can be improved upon will be able to adjust somewhat to get measurements which come closer to his judgment of reality. The general pattern, however, seems clear; benefits in relation to income are greater the lower the income, and benefits are much greater than taxes in lower brackets.

Table 14 shows by income levels the estimated benefits of state-local spending compared with the associated state-local taxes. Clearly the system as a whole is strikingly "pro poor" in the sense that for those with incomes under $2,000, benefits are 2.4 times as great as taxes; benefits are nearly twice as great as taxes in the $2,000 to $2,999 range. For those with incomes over $15,000, estimated benefits amount to only a little over half their state-local taxes.

Equity

Is the distribution of taxes described equitable? Each of us will have his own judgment. In general, state-local taxes as a percentage of income are approximat ly proportional for most of the population.

Of course, at all income levels some inequality in burden results from differences in consumption patterns, especially the use of cigarettes and alcoholic beverages. More serious probably, at least in some localities, is the inequity which results from inequality in property tax assessment. In another aspect of equity, however, the property tax can be said to score rather well — financing local services so that the community which bears the burden gets the benefits.

Economic Efficiency, Administration, and Compliance

State-local revenue systems can properly be criticized for their adverse effects on economic efficiency and resource allocation — but hardly to the extent resulting from Federal taxes. Remediable administrative defects and needless compliance burdens continue. By reasonable standards, however, many state systems deserve at least moderately favorable ratings. Some are better than good. They support the conclusion that there is much room for improvement by merely extending the use of methods and features that have been tested and used successfully somewhere. The search for means of further improvement must continue.

The greatest problems seem to be those of the property tax. Weaknesses of administration — and some of the bases for improvement — were indicated in Chapter V. An additional challenge arises from the fact that in some places, especially older urban areas, the property tax rates are high enough to have a substantial and unhealthy effect on investment in new construction.

Table 14

Ratio of Benefits of State and Local Expenditures to Tax Burdens for All Families by Income Class—1961

Income class[a]	Ratio, benefits to tax burden[b]
Under $2,000	2.4
$ 2,000 – $ 2,999	1.8
3,000 – 3,999	1.3
4,000 – 4,999	1.1
5,000 – 5,999	1.0
6,000 – 7,499	1.0
7,500 – 9,999	.9
10,000 – 14,999	.8
15,00 and over	.6
Total	1.0

a. Income class limits are expressed in money income after personal taxes.

b. General benefit expenditures distributed half in proportion to money income before taxes and half in proportion to the number of families and unrelated individuals.

Source: Tax Foundation, **Estimated Tax Burdens and Benefits of Government Expenditures by Family Income Class—1961 and 1965** (in preparation).

VII.
Borrowing and Debt

Since World War II, state-local debts have grown rapidly, as shown in Table 15. On a per capita basis, 1965 state debt varied from $21 in Idaho to $563 in Delaware. Cities owed nearly half the 1965 local government debt; school districts owed $16.7 billion, special districts $15.4 billion. The annual interest cost averages $15 per capita the country over but differs tremendously from one place to another.

Purposes and Logic of Borrowing

Most state and local debt is incurred to finance capital construction,[1] schools, highways, water systems, sewers. When such projects require a relatively large outlay at one time, construction would often be impossible if full payment from taxes were required at the time of building. Moreover, since the benefits to the public will appear over many years, is it not sensible to require future users to share the cost? People move in and out of a locality or a state; some who are around when the school or other project is being built will die or shift residence before long. Spreading the capital costs over several years seems only fair if it can be done – and there is a method of doing so: borrowing initially, followed by gradual repayment. But will borrowing be economically justified in view of the fact that the interest which must be paid will add to the total cost?

For the people of a state or a locality, as for a business or for a family buying a house, going into debt will be wise if the net benefits will exceed the full costs. Clearly, it is economically wiser to borrow than to go without an improvement in the hospital or a new school which would bring benefits worth around 15 percent of the borrowed funds a year, while the full cost of borrowing (each year's debt repayment, called *amortization*, plus interest) would be 10 percent. Yet who can really know how much a new school or other project will bring in community advantages?

Ordinarily, benefits of state-local capital facility projects are to some extent intangible. At times, it is true, benefits can be measured with enough accuracy to give a reasonably clear answer. It may be possible, for example, to make a reliable estimate of the saving in labor and fuel from a new heating plant and then to compare this amount with the cost of borrowing. More often, however, the community's decision must hinge on considerations which cannot be measured. How much can the public benefit from a better prison, college building, or bridge?

For a growing community, the benefits from many capital projects will be greater than the cost of financing them

1. Short-term borrowing, usually from banks, is sometimes necessary when the inflow of revenues and the outflow of expenditures are on different schedules. Governments which borrow at some times of the year frequently become lenders for short periods at other times.

