state and local governments. For Round II state governments received planning target amounts equal to 8% of the state area total. Local governments received planning target amounts which divided the remaining state funds on the basis of relative unemployment. Approval by the Economic Development Administration (EDA) of projects submitted under the planning targets was completed by September 30, 1977.

The Antirecession Fiscal Assistance Program

The Antirecession Fiscal Assistance Program was established by Title II of the *1976 Public Works Employment Act*, and extended as part of the economic stimulus program by the *Intergovernmental Antirecession Act of 1977*, May 23, 1977. This program selectively distributes emergency assistance in the form of unrestricted grants to state and local governments which have been adversely affected by sustained periods of high unemployment. Under the first act, $1.25 billion was authorized; an additional $2.25 billion was authorized under the second law which provides funds for payments through the quarter ending September 30, 1978. For the seven quarters beginning with July 1, 1976, through the quarter which ended March 31, 1978, $2.5 billion has been paid to recipient governments.

The amount to be allocated each quarter depends upon national unemployment for the quarter ending three months earlier. For each quarter that the national unemployment rate exceeds 6%, a base allocation of $125 million is made, plus $30 million additional for each one-tenth percentage point by which the rate of seasonally adjusted national unemployment exceeds 6%. No payments will be made for a quarter if the national rate for the quarter ending three months before, or the rate for the last month of the quarter, is below 6%.[10]

The national fund is divided into two parts: one-third of the total is for payments to state governments, and two-thirds of the total is for payments to local governments. Allocations to individual state governments are determined by their "excess" (over 4.5%) unemployment

and their general revenue sharing allocation for the relevant quarter. The two-thirds share is divided among local governments in the same manner as with the states. No payments are made to any government with an unemployment rate of 4.5% or less.

CETA Titles II and VI

State and local governments are provided with funds for public service employment under Titles II and VI of CETA (the *Comprehensive Employment and Training Act*, originally enacted in 1973). President Carter's economic recovery program proposed a substantial expansion of federally funded public service jobs aimed at providing employment for those who find it hard to obtain work in private industry. On June 15, 1977, CETA legislation was extended for one year. By the end of September, allocations of the $6.6 billion provided for CETA under the economic stimulus program had been made. This program differs from the Local Public Works Program and the Antirecession Fiscal Assistance Program in that its primary focus is providing jobs to persons residing in specific areas, rather than giving funds to state and local governments.

CETA Title II and VI programs operate through a system of "Prime Sponsors" which are units of local governments, or consortia of local governments, or states which serve as Prime Sponsors for portions of the state not otherwise covered (identified as the "Balance of the State"). A Prime Sponsor submits comprehensive manpower plans for approval of the Secretary of Labor, and selects its local service delivery agents (governments or private voluntary agencies).

Title II public service funds are allocated to Prime Sponsors in areas with unemployment of 6.5% or more. This money may be used only for public service needs that have not been met with local funds and to implement new services. Title VI funds are made available to all areas on the basis of a three-part formula: 50% in proportion to the relative number of unemployed residing in the area compared to the national total; 25% according to the number of unemployed persons residing in areas of substantial unemployment (with a rate of 6.5% for three consecutive months) compared to national totals; and 25% on the basis of the relative excess (over 4.5%) number of unemployed persons in the jurisdiction compared to the national excess.

ARE THE PROGRAMS EFFECTIVE?
Criteria for Judging Programs

Six considerations are important in evaluating these programs as countercyclical tools:

1. **Timing**—critical to the successful involvement of state and local governments in national antirecession policy and the stumbling block on which most such attempts have foundered. A basic lag that must be overcome is the time it takes state and local governments to spend the additional money.
2. **Triggering**—getting the policy off the shelf and into operation. There are two general ways to trigger a program: (1) discretionary action—Congress passes a grant-in-aid program (the case with the present economic stimulus package) or (2) formula flexibility—a prearranged signal of recession automatically activates the program.
3. **Reversibility**—having that degree of program flexibility which allows jurisdictions to drop out of the program as their individual economic situation improves. The issue involved is whether or not these programs can be discontinued without causing major disruption in the state and local government's financial system.
4. **Data Availability, Simplicity, and Certainty**—having a program which is based on readily available data, simple in operation, and certain in allocation amounts. Efficient state and local government budget planning requires these elements in federal grant-in-aid programs.
5. **Targeting**—deciding who gets the money. Two separate issues are important under this criteria: (1) which units of government should receive additional aid from these programs; and (2) which units of government actually do receive additional money from these programs?
6. **Effectiveness**—carrying out the program ob-

jectives. Does the program do what is claimed and in a more efficient manner than using other methods?

Program Findings

Within the framework of the criteria listed above, six major program findings are important. Four of the findings are relatively straight forward and require little explanation.

1. **While the three programs were not ideally timed to counter the 1973-75 recession, of the three, antirecession fiscal assistance distributes aid to state and local governments more rapidly than the other two programs and has the potential for closest coordination with swings in the national economy.**

2. **The Antirecession Fiscal Assistance Program as presently authorized, is the only one of the three grant-in-aid programs which provides formula flexibility.**
3. **The increased reliance of state and local governments on federal aid makes it difficult to reverse these programs quickly without causing disruption in state and local fiscal operations.**
4. **The unemployment data used for small units of government is unreliable. The programs are not simple in operation and under the Antirecession Fiscal Assistance Program, the amount of money going to an individual jurisdiction each quarter is highly uncertain.**

Antirecession fiscal assistance is both the fastest of the three programs and the only one which provides formula flexibility. Public works programs are inherently slow. It has been estimated that in fiscal year 1977 actual expenditures for the Local Public Works Program were only $585 million; estimated expenditures will be $2.3 billion for fiscal year 1978, $2 billion for fiscal year 1979, and $1.1 billion in fiscal year 1980. The CETA programs were also slow to go into operation, spending less than an estimated $500 million in fiscal year 1977.

In addition, the present Antirecession Fiscal Assistance Program is automatically activated by a pre-arranged trigger. If the national unemployment rate goes above 6% this program goes into operation. It also allows state and local governments to move in and out of the program depending upon the individual employment circumstances within their jurisdictions. An act on the part of Congress is required to start the other two programs. As a part of that act, Congress must also decide which jurisidictions are to receive funds. Tailor-made solutions can be devised for future programs under both the Local Public Works Program and under Titles II and IV of CETA. Those tailor-made solutions are, however, often so slow to go into operation that the problem has changed before the solution is ready.

The Antirecession Fiscal Assistance Program is the only one of the three which provides a continuing series of quarterly allocations with provision for jurisdictions to drop out of the program as their individual economic situation improves. Because it is unrestricted general aid, the recipients must decide where to make necessary cuts in their budgets if their allocations are reduced or cut-off. Cities which are continuing to suffer severe secular unemployment may find it hard to adjust to any loss of funds. The Local Public Works Program is difficult to reverse because expenditures must continue until projects are completed. In addition, this program accounts for a large percentage of total capital outlay in some major cities.

Finally, an ideal antirecession program would use readily available, accurate data. It would be simple to understand and state and local governments would be fairly certain of the amount of money they would receive. The present economic stimulus package is weak on all three of these characteristics.

The last two findings require more detailed explanation.

5. **In general, these three programs are well targeted to areas of high unemployment. They are also well targeted to cities, which according to the "Nathan Index"** *(see Table 9)*, **are suffering the greatest stress. The Antirecession Fiscal Assistance Program is the most highly targeted of the three.**

Cities are the big winners; they receive about 60% of the public works funds and

Table 7

PERCENT OF TOTAL ALLOCATION RECEIVED BY THE VARIOUS UNITS OF STATE AND LOCAL GOVERNMENT

	Antirecession Fiscal Assistance through March 31, 1978	Local Public Works Targets Round I	Local Public Works Targets Round II	Estimates CETA Economic Stimulus Titles II and VI
States	33%	6%	10%	8% to 30%
Counties	22	12	14	
Municipalities	40	59	60	
Townships	4			92% to 70%[2]
All other	[1]	23	16	
48 Largest Cities as Percent of State and Local Allocations	21.9%	20.3%		23.5%

[1]Less than 1%.
[2]For all local governments collectively; based on estimates furnished by the National Governors' Association.

Source: U.S. Department of Treasury, Office of Revenue Sharing; Commerce Department, Economic Development Administration; Labor Department, Employment and Training Administration; and ACIR staff calculations.

40% of the antirecession aid *(Table 7)*.[11] While the amount all cities receive under CETA is unknown, the 48 largest get more than 20% of the total $6.3 billion. Thus one would expect the share for all cities under CETA to be quite high.

As would be expected, the largest of these cities received the largest total payments *(Table 8)*. The range of per capita allocations is large—from a high of $198.15 for Newark to a low of $15.12 for Dallas. The per capita allocations are highly correlated with the city's unemployment rate, and fairly well correlated with Nathan's hardship index *(Table 9)*.[12] This table also shows the estimated 1978 dependency levels of these cities.

When total allocations under the economic stimulus program are examined on an individual state basis, a substantial range appears. California received $1.90 billion in total allocations and New York was not far behind with $1.894 billion. Wyoming and South Dakota, at the other extreme, each received about $45 million from the three programs. For nine states, all governments in the state received over $500 million while 18 received less than $100 million.

On a per capita basis, governments in states with the smallest populations tended to receive the highest per capita amounts *(Table 10)*: Alaska ($205.15), Vermont ($140.14), Delaware ($122.91), Nevada ($121.35), and Wyoming ($113.90). This is due chiefly to the $40 million floor for allocations to individual states under the Local Public Works Program. The states with the lowest per capita payments tend to be those with relatively low unemployment rates: Iowa ($25.08), Kansas ($28.52), Texas ($32.45), Nebraska ($36.69), and Virginia ($37.10).

6. The overall effectiveness of the economic stimulus package as a countercyclical tool is yet to be determined.

Detailed evaluation of the effectiveness of the present economic stimulus package is not yet possible because the majority of the money contained in the package has not yet been spent. However, some studies have been completed which indicate the probable degree of effectiveness.

