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## CHAPTER V

### Changing Responsibilities for Meeting Financial Requirements

If the apportionment of functions among the various levels of government were clear-cut and stable, one might safely consider the financial requirements of each level without regard to the requirements of the others. But both functions and the responsibilities for financing them overlap, and the apportionment of both functions and responsibilities has been gradually changing. Also, of course, an over-all expansion in government functions has been taking place.

There have been two main types of change in the responsibilities for meeting financial requirements, those resulting from changes in the apportionment of substantive functions and those in which one unit of government simply assumes part of the burden of financing a function performed by another. We will refer to them respectively as changes in substantive and changes in fiscal functions.

The substantive function changes we will be concerned with in this chapter are mostly on the state and local levels. But we will encounter two kinds of functions responsible for extensive state and local borrowing in the nineteenth century that have substantially ceased to involve state or local financial requirements. Although maintenance of the National Guard continues to be a state function, state borrowing to finance the raising and equipping of an army came to an end with the Spanish-American War.<sup>1</sup> And state and local governments have come to leave the functions of extending credit to private parties and guaranteeing private credit almost entirely to the federal government.

In connection with the substantive changes in state and local government functions we will have occasion to examine the restrictions that have developed on state and local financing.

Formerly poor relief was considered to be primarily a local community responsibility. In considering here the changes in fiscal functions brought about by federal grants-in-aid we will note the development of grants for general (i.e. unemployment) relief and special public assistance programs. But more detailed attention will be given to the change in responsibility for financing general relief in Chapter VI.

<sup>1</sup> Two states borrowed to help finance their parts in this brief war. See the *Census of Wealth, Debt and Taxation* for 1902, pp. 161 and 169.

### 1. *Substantive Functional Changes and Restrictions on Financing*

Table 24 sketches the growth of state and local debts since 1839. One may infer from the incompleteness of the record that local debts were relatively unimportant before 1850. And state debts were small during the early years of the nineteenth century. After the formation of the Union, Revolutionary War debts had been assumed by the new federal government, and the federal government reimbursed the states for deficits incurred during the War of 1812.<sup>2</sup> But New York State borrowed to finance the Erie Canal during the 1820's and the success of this canal encouraged an era of extensive state financing. We have information about state debts in 1839, because of the great volume of new issues in 1835-38—over \$100 million—and because of the financial difficulties following the crisis of 1837. The totals of state indebtedness in 1839 and 1841 compare with gross federal debt of \$10 million in the former year and \$5 million in the latter. From 1819 until the Civil War the federal debt was less than \$100 million.

Table 2A indicates that the main purposes of state borrowing in the 1830's were aid to banks, building canals, and aid to railroads. Although all three of these purposes can well be regarded as public in nature, it is clear that government borrowing was extensively used to finance privately owned enterprises. And if a major objective in such financing was encouraging the process of industrialization, this objective seems to have been combined with that of accumulating a portfolio of income-yielding investments.<sup>3</sup> However, the great increase in debts left several states in a definitely unsound financial condition after the 1837 crisis. Eight states defaulted and three of them repudiated bond issues.<sup>4</sup> The situation was complicated "by the fact that foreigners had invested liberally in the securities which were now disowned"<sup>5</sup> or in default or even merely selling at a substantial discount.

One result of the post-1837 financial difficulties was unsuccessful agitation, 1842-43, to have the federal government again assume state debts. A second result, which will be considered shortly, was the adoption by a number of states of constitutional restrictions on their financing. Between 1842 and 1857, nineteen states adopted such restrictions.<sup>6</sup>

<sup>2</sup> B. U. Ratchford, *American State Debts*, p. 74. New York was the principal borrower in 1800-1820 and was apparently the first state to make extensive use of the bond type of credit instrument in its financing.

<sup>3</sup> Cf. Ratchford, *op.cit.*, p. 78.

<sup>4</sup> Including Florida, then a territory. Paul Studenski and Herman E. Krooss, *Financial History of the United States*, p. 118.

<sup>5</sup> Davis R. Dewey, *Financial History of the United States*, p. 244.

<sup>6</sup> H. Secrist, *An Economic Analysis of the Constitutional Restrictions Upon Public Indebtedness in the United States*, Appendix II.

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TABLE 24  
The Growth of State and Local Debts since 1839  
(millions of dollars)

	States (1)	Counties (2)	Cities and Other Local Units (3)	Total (4)
GROSS DEBTS LESS SINKING FUND ASSETS				
1839	164	a	a	a
1841	190	a	a	a
1843	a	a	27.5 <sup>b</sup>	a
1853	193	a	a	a
1860	257	a	a	a
1870	353	188	328	869
1880	275	124	724 <sup>c</sup>	1,123
1890	211	145	781 <sup>c</sup>	1,137
1902	235	197	1,433 <sup>c</sup>	1,865
GROSS DEBTS				
1902	270	205	1,720	2,195
1913	423	393	3,682	4,498
1932	2,907	2,775	13,905	19,587
1940	3,526	2,156	14,564	20,246
1950	5,361	1,707	17,123	24,191
1953	7,824	2,454	23,282	33,560

<sup>a</sup> Not available.

<sup>b</sup> This figure covers only "cities." The increase in 1843-70 is therefore somewhat overstated by column 3. However, we may compare the debt of seventeen cities in January 1843 (reported in the *United States Magazine and Democratic Review*, February 1843, cited by A. M. Hillhouse, *Municipal Bonds*, p. 33) with the bonded debt of these cities outstanding in 1880 as reported in the census. For the seventeen cities the figures are: \$25.5 million, 1843; \$352 million, 1880. It is estimated that between 1843 and 1880 the population of these seventeen cities nearly quadrupled, while the population in all cities of more than 10,000 inhabitants increased more than sixfold. This suggests that the urban debt increase, 1843-80, was around twentyfold rather than the twenty-six indicated in column 3.

<sup>c</sup> School district debt was \$18 million in 1880, \$37 million in 1890, and \$46 million in 1902. It is not separately identified for 1870.

NOTE: Figures are from the 1880 census for 1839-70; from the 1902 census for 1880-1902. Column 1 includes territories and the District of Columbia. The former source indicates that the figures in column 1 are gross, but it gives \$260 million for gross state debt in 1880. The figures for 1870 are apparently partly net of sinking funds. All figures for 1880-1902 are net of sinking funds.

The 1880 census reports that from the time of the assumption of state debts in 1790 by the federal government to 1820 "but a small amount of state debt was contracted." It further reports that, of the \$174 million of stocks issued by eighteen states in 1820-38, \$108 million was issued during 1835-38.

Figures from 1902 to 1950 are from *Governmental Debt in the United States 1946* and *Governmental Debt in 1950*. Figures for 1953 are from *Summary of Government Finances in 1953*.

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During the 1850's various states—in general not the states that had defaulted after 1837—borrowed to finance public improvements. And again following the crisis of 1857 there were financial difficulties, defaults, and one repudiation.<sup>7</sup> Then, during the Civil War there was extensive state borrowing to finance the war, for war finance had not yet ceased to be considered at least partly a state function. War debts of the Union states totaled \$112 million and known war debts of the Confederate states, 1865, \$96 million.<sup>8</sup> But, as the victorious federal government reimbursed the northern states for army costs amounting to nearly 50 per cent of their war-connected debts and as the war debts of the southern states were repudiated, Table 24 reflects only a small part of this borrowing.

This table also fails to bring out the major developments in state and local finance in the years immediately following the war—reconstruction and alleged reconstruction borrowing mainly by states in the South, and borrowing mainly by cities and other local governments in the North and West, 1867–73, to finance new public improvements of various kinds. Per capita debts of 130 cities increased from \$37.30 in 1866 to \$70.50 in 1876.<sup>9</sup> Some indication of the nature of the improvements financed by municipal debt increases can presumably be gleaned from Table 2A, column 1. The three largest debt purposes there are identified as water works, streets, and railroads and other aid. As Hillhouse so pertinently remarks, "With state aid for internal improvements checked, municipal aid filled the gap."<sup>10</sup> Municipal bond issues provided, in effect, a means of detouring constitutional limitations on state borrowing, so far as aid to railroads was concerned.

We noted in Chapter I that the ousting of the carpetbaggers was followed by debt repudiations and compositions totaling more than \$100 million. In view of their experiences with the carpetbaggers several southern states adopted constitutional restrictions on state borrowing. Also most of the states admitted to the Union after the Civil War included debt restrictions in their constitutions. Even before 1873 a number of states had adopted constitutional restrictions on local government financing.<sup>11</sup> With the extensive defaults following the 1873 crisis—it has been estimated that 20 per cent of all outstanding municipal debt was in default<sup>12</sup>—there came a "wave of sentiment favorable to rigid restrictions on municipal indebtedness," and during 1873–79 restrictions on local

<sup>7</sup> Repudiation by Minnesota, at that time a territory. See Ratchford, *op.cit.*, p. 230.

<sup>8</sup> See Ratchford, *op.cit.*, pp. 136 and 151. A. M. Hillhouse, *Municipal Bonds*, pp. 61ff., notes that several cities borrowed to help finance the war.

<sup>9</sup> Data are from *Banker's Magazine* (New York) cited by Secrist, *op.cit.* Practically all of the cities of over 25,000 population must have been included in these data. And the growth of debt was certainly concentrated in the years 1866 to 1873.

<sup>10</sup> *Op.cit.*, p. 34.

<sup>11</sup> Secrist, *op.cit.*, p. 59.

<sup>12</sup> This estimate is cited by Hillhouse, *op.cit.*, pp. 15–17.

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government financing were incorporated in the constitutions of eighteen states.<sup>13</sup> Indeed during the years following 1873 restrictions on local borrowing, either constitutional or statutory, became general.

The severity and nature of the restrictions that were imposed on states and on local units varied from state to state. As of the beginning of the twentieth century about a quarter of the state constitutions vested broad borrowing powers in their respective legislatures. So far as state financing was concerned the other states were about equally divided into two groups. In one group borrowing—except borrowing in a major emergency (such as a war or an insurrection) or short-term borrowing in anticipation of tax receipts—required a constitutional amendment. In the other group most nonbudget, nonemergency borrowing required approval by a popular referendum. In some states a constitutional upper limit on most of the debt was set in terms of the ratio of specified types of debt to the assessed value of property; in a few there was an absolute upper limit. A number of constitutions prohibited borrowing for internal improvements; a number prohibited the assumption of local debts; most of them prohibited lending their credit to or becoming stockholders in private enterprises.<sup>14</sup> And more detailed requirements were not infrequent: these included requiring that provision be made for a sinking fund; fixing a maximum maturity period; prescribing a maximum interest rate and prohibiting sale of bonds below par; and requiring the levying of taxes to service the debt.

The restrictions imposed on local government borrowing have been of a quite similar character, except that while some of them have been written into state constitutions others have been merely statutes or municipal charter provisions. In general there are such local restrictions even in states like Massachusetts whose constitutions vest their legislatures with broad borrowing powers. The requirement of a popular referendum has been common. Frequently different quantitative restrictions have been prescribed for different types of local government units and for different classes of cities. Special limits have been set for several of the larger cities. The debt to assessed property value limit has been widely used. For a time a number of absolute limits were set.

We have noted the great increase in municipal debts, 1890–1929, and in state and local debts generally, 1902–29. At least from 1910 on, as Table 8 makes clear, this growth of debts took place despite a steady increase in nonfinancial receipts. Table 8 also shows a cyclical decline in such receipts, 1930–33, of some 6 per cent. No doubt this average figure conceals significantly sharper declines for many individual units of

<sup>13</sup> Secrist, *op.cit.*, pp. 60, 70, 71.

<sup>14</sup> For summaries of leading provisions see *ibid.*, Part I, Chapter 3, and Ratchford, *op.cit.*, Chapter XVII.

