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Volume Title: Trends in Government Financing

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Volume Publisher: Princeton University Press

Volume ISBN: 0-870-14105-8

Volume URL: <http://www.nber.org/books/cope61-1>

Publication Date: 1961

Chapter Title: Trends and Prospects

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Chapter URL: <http://www.nber.org/chapters/c2356>

Chapter pages in book: (p. 165 - 180)

CHAPTER IX

Trends and Prospects

This inquiry into government capital requirements has departed from the general plan for the broad study of capital formation and financing of which it is a part because of the distinctive characteristics of the economic sector with which it deals. We have been primarily concerned with the financial capital requirements of governments.

We have, with one exception noted below, taken those requirements to be the funds governments have actually raised, not the funds they required (in the sense of justifiably required).

In summarizing our findings it will be convenient first to restate some distinctions that we have found it important to insist on, next to recapitulate what seem to be the main trends in state and local financing, and then to review our analysis of federal financing. Finally we will attempt to draw some inferences from our findings that we consider pertinent for an appraisal of the prospects for future government financial requirements.

1. *Some Basic Distinctions*

Particularly for the federal government since World War I it is urgent to distinguish and to have in mind the difference between the budget deficit and what we have called the nonfinancial deficit. The concept of the federal budget surplus or deficit is, of course, the one that receives primary attention in the budget document and in Treasury financial reports. It has been gradually developed since the passage of the Budget and Accounting Act (1921), and especially since the 1930's by a process of study and experiment to serve broadly the purposes of legislative control in levying taxes and in making appropriations and the purposes of administrative management. Hence budget receipts and expenditures do not include the receipts and expenditures of federal trust funds (except that, in the case of transactions between general government funds and trust funds, the trust account receipts appear as budget expenditures, the trust account expenditures as budget receipts).

The deficit computation with which we have been principally concerned is not the budget deficit but one which is designed to serve another fiscal policy objective—the objective of economic stabilization. It is also especially appropriate as a measure of federal financial requirements. It is the excess of the nonfinancial uses of funds over the nonfinancial sources

shown for the federal government in the Federal Reserve *Flow of Funds* compilations—or the excess of financial sources over financial uses.¹ Nonfinancial receipts and expenditures, in contrast to budget receipts and expenditures, include both trust account transactions and general government transactions with the public (but not transactions between one government fund and another).

In addition to trust account operations there is another main category of nonfinancial transactions that are not classed as budget receipts and expenditures. These consist of certain transactions of government corporations and other business-type and lending activities. Just how to draw the line between the inside-the-budget and the outside-the-budget transactions of these federal agencies has proven a difficult problem. The solution adopted in 1951 has the effect of treating net funds provided each such corporation or activity by the rest of the government during the year as a net budget expenditure.²

Not only are there important categories of nonfinancial transactions in the FOF compilations that do not count as budget receipts and expenditures; there are also budget transactions of a financial nature that do not count as nonfinancial receipts and expenditures. These consist chiefly of budget expenditures for acquiring loans and securities and budget receipts from the sale or redemption of the loans and securities in government agency portfolios.

As a result of all the various differences in transactions included and excluded, there can be a substantial budget deficit when there is a nonfinancial surplus. In 1946 there was a budget deficit of \$2.5 billion; a nonfinancial surplus of \$5.0 billion.

Before the considerable expansion of federal functions and agencies that took place in the 1930's, budget receipts and expenditures were not distinguished from other federal agency transactions. Total expenditures minus total receipts equaled the increment in federal debt minus the increment in the general fund balance.³ Of course this is not true today of budget expenditures and receipts alone; balancing Treasury financial

¹ *Flow of Funds in the United States, 1939-53*. Figures for more recent years have been published in the *Federal Reserve Bulletin* as they have become available.

There are two other deficit computations that are useful for the fiscal objective of economic stabilization: (a) One is the deficit in the account for the federal government in the National Income and Product Accounts. (b) The other, in the compilation of which the Treasury Department and the Bureau of the Budget cooperate, has had various names. We refer to it here as net cash operating outgo. For our present purpose the FOF nonfinancial deficit is distinctly better than either of these. It spells out financial details as (a) does not. It consistently identifies all financial transactions as financial while (b) does not and it provides more clean-cut detail by object of expenditure.

² Technically the language here used applies to the way the Post Office is treated in the budget accounts. But in many respects the Post Office continues to be treated as a part of the general government rather than as a business-type activity.

³ Except for a technical float discrepancy.

statements include figures on the transactions of trust and other accounts too.

When we speak of the financial requirement of a government during a particular period we mean (unless otherwise indicated) the excess of its nonfinancial expenditures over its nonfinancial receipts. This is equal to the increment in its net debt,⁴ where by net debt we mean the excess of its outstanding debt over its total financial assets. These financial assets consist mainly of its cash balance and the loans and securities it holds. In the case of the federal government we have included in the minuend of this net debt computation, in addition to the direct debt, the bonds, notes, and debentures of and the privately held proprietary interest in government corporations, government accounts payable, and certain government trust and deposit liabilities.⁵ Federal financial assets other than the general fund balance are held chiefly by the Old Age and Survivors Insurance Fund and other social insurance funds and by credit agencies like the Commodity Credit Corporation and the Export-Import Bank. Both social insurance funds and federal credit started in the 1930's on a period of rapid growth. The assets of the social insurance funds—these are almost entirely government bonds—increased from around \$0.5 billion in 1929 to practically \$45 billion in 1954. Federal credit increased during this period from \$1.7 billion to \$28.2 billion.⁶ Mainly because of these two developments, gross direct debt less the general fund balance exceeded net debt by some \$73 billion as of December 31, 1954. It has become very important when speaking of federal debt to say whether one means gross debt outstanding, debt held by the public (i.e. by holders other than federal agencies), or net debt.