Table 15

Gross Debt of State and Local Governments

Total and Per Capita
Selected Years, 1927 – 1964

Year	Gross debt (billions) Total	State	Local	Per capita gross debt
1927	$14.9	$ 2.0	$12.9	$125
1936	19.5	3.4	16.1	152
1940	20.3	3.6	16.7	154
1946	15.9	2.4	13.6	114
1950	24.1	5.3	18.8	159
1954	38.9	9.6	29.3	242
1956	48.9	12.9	36.0	292
1960	70.0	18.5	51.4	389
1962	81.3	22.0	59.3	437
1964(a)	92.2	25.0	67.2	485

a. Fiscal year.
Source: Department of Commerce, Bureau of the Census; Treasury Department.

with borrowed money. Governmental facilities can be of large advantage – even essential if the local economy is to prosper and grow. Yet the local tax system could not stand the strain of paying in full at once. Borrowing offers a solution. As a community becomes more mature, however, much new construction of government facilities replaces older ones. In such cases the argument for an *increase* in borrowing loses force. From time to time, for example, a large school district can pay for a new building out of tax revenues which are no longer needed to repay debt incurred to pay for the first schools.

Another consideration affects the wisdom of borrowing. The benefits of a governmental capital project may not all appear in the form of dollars which are needed for paying interest and retiring the debt. Although better education and health are highly valuable, years may pass before such benefits appear in significantly improved money income – and servicing debt requires money that can be voted in taxes, beginning in a year or so.

Controls on Borrowing

Do state-local governments tend to overborrow? Temptations to incur debt can be strong even when the underlying justification is weak. Government officials who propose, and voters who approve, new public debt do not in doing so incur a personal obligation, as they do when they borrow as individuals. The debt is the community's. (The individual can get out of his part by moving away, or by death.[2]) Moreover, although new borrowing must meet the requirements of the municipal bond market, govern-

2. The individual who owns property cannot escape fully because the worth of what he owns will be affected by present and prospective tax obligations.

ment's use of borrowed funds does not need to meet the tests of economic productivity which are required for success in business borrowing. Experience supports logic in reaching the following conclusion: Unless special cautions are in effect, neither economic nor political restraints on the growth of state-local debt are likely to be as strong as long-run developments will prove to be desirable.

The people who approve new government debt commit future taxpayers. The debts owing today are obligations of many people who had no part in making them. The history of state-local borrowing includes follies and scandals the like of which we hope to avoid in the future. The most serious problem is not stupidity and corruption. Rather it is to avoid going too far, borrowing too much, for projects which have merit but whose cost would add to debt already high.

To help prevent over-borrowing, state constitutions or laws and city charters generally (1) set up *procedures* which require special voter attention before new debt is authorized and (2) fix *limits* on the total *amount* of debt which may be owed at any one time. The provisions vary greatly. For localities the debt limit is often related to the assessed value of property. In some cases, fixed dollar ceilings are in effect. Or by special approval of a large majority of voters (or property owners) the community may incur whatever debt it wishes – and is able to arrange to market on satisfactory terms.

Such legal limits, many dating from a distant past, do not necessarily represent considered judgment based on the realities of today. Nor are the limits as effective as a look at the laws might lead one to expect. The public has refused to be bound by such restrictions, and methods of borrowing "outside" the limits have been devised. Such debt, however, requires higher interest cost than regular borrowing on the "full faith and credit" of the locality or state.

Many debt limits need modernization to relate them to the economy of the 1960's and beyond. But what restraints on amounts, and what borrowing procedures, would be most desirable? Ties to the property tax base are less logical in theory than they were in the past because other revenue sources have become relatively more important. Additional considerations weaken any logic supporting such ties – from one place to another assessments have widely different relations to actual worth; in some localities property may be taxed by only one government while in others several tax the same property; the taxes needed for purposes other than debt service differ widely. Although there is wide agreement that decisions to incur debt should be made with more caution and forethought than essential for annual spending, the best methods of achieving this objective are not clear.

Revenue Bonds

Much borrowing is now done by states and localities which pledge certain sources of revenue to pay interest and amortization. Such "revenue" bonds – for thruways, college dormitories, water systems, or public housing – make up some of the debt which, as noted earlier, (1) falls outside the debt limit, and (2) is not an obligation of the taxpayers of the governmental unit. About $37.8 billion (38 percent) of total state and local debt in 1965 was payable from pledged earnings or other special sources. The quality of such debt varies widely, but on the basis of experience we must expect that some will go into default because the projects financed will not earn enough above their operating expenses to cover interest and amortization. Such default will cause difficulties, not only for the bondholders and other persons directly involved but also for state-local governments in somewhat similar situations who want to borrow later.