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government. A considerable number of units, too, had borrowed enough and had large enough current commitments to find themselves in serious financial difficulties. Several states were barely able to meet their obligations. And Arkansas, having assumed various local debts in addition to its own, defaulted on certain of its interest payments in 1932-34. But in general the particularly serious cases of financial distress were to be found among local government units. Hillhouse puts the aggregate debts of the local units defaulting during the depression of the 1930's at 10 per cent of the total outstanding.<sup>15</sup> According to the *Commercial and Financial Chronicle*, "Of the total bonds in default the cities of Chicago and Detroit represent by far the largest amounts, the two of them together being responsible for about 550,000,000."<sup>16</sup> But many smaller units were in default, over 3,000 in all up to the end of 1935.<sup>17</sup> About a fifth of these were in Florida.<sup>18</sup> Nearly 15 per cent of the reclamation, levee, irrigation, and drainage districts were involved. No satisfactory estimate of the ultimate losses of municipal bondholders during the 1930's seems to be available, but such losses were presumably a very small part of the total value of bonds in default.

The growth of state and local debt up to 1929 reflected the great pressures for highways and various local improvements, pressures that in turn reflected a combination of major technological changes and a rising level of living. Partly because of these pressures, and partly because the years from 1900 to 1929 were on the whole years of business expansion and optimism, it was inevitable that there should have been some relaxation of state and local restrictions on borrowing. Absolute local debt limits were replaced by limits permitting growth. North and South Dakota amended their constitutions to give their state legislatures broader borrowing powers; and court interpretations, particularly the special funds doctrine, had the effect, in a number of states, of exempting highway and bridge bonds and bonds of educational institutions and various special agencies from constitutional restrictions on state borrowing.<sup>19</sup> But relaxations also took the form of various evasions of the constitutional and statutory restrictions on local financing. The most important form of evasion—and indeed the most substantial type of relaxation—involves the growth of special districts, a development to which we will shortly give attention.

Possibly it might have been expected that the financial distress of the

<sup>15</sup> *Op.cit.*, p. 17. He compares this with the estimate of 20 per cent for the 1873 depression. Long-term local debt outstanding in 1932 totaled \$14.8 billion.

<sup>16</sup> January 30, 1934, pp. 35ff. Presumably the reference to Chicago should read "Cook County and three special districts in the Chicago area."

<sup>17</sup> See the *Bond Buyer* compilation summarized by Hillhouse, *op.cit.*, p. 25.

<sup>18</sup> *Commercial and Financial Chronicle*, January 30, 1934, pp. 35ff.

<sup>19</sup> See Ratchford, *op.cit.*, p. 434.

1930's, like that following 1873, would lead to some tightening of restrictions on public borrowing. Indeed by constitutional amendments Arkansas and North Carolina did make popular referendum, instead of legislative enactment, the main procedure for authorizing state debt issues. But on the whole what was done during the 1930's did not assume the form of imposing additional or more carefully drawn inflexible statutory and constitutional limitations and requirements along the lines of those established in the nineteenth century. Instead there were steps in the direction of temporary state administrative supervision or control of the finances of defaulting local units. Thus several states adopted measures during the 1930's for the administrative supervision of distress refunding issues.<sup>20</sup> Several states, too, earmarked state-collected, locally shared taxes to insure the servicing of defaulting local highway and other debt issues.<sup>21</sup> A more radical procedure, the administrative receivership of municipal corporations, was experimented with in three states and authorized in a fourth, and there were a number of states that made statutory provision for court-appointed receivers for defaulting special districts and municipally owned utilities.<sup>22</sup> It should be added that the federal bankruptcy act was amended in 1937 and 1940 to enable federal courts to give effect to appropriately approved plans for the composition of the debts of local government units.<sup>23</sup>

## 2. *The Rise of Special Districts*

Table 25 summarizes the part played by school and special district debts in the growth of total local government debt. Such units were unimportant borrowers before 1880. Indeed special districts were of little more than negligible consequence even in 1902; this type of governmental unit was then just beginning to come into use. Between 1902 and 1932 total local debts (net of sinking funds) increased nearly \$13.6 billion. Of this amount school and special districts together accounted for nearly a quarter, and school districts alone for over 14 per cent. During the next decade most local governmental units retired some of their indebtedness; school districts showed a net retirement of nearly 18 per cent. But the depression apparently did not check the increased recourse to the special district type of unit. Seven states for which the 1932 Census reported no special district debts or taxes had special district net debt amounting to

<sup>20</sup> See Hillhouse, *op.cit.*, pp. 330ff.

<sup>21</sup> *Ibid.*

<sup>22</sup> On the administrative receiverships see Wylie Kilpatrick, *State Supervision of Local Finance*, pp. 42 and 64. On court receiverships see Hillhouse, *op.cit.*, pp. 297-320 and 349.

<sup>23</sup> It may be noted that the statistical status of defaulting public corporations is somewhat anomalous. During the 1920's the Investment Bankers Association of America started and then dropped a project to establish a reporting service on defaulted liabilities comparable to the Dun and Bradstreet series for private businesses. Apparently the project was dropped because it was felt this type of market information would hamper sales. Cf. Hillhouse, *op.cit.*, p. 518.



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\$84 million ten years later. The total debt of all special districts more than doubled in these ten years, and in 1942 it exceeded that of school districts. During the nine years ending 1951 school and special districts together accounted for more than half of the \$3.7 billion of total local debt increase. It is clear that a substantial part of local government financing during the past half-century has been financed by school and special districts.

TABLE 25  
The Growth of School and Special District Debt, Selected Years, 1880-1951

	<i>School District Debt</i> (millions of dollars)	<i>Special District Debt</i> (millions of dollars)	<i>Total Local Government Debt</i> (3)	<i>School District Debt</i> (per cent of total local government debt)	<i>Special District Debt</i> (5)
	(1)	(2)	(3)	(4)	(5)
1880	18	<sup>a</sup>	849	2.1	<sup>a</sup>
1890	37	<sup>a</sup>	926	4.0	<sup>a</sup>
1902	46	5	1,630	2.8	0.3
1913	119 <sup>b</sup>	36 <sup>b</sup>	3,477 <sup>b</sup>	3.4	1.0
1922	1,053	626	7,754	13.6	8.1
1932	2,034	1,369	15,216	13.3	9.0
1942	1,662	2,791	14,965	11.1	18.7
1951	3,076	3,253	18,669	16.5	17.4

<sup>a</sup> Negligible.

<sup>b</sup> Places of less than 2,500 inhabitants not enumerated.

NOTE: Dollar figures are for gross debts less sinking fund assets as reported by the Bureau of the Census.

It is convenient to use the term "special district" in a sense which excludes school districts, but the school district may be said to be the prototype. The special district is, in general, a governmental unit devoted to one particular government function, or occasionally to two or three particular functions. In most cases the operations of the unit are confined to a district which is a small part of a state. And as a rule the unit is clearly autonomous and has a separate budget of its own, but sometimes the difference between a special district and a municipal department is not very wide. Table 26 classifies the 12,000-odd special districts in existence in 1952 by functional types. An increasing number of these government units are being established to undertake the construction and operation of revenue-producing facilities such as port facilities, airports, toll roads, and bridges.

There is something of a contrast between private corporations and municipal and other public corporations in respect to the incentives that make for and against consolidation. The sacrifices entailed in the decreased number of top jobs are perhaps similar in the two cases, but the loss of local

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autonomy when two or more geographically adjacent units of government are combined is likely to be a more serious deterrent to combining than any corresponding loss in the case of a horizontal business combination. The nearest thing to the profit incentive making for consolidations of public corporations is the incentive to economical and efficient operation, and this incentive makes principally for the consolidation of geographically

TABLE 26  
Functional Types of Special Districts in 1952

Functional Type	Number
All types	12,319
Fire	2,272
Highways	774
Health and hospitals	371
Sanitation	429
Nonhighway transportation	159
Housing	863
Natural resources	5,224
Drainage	2,174
Soil conservation	1,981
Irrigation and water conservation	641
Other	428
Cemeteries	911
Urban water supply	665
Other	651

SOURCE: Data are from Bureau of the Census, *Governments in the United States in 1952*.

adjacent like units; there is scarcely any analogue of the incentive to vertical integration. Doubtless there is some gain in prestige for those who engineer a consolidation of public corporations that promises more efficient or economical operations, but the prestige gained is probably rather smaller than that attaching to many private consolidations.

We take the weakness of the incentives to consolidate government units and the strength of the deterrents to consolidation to constitute one of the main reasons for the growth of special districts. In the first place, when there are serious obstacles to a city's annexing adjacent territory, most of the advantage in efficiency and economy that might be realized by such annexation may perhaps be obtained by establishing special school, sewage, water supply, and fire districts to serve the larger area. Again, when there are public functions that require operation over a territory larger than—or at any rate other than—a metropolitan area, such as the construction and maintenance of levees, and drainage and irrigation systems, the special district is often the answer to the jurisdictional problem. Further, the need for combining adjacent jurisdictions to make possible the performance of a function or to provide for performing it

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efficiently may go beyond the local level. Thus some units, like the Port of New York Authority, are interstate special districts. And the joint authority device is quite capable of handling a problem of combining jurisdictions even at the international level as in the case of the Buffalo and Fort Erie Public Bridge Authority.

But there is a second main reason for the growth of special districts. Establishing such units has proven a very convenient method of openly evading, or in effect amending, debt limits and other restrictions on local governments. If a maximum debt to assessed property value ratio has been prescribed for cities, the establishment of school and special districts with separate borrowing powers to take over some of the municipal functions means a *de facto* increase in debt limits. Similarly if maximum tax limits are prescribed and the new special districts are given taxing powers, there is a *de facto* increase in tax limits. Further, the special district device can be used to make *de facto* exceptions to civil service procedures. It is little wonder that some special districts appear to have been created merely as incidents in political manipulation.

One cannot hope to apportion responsibility for the growth of school and special district debts as between the necessity for or advantage of having a jurisdiction appropriate to the performance of a particular public function on the one hand and the desire openly to evade restrictions on borrowing, the levying of taxes, etc. on the other. But it may be noted that both these influences in some measure reflect technological change. Thus the development of improved transportation makes it possible for a school to service a larger area; the development of improved equipment (e.g. fire fighting equipment) calls for raising more money and this in turn puts pressure on debt and tax limits. And it may also be noted that there is no reason to expect the particularly rapid growth of special district debt in the past few years to slacken in the near future. It is estimated that school districts accounted for about two-thirds of total long-term school debt in 1951.<sup>24</sup> But, if water supply systems are indicative of special district functions, special districts apparently have plenty of room left to grow in; in 1952 they accounted for only about a sixth of total water supply system long-term debt.<sup>25</sup>

Most school and special districts are quite small. Nearly two-thirds of the school districts had less than fifty pupils each in 1952. More than a third of the special districts—and almost half of those devoted to fire protection—had no separate paid employees. Seventy-one per cent of the special districts had no outstanding debt. If this legal form of organization

<sup>24</sup> See note on Table 23 in Appendix A.

<sup>25</sup> On special district debt see Bureau of the Census, *Special District Governments in the United States*, 1954, p. 8. The total of other water supply system debt was estimated on the basis of Bureau of the Census data for systems of cities of over 25,000 population, the total debt of these cities, and the total debt of all cities.

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seems to offer some encouragement to larger-scale combinations, it has also facilitated a great deal of very small-scale operation. Still, mainly as a result of consolidations the number of school districts was reduced 47 per cent between 1932 and 1952.

Some special districts have been established to perform new government functions such as the maintenance and operation of an airport. Others have government functions of long standing: sewage systems, fire

TABLE 27  
Local Government Units in the Continental United States and Their Debts, 1951

	<i>Number of Units</i>	<i>Gross Debt 1951</i> (millions of dollars)	<i>Gross Debt 1902</i> (millions of dollars)	<i>Per Cent of 1951 Debts</i>	<i>Debt Per Unit in 1951</i> (thousands of dollars)
	(1)	(2)	(3)	(4)	(5)
A. Counties	3,049	1,875	205	9.1	615
B. Townships	17,202	411	57	2.0	24
C. Cities of more than 25,000 population in 1950	482	9,975	1,612	48.2	20,650
D. Other cities, towns, and villages	16,296	1,746			
E. School districts	67,346	3,257	46	15.7	48
F. Special districts	12,319	3,403	5	16.5	276
G. Total	116,694	20,667	1,925	100.0	182

SOURCE: Bureau of the Census, *Governments in the United States in 1952 and Governmental Debt, 1951*. The number of counties reported on line A includes ten that are identified with city governments.

protection stations, highways. And of course school districts perform a long-recognized government function. Indeed a large proportion of the functions of these new forms of government have been taken over from older forms, particularly from municipalities.