The most comprehensive of those studies was done by the Congressional Budget Office. In two separate reports done in preparation for legislative consideration of the economic stimulus program, it gave high marks to prototype public works, public service employment, and general assistance measures in terms of their ability to create jobs as compared to di-

Table 8

FORTY-EIGHT LARGEST CITIES—STIMULUS PROGRAMS

City	Local Public Works		Antirecession Fiscal Assistance		CETA: Economic Stimulus Program Titles II and VI		Total Economic Stimulus Program Allocations	
	Round II Unemployment Rate (year ending 2/28/77)	Planning Targets Rounds I and II (thousands of dollars)	Unemployment Rate in Seventh Data Quarter Ending 9/20/77	Cumulative Allocation Through Seventh Payment Quarter Ending 3/31/78 (thousands of dollars)	CETA Unemployment rate (average for three highest consecutive months of calendar 1976)	Allocations Through 9/22/77 (thousands of dollars)	Allocations (thousands of dollars)	Per Capita
New York	10.9%	$294,090	9.0%	$196,923	11.9%	$297,914	$788,927	$105.45
Chicago	8.5	59,673	6.1	32,889	10.4	103,873	196,435	63.38
Los Angeles	9.6	77,084	7.9	25,127	11.0	118,559	220,770	80.95
Philadelphia	11.3	67,941	9.4	38,575	11.7	68,192	174,708	96.22
Detroit	12.5	54,203	9.4	37,527	15.3	59,095	150,825	112.42
Houston	5.7	13,059	5.0	2,073	6.4	24,968	40,100	30.22
Baltimore	10.3	25,243	8.7	16,783	8.7	30,400[1]	72,426	85.04
Dallas	4.8	—	3.9	30	5.6	12,258	12,288	15.12
San Diego	12.1	28,945	9.9	6,933	12.8	38,000[1]	73,878	95.45
San Antonio	8.0	12,212	7.9	3,948	8.1	21,500[1]	37,660	48.70
Indianapolis	7.0	16,101	5.6	2,515	8.4	25,736	44,352	62.04
Washington	8.9	40,000	8.0	12,723	9.5	26,721	79,444	111.65
Honolulu	9.3	28,013	7.3	6,704	9.7	24,941	59,658	84.58
Milwaukee	8.4	15,406	7.1	5,744	8.2	23,600[1]	44,750	67.21
Phoenix	9.1	15,335	6.3	3,339	11.8	33,870	52,544	79.05
San Francisco	11.1	36,200	9.1	15,075	12.2	39,603	90,878	136.76
Memphis	5.8	3,508	5.0	1,994	6.6	11,000[1]	16,502	24.95
Cleveland	9.0	14,541	7.2	8,384	8.2	24,300[1]	47,194	73.88
Boston	10.2	23,664	7.0	11,651	12.8	32,299	67,614	106.19
New Orleans	8.8	14,744	9.0	11,337	8.9	19,973	46,054	82.27

San Jose	8.3	9,804	6.1	2,493	9.2	18,200[1]	30,497	54.88
Columbus	7.4	9,307	5.9	2,626	7.9	18,400[1]	30,333	56.63
Jacksonville	6.2	15,942	5.6	2,070	6.6	11,700[1]	29,712	55.53
St. Louis	12.5	19,221	10.1	10,593	14.2	24,110	53,924	102.72
Seattle	8.8	15,252	6.5	4,189	10.0	22,400[1]	41,841	85.90
Denver	6.8	12,442	6.8	4,665	7.6	14,104	31,191	64.37
Kansas City	6.8	6,995	6.5	3,486	8.1	15,700[1]	26,181	55.41
Pittsburgh	10.3	16,242	8.0	8,250	11.2	19,767	44,259	96.50
Atlanta	9.7	13,908	7.6	3,928	11.9	28,270	46,106	105.73
Nashville-Davidson	5.2	3,132	3.8	690	6.3	6,895	10,716	25.31
Cincinnati	10.2	13,162	8.8	6,541	11.8	19,116	38,819	94.09
Buffalo	12.9	21,846	9.9	7,570	15.8	27,259	56,675	139.20
El Paso	11.1	10,579	11.6	6,149	12.5	15,400[1]	32,128	83.30
Minneapolis	7.4	8,631	5.6	1,861	8.7	16,251	26,743	70.73
Omaha	5.1	20,036	3.7	821	6.1	7,800[1]	28,657	77.15
Toledo	8.5	8,352	6.8	2,176	9.4	14,300[1]	24,828	67.53
Oklahoma City	5.9	6,560	4.3	1,189	6.9	9,100[1]	16,849	46.05
Miami	10.2	14,034	8.1	5,946	10.8	20,500[1]	40,480	110.88
Fort Worth	5.2	—	4.2	355	5.8	8,121	8,476	23.65
Portland	9.3	12,510	7.6	5,441	11.0	17,797	35,748	100.21
Newark	17.4	26,753	14.0	13,358	19.4	27,174	67,285	198.15
Louisville	6.5	6,072	4.8	2,681	7.4	10,700[1]	19,453	57.90
Long Beach	8.6	5,567	7.1	1,784	9.9	12,519[1]	19,870	59.21
Tulsa	5.2	—	4.6	862	5.9	5,100[1]	5,962	17.97
Oakland	13.4	17,522	11.1	6,135	14.8	21,684	45,341	137.13
Norfolk	7.2	4,704	6.3	2,077	7.1	6,700[1]	13,481	47.02
St. Paul	7.0	4,937	5.3	1,128	8.2	10,723	16,788	60.06
Birmingham	7.6	5,350	6.6	2,776	7.3	9,200[1]	17,326	62.71

[1]Adjusted to show primary city allocations although allocations are made to area consortiums according to Treasury Department, Nov. 8, 1977, Memorandum for the Urban and Regional Policy Group, "Fiscal Impact of Economic Stimulus Package on 48 Urban Governments."

Source: Commerce Department, Economic Development Administration; Treasury Department, Office of Revenue Sharing; Labor Department, Employment and Training Administration; and ACIR staff calculations.

Table 9

CHARACTERISTICS AND PER CAPITA ALLOCATIONS FOR THE 48 LARGEST CITIES

City	1975 Population (in thousands)	Local Public Works Unemployment Rate[1] (percent)	"Nathan's Urban Conditions Index"[2]	Direct Federal Aid as a Percent of Own Source General Revenue 1976[3]	Direct Federal Aid as a Percent of Own Source General Revenue Est. 1978	Per Capita Amounts: Local Public Works	Per Capita Amounts: Anti-recession Fiscal Assistance[4]	Per Capita Amounts: CETA Stimulus Program Title II & VI
Newark	339.6	17.4%	321	11.4%	64.2%	$78.78	$39.34	$80.02
Oakland	330.7	13.4	176	25.0	64.5	52.99	18.55	65.58
Buffalo	407.2	12.9	292	55.6	75.9	53.66	18.59	66.95
Detroit	1335.1	12.5	201	50.2	76.8	40.60	28.11	44.26
St. Louis	525.0	12.5	351	23.6	56.1	36.61	20.18	45.93
San Diego	774.0	12.1	39	29.5	69.2	37.40	8.96	49.10
Philadelphia	1815.8	11.3	216	37.7	53.8	37.42	21.25	37.56
El Paso	385.7	11.1	80	27.8	57.3	27.43	15.94	39.93
San Francisco	664.5	11.1	188	31.0	39.6	54.48	22.69	59.60
New York City	7481.6	10.9	180	13.9	17.0	39.31	26.32	39.82
Baltimore	851.7	10.3	224	38.9	46.4	29.64	19.71	35.69
Pittsburgh	458.7	10.3	260	47.7	93.2*	35.41	17.99	43.10
Boston	636.7	10.2	257	31.5	30.2	37.16	18.30	50.73
Cincinnati	412.6	10.2	226	25.4	30.4	31.90	15.85	46.34
Miami	365.1	10.2	106	12.3	65.6	38.44	16.29	56.15
Atlanta	436.1	9.7	118	15.1	40.0	31.90	9.01	64.83
Los Angeles	2727.4	9.6	74	19.3	39.8	28.26	9.21	43.47
Honolulu	705.4	9.3	32	47.0	72.9	39.71	9.50	35.36
Portland	356.7	9.3	142	38.5	69.4	35.07	15.25	49.89
Phoenix	664.7	9.1	20	35.0	58.7	23.07	5.02	50.95
Cleveland	638.8	9.0	291	22.8	60.3	22.76	13.13	38.04
District of Columbia	711.5	8.9	155	90.9	71.5	56.22	17.88	37.56
New Orleans	559.8	8.8	274	47.2	58.0	26.34	20.25	35.68
Seattle	487.1	8.8	100	18.6	55.3	31.31	8.60	45.99
Long Beach	335.6	8.6	68	13.5	27.3	16.59	5.32	37.30

Chicago	3099.4	8.5	201	19.2	42.1	19.25	10.61	33.51
Toledo	367.7	8.5	101	32.7	65.2	22.72	5.92	38.90
Milwaukee	665.8	8.4	128	27.9	69.6	23.14	8.63	35.45
San Jose	555.7	8.3	11	21.4	45.4	17.64	4.49	32.75
San Antonio	773.2	8.0	100	37.1	67.2	15.79	5.11	27.80
Birmingham	276.3	7.6	218	26.6	36.7	19.36	10.05	33.30
Columbus	535.6	7.4	90	24.9	42.0	17.38	4.90	34.35
Minneapolis	378.1	7.4	174	23.3	58.2	22.83	4.92	42.98
Norfolk	286.7	7.2	105	33.8	54.6	16.41	7.25	23.37
Indianapolis	714.9	7.0	71	38.6	50.1	22.52	3.52	36.00
St. Paul	279.5	7.0	117	21.3	48.1	17.66	4.04	38.36
Denver	484.5	6.8	106	21.2	25.9	25.68	9.63	29.11
Kansas City	472.5	6.8	121	27.3	33.4	14.80	7.38	33.22
Louisville	336.0	6.5	195	45.2	66.1	18.07	7.98	31.85
Jacksonville	535.0	6.2	61	29.3	41.2	29.80	3.87	21.87
Oklahoma City	365.9	5.9	71	35.3	47.2	17.93	3.25	24.87
Memphis	661.3	5.8	75	23.4	43.7	5.30	3.02	16.63
Houston	1326.8	5.7	37	19.4	23.8	9.84	1.56	18.82
Ft. Worth	358.4	5.2	65	43.9	45.8	—	.99	22.66
Nashville-Davidson	423.4	5.2	58	17.4	19.6	7.40	1.63	16.28
Tulsa	331.7	5.2	49	52.6	27.6	—	2.60	15.37
Omaha	371.5	5.2	84	52.6	66.0	53.94	2.21	21.00
Dallas	812.8	4.8	39	20.0	17.8	—	.04	15.08

*Revised.

[1]The unemployment rate is an average unemployment rate for the year ending February 28, 1977.