Increasingly, state-local debt is being incurred to raise funds to build factories and other facilities for business. The company using the buildings will pay rent which covers the cost of servicing the debt; in doing so, the business gets advantages which reflect the income tax exemption of interest from state-local debt, discussed later. The practice grows, despite widespread disapproval even by many business firms and governments which engage in it. Governments feel that to attract or hold employers, they must meet the competition of other communities; a business firm may conclude that competitive pressures compel it to accept such offers when its rivals do so.

Interest Exemption from Income Tax

The Federal income tax statute specifically excludes interest on state-local debt from income subject to personal or corporation tax. Because of this explicit exemption the Supreme Court has not had occasion to rule whether Congress has authority (under the sixteenth amendment to the Constitution) to include such interest in taxable income. Would the taxation of such interest on the same basis as other income impair the sovereignty of states and localities?

The exemption enables states and localities to borrow at lower cost than even the U.S. Treasury. The net difference cannot be computed precisely because both the detailed features and the quality of state-local issues vary tremendously; moreover, interest-rate relations are constantly shifting. Generally, however, the saving for the borrowing governments in 1960 was between 30 and 50 percent of the actual interest paid. The benefit to the individual or corporation owning the bond, however, can be considerably greater. For example, when the taxpayer is subject to a marginal income tax rate of 50 percent, a 3.5 percent tax exempt yield is as good as a 7 percent taxable yield – and some taxpayers are subject to rates as high as 70 percent.

The revenue loss to the U.S. Treasury, though difficult to estimate, runs appreciably higher than the benefit to states and localities.[3] Why does competition not adjust taxable and tax exempt interest rates to enable the borrowing government to get all of the benefit? The reason; not enough taxpayers are subject to the highest marginal income tax rates, and are generally attracted to such assets, to buy all of the billions that states and localities offer for sale each year. In selling to a bigger market, these governments must offer interest yields which appeal to buyers whose tax rates are not so high.

The exemption is properly criticized as an inefficient way for the Federal government to aid state-local borrowing. Moreover, there is some criticism of a subsidy which concentrates benefit on upper income individuals.[4] A more rational system could be devised. But pro-

3. Ott, D., and Allan Meltzer, *Federal Tax Treatment of State and Local Securities*, (Washington, D.C., Brookings Institution, 1963).
4. Who gets the tax benefits going to banks, life insurance companies, and other corporations holding tax exempt bonds? The advantages will be diffused among customers, persons insured, stockholders, and possibly others.

posals for reform arouse little support in Congress and much opposition from mayors and governors.[5]

Borrowing Procedures, Cost, and Debt Management

When a state or locality wishes to raise more than small amounts by selling new debt, it will generally try to get financial firms to bid competitively. For large issues the competition may be intense so that the interest cost will be as low as market forces permit. For thousands of localities, however, the amount to be borrowed on any one occasion will be small in relation to capital market magnitudes. As a practical matter, not many a community can expect large investment firms to compete for its bonds. Therefore, it cannot be reasonably sure of obtaining the best terms that are potentially available. So some state governments help localities in floating new loans. State officials may give information and advice about borrowing procedures and in some cases actively participate in the negotiation on behalf of local governments.

In late 1966 state and local governments could borrow on long term – 20 years or so – for 3.7 to around 5 percent, depending, of course, upon the credit standing of the borrowing unit. U.S. Treasury bonds of comparable maturity yielded 4.7 percent. Some state-local borrowing plans are responsive to interest rates, for example, being postponed, reduced, or even abandoned when the interest cost rises above what had been expected.

Most state-local borrowing agreements now require systematic debt retirement. A sinking fund may be required to accumulate enough to pay off the debt when it falls due. More common is the use of serial bonds; each year a fraction of the debt must be repaid. These procedures require the borrowing government to include in the annual cost of debt service, not only interest but also some debt repayment (amortization). The latter may approximate, perhaps only crudely, the annual depreciation of the capital facilities to be constructed.

In the early 1930's defaults were numerous; for over 25 years, however, they have been rare, but not unknown. When they occur, extension of time for payment, and other adjustments, are arranged, with Federal bankruptcy law governing.

5. Growing use—even abuse—of the exemption privilege to finance facilities for businesses has created support for restricting the exemption to borrowing for bona fide governmental purposes. A more striking practice brought criticism in 1966; local governments were borrowing and using the funds to buy Federal debt, thereby reaping a riskless and appreciable difference in yield.

VIII.

Federal-State-Local Financial Relations

Every session of a state legislature or of Congress, and many meetings of city councils and other local government bodies, deal with problems involving financial relations with other governments. Federal, state, and local officials in their day-to-day activities deal with each other in many ways, most of which have financial significance. Numerous and persuasive changes are taking place in the relations among governments — city and suburb, neighboring towns, state welfare agencies with their Federal and local counterparts — and soon. The change may be large and well publicized; more often it is small and undramatic.