It is not surprising therefore that Table 27 shows that the increase in the financing functions of school and special districts in the last half-century has been mainly at the expense of cities. Five-sixths of all local debts in 1902 were municipal; it is little wonder the term has sometimes been used to cover all state and local issues. In 1951 less than three-fifths of the total were municipal. The units here called townships are to be found in twenty-two states. They include what are locally termed "towns" in New England, New York, and Wisconsin (as well as some "plantations" in Maine). Densely populated townships in New England, New Jersey, and Pennsylvania—and to a less extent in New York and Wisconsin—may perform various functions commonly associated with municipalities. Their importance has decreased from 3 per cent to 2 per cent of the total. Counties have almost held their own.

### 3. *Grants-in-Aid and Changes in Fiscal Functions*

In 1952 there were over 113,000 local government units in the United States. But the 482 cities of over 25,000 population in 1950 and the 408 special districts having debts of over \$1 million each together accounted for more than half of the total local debt in 1951. Apart from the tax-exempt privileges they enjoy, the many thousand smaller units of government are presumably not in a particularly advantageous position to borrow. Credit standing on the whole improves with increased size; so does the ability to place a loan on advantageous terms. Even the average city of over 25,000 is relatively a considerably smaller-scale borrower than the average state. The \$20.7 million of debt per city compares with an average debt per state of \$133 million. In 1950 the average amount of long-term debt issued by cities of 25,000 to 50,000 population was \$403,000 per city; by cities of 50,000 to 100,000 population it was \$723,000; by cities of 500,000 to 1,000,000 population it was \$11.75 million; for the five cities of over a million it was \$80 million; for the states it was \$28 million per state.

Thus far we have considered mainly those cases of changes in the responsibilities for meeting financial requirements that have entailed transfers of substantive functions from one type of government unit to another. The comparisons just made suggest another kind of change, one brought about by grants-in-aid. One factor in the growth of state grant-in-aid programs is that, in respect to credit standing and ability to place loans advantageously, states are in a much better position to borrow than are the vast majority of local government units. And superior ability to borrow in combination with the huge growth of state aid helps to explain why the states have been going into debt more rapidly than local governments. In 1902 states were obligors for less than one-eighth of the total gross state and local debt outstanding; in 1953 for 23 per cent. (See Table 24.)

But in connection with the shifting of part of the financial responsibility for local government functions to the states through grant-in-aid programs there is need to consider the whole budget, both state and local. We saw in Chapter III that state employment has grown more rapidly than local, and presumably by the same token so have state expenditures on other objects than grants-in-aid. We saw, too, that state tax receipts have grown more rapidly still. The great increase in state receipts was accomplished through the development of new tax sources; state property tax receipts were slightly less in 1950 than in 1932. But local governments have continued to depend heavily on the real property tax, and even in 1950 they were only beginning to tap new tax sources.

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It would seem that the states have had a superior ability to raise money through taxation as well as borrowing. In part this means that major new taxes—income, gasoline, alcoholic beverage, tobacco, and general sales taxes—can be more effectively administered on a state-wide basis; in part that even the limited recourse by local units to new tax sources that has taken place has required the states to grant them additional taxing powers. Probably it means, too, that the change in the structure of the tax system brought about by the development of the new taxes has somehow facilitated the vast expansion in tax revenues, even though the facilitation has presumably been primarily political rather than economic in nature.

To the extent that fiscal considerations have contributed to the growth of state grant-in-aid programs, we can say that this growth results from a combination of a very substantial expansion of local government functions—but a less rapid expansion than in the case of the states—and the superior ability of states to raise money by taxing and by borrowing. But nonfiscal considerations have been a factor too. In particular, states have sought to raise and maintain standards of performance of local government functions—education, welfare, and highways are the programs identified in Table 28—and to reduce interlocal inequalities in these standards of performance. No doubt these objectives involve some fiscal considerations in addition to those already noted. Interlocal differences in performance may be due to differences in ability to finance, the effects of which are diminished by the grants; also in the case of highway grants-in-aid one objective may be to make the (gasoline) tax fall on those responsible for the cost of the service. Further, the figures on state grants include state-collected, locally shared taxes; the main motive for this kind of aid is presumably improved efficiency in tax collection.

But raising, maintaining, and equalizing standards are clearly substantive rather than fiscal objectives; and to the extent that their realization requires state interference with local self-government the grant-in-aid device is a most agreeable form for the interference to take.

Table 28 outlines the growth of both federal and state grants-in-aid. State highway and welfare aid programs were apparently started a little earlier than federal programs in these fields. From the beginning aid to education has been the major type of state grants; and to date there have been only peripheral federal programs in this area such as the vocational training of veterans and school lunch programs.

Federal aid increased from less than one per cent of federal non-financial receipts and about 2.5 per cent of state receipts in 1913 to 17.2 per cent of state receipts and nearly 5 per cent of federal in 1950. State aid seems to have been a consistently larger total than federal. Even in 1913 (when the full amount cannot be identified) it must have been nearly

TABLE 28  
Intergovernmental Aid Compared to Nonfinancial Receipts,  
Selected Years, 1913-50

	1913	1929	1942	1950
		<i>Millions of dollars</i>		
A. Federal nonfinancial receipts	980	4,950	23,700	49,100
B. Federal aid	9	117	888	2,339
C. State nonfinancial receipts	368	2,375	6,870	13,600
D. State aid	87 <sup>a</sup>	647 <sup>b</sup>	1,791	4,011
E. Local nonfinancial receipts	1,882	6,325	8,630	18,000
F. Aid received by larger cities	26 <sup>c</sup>	116	394 <sup>d</sup>	744 <sup>e</sup>
G. Nonfinancial receipts of larger cities	700 <sup>c</sup>	2,597	2,516 <sup>d</sup>	4,512 <sup>e</sup>
		<i>Per cent</i>		
H. B/A	0.9	2.4	3.8	4.8
J. B/C	2.4	4.9	12.9	17.2
K. D/C	23.6	27.3	26.1	29.5
L. D/E	4.6	10.2	20.7	22.3
M. F/G	3.7	4.5	15.6	16.5
<b>THE LARGER FEDERAL AID PROGRAMS</b>				
		<i>Millions of dollars</i>		
N. Highways	0	84	164	455
P. Public assistance and relief	0	0	412 <sup>f</sup>	1,123
Q. Employment security	0	0	72	215 <sup>g</sup>
R. Public health and maternal and child welfare	0	1	31	214 <sup>h</sup>
S. Vocational training and rehabilitation	0	8	134	55
T. Agriculture and forestry <sup>j</sup>	2 <sup>c</sup>	12	29	61
U. Total above	2 <sup>c</sup>	105	842	2,123
<b>THE LARGER STATE PROGRAMS</b>				
		<i>Millions of dollars</i>		
V. Highways	12 <sup>k</sup>	194	338	576
W. Welfare	m	m	389	733
X. Schools	98 <sup>k</sup>	336	766	1,982
Y. Total above	110 <sup>k</sup>	530	1,493	3,291

NOTE: Figures on lines A and B, 1929 through 1950, are on a calendar year basis; other dollar amounts are on a fiscal year basis. Lines F and G are for cities of more than 100,000 population; but see note d. Some grants-in-aid are paid by local governments; in 1942 such payments totaled \$48 million. Cities of over 250,000 population received \$3 million in local grants in 1942; \$22 million in 1950. There are major types of intergovernmental payments not treated as grants-in-aid in this table; see accompanying text.

<sup>a</sup> Incomplete total. Only highway and education grants were fully identified for these years.

<sup>b</sup> By interpolation on data for 1927 and 1932.

<sup>c</sup> 1912 figure.

<sup>d</sup> This figure is for 1940. It covers only city corporations; figures for 1912 and 1929 include computed portions of receipts of overlying counties and school and special districts. On this more comprehensive basis the figure for line F is \$540 million; for line G, \$3,156 million.

<sup>e</sup> This figure covers only city corporations.

<sup>f</sup> The total was \$975 million in 1936.

<sup>g</sup> Includes reimbursements for administering veterans' readjustment allowances.

<sup>h</sup> Includes school lunch program.

<sup>j</sup> Excludes colleges of agriculture.

<sup>k</sup> 1915 figure.

<sup>m</sup> Not available.

SOURCE: See Appendix A.

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a quarter of state nonfinancial receipts and nearly 5 per cent of local receipts. By 1950 these ratios had risen to about 29 per cent and 22 per cent respectively. But again it should be noted that the figures on line D include state-collected, locally shared taxes.

It can be argued that for 1942 and 1950 the ratios on line J understate the importance of federal aid, because the figures for total state nonfinancial receipts include withdrawals from the Unemployment Compensation Fund while the figures on line B do not. Excluding such withdrawals from their denominators the ratios become respectively 15.5 and 19.2 per cent.

Aid seems to have represented a smaller proportion of nonfinancial receipts for the larger cities than for other local units from the very start.

The considerations which have led to the growth of federal aid are somewhat similar to those already noted in the case of the states. The federal government has fiscal advantages over the states; and it has sought to promote standards for the performance of various state functions and to decrease interstate inequalities in performance. Some of the substantive objectives of federal aid programs might have involved both political and constitutional difficulties had a less agreeable method than offering grants on the condition of meeting the standards been employed. In general the substantive considerations seem to have been more important in federal than in state aid programs. The public assistance and relief grants were intended to provide a national system of benefits to relieve general unemployment and aid the blind, the aged, mothers of dependent children, and the totally disabled in a way that would complement the national unemployment and old age insurance programs. The employment security grants—for state unemployment compensation administrations and employment exchanges—have constituted integral parts of the unemployment insurance system. The highway grants have provided a national system of rural roads which, among other things, serves the interests of national defense. Both the grants for veterans' education and rehabilitation and those for agriculture are small parts of broad federal programs. And one may suspect that the present health and education grants are parts of incipient more ambitious programs.

Table 29 analyzes by regions ratios for 1952 which are approximately equivalent to those shown on lines J and K of Table 28. All but 7 per cent of the intergovernmental revenue is federal aid; the intergovernmental expenditure includes in addition to state aid only a small unidentified amount of reimbursements for the cost of services performed by other units; total revenue is a slightly less inclusive concept than total nonfinancial receipts. Aid received is in general a larger proportion of state revenue in those states where per capita income payments to individuals are relatively low. The proportion of state revenue paid out in local aid



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follows no clear pattern. Presumably the ratios in column 5 reflect both the extent of the need to supplement local fiscal capacity and the degree to which the various states have sought to influence the standards of performance of local government functions.

Not quite all grants-in-aid are paid by federal and state governments; but no comprehensive recent compilation of total local grants is available. In 1942 local grants amounted to \$48 million, or about 2 per cent of the

TABLE 29  
1952 Intergovernmental Revenue and Expenditure and Total Revenue of  
State Governments in Relation to Per Capita Income, by Regions

	(2)/(3) (per cent)	Inter- governmental Revenue (millions of dollars)	Total Revenue (millions of dollars)	Inter- governmental Expenditures	(4)/(3) (per cent)	Per Capita Income Payments to Individuals
	(1)	(2)	(3)	(4)	(5)	(6)
A. New England	13.8	146	1,061	244	23.0	1,763
B. Middle East	10.0	370	3,698	1,035	28.0	1,892
C. S. East	18.3	578	3,157	871	27.6	1,127
D. S. West	21.0	253	1,205	334	27.7	1,422
E. Central	13.8	582	4,201	1,299	30.9	1,782
F. N. West	21.5	213	990	276	27.9	1,541
G. Far West	13.5	347	2,507	980	38.1	1,928
H. Total	14.8	2,485	16,815	5,044	30.0	1,644

Data for the Middle Eastern region (Del., D.C., Md., N.J., N.Y., Pa., and W. Va.) in columns 2, 3, and 4 do not include the District of Columbia. Other regions and the states they include are Southeast: Ala., Ark., Fla., Ga., Ky., La., Miss., N.C., S.C., Tenn., and Va.; Southwest: Ariz., N. Mex., Okla., and Tex.; Central: Ill., Ind., Iowa, Mich., Minn., Mo., Ohio, and Wisc.; Northwest: Colo., Ida., Kan., Mont., Nebr., N.D., S.D., Utah, and Wyo.; Far West: Calif., Nev., Ore., and Wash.