[2]Urban conditions index =

$$\frac{\dfrac{\text{Percent pre-1939 housing}}{\text{Mean percent pre-1939 housing}} \times \dfrac{\text{Percent poverty}}{\text{Mean percent poverty}}}{\dfrac{100 + \text{rate of population change}}{100 + \text{median rate of population change}}}$$

The larger the index number the greater the hardship

A complete description of "Nathan's Urban Condition Index" is included in the "Testimony Before the Joint Economic Committee, July 28, 1977," by Richard P. Nathan, Paul R. Dommel, and James W. Fossett.

[3]When own source general revenue is adjusted to exclude education revenue, such as substituting *adjusted taxes* as used in the general revenue sharing distribution formula and excluding current charges for education, the dependency percentages are increased for 15 of the 48 cities as follows: Atlanta, 16.1; Baltimore, 52.7; Boston, 38.5; Buffalo, 63.5; Cincinnati, 31.9; Honolulu, 48.1; Kansas City, 29.0; Louisville, 45.5; Memphis, 25.2; Milwaukee, 30.3; Nashville-Davidson, 28.0; Newark, 15.6; New York, 16.9; Norfolk, 41.8; and San Francisco, 31.1. No adjustment was made for Washington, DC, since adjusted taxes were not readily available.

[4]Cumulative allocations through the seventh quarter which ended March 31, 1978.

Source: ACIR staff computations based on U.S. Bureau of the Census, *City Government Finances*, annually; U.S. Department of the Treasury, Office of Revenue Sharing; Commerce Department, Economic Development Administration; Labor Department, Employment and Training Administration. Estimated city own source general revenue for 1978 based on annual average increase between 1971 and 1976. Direct federal grants to each city for fiscal 1978 based on (a) ACIR staff estimates of the federal stimulus programs for 1978, (b) Richard Nathan's estimates for all other federal aid in fiscal 1978 as set forth in his testimony before the Joint Economic Committee on July 28, 1977, and (c) ACIR staff estimates.

Table 10

ECONOMIC STIMULUS PER CAPITA ALLOCATIONS, BY REGION AND STATE
(1976 POPULATION)

State and Region	Local Public Works Rounds I and II	Antirecession Fiscal Assistance Cumulative Through Seventh Quarter 3/31/78	CETA Titles II and VI	Total Per Capita
New England	$39.53	$14.56	$40.00	$94.09
Maine	$37.45*	$21.83	$37.27	$96.55
New Hampshire	48.78*	2.06	27.31	78.15
Vermont	84.69*	19.58	35.87	140.14
Massachusetts	31.77	14.12	43.54	89.43
Rhode Island	52.68	15.64	35.80	104.12
Connecticut	41.15	15.10	39.56	95.81
Mideast	34.10	19.92	34.90	88.92
New York	40.20	26.95	37.91	105.06
New Jersey	43.80	20.05	41.51	105.36
Pennsylvania	22.70	13.15	29.81	65.66
Delaware	68.83*	19.68	34.40	122.91
Maryland	14.21	8.75	24.20	47.16
District of Columbia	56.98*	18.13[1]	38.06	113.11
Great Lakes	20.97	9.22	29.58	59.77
Michigan	40.75	17.38	38.89	97.02
Ohio	20.16	8.76	31.82	60.74
Indiana	11.73	3.32	26.00	41.05
Illinois	13.67	7.52	24.23	45.42
Wisconsin	12.19	5.06	23.13	40.38
Plains	18.56	3.17	16.51	38.24
Minnesota	12.05	4.70	24.69	41.44
Iowa	14.56*	1.16	9.36	25.08
Missouri	11.74	5.38	20.95	38.00
North Dakota	62.32*	1.65	15.85	79.82
South Dakota	65.67*	.86	6.65	73.18
Nebraska	26.23*	1.25	9.21	36.69
Kansas	17.48*	.84	10.20	28.52
Southeast	19.01	8.42	25.39	52.82
Virginia	12.30	4.16	20.19	37.10
West Virginia	22.66*	9.94	27.88	60.48
Kentucky	13.52*	4.91	20.98	39.41
Tennessee	12.99	5.60	20.43	39.02

Table 10
(Cont.)

ECONOMIC STIMULUS PER CAPITA ALLOCATIONS, BY REGION AND STATE
(1976 POPULATION)

State and Region	Local Public Works Rounds I and II	Antirecession Fiscal Assistance Cumulative Through Seventh Quarter 3/31/78	CETA Titles II and VI	Total Per Capita
Southeast (Cont.)				
North Carolina	13.51	5.93	22.60	42.04
South Carolina	15.42*	6.13	27.00	48.55
Georgia	20.47	8.97	30.92	60.36
Florida	35.08	12.47	34.97	82.52
Alabama	14.57	7.75	21.38	43.70
Mississippi	17.79*	9.69	20.70	48.18
Louisiana	15.73	14.76	21.80	52.29
Arkansas	19.10*	7.79	25.17	52.06
Southwest	19.20	6.25	20.17	45.62
Oklahoma	24.38*	4.81	16.47	45.66
Texas	11.69	4.37	16.39	32.45
New Mexico	44.07*	17.71	32.34	94.12
Arizona	41.41	12.45	39.21	93.07
Rocky Mountain	35.80	5.24	20.87	61.91
Montana	57.08*	6.65	26.29	90.02
Idaho	48.87*	5.87	22.25	76.99
Wyoming	103.43*	.36	10.11	113.90
Colorado	16.57*	5.95	20.52	43.04
Utah	32.86*	3.99	20.78	57.63
Far West	36.43	17.31	37.25	90.99
Washington	33.04	12.91	35.31	81.26
Oregon	36.87	17.63	42.72	97.22
Nevada	68.90*	11.64	40.81	121.35
California	33.71	17.95	37.00	88.66
Alaska	146.14*	28.68	30.33	205.15
Hawaii	45.23*	17.86	37.41	100.50

*State received minimum statutory allocation ($10 million in Round I and $30 million in Round II) in either one or both Rounds.

[1]For the Antirecession Fiscal Assistance Program, the District of Columbia is classified as a local government.

SOURCE: ACIR staff computations.

rect tax cuts and increases in direct federal expenditures.[13]

A recent report by the Department of the Treasury on the economic impact of these three programs was also quite favorable. It found that the programs targeted well and provided most money to cities facing extreme financial stress.[14]

The Comptroller General's Office examined only the antirecession assistance program and found several serious problems. The report found that many of the governments receiving payments under this program were not greatly affected by the recession, but that their problems resulted from long-term, secular declines in their economies. According to this study, the reason for this distributional pattern was that "excess unemployment" is not a good measure of recessionary impacts. In addition, the study found that some governments were not spending the money, thus limiting the effectiveness of the program.[15]

The House of Representatives Intergovernmental Relations and Human Resources Subcommittee of the Committee on Government Operations took extended testimony on the Antirecession Fiscal Assistance Program. Like the Comptroller General's Report, the subcommittee felt that the program could be greatly improved.[16]

Other studies of the Local Public Works Program and CETA Titles II and VI have dealt only with their potential effectiveness. For example, Georges Vernez and Roger Vaughan recently finished a massive study of public works as a countercyclical tool. Although emphasizing the problems which must be overcome, their study does conclude that countercyclical public works can be effective in creating employment.[17]

John Palmer urges caution in the development of CETA Titles II and VI as countercyclical tools.[18] His case for caution rests on three general concerns. First, to the extent that CETA funds are used to support employees that would have been hired from own source money had CETA not been available, the use of CETA has little to recommend it over general revenue sharing. Second, Titles II and VI have to some extent become confused. Title II was established as a structural unemployment program. However, because it is less restrictive in terms of who can be employed, it has been used primarily as a countercyclical program. Title VI was established as a countercyclical program. Because Congress imposed greater restrictions on eligibility of participants, however, it has been used primarily as a program to combat structural unemployment. Finally, Palmer points out that:

> It is important to concentrate on structural unemployment as the recovery proceeds in order to reduce the inflationary pressure associated with given levels of output and employment and to promote the long-run employment prospects of those who suffer from chronic unemployment. The requirements of programs designed for structural and countercyclical purposes are generally quite different, however. The countercyclical objective requires that the program be implemented rapidly while the stimulus is needed and be phased out as the unemployment rate declines. The structural objective requires much more methodical program design and implementation, and, if effective, programs should be retained at a substantial level of funding even after the recovery is accomplished. Mixing these two objectives is a risky strategy; it might be better to pursue them through more independent policies.[19]

In effect, the economic stimulus program represents a decision to use a shotgun approach for combating recession and stabilizing state and local financial positions. State and local budgets are supplemented with a capital component, a personnel component, and a general fiscal support component. Given what we know about the relationship between state and local finances and recession cum inflation, and the politics of compromise, this shotgun approach is a reasonable way to achieve these dual goals.

Comparative Ratings of the Present Stimulus Programs

Figure 1 provides an impressionistic analysis of how the programs in the present economic stimulus package might compare.

Figure 1

CRITERIA FOR COMPARING THE THREE FEDERAL COUNTERCYCLICAL PROGRAMS[1]

Criteria	ARFA (unconditional countercyclical support)	CETA (hiring public service workers)	LPW (public works construction)
Triggering (quickness of start)	Good	Fair to Good[3]	Poor
Timing (quick employment stimulation)	Good to Fair[2]	Fair to Good[3]	Fair to Poor
Reversibility	Good[4]	Fair to Good	Poor
Certainty concerning level of funding	Poor	Good	Good
Targeting			
General economic stimulus	Fair	Fair	Good
Financial support	Good	Fair to Poor	Poor
Recipient discretion in spending	Good	Fair to Poor	Fair to Poor

[1]Ratings apply to programs presently in effect, not to proposed extensions or revisions.
[2]Good if states and local governments act promptly to spend the money through regular budget procedures.
[3]Fair if states and local governments have to gear up too set up programs and hire additional employees.
[4]Good because funds automatically cut-off below a specified unemployment rate level.

FOOTNOTES

[10]Under the present legislation, the unemployment rates in the January 1978, quarter are the last used to determine a national payment; monthly unemployment rates in that quarter were 6.3%, 6.1%, and 6.2%.

[11]The concept of total allocations to date is used because it gives a complete picture of the money which has been made available by the federal government to state and local governments under these programs. While figures on expenditures for each fiscal year would be better, there are technical difficulties involved in obtaining such data on a fiscal year basis. Only national estimates of expenditures by fiscal years are available for the Local Public Works Program or the CETA programs.

[13]U.S. Congress, Congressional Budget Office, *Temporary Measures to Stimulate Employment: An Evaluation of Some Alternatives*, Washington, DC, U.S. Government Printing Office, September 2, 1975; and U.S. Congress, Congressional Budget Office, *Short-Run Measures to Stimulate the Economy*, Washington, DC, U.S. Government Printing Office, March 1977. These studies also estimated job impacts. Public service employment was estimated to have the greatest initial impact followed by antirecession assistance and then local public works.