The problems are so complex and their elements so interrelated, the developments are so numerous and widely varied, that no brief account can possibly do the subject justice. The space available here will be used to identify some of the problems and then to discuss what is perhaps the most important financial development, the growth of grants-in-aid.

Issues Bearing on the Study of Intergovernmental Relations

The analysis of intergovernmental financial relations can draw on a huge literature which deals with a variety of points, not always closely related to each other. The following brief statements summarize material useful for understanding the discussion which follows.

1. The American public believes that some functions can be performed best at the local level rather than the state (or by the state in preference to the national government). The assignment of responsibilities for performing governmental functions, however, has not always been matched by the grant of effective ability to raise revenue. For decades localities have faced increasing pressure to spend more, but their own effective power to raise the necessary revenue has lagged. Local governments have depended heavily upon the property tax. Though its yield has grown rapidly, especially since World War II, objections to the increasingly intensive use have been strong. Earlier, during the Great Depression, property owners often found themselves unable to pay the tax due, and various protective limits were imposed in many states. More recently, one objection to the heavier use of this tax is a conviction that to do so would lead some taxpayers to flee from, not enter, or not expand in, the community. When businesses are discouraged in this way, it is argued, the source of jobs and income will suffer.

2. Such mobility, very real among localities, also concerns states, though to smaller extent. The taxes which one government can impose will depend upon

what others do. Unless extra tax burdens pay for differential governmental services of (clear) benefit to the persons who are required to pay the costs, tax bills which are much above those of neighboring states and communities will, it is feared, weaken the economic base. A state, of course, has more effective taxing power than the sum of its localities acting individually. Each local unit faces competition from close neighbors. But if the state government imposes a tax to raise equal revenue, mobility is less of a threat. And if the national government does the job, no one state can attract either businesses or high income taxpayers away from other states by offering to lower the tax in question.

3. The vast majority of local governments cannot possibly administer nonproperty taxes as effectively and efficiently as a state. Similarly, the Federal government has some advantage over states in administering taxes. In short, the larger units of government are better able than smaller units to collect income, sales, death, and other non-property taxes. These, it became clear many years ago, will be called upon to provide some of the money for schools, public assistance, highways, and other functions.

4. States prescribe the obligations of localities to perform functions. States also grant the legal authority of local governments to tax and in other ways influence their power to raise revenue. State governments, therefore, exert commanding influence on local finances.

5. The spending in one community has "spillover" effects outside, nearby and possibly to some extent far across the country. The amount sent for functions, and the quality of performance, in one state, or locality, will not be a matter of indifference in the rest of the country.

6. Overlapping (sometimes called double or multiple) taxation, increases as more and more units at different levels of government utilize consumption, business, and income taxes. One burden piled on others may produce a total result significantly different from anything desired or desirable. The revenue which one government can raise will be affected by the use which others are making of the same tax base. Moreover, costs of administration and compliance of such multiple taxes lead to waste and apparently needless use of resources. Fortunately, evidence of progress exists; many states, as noted earlier, have made their income tax reporting requirements conform to the Federal, easing greatly the taxpayer's job of compliance. Undoubtedly, however, more can be achieved.

7. The use of government to redistrbute income by providing some groups with relatively more than others, perhaps in government service or perhaps in transfer payments of money, will create special problems of intergovernmental relations.

8. The exemption of governments from one another's taxes creates conflicts. For example, when the Federal or a state government acquires real estate, the locality loses part of its property tax base. When a town or city engages in business-type activity, such as the provision of utility services, the state government cannot collect income tax as it could if a private, profit-making business supplied the service. Deductibility, such as local taxes in computing state or Federal income tax, will relate the finances of different governments in ways which can be complex; the results will be difficult to appreciate fully.

Coordination and Cooperation[1]

In some respects various states and localities have competing, even antagonistic, interests. Yet these governments also need to cooperate if they are to deal efficiently with problems of mutual concern — water, traffic, or policing in a metropolitan area; preventing evasion of state sales taxes; deciding on the relative state and local use to be made of the same tax base. Arrangements for getting such cooperation are far from adequate, but many de . elopments are taking place.

Interstate compacts, *e.g.*, regarding license fees and motor fuel taxes paid by truckers or the development of river areas, are negotiated and approved by Congress. Less formal agreements among states deal with a variety of problems. Governors meet together to discuss their common problems; so do mayors. Interesting procedures to serve mutual interest are developing in urban areas where the problems are varied, complex, and changing. Dozens of separate governments in the same area claim independence, but in fact they depend on each other. In some cases, state governments provide authority or compulsion for neighboring localities to work together. Frequently, localities contract for services to be provided by one government in return for payment. The growth of professionalism among civil servants enlarges informal cooperation; influential results, even though largely unnoticed by the public, are modifying local performance and even policymaking. Local personnel discover many aspects of common interest in the solution of problems of policing, public health, education, and other activities.