SOURCES: Columns 2, 3, and 4, *State Government Finances in 1952*; Column 6, *Survey of Current Business*, August 1954, p. 15. Note: Details may not add to totals because of rounding.

grants by all levels of government in that year. Three-quarters of the 1942 local grants were made by counties.

At least in respect to fiscal considerations cash grants by one nation to others, either directly or through United Nation channels, should be classed with grants to state and local governments. But we will defer comment on international grants to Chapter VIII.

### 4. Summary

Because of the changes that have taken place in the apportionment of substantive government functions among the various levels of government and because of the growth of federal and state aid programs, it is advisable to consider the financial requirements of all the levels of government together.

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Formerly states shared with the federal government the responsibility for expanding and equipping the army in time of war; what remains of state responsibility for the National Guard is unlikely again to involve state governments in war finance. And although state and local governments formerly engaged in extending credit to and guaranteeing the credit of privately owned undertakings, such activities are today almost exclusively federal functions.

Past financial difficulties have led to the imposition of various restrictions on the borrowing powers first of state and later of local governments.

With restrictions on state borrowing and on state aid to railroads and other enterprises incorporated in the constitutions of many states between the crisis of 1837 and the end of the Civil War, municipal aid programs and municipal borrowing expanded rapidly, 1866-73. Then the financial difficulties following the 1873 crisis led to a wave of restrictions on local borrowing.

In 1902 school and special district debts were less than 3 per cent of all local debts. By 1951 this ratio had increased to nearly one-third. These districts have important advantages from the point of view of the horizontal integration of local government functions. They are also means of getting around debt and tax limits and other legal restrictions on local governments. Some of the functions of these units are new; most of them have been taken over from other forms of local government, particularly municipalities, and from the states.

The relative importance of the financial requirements of school and special districts is likely to continue to increase. Consolidations decreased the number of school districts between 1932 and 1952, and this process too is likely to continue. In the course of time it may embrace special districts as well.

States have been assuming responsibility for providing a larger and larger share of the costs of local government, and the federal government has been doing so for both states and local units. In 1950 federal aid was 17.2 per cent of state nonfinancial receipts. Fiscal considerations have played an important part in aid programs—particularly the advantages of the federal government and the states over other units both as tax collectors and as borrowers. Another major set of considerations, more important in the case of federal than of state programs, relates to substantive policies: the promotion of standards of performance and uniform performance on the part of the units of government receiving the aid. The grant-in-aid device is an agreeable form for such supervision of local and of state performance to take, and in the case of federal aid a form that sometimes avoids the possibility of constitutional questions.

In general, federal aid is a larger proportion of state revenues in those parts of the country in which personal income per capita is low.

## CHAPTER VI

# Fiscal Flexibility and Countercyclical Financial Requirements

Since World War I and more especially since the 1929–33 recession there has been an increasing tendency to think that the federal government has some measure of responsibility for seeing that the employment of our manpower and material resources is kept at a high and fairly stable level.

We have noted that practically all of the net federal debt that is not war debt is attributable to efforts to discharge this responsibility during the 1930's. From 1929 to 1939 net federal debt increased by \$16 billion, and we may take this amount as a rough measure of depression-connected debt.

In this chapter we will first review federal fiscal policy during the years when the full-employment responsibility was emerging as a new government function, then examine the experiences of the 1930's and of three recessions that have occurred since that decade as they bear on the financial requirements which this function may entail.

Past experience seems to make it advisable to distinguish two sets of circumstances under which measures designed to maintain or raise the level of employment may occasion financial requirements. On the one hand there have been short, relatively minor recessions from high level employment that have commonly been followed without great delay by periods of substantial prosperity. On the other hand there have been periods of far more severe unemployment. We propose therefore to treat separately the experience of the 1930's and the recessions of 1945, 1949, and 1953–54. Whatever the future may have in store in the way of business recessions, we deem it advisable to deal separately with the experience of the 1930's and, despite the minor cyclical peak in 1937, to treat 1929–40 as a single period.

### 1. *On the Evolution of Fiscal Policy*

Before World War I federal fiscal policy reflected business cycles in a passive sense only. Table 30 shows average annual general receipts and surpluses by alternate periods of relatively good and relatively poor business. In the absence of a countercyclical policy we might expect both column 1 and column 2 to increase or decrease with general business activity. In seven out of the thirteen cases shown they do. And the other

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TABLE 30

Federal General Receipts and Surpluses by Selected Business Cycle  
Periods, 1867-1915  
(annual averages for fiscal years in millions of dollars)

Years of Relatively Good and Relatively Poor Business	Receipts (1)	Surpluses (2)	NBER Contraction Periods (3)
1867-73	395.6	77.5	June 1869-Dec. 1870
1874-79	283.3	18.8	Oct. 1873-Mar. 1879
1880-82	365.9	103.8	
1883-85	356.8	100.2	Mar. 1882-May 1885
1886-92	374.9	74.0	Mar. 1887-Apr. 1888
			July 1890-May 1891
1893-97	340.6	-25.4	Jan. 1893-June 1894
			Dec. 1895-June 1897
1898-1902	527.7	11.9	June 1899-Dec. 1900
1903-04	551.5	1.2	Sept. 1902-Aug. 1904
1905-07	601.7	32.8	
1908	601.8	-57.3	May 1907-June 1908
1909-10	639.9	-53.8	
1911	701.8	10.6	Jan. 1910-Jan. 1912
1912-13	708.4	1.2	
1914-15	716.3	-31.5	Jan. 1913-Dec. 1914

SOURCE: Columns 1 and 2 are from *Historical Statistics*, pp. 89, 97. Column 2 reports the excess of nonfinancial receipts over nonfinancial expenditures. General receipts in column 1 are less than total nonfinancial receipts by the amount of postal revenues. The left-hand dates in column 3 are upper cyclical turning points, the right-hand dates are the immediately following lower turning points. The dates are from A. F. Burns and W. C. Mitchell, *Measuring Business Cycles*, pp. 510-511. Thus three of the periods here classified as periods of relatively good business include minor recessions: 1867-73, 1886-92, and 1898-1902; and the period of relatively poor business, 1893-97, includes a minor upswing.

six can hardly be considered exceptions to the rule of a cyclically passive fiscal policy.

There was a persistent surplus in 1866-92, resulting in large part from the retention of customs duties at not far from the levels they had reached during the Civil War. The contracyclical drop in the average surplus from \$100 million in 1883-85 to \$74 million during the next seven years was mainly the result of steps taken to eliminate this surplus, particularly various increases in veterans' pensions in 1886-90 and the substitution in the McKinley Tariff Act (1890) of a subsidy on domestic sugar for the previous import duty.

In three of the cases shown the surplus declines when business activity declines, but not as a result of decreased receipts: 1903-04, 1908, and 1914-15. However, there is no reason to regard the expenditure increases in these three cases as reflecting a countercyclical policy. The chief factor in 1903-04 was the \$50 million purchase cost of the Panama Canal. And while in 1908 there were various increases in expenditures, particularly

those on the War and Navy Departments, on the Panama Canal and rivers and harbors, and on veterans' pensions, these must have been authorized by Congress by the midsummer of 1907. Again, the 1914-15 deficit reflected mainly a resumption in the marked upward trend in expenditures following a temporary check in 1909-12. But in this instance the revenue increase was small too, owing in part to a cut in customs receipts following the Underwood Tariff Act (1913).

While the cases of positive cyclical correlation help to support the proposition that before 1916 federal fiscal policy reflected business cycles in a passive sense only, the decrease in receipts from 1886-92 to 1893-97 by no means fully explains the \$100 million surplus drop. Increased pensions and other expenditures were factors here too. And while the average surplus increased simultaneously with an improvement in business conditions from 1893-97 to 1898-1902, dropped during the 1902-04 business contraction, and rose again with improved business in 1905-07, the 1898-1902 surplus increase reflects in large measure the prompt enactment of war taxes during the brief Spanish-American War and the continuation of most of these emergency levies until 1901. On the other hand if the relationship between surpluses and cycles seems to be negative, 1909-12, this appearance results at least in part from the failure of fiscal year-ends to coincide with cyclical turning points.

On the whole the attitude of the federal government toward the cycle throughout this period was one of *laissez faire* both with respect to the possibility of controlling or influencing the level of gross national product and with respect to measures for relieving or diminishing the suffering caused by business recessions and depressions. Indeed, in accord with this philosophy it was in general considered that provision of relief beyond what could come from private charity was the responsibility of local governments, and that relief should be given only to persons incapable of self-support and should be provided through poorhouses and orphan asylums rather than in the form of an "out-relief" dole. However, the Homestead Act, the veterans' programs, the Indian reservation policy since the Dawes Act (1887), and the extension of relief to victims of various major disasters might be cited as exceptions to this view of government functions.

Though the *laissez faire* philosophy dominated the attitudes of the federal government toward business cycles, the main components of the tax system were, paradoxically, of a regulatory nature. Thus the protective tariff together with the excises on alcoholic beverages and tobacco manufactures yielded almost nine-tenths of total general receipts in 1880 and were still yielding about this proportion in 1910.<sup>1</sup> But despite their regulatory character these revenue sources were quite compatible with one

<sup>1</sup> That is, nine-tenths of total nonfinancial receipts other than postal revenues.

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basic tenet of *laissez faire* fiscal policy—a balanced budget. And from 1890 to 1916 the gross federal debt was approximately stabilized at a little over \$1 billion.

During the period following the Civil War the idea of federal responsibility for taking steps to end bad times or assure good ones was injected into political campaigns in various ways. Both Greenback and Populist parties were concerned to remedy the hard times for farmers and urban wage earners that followed deflationary financial crises.<sup>2</sup> And it can be cogently argued that the real issue in the campaign of 1896 was whether the free coinage of silver in the ratio of 16 to 1 or retention of “sound money” together with a tariff that protected “the full dinner pail” was the more effective countercyclical policy.

With the somewhat buoyant business that characterized the early years of the twentieth century, agitation for countercyclical measures concentrated for a time on revising the banking and monetary system so that it would not be a cyclically disturbing influence. Then, a decade after the establishment of the Federal Reserve System, the Reserve Board in its Tenth Annual Report proposed, in part because “central bank practices associated with an effective international gold standard are now inoperative,” to substitute “current surveys of business conditions” for “the reserve ratio” as a guide to its credit policy.<sup>3</sup> Thus it adopted a countercyclical credit policy as a major objective.

During the 1920's the federal government took one other step that could be characterized as a move in the direction of a countercycle—it accepted some responsibility for helping farmers to dispose of agricultural surpluses. Thus when the 1929–33 recession began there were several more or less established policies that could be brought to bear on it: Federal Reserve policy, the veterans' benefits program, and Federal Farm Board loans on commodities to cooperatives and stabilization corporations. To these were quite promptly added an acceleration of work on federal construction projects and increased grants-in-aid of road construction to the states. Table 31 relates the countercyclical expenditure programs undertaken during the early 1930's to the gross national product. If the increases in federal expenditures in 1929–31 seem extremely small in relation to the

<sup>2</sup> “Two of the three Presidential candidates (1876–1884) nominated by the Greenback party represented labor rather than agriculture.” Earl D. Ross, “The Emergence of Agricultural Regionalism,” in *The Growth of the American Economy*, edited by Harold F. Williamson, pp. 385–86. According to Studenski and Krooss, *Financial History of the United States*, p. 221, the legislation for which Coxe's army pleaded in 1893 included bills to authorize the issue of “\$500 million of noninterest-bearing legal-tender notes by the federal government to finance construction of roads,” and by state and local governments of “noninterest-bearing bonds against the credit of the United States up to one-half of the assessed valuation of property, the proceeds to be spent for the relief of the unemployed.”

<sup>3</sup> Pp. 29–39.