[14]U.S. Department of the Treasury, Department of State and Local Finance, *Report on the Fiscal Impact of the Economic Stimulus Package on 48 Large Urban Governments*, Washington, DC, U.S. Government Printing Office Jan. 23, 1978.

[12]Correlation matrix of per capita allocations under the stimulus package and indicators of fiscal condition (48 largest cities 1976).

	CETA	LPW	Total	UCI	DR	UARFA	UCETA	ULPW
ARFA	.70	.77	.86	.76	.07	.84	.82	.87
CETA		.75	.92	.50	–.13	.79	.89	.86
LPW			.94	.51	.20	.74	.76	.78
Total				.60	.05	.85	.90	.91
UCI					.09	.54	.54	.60
DR						–.06	–.07	–.07
UARFA							.89	.96
UCETA								.96

AFRA =per capita allocation under the Antirecession Fiscal Assistance Program through 12/31/77.
CETA =per capita allocation under CETA programs.
LPW =per capita allocation under Local Public Works Program.
Total =per capita allocation for ARFA, CETA, and LPW combined.
UCI =Nathan's Urban Conditions Index.
DR =dependency ratio.
UARFA =unemployment rate used to target ARFA funds through 12/31/77.
UCETA =unemployment rate used to target CETA funds.
UPLW =unemployment rate used to target LPW funds.

[15]The Comptroller General of the United States, *Antirecession Assistance is Helping but Distribution Formula Needs Reassessment*, Washington, DC, U.S. General Accounting Office, July 20, 1977.

[16]U.S. House of Representatives, Intergovernmental Relations and Human Resources Subcommittee of the Committee on Government Operations, House Report 95-275, *Intergovernmental Antirecession Assistance Act of 1977*, 95th Congress, 1st Sess., Washington, DC, U.S. Government Printing Office, 1977.

[17]Georges Vernez, Roger J. Vaughan, Burke Bunright, and Sinclair Coleman, *Regional Cycles and Employment Effects of Public Works Investments*, R-2052-EDA, Santa Monica, CA, The Rand Corporation, Jan. 1977, p. XX. Also see Roger J. Vaughan, *Public Works as a Countercyclical Device: A Review of the Issues*, R-1990-EDA, Santa Monica, CA, The Rand Corporation, July 1976, and Georges Vernez, *Public Works As Countercyclical Fiscal Policy*, P-5859, Santa Monica, CA, The Rand Corporation, April 1977.

[18]John L. Palmer, "Employment and Training Assistance," *The 1978 Budget: Setting National Priorities*, Joseph A. Pechman ed., Washington, DC, The Brookings Institution, 1977, pp. 143-75.

[19]*Ibid.*, pp. 174-5.

Designing an Antirecession Program

In laying the basis for Commission action on this study of countercyclical aid to states and localities, a certain distinction needs to be drawn that pertains to the scope of this research and related recommendations. Our research has focused on only those programs that were originally conceived of as being temporary—namely, ARFA to provide temporary general support for recipient governments, the economic stimulus portions of CETA to provide subsidized job opportunities, and local public works for discrete construction projects. The current urban policy debate, however, is centered more on the need for longer term federal and state programs and policies aimed at strengthening the economic bases of declining communities. The three countercyclical programs are intimately related to, but distinguishably different from, this longer term purpose. Moreover, some assert that any or all of the three programs can or should be converted into or replaced by longer term economic base programs. ACIR's research, however, has not examined the case for, or optimum characteristics of, longer term economic base programs, so the proposed recommendations do not encompass this subject.

The alternative policy positions set forth in this section deal with the current economic stimulus programs. They consider under what conditions or with what modifications the present economic stimulus aid programs to state and local governments should be continued and more generally, under what conditions the federal government should attempt to accelerate state and local government spending as a part of its antirecession policies.

THREE POLICY OPTIONS

The Commission considered three alternative positions on the current economic stimulus programs:

1. **A get out and stay out policy**—the present economic stimulus program should not be renewed and the federal government should not in the future attempt to stimulate state and local government spending as a part of a national economic recovery program.

2. **A phase out and go slow policy**—the programs contained in the current economic stimulus package should be gradually phased out over a two or three-year period and only during severe recession should the federal government attempt to sustain and accelerate state and local government spending rates as a part of a general antirecession policy.

3. **A permanent and flexible aid policy**—an "accordion type" aid program that automatically expands to provide aid to an increasing number of jurisdictions as unemployment rises and automatically contracts to provide aid to a decreasing number of jurisdictions as unemployment rates fall.

The Case For the Get Out and Stay Out Policy

Four major considerations can be advanced for terminating the economic stimulus programs when present legislative authority expires.[20]

First, we do not need a stimulus program now that the nation is in its 12th quarter of continuous economic expansion. The need for additional economic stimulation brought about by increased spending filtered through state and local governments is over. If additional "fine tuning" is needed at this point in the recovery process there are better, more direct, federal fiscal policy tools available. What these more direct tools lack in ability to target to specific areas, they more than make up for in speed of impact.

Second, the countercyclical programs have raised serious technical problems concerning the reversibility, timing, and targeting of expenditures. As illustrated by the present debate over continuation, it is far easier to extend "temporary" aid to states and localities during an economic downturn than it is to withdraw or reverse that aid after national recovery is well underway. Even temporary aid increases state and local governments' reliance on federal dollars.

If these programs cannot be reversed, their value as countercyclical tools is indeed limited. They become continuing aid programs losing to a large extent their original purpose. Moreover, their continuation makes future federal leverage on state and local financial behavior more expensive. Any new temporary aid program would have to be proportionately larger to make a real difference to state and local governments.

Poor Timing—Coordinating countercyclical aid with the swings of the business cycle has proved to be a major problem. It takes considerable time to pass aid money through state and local governments and get it into the economy. As a result, bringing state and local governments directly into national antirecession policy may not be the most efficient approach to stabilization. These programs were not even enacted until recovery was already underway. After enactment, there was an inevitable time lag for the development of the necessary administrative machinery to allocate the funds.

A third time lag developed between the allocation and the actual spending of the money. The goal of 725,000 jobs to be funded by the CETA program was reached six months after the final allocations were determined. Estimated spending under the Local Public Works Program will not peak until almost one year after final allocations were determined. Finally, there is some evidence of a substantial time lag in the spending of ARFA funds.

The Target Issue—The question of which state and local governments should receive countercyclical assistance has been cloudy from the beginning of these programs because the targeting mechanism, the unemployment rate, makes no distinction between areas with high unemployment caused by short-run (cyclical) fluctuations and areas with high unemployment caused by long-run (secular) changes. Areas with both types of unemployment are aided by these programs. Our own study indicates that the money does go to cities with high rates of unemployment and to cities high on Nathan's Urban Conditions Index which attempts to measure economic distress. However, the cloudiness between cyclical and secular unemployment remains and was considered such a drawback that GAO in its study of antirecession fiscal assistance strongly argued that a new targeting mechanism would be necessary if the programs were to continue as a countercyclical measure.

In addition, some argue that unemployment rates do not reflect real fiscal differences between jurisdictions. They are not sensitive to differences in revenue structures or expenditure responsibilities and therefore are not good measures of the effect of the cycle on the various units of state and local government.

The ability of these programs to target for countercyclical purposes is also undercut because of the lack of reliable unemployment data for small places and the "spreading effect" caused by the $40 million state area floor in the Local Public Works Program.

Third, only during the Depression of the 1930s is there significant evidence that the general fiscal behavior of states and localities

worked against national economic stabilization objectives. During the 1973-75 recession, state and local government's fiscal behavior actually helped to get the economy out of the recession by drawing down balances and thereby maintaining their expenditure levels and avoiding the need to increase taxes. Without their generally countercyclical policies, the recession would have been much worse.

State and local governments in the aggregate were not severely hurt by the recession. The estimated loss of revenues from the recession amounted to only about 8% of actual revenues in 1976.

Finally, it can be argued that the goals of fiscal federalism are not well served by this kind of aid program. The federal interest in accelerating state and local spending during periods of economic decline and in slowing it down during periods of inflation works against the orderly and efficient allocation of state and local resources. To put the issue bluntly, this "yo-yo" effect makes state and local fiscal planning extremely difficult. Under ARFA, most state and local governments do not even know what their next quarter's allocation will be.

There is also little justification for insulating states and localities from the same "belt tightening" discipline that other sectors of the economy must follow during a recession. Moreover, a recession provides the state and local fiscal managers with the best opportunity for cutting back inefficient operations. If the federal government immediately steps in with additional money, such an opportunity may easily be lost.

Not only is the opportunity to retrench during recessions lost, but aid continued for too long may simply result in increased surpluses. At present the states are rapidly increasing their surpluses. As a result most states should be in a fairly good financial position to help cushion the shock to their cities caused by the federal termination of the antirecession programs.

The Case For the Phase Out and Go Slow Policy

The second position holds that the programs contained in the current economic stimulus package should be gradually phased out over a two or three-year period. In the future, only during severe recessions should the federal government attempt to sustain and accelerate state and local government spending rates as a part of a general antirecession policy.

Three primary considerations underpin this policy.

First, a gradual phase out rather than rapid termination is required to cushion the fiscal shock of federal aid withdrawal for high unemployment jurisdictions in general and many of the big central cities in particular. Our study of the countercyclical programs identifies two major reasons for their enactment. The first objective was to stimulate the economy by giving additional money to state and local governments so that they could maintain and/or increase their public services. The economic stimulus funds funneled into the economy by ARFA, CETA, and the Local Public Works Program have fed the recovery. Studies by Treasury and other agencies have confirmed the role of stimulus funds in maintaining public services, avoiding tax increases, and strengthening the fiscal position of states and localities.

The second and equally important objective was to maintain fiscal balance within the state-local system by protecting those jurisdictions most vulnerable to the recession. Since state and local governments neither enter a recession at the same level of financial strength nor all recover from a recession at the same rate, some jurisdictions will still suffer from the effects of recession long after recovery is well underway. For the quarter ending on September 30, 1977, New Jersey still had an unemployment rate of 8.2%; in New York State, 8.1% of the labor force was still out of work. Lingering unemployment in some of the major cities is even more substantial. Detroit and Philadelphia both had unemployment rates of 9.4% for the quarter ending in September 1977, and New York City was not far behind with its 9% rate of unemployment. To terminate these programs abruptly when some jurisdictions still have such high unemployment rates would defeat the original objective of maintaining fiscal balance within the state-local system.