1. The coordination which results from grants-in-aid is discussed later.

Table 16

Intergovernmental Revenue as Percent of Total General Revenue

Selected Years, 1922 – 1965
(Millions)

Year	State: Amount: From Federal government	State: Amount: From local government	State: Percent of total general revenue: From Federal government	State: Percent of total general revenue: From local government	Local: Amount: From Federal government	Local: Amount: From state government	Local: Percent of total general revenue: From Federal government	Local: Percent of total general revenue: From state government
1922	$ 99	$ 27	7.9%	2.2%	$ 9	$ 312	(a)	8.1%
1927	107	51	5.3	2.5	9	596	(a)	10.1
1936	719	39	19.6	1.1	229	1,417	3.7%	22.9
1946	802	63	12.8	1.0	53	2,092	.6	25.4
1954	2,668	215	17.4	1.4	298	5,635	1.5	28.8
1960	6,382	363	23.3	1.3	592	9,522	1.8	28.8
1962	7,108	373	22.8	1.2	763	10,879	2.0	28.4
1964[b]	9,046	417	24.0	1.1	956	12,873	2.2	29.2
1965[b]	9,874	447	24.1	1.1	1,155	14,077	2.4	29.4

a. Less than .05 percent.
b. Fiscal year.
Source: Department of Commerce, Bureau of the Census.

How can we improve methods of dealing with the many and overlapping problems. Possibilities have been studied extensively, by legislative bodies, special commissions, professional groups, and scholars. In 1959 President Eisenhower signed a law setting up the Advisory Commission on Intergovernmental Relations. Its 25 member include Congressmen, cabinet members, governors, mayors, members of state legislatures, county officers, and private citizens. A professional staff aided by expert consultants has produced excellent analyses of problems, some broad and some pinpointed to narrowly specific problems. The Commission has seen some of its recommendations adopted widely. For example, in their 1964-1965 sessions 39 state legislatures enacted one or more proposals of the Commission. In 1965 Congress adopted a dozen recommendations. Yet, as of 1966, the Commission's list of unfinished business is long and growing.

Intergovernmental Payments: Grants-in-Aid

Payments from governments at one level to those at another are no modern creation. Their rapid growth in recent years, however, has altered their role beyond measure (Table 16). Complex and widely diverse systems have been developed. States frequently *share* with localities the revenue from one or more taxes. For example, Michigan gives cities and townships one-eighth of sales tax proceeds on the basis of population; Wisconsin shares one-third of personal income tax revenue with counties, cities, and towns. However, a large portion of state payments to local government, and almost all Federal distributions, take the form of *grants-in-aid.*

Although Federal grants to aid a few state-local activities go back many decades, the dollar amounts were small before the Great Depression. They then increased to meet serious emergencies. New programs were added, and with a few exceptions, they continued after prosperity returned. Since World War II Federal grants have multiplied, not only in dollar amounts but also in the number of different programs. In 1955 around 90 Federal *grant-in-aid* programs were in effect; the 1965 total was at least 140,[2] and in 1966 the number was increased significantly.

Functions Financed by Intergovernmental Payments

Table 17 shows the major functions which are financed by intergovernmental payments. Education gets much the largest total, with highways and public welfare next and approximately equal. The latter two each received roughly twice or more as much as education in Federal funds. By 1967, however, Federal grants for education will have risen markedly.

Reasons for Grants[3]

Why have intergovernmental grants grown so much? Some of the reasons are

2. Estimates of the number of programs differ because of lack of agreement whether related activities make up a single program or are better considered as two or more. For example, the "school lunch program," which distributes commodities and makes direct payments to participating schools, may not be substantially different from the "school milk program," which makes payments to states to increase milk consumption by school children.

3. For the sake of simplicity, the term "grant" will be used here to include tax sharing. Although this usage is now customary, the two have somewhat different economic and political significance. Grants may carry with them more control over spending of the funds than does tax sharing. When the state and its localities share in the revenue from a tax, each feels the effect of fluctuations in yield; some grants, however, are for fixed amounts in the short run so that one level, usually the state, must absorb all of the results of yield variations.