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drop in gross national product, and if expenditures were contracted in 1932,<sup>4</sup> it must be remembered that belief in balancing the budget was still prevalent. Both major parties had balance-the-budget planks in their 1932 platforms. Probably it should be added, too, that three times during

TABLE 31  
Various Federal Expenditure Programs and Federal Credit, 1929-33  
(millions of dollars, calendar years)

	1929	1930	1931	1932	1933
A. Benefit payments to veterans <sup>a</sup>	562	603	1,577	781	554
B. Direct new construction expenditures	155	209	271	333	346
C. Construction grants-in-aid to states	80	104	235	111	286
D. Work relief payrolls	0	0	0	0	356
E. Total nonfinancial expenditures	3,700	3,800	5,050	4,100	5,050
F. Federal Farm Board cumulative advances less repayments, December 31	41	232 <sup>b</sup>	436 <sup>b</sup>	480 <sup>c</sup>	334 <sup>d</sup>
G. Other Farm Credit Administration loans outstanding, December 31	1,282	1,328	1,349	1,335	1,633
H. Reconstruction Finance Corporation portfolio of non-agricultural loans and securities	0	0	0	1,187	1,993
J. Gross national product	104,436	91,105	76,271	58,466	55,964

<sup>a</sup> Includes loans on the security of adjusted service certificates. Loans made on such security by the United States Government Life Insurance Fund are not included in line E.

<sup>b</sup> Includes a small amount of delinquent loans.

<sup>c</sup> As of May 26, 1933, when the Board and other agricultural credit agencies were consolidated into the Farm Credit Administration. Includes \$13.5 million of foreclosed loans on wheat, collateral for which had been donated to the Red Cross, and \$5 million of delinquent loans.

<sup>d</sup> A part of the decrease from May 26 (footnote c above) reflects losses. Total losses in 1935 were estimated at \$345 million (see Appendix A).

SOURCE: See Appendix A.

1930-32 temporary reversals of the downward trend of industrial production seem to give some ground for thinking "prosperity is just around the corner."

The federal countercyclical expenditure programs identified in Table 31 undoubtedly set a new precedent regarding federal responsibilities. But they did very little to provide unemployment relief. And as the recession continued and incomes and employment declined further and further, the need for relief and assistance grew far beyond what local and private agencies could provide. Indeed, with the decline in personal and national income the ability of such agencies to finance relief and assistance programs

<sup>4</sup> Federal payrolls other than work relief payrolls decreased from \$1,353 million in 1932 to \$1,232 million in 1933.

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was seriously curtailed. In September 1931 New York State established a Temporary Emergency Relief Administration and appropriated \$20 million<sup>5</sup> for state aid to localities for unemployment relief. Other states followed New York's example. But the problem had become too large even for the states, and in July 1932 Congress, after more than six months of consideration, passed a \$322 million appropriation bill (the Emergency Relief and Construction Act of 1932), which authorized the newly organized Reconstruction Finance Corporation to make \$300 million of loans to states and local governments for unemployment relief. Originally it had been expected that the RFC would extend financial assistance to agriculture, commerce, and industry by making loans to banks and other financial institutions; and it had been intended that the corporation should confine its operations to "fully and adequately secured" loans.<sup>6</sup> But the nearly \$300 million of loans extended to states under the enlarged RFC authority of the July 1932 act were later made forgiven debts. And in May 1933 Congress passed another Federal Emergency Relief Act which made unemployment relief definitely a federal function. Moreover, 1933 saw the inauguration of what turned out to be a \$12 billion work relief program.<sup>7</sup>

Other steps taken during 1933-39—they are considered in Section 2 below—broadened federal responsibilities both for promoting an increase in business activity when business is poor and for relieving the distress caused by a depression. But the objective of a balanced budget had not been entirely dropped. In March 1933, pursuant to a recommendation by President Roosevelt, Congress had passed an Economy Act providing for a 15 per cent cut in federal salaries and for restricting the payments of veterans' pensions.<sup>8</sup> Also the years 1931-36 were characterized by a general upward trend in tax rates and a resort to additional tax revenue sources. As a result the ratio of federal taxes to gross national product increased from 3.5 per cent in 1929 to 7.5 per cent in 1937.<sup>9</sup> And in 1935, despite

<sup>5</sup> Intended to last eight months. Another \$20 million was appropriated five months later.

<sup>6</sup> Cf. the first Quarterly Report, March 31, 1932, p. 2.

<sup>7</sup> The Civilian Conservation Corps was organized in April, the Civil Works Administration in November 1933. The Works Progress Administration was organized in May, the National Youth Administration in June 1935.

<sup>8</sup> Cf. footnote 4 above on federal payrolls. The cut proved to be temporary. See Table 31 on veterans' benefits. Veterans' benefits were reduced again in 1934. They were \$554 million in 1933; \$452 million in 1934.

<sup>9</sup> The numerators of these ratios are net tax accruals and miscellaneous receipts computed from Tables 8, 34, and 35 of the 1954 *National Income Supplement to the Survey of Current Business*. They equal total federal receipts minus contributions for social insurance on account of federal civilian employee retirement systems and government life insurance. The comparison presumably understates the increase, because of the "built-in flexibility" of the individual and corporation income taxes. In 1937, 14.3 per cent of the labor force was unemployed; in 1929, only 3.2 per cent.



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the fact that there were over ten million unemployed, work relief payrolls were cut 20 per cent below their 1934 level to \$611 million. But in January 1936 Congress passed a veterans' bonus bill over a presidential veto.

Although the deficit in nonfinancial transactions showed a decrease of about \$500 million in 1935,<sup>10</sup> on the whole federal fiscal policy for 1933-36 pushed in the direction of an increase in gross national product. But from 1936 to 1937 the push was markedly in the other direction. The nonfinancial transactions deficit dropped from a little under \$5 billion to less than \$50 million.<sup>11</sup> In substantial part this drop resulted from what the veterans' bonus added to the 1936 deficit. But tax increases were quite as important. Individual income, estate, and gift tax collections in 1937 were up some \$840 million over 1936; corporation income and related tax collections were up some \$680 million; and the receipts of social security taxes—which began in 1937—were about \$660 million.<sup>12</sup> Moreover, the Revenue Act of 1936 imposed an undistributed earnings tax on corporations. And whatever the theoretical merits of undistributed earnings as a tax base, the 1936 tax seems to have proven administratively to be very irritating.

In the third quarter of 1937 private domestic demand for gross national product was at an annual rate of \$86.1 billion. By the second quarter of 1938 it had shrunk to \$64.2 billion. Of this \$21.9 billion decline, the inventory increment accounted for \$8.1 billion, consumer expenditures for \$10.0 billion, and construction and producers' durables for \$4.8 billion.<sup>13</sup> In view of the large part played by inventories in the 1937-38 business contraction, and the fact that wholesale price increases in late 1936 and early 1937 contributed to profits reckoned on a FIFO basis, wholesale price decreases in late 1937 and early 1938 to FIFO basis losses, it is reasonable to suppose that the immediate cause of the contraction was a change in business psychology. And the magnitude of the adverse

<sup>10</sup> For this deficit see Table 5.

<sup>11</sup> In the national income and product accounts the drop is from \$3.5 billion to \$186 million. On this basis veterans' benefits, other than life insurance policy benefits, were \$1.9 billion in 1936; on the basis used in Table 5 (which includes the taking up of adjusted service certificates used as collateral for prior year loans by the United States Government Life Insurance Fund) they were \$2.5 billion. Also 1936 corporation income and profits tax collections in the Table 5 computation were slightly larger than the corresponding accruals in the national income and product account computations. Other factors common to 1935 and 1936 tend to make the Table 5 deficit larger than that shown in the national income and product accounts in both years.

<sup>12</sup> The Revenue Act of 1935 increased tax rates particularly for the upper brackets, although it did not go as far in taxing large incomes as President Roosevelt had recommended.

<sup>13</sup> See Harold Barger, *Outlay and Income in the United States 1921-38*, Table 11. The annual rate figures are seasonally adjusted. The inventory increment fell from plus \$5.95 billion to minus \$2.13 billion.

impulse from federal fiscal policy makes it seem probable that this adverse impulse touched off the change in psychology.<sup>14</sup>

The 1937-38 contraction made many converts to the view that economic stabilization should be a major—if not the main—objective of fiscal policy. And the widespread concern about a possible sharp postwar recession that prevailed immediately before V-J Day helped the passage of the Employment Act of 1946. But in February 1946, when the act was passed, it was clear that the recession was less sharp than the Office of War Mobilization and Reconversion had predicted, and the language used was qualified accordingly. Section 2 of the act declares it to be a federal policy to create and maintain “conditions under which there will be afforded useful employment opportunities . . . for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power,” this policy to be carried out in a manner consistent with the federal government’s “needs and obligations and other considerations of national policy” and “in a manner calculated to foster free competitive enterprise and the general welfare,” and to be carried out “with the assistance of industry, agriculture, labor, and state and local governments.” In effect, the act, having declared this policy, left its implementation largely to subsequent acts of Congress.

If one may draw a firm conclusion from this review of the process by which a government responsibility for economic stability has been developing, it would appear to be that a prolonged period of high employment would be likely to weaken the responsibility, a period of severe unemployment to push in the other direction. But the trend is toward broadening the responsibility and making it more categorical.

<sup>14</sup> It can be argued that Federal Reserve policy (and Treasury policy in “sterilizing” gold) helped to start the contraction; cf. Kenneth D. Roose, *The Economics of Recession and Revival*, p. 239; “The Federal Reserve action on excess reserves caused short-term governments to weaken and . . . thereby . . . the weakening of the securities markets to which business expectations are very sensitive.”

This seems an overstatement of the contractive influence of central banking and monetary policy. There were still \$750 million of excess member bank reserves in August 1937 (\$108 million of these in New York City); and the New York Federal Reserve Bank reduced its rediscount rate from one and one-half to one per cent on August 27. It is true that member bank borrowings increased during the first nine months of 1937, particularly in New York City, and that member bank holdings of governments were reduced from \$13.5 billion on December 31, 1936, to \$12.7 billion on June 30, 1937, and to \$12.4 billion on December 31 of that year. But member bank loan portfolios were increased from \$13.4 to \$14.3 billion during the first six months of 1937 and reporting member bank loans continued at the June 30 level until the last week in October. Also, while the open market rate on four to six months commercial paper in New York rose from the 1936 level of three-fourths per cent to one per cent in March 1937 and continued at that figure for nearly a year, the rates on ninety day loans and call loans on the Stock Exchange remained steady from June 1936 to the end of 1938. The tightness in the money market does not seem to have become serious enough to have been a major recession-precipitating factor.

## 2. *The Experience of the 1930's*

Since the idea of countering the cycle as a major federal policy objective was a new one developed in response to the severe and prolonged depression of the 1930's and one not yet wholeheartedly accepted, there was naturally a wide variety of measures adopted and programs undertaken to implement this objective, some more, some less apropos, some experimented with only to be dropped. Some of the measures and programs, too, entailed a substantial increase in the federal net debt, others meant an increase in the gross volume of federal obligations held by the public but had little or no effect on the net debt, and still others affected neither the net nor the gross debt significantly.

It will be convenient to consider the measures adopted and programs undertaken under the four following heads: (a) those which, though motivated in some way by the depression, were primarily of a noncyclical character; (b) those allegedly apropos measures and programs whose cyclical relevance or effectiveness is open to some question; (c) countercyclical nonfinancial expenditure programs; and (d) apropos measures and programs primarily of a financial nature.

Let us first simply note the primarily noncyclical measures and programs. Among these were the Norris-LaGuardia Act; the National Labor Relations Act; the Chandler amendments to the bankruptcy act; the holding-company death sentence; most of the provisions of the Securities Exchange Act of 1934; the Fair Labor Standards Act (which can be regarded as about all that survived of the NRA codes); several of the provisions of the Banking Acts of 1933 and 1935;<sup>15</sup> the Merchant Marine Act of 1936; the Old Age and Survivors Insurance system; and the special public assistance programs (old age assistance, aid to the blind, and aid to dependent children). Each of these was in some sense a product of the depression. And no doubt the inauguration of several of them made contributions to recovery and relief. But they do not constitute significant continuing measures against a major depression;<sup>16</sup> and, although four of them—the OASI system and the three public assistance programs—entail substantial additions to federal nonfinancial expenditures, no part of the \$16 billion debt increase can be attributed to this group of primarily noncyclical measures and programs. Indeed, were it not for the OASI system, the net debt increase might have been larger.

Next let us briefly consider three types of measures and programs

<sup>15</sup> Notably the prohibition of interest on demand deposits; vesting the control of interest on time deposits in the Board of Governors of the Federal Reserve System; requiring the separation of security affiliates from commercial and savings banks; permitting national banks to engage in branch banking to a limited extent; and a cumulative voting requirement for national banks.