Second, a gradual phase out of the ARFA and CETA programs would provide a bridge of

financial support between the present economic stimulus package and the advent of that longer range urban program that may result from current deliberations in the Administration and Congress. Each of the programs contained in this package has objectives in addition to its countercyclical goals. The Local Public Works Program provides funds for capital construction which, judging from the $25 billion of requests, was badly needed. The CETA program provides an additional 725,000 jobs for the unemployed, and ARFA provides general support to governments in places suffering high unemployment. These objectives coincide with the goals of an urban aid program; a gradual phase out approach will permit federal policymakers to make a smooth transition to the longer range urban program.

Once established, an urban aid program that helps jurisdictions with long-term unemployment problems would reduce the need for additional fiscal countercyclical support. The long-term program would partially correct fiscal imbalances in the system and in turn both reduce the need for, and alter the design of, any new countercyclical effort.

Third, the phase out and go slow policy is fairly similar to the Administration's proposed position on the future of these three programs. The Administration has proposed replacing ARFA with a "Supplementary Fiscal Assistance Program" at a reduced funding level through fiscal year 1980. At that time continuation of supplementary fiscal assistance is to be considered in conjunction with the future of general revenue sharing. Under the new proposal, states will no longer receive aid and the targeting to local governments is to be refined. The Administration has also proposed the continuation of CETA Titles II and VI. These two titles are to be combined into a new Title VI which includes provisions for varying the amount of aid on a quarterly basis depending upon the national rate of unemployment. Under this proposal the countercyclical part of CETA aid would terminate if the national unemployment rate dropped below 4.75%. Finally, the Administration is planning to reformulate the Local Public Works Program into a program for "soft public works" for local governments. This proposed change would allow public works expenditures to be more closely timed with swings in the national economy.

The Case For the Permanent and Flexible Aid Policy

The third position both endorses the concept of continuing countercyclical aid to state and local governments and sets forth the alternative form which that aid can take. It makes countercyclical revenue sharing (ARFA) the foundation of an "accordion-type" aid program that automatically expands to provide aid to an increasing number of jurisdictions as unemployment in those jurisdictions rises and automatically contracts to provide aid to a decreasing number of jurisdictions as their unemployment rates fall. Jurisdictions with high individual rates of unemployment would continue to receive this type of aid regardless of the national unemployment rate. As the national economy entered a recession the CETA and Local Public Works Programs would both "kick-in" complementing the antirecession impacts of countercyclical revenue sharing and aiding in the achievement of rapid national recovery.

Five considerations support this policy.[21]

First, it is unrealistic to argue that the federal government should not involve state and local governments in antirecession activity. From the national perspective a "stay-out" policy materially restricts the fiscal options available to federal policymakers confronted with the need to combat a recession. The importance of keeping this option open is reflected in the fact that state and local spending now accounts for approximately 15% of gross national product. State and local governments employ over 12 million workers compared to less than 4 million in 1948. In addition, state and local governments are directly affected by recession, as witnessed by the estimates of revenue loss due to the past recession.

In its 1970 report on *Federal Approaches to Aid State and Local Capital Financing*, the Commission stated that state and local governments with federal assistance could play a significant role in antirecession policy.[22] The findings of this report support that position by noting that with better data it is possible to develop an integrated federal-state-local sta-

bilization program which would cushion state and local governments from cyclical variations in revenues while minimizing undesirable fiscal disruptions or imbalances.

Early estimates prepared by the Congressional Budget Office suggest that state and local governments can be effective instruments in a multifaceted federal effort to combat recession. Thus both the size of the state and local government sector and its influence make noninvolvement an unrealistic policy alternative.

Finally there is the practical consideration. These programs involving state and local governments in antirecession policy are already in place and available for use if there is another recession.

Second, a permanent and flexible standby program which responds automatically to changes in economic conditions at both the national and local levels insures that antirecession actions are taken on a timely basis. One of the most persuasive arguments for a permanent and flexible accordion-type countercyclical aid program can be traced to the political reluctance of federal policymakers to take countercyclical action until it becomes very apparent that the nation has slipped into a major recession. As a result, the current antirecession programs were not even enacted by Congress until after the recovery was already underway.

This lack of timeliness can be traced in large part to the understandable fear of the Administration in power that an early request to Congress for countercyclical legislation would do more harm than good. It would be widely interpreted by the public as an admission of the Administration's inability to keep the economy on the track and that the nation would soon confront another major recession. In fact, the announcement itself could become a self-fulfilling prophecy. As a result, an Administration is likely to wait until the situation becomes very serious before recommending corrective action.

Thus, the only way to insure a timely response to an economic downturn is to create a permanent, flexible program equipped with appropriate standby authorizations that insures:

- **a)** normal delivery of state and local government services during recessions by providing general budgetary support;
- **b)** the creation of a shelf of public works projects at the state and local government level which could be quickly drawn upon at the beginning of a recession; and
- **c)** the development of plans for the implementation of an emergency jobs program if the economy begins to decline.

Edward Gramlich has argued that the major rationale for these programs may be to provide "a form of economic disaster insurance for state and local governments."[23] Under a permanent and flexible standby policy, that economic disaster insurance would be provided on a timely basis thus giving greatest assistance to state and local governments.

Third, the geographic targeting of these three programs is much more precise than other, more traditional tools of antirecession economic policy. Another major advantage of these programs is their ability to target aid to those jurisdictions suffering severest unemployment problems. Using "excess unemployment" as the targeting mechanism allows those places with low rates of unemployment to be automatically dropped from the list of recipient jurisdictions while at the same time concentrating the aid on those places with the greatest unemployment problems. Other tools of national fiscal policy—e.g., a general tax cut—lack this precise geographic targeting feature.

By choosing a level of national unemployment and continuing aid to those jurisdictions with unemployment above that level, the precise geographic targeting advantage of these programs is maintained. The actual rate to be selected must balance the desire for even greater targeting which would result from the selection of a higher rate with the need to spread the aid across a large number of jurisdictions which would result from the selection of a lower rate. One way to provide this balance would be to choose a relatively low unemployment cut-off for ARFA and relatively higher unemployment cut-off levels for CETA and LPW.

Fourth, a permanent accordion-type program provides the best alternative for solving

the problem of choosing between those jurisdictions suffering from cyclical unemployment and those feeling the effects of long-term secular decline. It also provides a mechanism for preserving and strengthening an aid program which gives additional funds to large, financially hard-pressed central cities. Not only is it extremely difficult to separate cyclical from secular unemployment but also such a separation ignores the linkage between these two causes of fiscal stress. The business cycle affects different areas both at different points in time and to different degrees. Trying to choose one point in time and using changes in local unemployment from that point as a measure of fiscal stress penalizes places that lead national business cycle declines while rewarding places that do not feel the effect of the cyclical downturn until the recession is well underway.

In addition there appears to be a link between those places already suffering from fiscal stress and the severity of the impact of the recession. When the nation develops a fiscal cold, many of the major cities come down with financial pneumonia. In testimony before Congress it was estimated that New York City, a place already suffering from long-term decline, lost in six months about $150 million in revenues because of the recession. Using the unemployment rate, the present economic stimulus package recognizes both cyclical and secular problems and does not try to make a distinction between them.

Finally, political reality dictates support for these programs based on the contention that Congress is unlikely to enact an urban aid program which targets aid to large cities better than the proposed permanent accordion-type program.[24] If these programs can be modified as suggested in this alternative and kept in effect they will continue to be of great help to urban areas. Even though many states have moved into a somewhat stronger fiscal position within the last year, history and experience show that states are not particularly helpful to the large cities within their borders. Thus a federal aid program that targets primarily toward cities in need should be preserved and strengthened.

Fifth, making ARFA the centerpiece of a new accordion-type countercyclical aid program and allowing both CETA and LPW to kick-in at an early point in a recession balances the goals of an integrated stabilization program directly involving state and local governments with the desire to maintain fiscal balance within the state and local government financial system.

Three important reasons support making ARFA the centerpiece of this new accordion-type aid program:

1) ARFA responds both rapidly and automatically to changes in general economic conditions;
2) ARFA is better targeted to areas of high unemployment than the other two programs; and
3) ARFA provides general budgetary assistance and allows jurisdictions to move in and out of the program depending upon their individual employment circumstances.

As presently constituted, however, the ARFA program has two problems which can be corrected by the adoption of this recommendation. First, the entire ARFA program closes down if the national unemployment rate goes below 6% either for one quarter or for the last month of a quarter. Certain places may continue to have high unemployment even if the national rate is under 6%. Removing the national 6% cut-off and retaining a base appropriation insures that those places which have not yet fully recovered from the recession continue to receive aid.

Second, under the present formula, it is possible for a jurisdiction's unemployment rate to decline and its aid to increase or for its unemployment rate to rise and its aid decrease. For example, for the fourth quarter of allocations New York City's unemployment rate was 10.4% and it received $35.8 million. By the seventh quarter of payments its unemployment rate had dropped to 9%. Its allocation for that quarter increased to $37.1 million. For the eighth quarter its unemployment increased to 10.3% while its allocation fell to only $32.4 million. A technical change is needed in the formula to insure that as the unemployment rate falls the dollar amounts of aid to a jurisdiction

do not rise. Changes in the dollar amounts of aid to a jurisdiction should reflect changes in the unemployment rate of that place.

Placing CETA and the Local Public Works Program on a permanent standby basis and having them kick-in at an early point in the recession would provide state and local governments with the additional resources necessary to become major partners in an antirecession program. It would also automatically add money into the economy to speed the recovery.

ACIR RECOMMENDATION ON ANTIRECESSION PROGRAMS

After weighing the three alternative positions the Commission chose the "accordian" aid policy. The recommendation is as follows:*

The Commission concludes that the interests of our federal fiscal system would be well served by an accordion-type aid program that automatically expands to provide federal aid to an increasing number of state and local jurisdictions as unemployment rises and automatically contracts to provide aid to a decreasing number of jurisdictions as unemployment rates fall. The Commission also concludes that such a flexible and permanent aid policy can complement federal economic stabilization policies and also help states and localities deal with both short-term (cyclical) and long-term (secular) unemployment problems. This accordion-type policy would also reduce the time lag associated with legislative enactment of federal aid to state and localities during periods of rising unemployment.