Table 17

Intergovernmental Expenditure by Selected Function and Level of Government

Selected Years, 1953 – 1965
(Millions)

Source of Intergovernmental Funds (a)	FUNCTIONS: Education	Highways	Public welfare	Health & hospitals	Natural resources	Social insurance administration
1953:						
Federal	$ 508	$ 510	$1,332	$116	$ 66	$196
State	2,737	803	981	130	11	–
Local	14	67	23	39	8	–
1957:						
Federal	60	944	1,557	111	122	245
State	4,094	1,071	1,025	253	11	–
Local	16	26	25	54	2	–
1960:						
Federal	950	2,905	2,070	135	127	325
State	5,300	1,247	1,483	176	20	–
Local	(b)	41	31	72	(b)	–
1963:						
Federal	1,384	2,981	2,752	184	164	342
State	6,993	1,416	1,919	207	28	–
Local	25	29	35	75	3	–
1965:						
Federal	1,677	3,997	3,098	292	187	413
State	8,351	1,630	2,436	241	38	–
Local	20	32	36	80	1	–

a. Local figures represent payments to state governments only; interlocal transactions excluded.
b. Minor amounts not included.
Source: Department of Commerce, Bureau of the Census.

implied in the points made earlier. Local governments have felt pressures to enlarge expenditures more rapidly than the public wished to increase utilization of the property tax; states developed new revenue sources which could help finance payments to localities. Somewhat similarly, the Federal government has been able to raise funds – by borrowing during the 1930's and more recently from a rapidly growing income tax base and progressive rates – with less difficulty than states or localities would have in getting such amounts. Some supporters of Federal aids emphasize the argument that the Federal revenue system utilizes taxes which come nearer to meeting the criteria of a good revenue system than do the taxes of states and localities.[4]

Another reason for the growth of "payments" from higher to lower levels of government has been a desire by various groups to influence both the total and the pattern of government expenditure. For example, how could the counties of

4. While the argument seems plausible, a more thorough analysis reveals reasons for doubt. No one can be sure what *changes* in the two revenue systems would result from the heavier use of one to relieve the other.

a state — or the states of the nation — be induced to develop a unified highway system? Would it not be desirable to get all school districts to offer standards of education above the level some would provide? How could all states be induced to offer more medical aid to the aged poor? In practice, grants have been responsible for an increase in the total amount of state and local expenditures. Moreover, the allocation among functions has undoubtedly been modified, and so have the methods of actual performance.

The justification advanced for the extension of influence may be a belief that the quality of performance of a function in one community has significance outside. It is argued, for example, that the common responsibility for defense, the constant movement of population, the interdependence of all parts of the economy, and the needs of citizenship — all combine to make health, education, reduction of poverty, urban transit, and so forth more nationwide, and less completely local, matters than Americans once believed. When some areas fail to provide good quality government service, people far removed may suffer at least a little. Perhaps, therefore, all taxpayers should be compelled to help pay for services in other areas. Some spillover effects unquestionably develop. But to what extent? The benefit to people in one area of better performance by localities at the other side of the state or nation may be trifling. Yet the existence of even a little potential benefit has been cited to support action to compel one group to help pay for services elsewhere without any evidence that on balance there is likely to be net benefit.

Support for the use of grants to influence expenditures also comes from a belief that the larger jurisdiction (state vis-a-vis localities or nation vis-a-vis states or localities) can and will direct performance to achieve better results than would the smaller ones acting on their own.

The growth of Federal-to-state and state-to-local grants for assistance to the poor rests in part upon a belief that the provision of relief aid is more properly the responsibility of the larger, than of the smaller, units of government. Otherwise some localities (or states) would have much greater burdens per capita than would others. And the sources of distress and causes of poverty, it is argued, lie in forces operating on a broader scale than any locality (or state) can control. Whatever the reasons for economic recession, they are not actions of state or local governments; nor are they forces which states or localities have power to control. Moreover, will not the ability to finance relief aid be least just where the need is largest?

Another type of consideration helps account for the growth of grants — the greater practical capacity of larger units to raise revenue. Localities contain all the taxpayers from whom states and the Federal government can collect revenue. Why, then, is the ability of localities to raise taxes less than that of states? Inadequate facilities for administering some taxes, fear of suffering in the competition for business, and the greater force of opposition to tax increases when exerted close to home — all these, it is said, limit the actual ability of many localities to pay their own way. States are somewhat freer than localities from inter-area competition for business, but it cannot be ignored.

Taxes which apply to the whole state offer less room for competition among communities than when local taxes must raise the same revenue. National taxes eliminate both inter-locality and interstate competition. Federal financing, therefore, seems a way around one obstacle to either local or state financing. And is it not human for local officials to prefer to have states (or Congress) levy taxes for local benefits?