<sup>16</sup> It can be argued that the OASI system slightly increases the built-in flexibility of federal fiscal operations.

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whose cyclical relevance or effectiveness is open to some question. None of these entailed any significant financial requirement.

In our résumé of the development of the view that the federal government has a responsibility for promoting full and stable employment and for relieving the distress caused by business depressions, we noted several proposed monetary measures that were advocated as means of increasing prices and employment. Since the effectiveness of these devices is open to some question, we venture to call them monetary nostrums. More than one monetary nostrum was tried during the 1930's. The most important was the devaluation of the dollar, which began with the national bank holiday of March 6, 1933.<sup>17</sup> The Swiss franc rate,<sup>18</sup> which had been 19.4 cents in February and March 1933, rose until in February 1934, after the United States Treasury had fixed the mint price of gold at \$35 an ounce,<sup>19</sup> it was 31.7 cents. The major part of this increase took place before the Warren plan to raise the commodity price level by raising the price of gold went into operation on October 25, 1933; in September the franc rate had been 28.7 cents. And while the Bureau of Labor Statistics wholesale price index rose from 59.8 in February to 71.2 in October, it dipped slightly in November and December despite increasing the gold price to \$35, and in January when the Warren plan was terminated it had risen only to 72.2.

We will not stop to comment on the other monetary nostrums that were tried during the 1930's.<sup>20</sup> Devaluation was not only a monetary device, but a part of a quite general reaction to the severe prolonged depression, a reaction in the direction of autarchy and economic nationalism.<sup>21</sup> The other main steps taken in this direction by the United States were the Fordney-McCumber Tariff Act (1930), and the authorizations to the President under the National Industrial Recovery Act and the Agricultural Adjustment Act to impose quotas and additional duties. Because autarchic moves were quite general they were not very effective counter-cyclically. Two major steps that contributed to a reversal of the direction of the external economic policies of the United States were the Trade Agreements Act (1934), and the Tripartite Accord (September 25, 1936) entered into by Great Britain, France, and the United States to stabilize exchange rates.

<sup>17</sup> Most of the commercial banks in the country had already been closed at this date through state "holidays."

<sup>18</sup> The Swiss franc is used here since it was one of the currencies that was not devalued until after 1934.

<sup>19</sup> Under the provisions of the Gold Reserve Act, January 31, 1934. This represented almost a 70 per cent increase over the preholiday price.

<sup>20</sup> The silver purchase program and several attempts to legislate an increase in the quantity of paper money.

<sup>21</sup> So was the silver purchase program, for it discriminated in favor of domestic production.

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Another type of measure that it seems fair to characterize as allegedly but not clearly a very effective part of an antidepression program was the competition-restricting industry code. Such codes were adopted under the provisions of the National Industrial Recovery Act (1933), and, in the case of some industries, under the Agricultural Adjustment Act (1933). Possibly they had some part in checking the downward price and wage spiral, and it has been suggested that efforts to make purchases before the codes took effect, many of them in the late summer and the fall of 1933, contributed to business revival.<sup>22</sup> But their contribution to recovery does not seem to have been a major one, and they were terminated by a decision of the Supreme Court.<sup>23</sup>

So much for the measures of questionable cyclical relevance. Next as to the nonfinancial countercyclical expenditure programs. This type of policy during the 1930's was a distinctly vacillating one. Even under the Democratic administration there continued to be two strongly opposed schools of thought, the budget-balancing school and the fiscal countercycle school. As a result the countercyclical stimulus was interrupted in 1935 and again more markedly in 1937. Further, much of the time while an expanded expenditure stimulus was being applied with one hand, the other hand was simultaneously effecting expenditure cuts. This inevitably made it necessary to draw a sharp legal line between expenditures on functions subject to the cuts (the "normal functions") and emergency expenditures for recovery and relief, so that no made-work project could be approved and allocated funds to perform a normal function.<sup>24</sup>

Despite their vacillating nature such emergency expenditures were undoubtedly of substantial importance. They served both to provide relief by contributing to disposable personal income and to aid recovery by augmenting aggregate demand. Table 32 summarizes the program expenditures that helped to provide relief. Since the level of such expenditures was substantially higher during the second half of the decade of the 1930's a separate column is devoted to the averages for these five years. But even in the 1935-39 column the ratio of line F to the \$16.8 decrease shown on line G is only about 1 to 5; the corresponding ratio for the decade is 1 to 10.3. However, the purchasing power of the consumer's dollar averaged nearly 20 per cent above the 1929 level during the 1930's,

<sup>22</sup> The declines in prices, wages, and production were checked before any code went into effect. The Federal Reserve index of industrial production (seasonally adjusted) rose from 59 in March to 100 in July, then fluctuated between 71 and 91 for more than a year. The Bureau of Labor Statistics index of wholesale prices of nonfarm, nonfood commodities started a sharp upward movement in May; average hourly earnings of manufacturing employees did likewise in July.

<sup>23</sup> *Schechter v. United States*, 295 U.S. 495 (June 1935).

<sup>24</sup> But there is a presumption that the normal functions subject to the expenditure cuts were socially more important than the functions performed by the made-work projects.

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TABLE 32

Federal Countercyclical Programs Related to Personal Income and Farm Income, 1929-39  
(millions of dollars per year)

	1929	1930-39 Average	1935-39 Average
A. Federal direct relief	0	10	21
B. Public assistance grants-in-aid	8	412 <sup>a</sup>	617
C. Unemployment compensation benefits	0	83	166
D. Work relief payrolls	0	953	1,682
E. Veterans' pensions, etc. <sup>b</sup>	536	766	776
F. Total above	544	2,224	3,262
G. Disposable personal income	83,120	61,628	66,336
H. Government payments to farmers	0	309	573
J. Federal Farm Board loan losses	0	35	0
K. Net cash income to persons on farms from farming	4,304	2,711	3,293

<sup>a</sup> Includes \$280 million of RFC loans to states, 1923-33, which were later forgiven, grants for vocational education and rehabilitation, for maternal and child health and welfare, for old age assistance, for aid to dependent children, and for aid to the blind, and FERA grants for general relief.

<sup>b</sup> Pension, disability, and retirement payments and adjusted compensation benefits.

SOURCE: See Appendix A.

and a fair comparison of relief expenditure to income decline should take account of this fact. A fair comparison, too, should take account of the growth of population. The following computation makes a rough allowance both for price changes and for population growth:

	1930-39 Average	1935-39 Average
a. Consumer expenditure price index <sup>a</sup>	80.4	79.7
b. Population (in millions) <sup>b</sup>	126.9	129.0
c. Line G/(line a × line b)	\$603 <sup>c</sup>	\$644 <sup>c</sup>
d. (Line G - line F)/(line a × line b)	\$581 <sup>c</sup>	\$612 <sup>c</sup>

<sup>a</sup> Index in Table 41, 1954 *National Income Supplement to the Survey of Current Business*, converted to a 1929 base.

<sup>b</sup> Continental United States.

<sup>c</sup> 1929 dollars.

Per capita disposable income in 1929 was \$682. Line c indicates that for the following decade it averaged the equivalent of 603 1929 dollars, and that during 1935-39 it averaged the equivalent of 644 of these dollars, or about 5.6 per cent below the 1929 level. Without the transfer payment (and work relief) items summarized on line F of Table 32, per capita disposable income would have been \$677 in 1929, 581 1929 dollars per year during 1930-39; and 612 1929 dollars per year during 1935-39 or 9.6 per cent below the 1929 level. The transfer (and work relief) items

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seem to have been large enough in 1935-39 to offset about half the average per capita income decline.<sup>25</sup> The 1935-39 level of per capita farm income, corrected for price changes, was about 4 per cent below that of 1929. Without government transfer payments it might have been something like 20 per cent down from the 1929 level.

TABLE 33  
Federal Countercyclical Programs Related to Aggregate Demand, 1929-39  
(millions of dollars)

	1929	1930-39 Average	1935-39 Average
A. Work relief payrolls	0	953	1,682
B. New construction <sup>a</sup>	155	414	511
C. Purchases of silver <sup>b</sup>	0	28	43
D. Other federal GNP expenditures	1,156	1,823	2,312
E. Non-public-assistance grants-in-aid	109	355	375
F. Total above	1,420	3,575	4,923
G. Total GNP expenditures	104,436	76,913	84,469

<sup>a</sup> Excludes relief work construction.

<sup>b</sup> Domestic only.

SOURCE: See Appendix A.

The WPA and other work relief programs—Civilian Conservation Corps, Civil Works Administration, and National Youth Administration—accounted for a very substantial part of the relief expenditures shown in Table 32. They also accounted for a substantial part of federal demand for GNP. Table 33 relates the components of this demand, and federal grants-in-aid that added to state and local demand for GNP in 1930-39, to 1929 levels. Line F in Table 33 may be taken as a rough measure of the total direct federal contribution to aggregate demand. There is no very satisfactory way of appraising quantitatively the significance of line F for recovery. However, we may note that the average annual contribution to aggregate demand in 1930-34 was \$2.2 billion; average GNP was \$69.4

<sup>25</sup> This comparison of declines with and without the expenditure programs takes no account of any possible "multiplier effect." Nor does the farm incomes comparison that follows.

Corresponding computations for farm income are as follows:

	1929	1930-39 Average	1935-39 Average
a. Price index <sup>a</sup>	100	77.5	77.5
b. Population (in millions)	30.2	31.1	30.9
c. Line K/(line a × line b)	\$142.5	\$112 <sup>b</sup>	\$137 <sup>b</sup>
d. (Line K - line H - line J)/(line a × line b)	\$142.5	\$98.2 <sup>b</sup>	\$113 <sup>b</sup>

<sup>a</sup> Prices paid by farmers for family living expense items, *Historical Statistics*, E-99, converted to a 1929 base.

<sup>b</sup> 1929 dollars.

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billion. Thus from 1930-34 to 1935-39 the annual level of the GNP increased by \$15.1 billion, and the increment in the direct federal contribution accounted for \$2.7 billion or roughly 18 per cent of this increase.

It remains to consider recovery, relief, and economic stabilization measures and programs of a financial nature. Three general types may be distinguished: (a) central banking measures, (b) private credit underwriting measures, and (c) direct federal lending. Only in the case of the third type is a substantial financial requirement involved, and this requirement relates to gross rather than net debt. During the decade of the 1930's the federal loan portfolio increased by \$9 billion.<sup>26</sup>

The principal central banking measures adopted during the 1930's were as follows: giving the Board of Governors of the Federal Reserve System limited discretionary power to vary member bank reserve requirements; giving this Board discretionary power to vary margin requirements for margin trading on the stock exchanges; and giving the System's Open Market Committee power to regulate Federal Reserve Bank open market operations. There is no reason to suppose these measures contributed anything significant to the objective of recovery, still less to that of relief. Rather what they did provide was the basis for a strengthened countercyclical central bank credit policy whose effectiveness was mainly pertinent to other stages of the cycle.

The principal federal credit underwriting programs inaugurated during the 1930's were: insurance of demand and time deposits in most commercial banks and mutual savings banks; insurance of most of the purchasable shares (and credited earnings) of savings and loan associations; insurance of important types of home mortgage loans and loans to finance home repairs and improvements. If in this connection we stretch the subject of the chapter, we may add to the list the more recent programs of the Veterans' Administration for guaranteeing loans to veterans for purchase or construction of homes and purchase of farms or business property.

Since 1950 deposit insurance has covered deposits up to \$10,000. As of the end of 1954 there were \$212 billion demand and time deposits in banks in the United States; 53 per cent of these were insured by the Federal Deposit Insurance Corporation. At this time also the private savings capital of all savings and loan associations in the United States totaled \$27.3 billion; of this amount practically 90 per cent was invested in institutions insured by the Federal Savings and Loan Insurance Corporation. The extent of other government underwriting programs for private credit is shown in Table 34.

<sup>26</sup> See Table 35. The spread between gross and net debt is affected by other factors as well as the loan portfolio, particularly the balance in the general fund and federal obligations held by federal agencies.