The Commission recommends, therefore, that Congress initiate this policy by making permanent the present countercyclical revenue sharing program (ARFA) and by:

a) removing the present 6% national unemployment cut-off provision while retaining an authorization for a quarterly appropriation which would increase as the national unemployment rate rises and decrease as the national unemployment rate falls;

b) helping communities with long-term (secular) unemployment by allowing them to continue to receive ARFA funds until their unemployment rates fall below a designated national unemployment rate;

c) insuring that the funds for a recipient jurisdiction automatically increase as unemployment rates rise and decrease as unemployment rates decline.

The Commission further recommends that the Congress make permanent the present public service countercyclical jobs program and the Local Public Works Program by:

a) providing a fixed authorization for each of these two programs that would automatically be appropriated if the national unemployment rate reaches a designated national unemployment rate;

b) increasing the national authorization and appropriation by a stated amount each quarter for each 0.5% by which the national unemployment rate exceeds a designated national unemployment rate;

c) insuring that the new funds for the programs and for all recipient jurisdictions automatically increase as unemployment rates rise and decrease as unemployment rates decline.

*DISSENTS TO THE RECOMMENDATION ON ANTIRECESSION PROGRAMS

Secretary Blumenthal

Since the scope of the ACIR report is limited to an economic stabilization policy incorporating the state and local sector, the alternatives considered and the recommendation on recession do not encompass the case for, or the relationship of, programs dealing with longer term economic base development. The evidence supporting the case for an integrated antirecession federal aid policy which incorporates a fluctuating flow of funds to state and local governments using quarterly unemployment rate changes is not clearly convincing. In

the absence of a determination on the role of overall federal aid to state and local governments as this relates both to longer term programs and policies aimed at strengthening the economic bases of fiscally hard pressed governments, and to the need for temporary assistance for cyclical economic stimulus offsetting state and local government budgetary disruptions, the Secretary of the Treasury reserves opinion on the ACIR's recommendations on recession.

The principal reason for the Treasury reservation is the fact that ACIR is recommending that the economic stimulus program (ARFA, CETA II and VI, and LPW) be maintained on a permanent basis with funding fluctuating with quarterly swings in unemployment rates.

The Administration, in the Urban Program, has taken a different approach, namely one built upon the concept of longer term economic base development leading toward greater selfsufficiency and, eventually, less dependency on federal aid by state and local governments. The Supplementary Fiscal Assistance (SFA) Program, which the Administration has proposed as a replacement for ARFA, is an excellent illustration of this approach. In contrast to ARFA's short-term antirecession emphasis, SFA provides fiscal assistance on a longer term basis which is targeted to areas experiencing secular distress and decline.

Congressmen Fountain and Brown

We dissent from this recommendation on the grounds that it is contrary to the evidence in the report and erroneously assumes that unemployment is a valid and reliable measure of government fiscal need.

Specifically, this recommendation is untenable in the following respects:

1. The recommendation would make the present countercyclical revenue sharing program permanent despite the Commission's contrary finding that state and local governments have taken appropriate countercyclical actions, without the benefit of federal assistance, in every recession since World War II.
2. While the report warns that ACIR's research has not examined the need for, or optimum characteristics of, longer term programs aimed at assisting communities experiencing secular decline, the recommendation addresses this very problem.
3. The recommendation improperly equates high unemployment with recession and, thereby, ignores both the changing characteristics of today's unemployment (e.g., youth unemployment which accounts for approximately one-half of total unemployment, and the increasing participation of women in the labor force) and the impressive growth in employment since the last recession. It should be noted that our economy created four million new jobs in 1977 alone, at the same time as the national unemployment rate remained high—averaging 7% for the year.
4. The use of local unemployment rates to allocate funds as proposed by the recommendation, would produce very inequitable results since unemployment does not measure a local government's service responsibilities or its fiscal burdens. While invalid as an indicator of government fiscal need, the available local unemployment rates are also of poor quality and therefore unreliable for the purpose of distributing fiscal assistance.

Governor Snelling

The Advisory Commission on Intergovernmental Relations was asked to adopt a position with regard to a policy on countercyclical aid to state and local governments.

The staff report clearly and multiply found:

1. In practice, countercyclical aid programs have not been "countercyclical," because the "on-off" process tended to take a long time and the minimum effects of such aid tended to be felt after the economy had turned upwards.
2. In practice, countercyclical programs tend to become built into the expected revenue sources of states and municipalities and to encourage permanent additional revenue needs. Staff data did not really explore the impact of countercyclical aid as a macro device to stimulate the economy or compare the relative effects of such programs

to other more basic policies of the federal government.

From all of the foregoing, it seems to me that ACIR policy should properly address itself to the extent to which countercyclical aid could be used to *stabilize* the capacity of state and local government to provide needed services during periods of economic downturn when the effects of such economic disability resulted in reducing the revenue of state and local governments, or of limiting increased revenues to amounts less than those required to offset the effects of inflation on existing programs.

The policy position adopted argues for a program designed to "automatically" expand or contract where the only trigger for determining the availability of so-called countercyclical funds is an increase in unemployment above an average unemployment rate. Obviously, the only justification for such a policy would be the belief that the funds thus spent in the public sector through state and local governments would have a beneficial effect on the macroeconomic circumstances of the country. No research offered by the staff really supported a finding that countercyclical funds would be useful or appropriate as a neo-Keynesian device to "stimulate" the economy.

I believe the trigger to effectively designate the appropriateness of these payments to state and local governments should be measured in terms of the availability of revenues from existing tax systems able to keep pace with the complete costs of established services.

Mr. Merriam

I dissent to the recommendation that the present countercyclical program be made permanent for the following reasons:

1. The recommendation is not supported by staff findings which clearly outline, among other things, the inadequacies of current unemployment figures.
2. In fact, there is much evidence that unemployment data, locality by locality, does not accurately measure economic downturns or recoveries.
3. The relationship of the countercyclical program to revenue sharing and other federal assistance was not analyzed in this report.
4. Economic stabilization policy must be looked at in terms of our entire economy; conclusions regarding the effectiveness of programs relating only to the state and local governmental sectors may not be valid. Therefore, to recommend a permanent program based on these conclusions is wrong.

FOOTNOTES

[20]The arguments against this policy are set forth in the case for a permanent and flexible aid policy.

[21]The arguments against this policy are set forth in the case for a get out and stay out policy.

[22]Advisory Commission on Intergovernmental Relations, *Federal Approaches to Aid State and Local Capital Financing*, A-37, Washington, DC, U.S. Government Printing Office, 1970, pp. 10-11.

[23]Edward M. Gramlich, "State and Local Budgets the Day After It Rained: Why is the Surplus so High?", *Brookings Papers on Economic Activity*, Arthur M. Okun and George L. Perry, eds., Vol. 1, Washington, DC, The Brookings Institution, 1978, p. 213.

[24]Secretary of the Treasury Blumenthal dissents: "I cannot agree that 'Congress is unlikely to enact an urban aid program which targets aid to large cities better than the proposed permanent accordion-type program.' "

Designing an Anti-Inflation Program

The appropriate role for state and local governments to play during a period of inflation depends to a large extent on the causes of the inflation and the goals of federal anti-inflation policy. Policy design must therefore be flexible enough to allow the state and local government role to fit changing circumstances. However, past experience with attempts at involving all levels of government in anti-inflation efforts have demonstrated inadequacies and shortcomings in some of the previous programs.

Mandatory controls in the form of wage and price freezes or impoundments are open to sharp criticisms because they arbitrarily impede state and local government decisionmaking. Neither impoundment nor wage and price freezes are available as anti-inflationary tools at present. Voluntary cooperation between the federal government and state and local governments offers an avenue for directly involving all segments of the public sector in effective anti-inflation policy.

PREVIOUS INTERGOVERNMENTAL ANTI-INFLATION PROGRAMS

Until the last decade, the federal government made very little effort to involve the state and local governments in anti-inflation activities. State and local governments were exempted from price and wage controls in both the Second World War and the Korean conflict. Little attention was paid to the economic impact of state and local expenditures.

Around 1969 it became apparent that fundamental changes were taking place in the characteristics of the state-local sector. It had become one of the fastest growing segments in the national economy and was beginning to account for a significant share of GNP. State and local expenditures for construction were of sufficient magnitude to exert pressure on supply and prices during peak construction periods. The process of wage determination in the public sector was taking on many of the characteristics of the private sector, with many public employees joining unions. The wage level of the public sector was moving closer to that of the private sector, and well publicized wage settlements in some of the larger states and local governments were influencing private sector wage levels.

Recognizing these changes, the federal government has made sporadic efforts on occasion to involve state and local governments in anti-inflation measures. Officials of states and localities have been asked to consult with federal officials on economic policy. At times they have been asked to undertake voluntary actions in restraint of inflation, such as the deferral of expenditures for construction projects. Federal grants to states and local govern-

ments have been subject to federal Executive impoundment for reasons of economic policy. And in 1972, for the first time, wages and prices of states and local governments were made subject to mandatory price and wage controls.

In addition, during inflation state and local governments are automatically involved in stabilization policy through the grant-in-aid system. To the extent that Congressional appropriations for grant programs do not keep up with the rate of inflation, the result is a reduction in the real purchasing power of grant dollars. For example, renewal of the general revenue sharing program at close to constant nominal dollar levels meant a reduction in the real dollar value of the grant. While such a reduction is anti-inflationary, its impact is also ad hoc in character.

Voluntary Cooperative Efforts

During 1969, the Nixon Administration launched a large-scale attack against inflation. Cooperation of state and local governments was solicited as part of a national program to attack the inflationary effects of construction wage settlements, which had been running in excess of 12% a year in contracts lasting two and three years. On September 4, 1969, the President announced that the federal government would cut new contracts for direct federal construction by 75%. (For the full year of fiscal 1970, this would have reduced federal contract awards by about $1.8 billion.) State and local governments were requested to cut their new construction voluntarily. However, the Administration warned that it would consider a reduction in federal grants for construction "if not enough voluntary restraint was forthcoming."[25] At that time construction was estimated to account for about one-fourth of state and local governments purchases.[26]

Twenty-four states agreed to defer road building amounting to about $945 million.[27] The Administration target had been about $1.1 billion. On March 17, 1970, President Nixon terminated the freeze saying that he felt that the economy was on the path of stable growth.

The Economic Report for 1970 indicated that although state-local construction had shown annual increases of around 10% in the three preceding years, it rose very little during 1969.[27a] However, the report commented that the slowdown was due chiefly to high interest rates, rather than the voluntary program which came too late in the year to have much impact.