Families and businesses which are free to decide where to locate will presumably take account of governmental services, tending to favor locations where services are relatively attractive. Some of the persons attracted, however, may be unable, or unwilling, to pay the taxes needed to cover the cost of such services. High standards of welfare aid, for example, or housing subsidy or superior public schools may draw into an area some families whose presence may add more to governmental costs than to revenue. Relatively high quality government service which is supplied without a charge on the specific users will to some extent create its own demand for the service. The necessary taxes, however, will be higher than those elsewhere. The extra burdens may tend to drive away some individuals and businesses, perhaps those with relatively high taxpaying capacity but not attracted by the particular services (especially benefits for low income groups).

Some people believe that government finances should be used to redistribute income from the more to the less prosperous. What would happen if some local governments were to attempt to do much more in this direction than at present? Imagine a local tax system designed to finance far more redistribution than in other communities, *e.g.*, provide relatively extensive services for the poor to be paid for by taxes on those at the top of the income scale. In time, many businesses and individuals most burdened would tend to move to areas where they would not be compelled to pay for services bringing them little or no benefit. No single locality, nor even the largest state, on its own can do much through taxes and spending to alter greatly the distribution of income. The smaller the jurisdiction – school district, village, city, or state – the narrower the limits on its power to tax without providing benefits which the major taxpayers believe will be worth the approximate cost to them.[5] Consequently, Americans who hope to use government to force one group to pay for benefits to others can be expected to prefer Federal taxes over reliance on state taxes – or state taxes rather than local – often press for grant method of finance by pointing out the merits of the *function*, what desirable things would result, with little or no mention of how the cost would be met. Finally, among the reasons for the growth of grants, we can note that government officials who are closely associated with particular programs, seeing opportunities for better performance, are likely to urge expansions.

Bases for Distributing Grants

Proposals for grants (or for tax sharing) must consider the question: On what basis shall the money be distributed? Sometimes the goal is to return the dollars to the places from which they come – the point of *origin* determined accurately or asserted arbitrarily. Often, however, plans utilize one of two other systems

(1) Grant distribution may try for an element of *equalization*, perhaps by pro-

5. Zoning can serve to exclude low income families by requiring high quality housing; the residents, though prosperous, may then pay less than the average of the area for public services.

viding more for relatively poor areas than for the more prosperous.[6] For example, more funds for schools or for relief of the needy may be given to poorer communities than to the more prosperous, that is, more relative to some measure of income or need. Presumably, then, some of the spending in poorer localities is paid for by taxes from higher income areas. Allowance may be made, at least roughly, for the effort a community has exerted in utilizing its own revenue sources. Frequently, the objective is to assure at least a minimum standard of performance everywhere.

(2) Grant funds may be used to offer incentives, to *stimulate* local (or state) governments to make efforts of certain kinds, to do more of something (or in a different way) than otherwise. A state, for example,may "say" to local governments, "For each dollar of your own money that you spend on function A, you can spend a dollar of state money." The prospect of getting $2 worth of a service by spending only $1 of money raised locally can induce localities to spend more than they ordinarily would on the designated activity. They will do so, not only because more dollars become available but also because of the incentive stemming from the nature of the grant. Sometimes, however, such a grant may do relatively less to increase the total outlay on the function than to change the emphasis and manner to comply with directions from the government which gives the funds.

Both equalization and stimulation have merits and weaknesses in theory and in practice. Stimulating grants, for example, can certainly be effective. In such cases, however, they are sometimes properly criticized for inducing "overspending" on the aided functions relative to others. Such a grant also tends to favor the more prosperous communities because they can afford to put up the money needed to take full advantage of the grant offer.[7] Equalization in grant distribution gets support from persons who believe that aiding the poorer localities (or states) also serves the broader public by making possible more and better government services of types which have significance beyond local (or state) boundaries. But who can be sure? The recipient area may keep its own effort to pay for the function below what it would otherwise exert.[8]

The actual distribution of grants will depend upon the balance of political power in state legislatures, in Congress, and in the executive branch of government. Groups of voters who are overrepresented (in relation to population) in legislative bodies may succeed in getting for themselves relatively generous benefits. Recent reapportionment of both state legislatures and Congressional districts has altered the balance of political power. Rural areas have generally lost power to urban areas, and there have been shifts in voting power which will affect city-suburb and intersuburb relations. The effects on distribution of grant funds will develop gradually.

As more Federal grants are made directly to local governments, new prob-

6. The grant-in-aid literature uses the term "equalization" with many different shades of meaning. Rarely if ever does it imply getting all persons or areas on exactly the same basis as regards the program being considered.

7. The state or Federal tax system, of course, will take more tax dollars from people in such areas.

8. Grants which are relatively generous to areas of below average income may delay movement of population to localities where the fundamental economic outlook offers greater promise. Grants may also discourage other adjustments which in the longer-run would prove beneficial. Evidence as to what extent these possibilities become actualities is incomplete.

lems of state-local relations must be faced. Governors, state legislatures, and state agencies are by-passed. How, then, can effective statewide programs be planned and administered? Yet in the view of some observers, society will benefit from freeing urban areas from the restrictions of state governments, which are, or are said to be, less than adequately concerned with the problems of cities.