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The FDIC began operating in 1934, probably not soon enough to have contributed significantly to the restoration of confidence in the nation's banking system that followed the bank holiday. The Federal Housing Administration loan insurance programs may well have done something to augment the volume of residential construction in the later 1930's.<sup>27</sup> Also, in the future FHA terms may be adjusted from time to

TABLE 34  
Loans Guaranteed or Insured by Federal Agencies, 1939 and 1954

	December 31, 1939	June 30, 1954
UNDERWRITTEN LOANS OUTSTANDING		
	(billions of dollars)	
A. Housing and home loans	2.14	37.6
B. Farm credit	0.0	2.2
C. Other loans	0.5	0.9
D. Total federally underwritten loans	2.6	40.7
RATIO OF UNDERWRITTEN LOANS TO ALL OUTSTANDINGS		
	(per cent)	
E. Mortgages on 1- to 4-family nonfarm residential properties	11	42
F. Farm credit	0	13

SOURCE: See Appendix A.

time so as to provide a countercyclical credit policy.<sup>28</sup> But the principal countercyclical significance of all these credit underwriting programs surely is not in providing relief from a depression or in promoting recovery. Rather it is that they serve to strengthen important parts of the economy's financial structure, so that these parts will not again accelerate a downswing as they did during 1929-33.

In discussing federal lending programs it will be convenient to stretch the subject of this chapter somewhat further, considering not only those inaugurated during the 1930's but also those started earlier and those started since.

Although with negligible exceptions state and local governments had long before that ceased to engage in credit operations, prior to World War I there had been no direct federal activities in the credit field since the Second Bank of the United States. A major credit program was initiated

<sup>27</sup> Cf. Leo Grebler, David Blank, and Louis Winnick, *Capital Formation in Residential Real Estate*, pp. 148-49.

<sup>28</sup> The home mortgage insurance system established under the National Housing Act (1934), was designed to operate with countercyclical variations in insurance premium rates. And provisions for varying down payments and amortization periods have since been added. But there is no real provision for the cyclical coordination of FHA policies with those of the Federal Reserve, or of Veterans' Administration policies with either.

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by the Federal Farm Loan Act (1916), which provided for the organization of federal and joint-stock land banks. Then when the United States entered the war it promptly began to help finance the war activities of its allies by extending them loans, though viewed in retrospect these loans are better

TABLE 35  
Federal Credit at Selected Dates, 1920-53  
(millions of dollars)

	June 30, 1920	December 31, 1929	December 31, 1939	December 31, 1953
A. Farm credit	350 <sup>a</sup>	1,296	3,620	6,811
B. Housing loans	0	0	2,540	2,930
C. Obligations of financial institutions	0 <sup>b</sup>	0	1,185	985
D. State and local government obligations	0	0	455	645
E. Railroad obligations	445 <sup>b</sup>	60	500	79
F. Life insurance funds loans to veterans	0	270	152	208 <sup>c</sup>
G. Investments in IMF, IBRD, and Exchange Stabilization Fund	0	0	2,000	3,585
H. Recent loans to foreign governments	0	0	0	11,883 <sup>d</sup>
J. Other loans and securities	119 <sup>b</sup>	80	248	1,070
K. Total above	914	1,706	10,700	28,196
L. World War I obligations of foreign governments	10,092	11,532 <sup>e</sup>	12,661 <sup>e</sup>	12,553 <sup>f</sup>

<sup>a</sup> December 31.

<sup>b</sup> Line J reports War Finance Corporation loans as of November 15, 1920. About one-half of the \$119 million were loans to railroads, and about one-third were loans to banks and exporters to finance agricultural and other exports. By June 30, 1921, railroad obligations as reported in line E had increased to \$680 million.

<sup>c</sup> Life insurance policy loans only.

<sup>d</sup> Includes loans made by the Export-Import Bank and RFC prior to V-J Day.

<sup>e</sup> Excludes accrued interest.

<sup>f</sup> As of June 30, 1954, excludes accrued interest, but includes \$91.5 million debt of Federal Republic of Germany under agreement of February 27, 1953.

SOURCE: See Appendix A.

called grants. And by the Act of April 5, 1918, the War Finance Corporation was established. While it was initially expected the WFC would lend chiefly to banks, the corporation made direct industrial loans, and after the war and before the establishment of federal intermediate credit banks under the Agricultural Credits Act (1923), it was for a time primarily an agricultural credit agency.

On June 30, 1920, the loans and securities held by the federal government and its agencies included the foreign government obligations, the

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portfolios of the WFC and the land banks, loans extended to railroads during federal control and in connection with their return to private operation, and securities acquired in exchange for war surplus properties (see Table 35). During the 1920's farm credit increased by some 270 per cent, and a new type of credit appeared, loans to veterans by the United States Life Insurance Fund. The other portfolio items, being war-connected, declined.

If we do not count Federal Farm Board loans, the expansion of federal credit activities during the 1930's began with the establishment of the Reconstruction Finance Corporation by the Act of January 22, 1932, of twelve Regional Agricultural Credit Corporations under the Emergency Relief and Construction Act (1932), and of twelve federal home loan banks under the Act of July 22, 1932. We have noted that the original idea that the RFC should make only fully and adequately secured loans was shortly modified. What could be done at the time to promote business recovery by extending loans on a strictly commercial basis was extremely limited. At the end of February 1933 the home loan banks (which were still operating on this basis) held only \$9 million of home mortgages. However, during the three years ending December 31, 1932, federal credit more than doubled. Then during 1933 it increased by \$1.2 billion and during 1934 by \$4.1 billion.<sup>29</sup> A major part of this expansion reflected the temporary substitution of federal for private credit at strategic points in order to bolster up the whole credit structure of the economy. And striking as these figures are, they do not include what was by far the largest and most important operation of this sort, the very temporary substitution of the

<sup>29</sup> Credit figures for these three year-ends are as follows:

	12/31/32	12/31/33	12/31/34
A. Loans and preferred stock held by government corporations and credit agencies, n.e.c.	3,192	4,174	8,202
B. Loans held by U.S. Life Insurance Fund	477	529	561
C. State and local government securities held by federal agencies	14	90	250
D. Total credit above	3,683	4,793	9,013

On line A see R. J. Saulnier, Harold G. Halcrow, and Neil H. Jacoby, *Federal Lending and Loan Insurance*, Tables A-1, A-4, A-5, A-6, A-8, and A-10. Line A of the above table includes loans by Federal Land Banks, banks for cooperatives, intermediate credit banks, and Federal Home Loan Banks. It excludes Veterans' Administration loans and loans to state and local governments that are components of the Table A-1 total and loans by Federal Reserve Banks shown in Table A-5. On line B of the above table, see Administrator of Veterans' Affairs, 1935 *Annual Report*, p. 90. On line C see Secretary of the Treasury, 1945 *Annual Report*, p. 697 (average of two June 30 figures).

Lines B and C have the effect of adjusting the definition of total federal credit (line D) to suit our present purpose. The line B adjustment makes it inclusive of Adjusted Service Certificate loans; the line C adjustment excludes the \$300 million RFC loans to states that subsequently became grants-in-aid.

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government's credit for that of all the banks of the country in 1933 during the brief interval following the holiday in which they were in process of being reopened. But the figures do include two large-scale credit substitutions, the taking over of distress home and farm mortgages at a loss by two corporations organized especially for the purpose, the Home Owners Loan Corporation and the Federal Farm Mortgage Corporation. Smaller in volume but at least of equal strategic importance were the loans to banks by the RFC and the Federal Deposit Insurance Corporation and the acquisitions of bank preferred stock and the loans to other financial institutions by the RFC.

In addition to this temporary distress refinancing, federal credit was expanded during the 1930's to finance purchases of new national product. Thus there were emergency loans by the Public Works Administration and, especially after 1937, loans by a number of corporations and agencies organized to promote particular programs.<sup>30</sup>

During World War II federal credit at first increased, then markedly declined. Other sectors of our economy, having substantial cash surpluses after 1941, paid off debts and added to their holdings of cash, governments, and private securities. Also, after the passage of the Lend-Lease Act, March 11, 1941, financial assistance was extended to allied governments by purchasing goods for them—the nature of the obligations involved not being definitely fixed at the time—rather than through loans as in World War I.

By June 30, 1945, federal loans to foreign governments, other than the World War I obligations on line L of Table 35, totaled only about \$800 million. Thus there has been an expansion of over \$11 billion in such loans since that date and up to the end of 1953.<sup>31</sup> Most of the rest of the increase in external federal credit after V-J Day reflects capital subscriptions to two international financial institutions, the International Monetary Fund and the International Bank for Reconstruction and Development. However, a substantial part of the IMF subscription, \$1.8 billion, was provided by reducing investment in the Exchange Stabilization Fund, the main function of which—to discharge American obligations under the Tripartite Accord of 1936—in effect passed on to the IMF.

The increases in internal credit from V-J Day to the end of 1953 were small by comparison. The chief expansions were in loans to finance farms and homes (including veterans' homes and farms) and in other loans to veterans.

<sup>30</sup> The following list of lending agencies will serve to indicate the variety of programs so promoted: Rural Electrification Administration, Federal National Mortgage Association, United States Housing Authority, Electric Home and Farm Authority, Farm Security Administration, Commodity Credit Corporation, Export-Import Bank, RFC Mortgage Corporation, United States Maritime Commission.

<sup>31</sup> See Chapter VIII for a comparison between loans and grants during this period.

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On the basis of the above examination of the experience of the 1930's it may be in order to speculate briefly on some of the developments that might take place if perchance our economy were again to undergo a severe recession and depression lasting, say, as long as three years.

If the depression were sufficiently severe, it might well be the occasion for adopting various measures and programs that were not cyclically particularly relevant. And there would probably be allegedly pertinent measures and programs whose actual effectiveness was small, among them one or more monetary nostrums. Again the process of recession would be likely to disclose additional weak parts of our economy's credit structure, with the result that measures would be adopted to strengthen these parts. Also steps might be taken toward a stronger, better coordinated countercyclical credit policy, and other countercyclical measures of a regulatory nature might be adopted. Quite possibly none of these developments would involve any extra net financial requirement; none would be likely to except perhaps some cyclically irrelevant measure or program.

If the process of recession disclosed additional weak spots in our credit structure, there might again be need for large-scale substitutions of federal for private credit. And in any case large federal lending programs might be inaugurated to finance and to encourage expanded purchases of our national product. It would be strange indeed, with the growth of our economy since the 1930's, the extent to which the federal government has come to be involved in making loans, and the higher level of prices prevailing in recent years,<sup>32</sup> if depression lending did not lead to a step-up of gross in relation to net debt of a number of times \$9 billion.

In general the measures that contribute most to dealing with a severe depression, once there has been a sufficient business contraction to involve one, are measures that require to be financed either in the grosser sense of borrowing to finance lending or in the net sense of financing increased GNP expenditures, state and local grants-in-aid, and transfer payments to individuals.<sup>33</sup> Should there be another severe depression, it is reasonable to suppose that there would be a fuller and more general recognition of federal responsibility for promoting recovery and providing relief and that the balance-the-budget-during-depression school of thought would have somewhat less of a following, so that expenditure programs would get under way less tardily and be maintained more consistently, and so that they would be larger relative to the size of the economy and to the degree of business contraction. One might expect too, that federal taxes would

<sup>32</sup> The implicit deflator of the GNP for 1954 is 71 per cent above that for 1929.

<sup>33</sup> It could be argued that it would theoretically be possible to stimulate recovery and relieve distress without incurring a deficit, provided there is a sufficiently large expansion of nonfinancial expenditures and receipts. But it will probably be conceded that the expansion would have to be so large as to make such a government budget most unlikely.

not be stepped up as they were during the 1930's; rather yields would decrease and rates might be reduced. Possibly too there would be experimentation with incentive tax concessions or subsidies to encourage increases in private components of aggregate demand. These considerations—and the higher level of prices—suggest that, if our economy were again to undergo a marked recession and depression, even though it were shorter and far less severe than was the case in the 1930's, net borrowing to the extent of quite a number of times \$16 billion might easily be entailed.

These speculations regarding possible developments in the event of another marked business contraction imply a premise that should be made explicit. We assume that the changes in the economy of the United States and of the world that have come about since 1929—both planned and unplanned—do not preclude such a contraction. It would mean somewhat of a digression to argue that this is so; hence it is merely stated as a premise. One who rejects the premise will of course reject the speculations too.