Federal Requirements Tending to Increase Costs

During the 1971 period of concern about rising construction costs, a brief experiment was conducted in fighting inflation by removing federal requirements which might increase state and local government costs. On February 23, 1971, President Nixon suspended provisions of the *Davis-Bacon Act of 1931* which required payment of prevailing wages (generally interpreted as union wages) on construction projects involving federal funds. The President took this action to force voluntary wage-price restraint in construction. At the time it was stated that the suspension could affect some $25 billion in construction costs a year.[28]

The existence of many state Davis-Bacon acts, modeled after the federal statute, severely limited the impact on wage rates of the President's suspension order. The suspension was rescinded at the beginning of April when a tripartite Construction Industry Stabilization Committee was established to regulate collective bargaining settlements in the industry.[29]

Mandatory Price and Wage Controls During 1972

In August 1970, Congress enacted the *Economic Stabilization Act*, which gave the President broad powers to stabilize wages, prices, and rents without Congressional approval. The act was extended in May 1971. As inflation continued, and the wage increases continued to mount, the President on August 15, 1971, imposed a comprehensive 90-day freeze on wages, salaries, prices, and rents (with the sole exclusion of raw agricultural products).

Since in earlier price and wage control measures (during World War II and the Korean conflict), state and local governments had been exempt from control, it was generally assumed that they would be exempt at this time. However, during the first week of the freeze, the Governor of Texas announced publicly that he planned to go ahead with scheduled wage and salary increases for state employees on

September 1. The Administration felt that such a publicly announced wage increase would be highly detrimental to public acceptance of the anti-inflation effort. The Cost of Living Council, fortified by a Justice Department opinion that the President had the authority to apply the freeze to state and local governments, ruled that such governments were covered by the freeze. Since the Governor of Texas indicated he was willing to abide by this ruling a court test was not necessary. For the duration of the freeze, wages and salaries of state and local government employees were covered, as well as rates charged by the governments for services such as electricity, water, and sewerage.

During Phase II, which began in October, the Advisory Committee on State and Local Government Cooperation with representation from state, county, municipal, and education interests was set up to advise the Cost of Living Council on special problems involving control over the state-local government sector.

Relations between the Cost of Living Council and the Committee on State and Local Government Cooperation were not always harmonious. Handicaps to the effectiveness of the committee's role included the lack of analytical support for its recommendations, the fact that Pay Board staff tended to see the committee as an "interest group," and "differences in priorities and perceptions" between the two groups.[30]

In December 1971, the Cost of Living Council exempted from control, fees and charges (except for health services) of federal, state, and local governments on the grounds that these charges were really taxes and therefore not subject to control. Nevertheless state and local governments were requested to take steps to make sure that any increases in fees and charges were not more than 2.5% each year.

Wages remained subject to Cost of Living Council regulation throughout the life of the program, although in Phases III and IV they were placed under selfadministered controls where prior council approval of wage increases was not required. Special units were established within the council to monitor public wages. Authority for the stabilization program ended on April 30, 1974.

Impoundment

Another technique of fighting inflation which frequently involves the states and local governments—although not voluntarily—is Executive impoundment of appropriated or authorized funds. Both President Eisenhower and President Johnson frequently impounded funds intended for federal highway grants to states. In many cases the funds were released fairly rapidly. During the Nixon Administration, Executive impoundment of funds for anti-inflationary reasons as well as for other policy reasons became a conspicuous practice. In 1971, it was estimated that $12.2 billion was impounded. Congress objected strenuously to what it considered Executive usurpation of the legislative power of the purse.

Attempts to counter Nixon impoundments took several forms, ranging from riders to substantive or appropriation bills prohibiting impoundment or requiring expenditure of the total amounts, to court actions brought by state and local governments contesting the authority of the Executive to withhold appropriated funds. Out of 30 court cases, the right of the Executive to impound was upheld only five times.[31]

Congressional opposition culminated in the passage of the *Congressional Budget and Impoundment Control Act of 1974* (P.L. 93-344), which provided that the President must promptly report to the Congress all actions to defer or cut spending of appropriated funds. Congress was empowered to counter the President's impoundments in two ways:

- for deferrals of spending, Congress may force release of the funds if either House passes a resolution calling for their expenditure. There is no time limit.
- for recissions of funds or cuts in total spending for policy reasons, unless the House and the Senate pass a rescission bill within 45 days, the President is required to spend the money as originally appropriated.

Since this procedure was established, Congress has shown marked reluctance to uphold impoundment actions. Impoundment as a tool against inflation is in effect no longer available.

In examining the effect of impoundment, ACIR found stability of long-term capital commitments to be very important. Thus the Commission recommended that such a procedure

be undertaken only on a voluntary basis with the states and in accordance with mutually established priorities.[32]

In that same report the Commission went on to point out:

> 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. . . .
>
> [Thus,] to go beyond the use of general monetary controls and to attempt to force cutbacks in federally aided as well as nonaided 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?[32a]

TWO POLICY OPTIONS

Congress asked the Advisory Commission on Intergovernmental Relations to "conduct a study to determine the most effective means by which the federal government can stabilize the national economy during periods of rapid economic growth and high inflation through programs directed toward state and local governments." The purpose of the study was to emphasize the intergovernmental aspects of the inflation issue. It was not to focus on the various traditional macroeconomic policy tools—e.g., monetary policy—which have historically been used to combat inflation.

The findings of the study identified two alternative policy positions:

1) **noninvolvement**—the federal government should not attempt to slow down state and local government spending during periods of high inflation and low unemployment as a part of a national anti-inflation policy;
2) **limited involvement**—the federal government should establish a voluntary, cooperative approach to involving state and local governments in national anti-inflation policy.

The Case For Noninvolvement

Several considerations favor the noninvolvement approach.[33]

First, the findings of this study indicate that state and local government financial actions are not at present a major cause of inflation. State and local governments are now in the process of rebuilding their depleted surpluses rather than rapidly increasing their rates of expenditure. As a result they are not adding to aggregate demand. In addition, state and local governments spend a large share of their funds on personnel—a factor which has not been in short supply. Even the average rates of pay increases that state and local governments have given their employees over the last few years have been less than the average raises given in the private sector.

In view of this "no fault" finding, many would argue that involving states and localities in a federal effort to combat inflation would tend to place blame on the wrong source. State and local governments would be at least indirectly accepting responsibility for a problem which they have not caused.

Second, the diversity within our federal system makes direct involvement of state and local governments in national anti-inflation policy at best difficult to achieve and at worst suggests direct federal controls. At a minimum, suggesting direct involvement in anti-inflation national policy would endorse "boilerplate" federal guidelines that cannot possibly do justice to the diverse needs and conditions confronting the various state and local governments across the country. Such guidelines might be expected to place undue emphasis on public sector wage increases as the cause of inflation—often an unjustifiable position. At the extreme, suggesting direct involvement might

lay the ground work for direct federal controls on state and local government wage and spending policies.

Finally, direct involvement of state and local governments in national anti-inflation policy may actually work against the goals of fiscal federalism. In general, inflation is a national problem which can only be solved at the federal level. There is little an individual state or local jurisdiction can do to slow the rate of price increases. In addition, direct involvement of state and local governments would work against the principle that they should be allowed to concentrate on their major responsibilities—that of providing public service regardless of the national economic condition.

The Case For Limited Involvement

The voluntary cooperative process envisions a degree of mutual cooperation not heretofore exhibited in federal-state-local relations and for this reason may be viewed as somewhat utopian. But it is advanced as an orderly way to enlist the states and localities in any federal anti-inflation program and as a policy superior to that of no direct involvement at all.[34]

First, the reasons given for ACIR recommendations supporting anti-inflation efforts are as valid today as they were in 1970. In its 1970 report, the Commission explicitly recognized the importance of controlling inflation and recommended "that policymakers at all levels of government support effective anti-inflation action."[35] A part of the basis for this recommendation was the Commission's contention that state and local governments should not be excluded from directly participating in federal countercyclical action. The report pointed out that whether the federal government acknowledges it or not state and local governments are continually involved in federal economic stabilization policy. For example, federal monetary policies influence their willingness and ability to borrow. High interest rates translate quickly into reduced ability of states and localities to finance capital construction projects.[36]

In urging voluntary cooperation the Commission also pointed to the encouraging response of some states to President Nixon's pleas for voluntary capital expenditure cutbacks. The subsequent lack of success in preventing inflation both with a mandatory wage-price freeze imposed on state and local governments and with the impoundment of grants-in-aid lends additional support to this early Commission recommendation.

Four additional considerations—past federal behavior during inflation, the inability of traditional solutions to solve the problem, the fact that all anti-inflation policies have some element of cooperative action, and the size and character of the state and local government sector—argue for the limited involvement approach. In the past the federal government has done as it sees fit to combat inflation. The results have often caused disruptions in the smooth delivery of state and local government public services. Neither impoundment of grants-in-aid nor mandatory wage and price controls stopped inflation. Both however, disrupted state and local government financial systems. Rather than simply waiting for the federal government to impose some new controls at its pleasure, state and local governments should be involved in both the development and implementation of anti-inflation policy.

In addition, the classical approaches to combating inflation may no longer be acceptable. The economy has most recently experienced both high unemployment and inflation. The traditional approach to combating inflation—reducing the money supply and cutting federal spending—may increase the rate of unemployment to levels considered by many unacceptable. Wage and price controls on the other hand generate an unacceptable number of inequities within the system. A voluntary cooperative effort offers a middle ground between these two extremes enhancing potential development of new approaches to stopping inflation.

Inflationary expectations are considered to be a major cause of the present inflation. In cooperation with the federal government, state and local governments can play a role in reducing these expectations by voluntarily slowing the rate of their wage increases and by other expenditure reductions. Such actions

would be in the traditional leadership role of state and local governments—finding solutions to public policy issues. Simply asking the private sector to restrain their spending without including state and local governments sets a very bad example that could undermine the entire anti-inflation effort.

Finally, the state and local sector now makes up almost 15% of GNP and is much too large a part of the national economy to be ignored in anti-inflation policies. Leaving them out would almost insure the defeat of efforts to control inflation. In addition, if state and local policymakers seek special federal aid in time of recession they are hardly in a position to resist limited involvement during periods of inflation.

The limited involvement alternative calls for the establishment of a federal-state-local cooperative process for bringing state and local governments into a national anti-inflation policy and for voluntary wage and price restraint on the part of state and local governments. The exact character of the cooperative approach may include a number of features. For example, since state and local governments are already involved in anti-inflation policy, keeping them informed of the current economic situation and the outlook for the future would be a major first step toward an integrated anti-inflation policy. Such a process would allow voluntary state actions to be coordinated with the plans of the federal government and therefore would improve the chances of success for federal anti-inflationary actions.