Some Features of Grant Programs

Great programs are profoundly influencing American society. But in the absence of knowledge about what would have developed otherwise, judgment of the results must be tentative. The following generalizations do not cover the whole subject and do not pretend to present a coordinated summary.

The programs have become increasingly complicated. Only experts may be able to understand some formulas now used. The few persons who are qualified to evaluate the results are likely to be too specialized (and possibly biased) to have good judgments about the merits compared with those of other public programs or private alternatives.

Details of grants can get out of date, but modernization may be put off year after year because of disagreement about what would be preferable. In one state, for example, grants to induce school consolidation continued for many years after the objective had been essentially achieved.

When one level of government pays part of the cost of programs carried out by others, officials at the level which hands out the money have responsibility for seeing that the funds are used as intended. Frequently, however, the resulting supervision arouses criticism. A weakening of local independence may be alleged, perhaps with good reason. Such control can reduce the opportunity to adapt to differences in circumstances among localities (or states). Red-tape can be worse than a nuisance. It can obstruct innovation and tie the hands of persons who would like to try something that seems better. For a single program the cost in time and money of filling out seemingly endless questionnaires (and maintaining the records required) and of handling the data submitted may not seem unreasonable. But for dozens of grant programs the total burden can weigh heavily.

"Direction from above," however, finds support as a source of positive advantage. Officials who administer grants (or lawmakers who establish programs) may set better standards than would otherwise prevail in some areas. Administrators who are able to draw upon broad experience can use it to induce — or force — improvement in performance. In many communities, for example, little or nothing may be known about the best of developments; some officials if free to do so, will resist constructive change. The central agency distributing grants occasionally helps to arrange cooperation among localities or states.

Federal influence has grown rapidly, along with Federal dollars. State and local lawmakers and administrators feel compelled to accept Federal money when it is offered; their residents would save nothing in Federal taxes (or nothing large enough to be identified) by rejecting a grant. To get the money, however, even when the Federal dollars are a small fraction of the total to be spent on the program, the receiving government may need to modify its operations to meet Federal requirements. Some of the newer programs give Federal officials considerable discretion in allocating funds. Governors, mayors, and other state-local officials are experiencing new problems in trying to get Federal funds when the decision hinges upon the judgments of a few men in Washington rather than upon fixed rules known clearly in advance.

People close to various programs differ in their evaluations of the results of the controls (as distinguished from the money). There is wide agreement, however, that efforts for improvement of controls and coordination devices are increasingly necessary as grants exert wider influence and become more complex.

Despite the large growth of Federal grants already scheduled, proposals for still greater expansion find support. A few states, and more localities, the argument runs, are not expanding and improving services rapidly enough within the limits of what appears potentially possible for the economy as a whole. Expansion of Federal aid seems to offer a way toward improvement.[9] The dollars alone will make a difference; and in addition the control exerted might increase the effectiveness.

Recently there has been discussion of a new type of Federal grant along the lines found in some other countries. The aid would be for general purposes (block grants) rather than tied to specific expenditure programs. Each state — perhaps even each locality — would be free to use the funds for what its residents believe to be of highest priority. No Federal control of particular spending programs would be involved. Although impressive arguments are made in support of such untied aid, the supporters of particular programs seem to exert more total influence. One possibility would be to consolidate the numerous grants for each broad function -- welfare, education, health — freeing the states from many of the detailed controls of specific programs.

Concluding Comment

Changes of profound importance are taking place in the system of grants and, more broadly, in all aspects of intergovernmental relations. Ever larger amounts of money are involved. Complexity and interdependence increase each year. Federal influence continues to multiply. In some cases the pattern of controls has become so largely fixed that modification proves very difficult. But for the system as a whole, and, of course, especially for the newer programs, important areas of choice remain open. The quality of American government for the indefinite future will depend significantly upon how the public deals with the many problems of intergovernmental financial relations as they arise at each level of government.

9. Compared with the necessary Federal taxes they would pay, the people of some states would get more, others less, from almost any expansion of Federal grants. Federal taxes paid by the residents of each state can be estimated and compared with grants-in-aid now received by each state. For 1965 the people of Illinois, Indiana, and New York, for example, paid about $1.60 in Federal taxes for each dollar of nonhighway aid while for Arkansas, Mississippi, and Oklahoma the figure was around 30¢. Tax Foundation, *Allocation of the Federal Tax Burden by State* (New York: The Foundation, 1966), p. 3.