### 3. *More Recent Minor Recession Experiences*

Of the four main types of measures and programs distinguished in the preceding section there is one we certainly need not consider in connection with minor recessions: new programs that are primarily of a noncyclical character. Nor is there much reason to expect a minor recession in the United States to stimulate recourse to monetary nostrums, general competition-restricting arrangements, or autarchic measures under present conditions.<sup>34</sup> But what is often called monetary policy—accurately speaking, what is usually meant is mostly central bank credit policy—was an important part of federal policy toward the 1953–54 recession. And if definite countercyclical movements in Federal Reserve rediscount rates, the volume of Federal Reserve credit outstanding, member bank reserve requirements, and margin requirements did not characterize the twelve months following V-J Day, and if rediscount rates were maintained and Federal Reserve credit was contracted during the 1949 recession, there were special postwar circumstances to explain these facts.<sup>35</sup>

Table 36 summarizes the main other phases of federal policy and federal operations pertinent to recent recessions, except for policies and operations relating to agriculture. During 1945–46, despite the drop in distributive share receipts, disposable income was maintained chiefly as a result of increases in veterans' and unemployment compensation benefit payments. And with the decrease in corporate profits tax accruals, profits after tax averaged about the same in the first half of 1946 as in the second

<sup>34</sup> Of course the 1949 recession did precipitate devaluation of the pound sterling and various other currencies.

<sup>35</sup> Rediscount rates were raised in April–May 1946. There were reductions in member bank reserve requirements and in margin requirements during 1949.

TABLE 36

## Countercyclical Fiscal Influences in Recent Minor Recessions, 1945-54

	II 1945	I 1946	II 1946	III 1948	IV 1948	III 1949	IV 1949	I 1953	II 1953	III 1954	II 1954	III 1954
	(QUARTERLY TOTALS AT ANNUAL RATES IN BILLIONS OF DOLLARS)											
A. Personal receipts of distributive shares <sup>a</sup>	165.2	153.7	159.4	196.7	197.6	188.2	188.1	263.2	265.9	264.6	265.1	265.1
B. Unemployment compensation benefits	.1	2.9	3.1	1.2	1.1	2.3	2.1	1.3	1.1	2.6	2.3	2.3
C. Other government transfer payments	4.1	9.1	8.0	9.2	8.8	9.6	9.7	11.3	11.5	12.2	12.4	12.4
D. Federal personal taxes	19.8	16.2	17.0	18.0	18.2	16.2	16.1	32.3	32.8	29.2	29.2	29.2
E. Fiscal influences identified above = B + C - D	-15.6	-4.2	-5.9	-7.6	-8.3	-4.3	-4.3	-19.7	-20.2	-14.4	-14.5	-14.5
F. Disposable personal income	152.2	152.8	157.0	192.1	192.4	186.9	186.7	245.4	247.7	252.9	253.2	253.2
G. Corporate profits tax liability	13.0	6.0	7.8	13.1	12.0	10.5	9.9	24.4	25.0	17.0	16.8	16.8
H. Corporate profits after tax	10.1	8.8	11.5	21.2	19.5	15.9	15.0	20.3	20.8	17.5	17.4	17.4
J. Net effect on federal financial requirements above <sup>b</sup>	-28.6	-10.2	-13.7	-20.7	-20.3	-14.8	-14.2	-44.1	-45.2	-31.4	-31.3	-31.3
K. Loans outstanding, government corporations and credit agencies	5.8	5.3	5.4	10.6	11.7	11.7	12.7	18.1	17.6	18.5	18.6	18.6
L. Government underwritten housing loans outstanding <sup>c</sup>	4.2	4.7	4.8	11.9	12.5	13.3	15.0	26.1	26.7	29.7	30.5	30.5

<sup>a</sup> Distributive shares included in personal income.

<sup>b</sup> Line E minus line G.

<sup>c</sup> Mortgage loans on nonfarm 1- to 4-family properties.

Notes: Line A and lines D through J are adjusted for seasonal variation; lines B, K, and L are not. Line C was computed by subtracting line B from the seasonally adjusted total of all government transfer payments. Line H includes a relatively small amount of state taxes, about 5 per cent of the total.

SOURCE: See Appendix A.

## COUNTERCYCLICAL FINANCIAL REQUIREMENTS

quarter of 1945. Government credit and government underwritten credit were not important cyclical influences in this period.

During the 1949 recession the annual rate of distributive share receipts decreased by about \$9 billion. Roughly half of this decrease was offset by the three fiscal influences identified on lines B, C, and D. And of the cyclical decrease of over \$9 billion in the annual rate of corporate profits (before tax) the tax accrual decrease absorbed about one-third. There were minor increases during this recession in government credit and government underwritten credit. The nonfinancial surplus of the federal government dropped from \$9.9 billion in 1948 to \$0.5 billion in 1949.

Between the second quarter of 1953 and the second quarter of 1954 distributive share receipts declined only slightly. The decrease in personal taxes during this interval and the increases in unemployment compensation benefits and miscellaneous federal transfer payments were sufficient to boost the annual rate of disposable income by some \$5 billion. The annual rate for corporate profits after tax declined nearly 16 per cent despite the sharp cut in profits tax accruals. There was a small increase in federal credit, a significant increase in government underwritten loans.

Line J indicates a substantial increase in federal financial requirements between the second quarter of 1953 and that of 1954. But there must have been other developments that helped to offset those shown in the table. The federal nonfinancial deficit for the year ending June 30, 1954, was only \$1.5 billion; the deficit for the third quarter of 1954 was only \$0.5 billion above that a year earlier.<sup>36</sup>

It is convenient to deal separately with the federal policies and operations affecting agriculture because it seems desirable to use annual data to portray them and because the year-to-year changes are not purely cyclical (see Table 37). Net income of farm operators dropped sharply from the 1948 level during 1949, recovered somewhat during 1950-51, and then contracted during the three years 1952-54. Three fiscal influences on net operator income are identified in the table: government payments, the increment in inventories and the loan portfolio of the Commodity Credit Corporation, and property taxes. Although these taxes are levied by state and local governments, especially the latter, it seems wise to

<sup>36</sup> These figures are derived from the quarterly federal sources and uses statement, 1953-55, compiled as a part of the National Bureau's study of Postwar Capital Markets. An annual figure and a year-ago comparison are given here because there is a marked seasonal variation in the federal nonfinancial deficit for which no seasonal adjustment is yet available.

Quite possibly some part of the \$2 billion financial requirement indicated by these figures is due to factors other than the 1953-54 recession. While the nonfinancial transactions account was in balance for calendar 1952, if due allowance could be made for seasonal variation, it might show a deficit even before the recession began. The adjusted National Income and Product Account for the federal government does show one for the first half of 1953.



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TABLE 37  
Fiscal Influences on Net Income of Farm Operators since World War II  
(billions of dollars)

	1945	1946	1947	1948	1949	1950	1951	1952	1953	1954
A. Gross cash income from marketings <sup>a</sup>	22.1	25.3	30.0	30.5	28.1	28.6	33.1	33.0	31.6	30.2
B. Government payments	0.74	0.77	0.31	0.26	0.19	0.28	0.29	0.28	0.21	0.26
C. CCC net contribution <sup>b</sup>	-0.67	-0.55	0.15	1.00	1.38	-0.57	-0.57	0.44	2.76	1.12
D. Federal fiscal influence identified above <sup>c</sup>	0.07	0.22	0.46	1.26	1.57	-0.29	-0.28	0.72	2.97	2.38
E. Property taxes	0.55	0.62	0.71	0.77	0.82	0.92	0.99	1.05	1.08	1.11
F. Net fiscal influence identified above <sup>d</sup>	-0.48	-0.40	-0.25	0.49	0.75	-1.21	-1.27	-0.33	1.89	0.25
G. Net income of farm operators	11.8	13.9	14.5	16.7	12.7	13.3	15.8	14.3	12.5	12.3

<sup>a</sup> Includes government payments and CCC contribution.

<sup>b</sup> Increment in inventories plus increment in loans outstanding.

<sup>c</sup> B plus C.

<sup>d</sup> D minus E.

NOTE: All figures refer to calendar years. Data for lines A, B, E, and G are from the Agricultural Marketing Service Farm Income Situation. Data for line C are from CCC balance sheets filed with the Treasury.

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include them in the table, because they have often been cyclically perverse. The combined fiscal influence reflected in line F made some contribution to net operator income in 1949, and a substantial one in 1953.

The significance of the fiscal operations covered by the two tables for federal capital requirements can perhaps be best appraised in terms of the increments shown. The maximum cyclical increments in the annual rates on line J of Table 36 are: for 1945-46, \$18.4 billion; for 1948-49, \$6.5 billion; for 1953-54, \$13.9 billion. In Table 37 line D increases by \$1.11 billion from 1947 to 1949 and by \$3.25 billion from 1951 to 1953.

These figures suggest that even a minor recession might easily entail net borrowing of the order of magnitude of \$16 billion, if at the outset nonfinancial receipts did not exceed nonfinancial expenditures. Particularly is this so in view of the possibility that federal fiscal operations in time may well become somewhat more markedly flexible countercyclically not only in a built-in but also in a managed sense than in the three postwar recessions we have been considering. And while conceivably the federal government might at the outset of a recession be enjoying a substantial nonfinancial surplus, as in 1948 (see Table 5), we should note also that the cash surpluses of the social insurance funds may be smaller in the future than they were during the 1940's.

Assuming net borrowing during a business contraction, either major or minor, the question arises, Is the resulting additional net debt likely to be paid off when the depression is over? Some attention is given to this question in Chapter VIII.

### 4. *Summary*

Responsibility for seeing that the economy operates at a somewhat stable, high employment level seems to have been becoming a recognized function of the federal government. Recognition of this function has tended to grow during periods of depressed business; interest in it to weaken during periods of prolonged prosperity.

The great depression of the 1930's stimulated the federal government to take a wide variety of steps. Among these were measures and programs that, though in some sense motivated by the depression, were definitely not primarily countercyclical in nature, e.g. the National Labor Relations Act and the Old Age and Survivors Insurance System. There were also measures of alleged but questionable pertinence or effectiveness, monetary nostrums, autarchic measures, and the NRA and AAA competition-restricting codes. And there were measures and programs that clearly served the objective of recovery and relief: expenditure programs to bolster personal and farm income and aggregate demand and lending and loan underwriting programs, some aimed at relieving financial distress, others at increasing the private components of aggregate demand,

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still others like deposit and savings insurance at strengthening the economy's financial structure.

Before the 1930's relief programs were quite generally regarded as functions of private charity and of local government; and federal countercyclical responsibilities were for the most part confined to those exercised by the Federal Reserve System. During the 1930's the Federal Reserve's countercyclical powers were strengthened through new controls of margin trading requirements and member bank reserve requirements and through statutory recognition of the Open Market Committee. The great 1929-33 recession also brought recognition of a new federal function, responsibility for recovery and relief. And the 1937-38 recession pushed this function in a more forward-looking direction, a responsibility for maintaining a high and stable level of employment.

Were we to experience another severe, long-continued business depression, a number of the developments of the 1930's might be more or less closely paralleled. The response might well include various measures and the inauguration of various programs of essentially an irrelevant nature as well as allegedly relevant ones that did not contribute much to recovery and relief. Of course it would encourage relevant measures and programs too. We might expect a strengthening of central bank countercyclical influences and development of other forms of countercyclical influence. Also we might expect new weak spots in our credit structure to be revealed, and anticipate that measures would be adopted to remedy them. And there might easily be federal credit extension programs both to relieve financial distress and to promote recovery—programs that would entail an increase in the federal loan portfolio of far more than \$9 billion. Likewise there might easily be expenditure programs—for purchases of GNP, for grants-in-aid, for subsidies, and for transfer payments to individuals—which, together with tax decreases, would mean an increase in net federal debt of many times more than \$16 billion.

In the minor recessions since World War II there have been substantial countercyclical variations in federal nonfinancial receipts and expenditures—to a considerable extent built-in variations. And while there were special postwar circumstances that precluded this development in the 1945 and 1949 recessions, during 1953-54 countercyclical Federal Reserve policy—along with other credit measures—was a principal reliance. In future, countercyclical fiscal operations may well be on a larger scale than they were during the postwar decade. In any case from that experience it is clear that even a minor recession could easily entail a net debt increase as large as the increase incurred during the 1930's, particularly if at the start of the recession federal nonfinancial expenditures were as large as nonfinancial receipts.