In addition, it may be argued that before directly involving state and local governments in an anti-inflation policy, the federal government should "put its own house in order." Many of its requirements and controls are inflationary because they impose added costs on state and local governments. As an example of the magnitude of these costs, the State of Kansas recently did a study on the costs of federal assistance to the state.[37] It found that "at a minimum, state participation in federal assistance involves the equivalent of 5,318 full-time state professional and clerical personnel amounting to $53 million in administration costs and encompassing approximately 15.2% of the nonstudent state work force."[38] With the advice of state and local officials, federal policymakers could examine those federal policies and programs which are most inflationary and take remedial actions.

This voluntary, cooperative process could also include discussion and evaluation of any new alternatives for fighting inflation such as Arthur Okun's suggested sales tax reduction rebate, Michigan's new budget stabilization fund, or Colorado's law providing for a reserve fund. As a last step, the cooperative process could include consideration of innovative approaches to reductions in the flow of federal aid if such action appears necessary.

The second part of the voluntary cooperative alternative suggests that when the President calls upon the private sector to restrain wage and price increases, he also urge state and local officials and public employee union leaders to accept a commensurate slowdown in the growth rate of total personnel compensation bills in their jurisdictions.

Both the magnitude and the character of state and local government personnel costs support this voluntary wage restraint alternative. State and local governments now employ over 12 million persons. Their $116 billion personnel outlay for 1977 accounts for approximately 55% of their current operating budgets. Thus increases in state and local government wages and salaries can have an impact on the rate of inflation.

ACIR RECOMMENDATIONS ON ANTI-INFLATION PROGRAMS

After considering the merits of these two positions, the ACIR made the following recommendations:*

I. Guidelines for Involvement During Inflation

The Commission concludes that there are opportunities for intergovernmental cooperation on the anti-inflation front. To assure the minimum disruption to the state and local

***Secretary Blumenthal**

I would note that the report's anti-inflation recommendations are in complete harmony with the President's recent actions in enlisting the cooperation of state and local officials and public employee labor leaders in an anti-inflationary program of wage and spending constraint.

fiscal systems and at the same time, the success of the federal government economic stabilization activity, the Commission recommends that the President, in cooperation with state and local government officials develop a cooperative anti-inflation policy.

II. State and Local Wage Restraint

It may be necessary under certain inflationary circumstances for the federal government to enlist the cooperation of state and local policymakers and public employee labor leaders in an anti-inflationary program of wage and spending restraint. The Commission recommends that when the President embarks on an economic stabilization program requiring wage and price restraint on the part of management and labor in the private sector that the President also urge state and local officials and public employee union leaders to accept a commensurate slowdown in the growth rate of total personnel compensation bills in their jurisdictions.

FOOTNOTES

[25]Council of Economic Advisors, *Economic Report of the President*, Washington, DC, U.S. Government Printing Office, 1970, p. 43.

[26]*Ibid.*, p. 44.

[27]Vera Herschberg, "CPR Report/Forces Gather for Stormy Debate over Highways with Trust Fund as Lightning Rod," *The National Journal*, 2, Washington, DC, Government Research Corporation, June 6, 1970, p. 1197.

[27a]Council of Economic Advisors, *op. cit.*, p. 45.

[28]"Weekly Briefing: Nixon Curbs Wages, Asks Controls Power," *The National Journal*, 3, Washington, DC, Government Research Corporation, Feb. 27, 1971, p. 435.

[29]Arnold Weber, *In Pursuit of Price Stability*, Washington, DC, The Brookings Institution, 1973, pp. 4-5.

[30]Eugene R. Elkins, "Economic Controls of State and Local Government," *Historical Working Papers on the Economic Stabilization Program*, U.S. Department of the Treasury, Washington, DC, U.S. Government Printing Office, 1974, p. 450.

[31]Congressional Quarterly, *Congressional Quarterly Almanac, 1973*, Washington, DC, Congressional Quarterly, Inc., 1973, p. 253.

[32]ACIR, A-37 *op. cit.*

[32a]ACIR, A-37, *op. cit.*, p. 10.

[33]The arguments against this policy are set forth in the case for limited involvement.

[34]The arguments against this policy are set forth in the case for noninvolvement.

[35]ACIR, A-37, *op. cit.*, p. 4.

[36]ACIR, A-37, *op. cit.*, p. 10.

[37]State of Kansas, Division of State Planning and Research, Department of Administration, *Federal Assistance in Kansas*, Topeka, KS, State of Kansas, 1976.

[38]*Ibid.*, pp. 1-2.

Unemployment Data as a Guide for Economic Policy

THE ADEQUACY OF UNEMPLOYMENT DATA FOR INTERGOVERNMENTAL ECONOMIC STABILIZATION

Under the present economic stimulus program, the unemployment rate plays a crucial role in the allocation of more than $16 billion, a drastic change from past decades in which the unemployment rate was of interest chiefly to economists. It plays a dual role, both targeting and allocating funds, and triggering and cutting off the programs.

The unemployment rate when used as a targeting and triggering device has a number of important shortcomings. These two functions place heavy burdens on a statistical measure which was not originally designed for these purposes. Because the rates determine allocations of funds to individual jurisdictions, comparability and consistency of data becomes extremely important. The data however, were originally developed for analysis of the individual labor market situations and were of varying quality and not necessarily consistent.

The Antirecession Fiscal Assistance Program both greatly expanded the number of governments for which individual unemployment rates had to be available from less than 1,000 to approximately 40,000 units of general purpose government and required that the rates be provided quarterly on an extremely tight time schedule. The commissioner of Labor Statistics in testimony before a House subcommittee described the legislation as "really years ahead of BLS' ability to produce required statistics at reasonable levels of accuracy."[39] Not only are the collecting agencies under severe pressure to collect and process data on time, but the quality of the data for smaller areas has been questioned by almost all experts in the field.

At present, the BLS is reasonably confident of the validity of figures for states and for governments with populations of 50,000 or more, but considers that the figures for smaller jurisdictions are generally subject to a considerable range of error. In addition, most smaller recipients of ARFA funds receive their funds on the basis of assigned rates (derived from the rates of larger units in which the recipient unit is located) rather than rates specific to the individual jurisdiction. Further problems result from the necessity of annual reconciliation of the monthly figures for individual governments (which are based on labor market data) to the statistically more accurate Current Population Survey data. Revisions in unemployment rates for individual jurisdictions resulting from this procedure are frequently substantial and the cause of considerable controversy and distress on the part of individual governments.

Steps have been taken to improve the reliability of the unemployment data. An

awareness of these problems by both Congress and federal statisticians led to the establishment last year of the National Commission on Employment and Unemployment Statistics, which has been given the task of considering the conceptual problems relating to unemployment statistics: how accurately unemployment data measure hardship, and how efficiently and equitably the indices operate as a basis for policy and the distribution of public funds. The commission, under the chairmanship of Dr. Sar A. Levitan, has begun its deliberations, but its final report will not be available for some time.

In the meantime, federal statisticians are making efforts to improve the quality of the existing data system. Over the past few years, BLS has made several major improvements. The most recent changes made by BLS, in January 1978, should improve current estimates, and moderate the revisions necessary to reconcile the figures with the Current Population Survey. In addition, the procedures for gathering data for some of the larger areas have been substantially improved so that the estimates will be more accurate.

Further improvement is more difficult to achieve; we have run out of easy solutions. However, there are still some steps which could be taken. Ideally, unemployment rates for individual jurisdictions should be collected by survey of each jurisdiction, but such surveys would be prohibitively expensive, and would require a huge number of survey personnel. The BLS has suggested that the system could be improved through the use of quarterly average unemployment rates rather than the monthly rates which are presently used in the allocation process. Reliable quarterly averages can be done with smaller samples, and furthermore are less apt to be subject to minor irregularities. At the present time, the Bureau of Labor Statistics has submitted to the Office of Management and Budget a request for additional funds, amounting to between $3 and $4 million annually, to allow an improved system for quarterly collection of unemployment data. It is also necessary to revise the basic authorizing legislation for the economic stimulus programs in order to allow quarterly data as a basis for allocations.

Congressional support for continued improvement of unemployment statistics—and any other statistical data used as the basis for allocation of economic stimulus funds—is essential if the economic stimulus programs are to achieve their objectives. Provision of financial support necessary to improve the collection of unemployment data is only one element of necessary Congressional support. It is important that members of Congress be aware of the inherent limits of the statistical data chosen, such as the fact that it may be impossible, without unreasonable expenditure of funds and manpower, to collect accurate data on unemployment in each of 40,000 jurisdictions each month. The existence of computer technology which makes possible distribution of checks to large numbers of recipients at frequent intervals, does not automatically insure that the quality of the data fed into the computer is adequate to the demands placed upon it.

ACIR RECOMMENDATION ON UNEMPLOYMENT DATA

To insure that these formula grant-in-aid programs meet their stated objectives Congress should provide the support necessary to collect reliable and current unemployment data as required by the countercyclical aid program formulas, and the Executive Branch should launch an aggressive effort to achieve this objective.

FOOTNOTE

[39]U.S. House of Representatives, Committee on Government Operations, *Intergovernmental Antirecession Assistance Act of 1977*, Hearings before a Subcommittee of the House Committee on Government Operations, 95th Cong., 1st Sess., Washington, DC, U.S. Government Printing Office, 1977, p. 144.

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The Advisory Commission on Intergovernmental Relations (ACIR) was created by the Congress in 1959 to monitor the operation of the American federal system and to recommend improvements. ACIR is a permanent national bipartisan body representing the executive and legislative branches of Federal, state, and local government and the public.

The Commission is composed of 26 members—nine representing the Federal government, 14 representing state and local government, and three representing the public. The President appoints 20—three private citizens and three Federal executive officials directly and four governors, three state legislators, four mayors, and three elected county officials from slates nominated by the National Governors' Conference, the Council of State Governments, the National League of Cities/U.S. Conference of Mayors, and the National Association of Counties. The three Senators are chosen by the President of the Senate and the three Congressmen by the Speaker of the House.

Each Commission member serves a two year term and may be reappointed.

As a continuing body, the Commission approaches its work by addressing itself to specific issues and problems, the resolution of which would produce improved cooperation among the levels of government and more effective functioning of the federal system. In addition to dealing with the all important functional and structural relationships among the various governments, the Commission has also extensively studied critical stresses currently being placed on traditional governmental taxing practices. One of the long range efforts of the Commission has been to seek ways to improve Federal, state, and local governmental taxing practices and policies to achieve equitable allocation of resources, increased efficiency in collection and administration, and reduced compliance burdens upon the taxpayers.

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