What has been said about federal finances applies on the whole also to the finances of state and local governments. The distinction between the budget surplus or deficit and the nonfinancial surplus or deficit is much the same. Current Bureau of the Census compilations of government financial data use the terminology "general revenues and expenditures" instead of "budget receipts and expenditures," and they report in addition to these the transactions of government enterprises and social insurance trust funds. The Federal Reserve *Flow of Funds* compilations include a statement of state and local nonfinancial receipts and expenditures and financial sources and uses of funds.

The parallel to federal finance goes farther. With the rapid growth of their financial assets in recent years the distinction between gross state

⁴ There can be a technical discrepancy in this equation too.

⁵ But not insurance policy reserves or state balances in the Unemployment Compensation Fund.

⁶ As of June 30. The figures on federal credit do not include World War I international debts to the United States. They do include small amounts of veterans' loans also included in the social insurance funds.

and local debt, debt net of sinking funds, and net debt has become extremely important. In addition to sinking funds and social insurance trust funds, there have come to be substantial endowment and investment funds. Total cash and security holdings of state and local governments were \$7.4 billion at the close of their 1937 fiscal years; \$38.0 billion nineteen years later.⁷ General expenditures exceeded general revenues in the 1956 fiscal year compilation by \$3.0 billion; the 1956 calendar year nonfinancial deficit is estimated at \$2.5 billion.⁸

2. *The Record of State and Local Financial Requirements*

It will be convenient to summarize our findings regarding state and local financial requirements under the following six headings: (a) geographical debt patterns, (b) construction indebtedness, (c) orderly and disorderly finance, (d) financing by different units of government, (e) emergency borrowing, and (f) the general trend.

a. Geographical debt patterns. The borrowing practices of communities of different size have been sufficiently distinctive so that there has been at least until quite recently a very striking pattern of per capita local government indebtedness. Likewise there has been a somewhat definite, though gradually changing, regional pattern of per capita indebtedness.

In general the tendency has been for per capita gross debts to vary with community size—the larger the community, the larger the per capita debt. It is true the rapid growth of the financial assets of some of the larger cities during the last few years has made the net debt pattern for cities of more than 25,000 inhabitants a distinctly irregular one and even impaired the regularity of the gross debt pattern. But the tendency of per capita debts to decrease with community size is still clearly discernible.

The available information on the trends of per capita debts by community size is mostly on a gross basis. The growth of per capita gross debts in the smaller communities has shown a tendency to catch up with the growth in the larger cities. We think this catching-up process likely to continue, particularly if rural communities continue to acquire more urban characteristics. But the recently developed irregularities in the community size pattern raise the question whether uniformity on a net basis may not eventually be achieved by a leveling-down rather than a leveling-up process.

Regional differences in per capita state and local debts (gross debts less sinking fund assets), 1890–1942, have reflected a very rough correlation with per capita incomes. Between 1890 and 1922—the impact of the

⁷ This figure does not include the Unemployment Compensation Fund.

⁸ See Bureau of the Census, *Summary of Government Finances in 1956*, Tables 1 and 6, and October 1957 *Federal Reserve Bulletin*, p. 1192.

industrial revolution on state and local government capital outlay seems to have been particularly strong during this interval—these regional differences widened. But the longer-term trend of 1890–1942 seems to have been toward narrowing them. In large part this trend was probably due to the growth of cities in regions that were relatively little urbanized in 1890.

b. Construction indebtedness. Most state and local long-term debts can be identified by purpose of issue, and the purposes that account for the bulk of these debts are capital formation financing purposes. Further, most of the capital outlays—and the only capital outlays on which a reasonably satisfactory statistical time series is available—are construction outlays. Still the relation between construction expenditures and financial capital requirements is not a very close one. The ratio of the aggregate nonfinancial deficit for state and local governments to their new construction expenditures (excluding expenditures financed by federal aid) is extremely variable. On an annual basis in 1929–52 it varies between about 2:5 in 1950 and about —6:1 in 1944 (the 6 is negative because there was a surplus in 1944). Even on a quinquennial basis this aggregative ratio is highly erratic. The quinquennial ratio of new long-term debt issues to new construction is a good deal more stable. It varies between 45 and 77 per cent for 1915–53.

The volume of new security issues reflects new construction expenditures somewhat more closely than do the increments in net indebtedness. No doubt this is partly because nonfinancial surpluses can be used to finance debt retirements. But perhaps a more important consideration is that differences between the net surplus or deficit and the volume of securities issued are in considerable measure absorbed by changes in cash balances, in short-term debts, and in sinking fund assets.

Since state and local public buildings and other public works are in substantial part financed by borrowing, we might expect a somewhat stable relation between the investments in such structures and the debts they have occasioned. There are three categories of public capital assets and of debts specifically incurred to finance them for which it is possible roughly to determine what has been happening in recent years to the ratio of debt to depreciated value: highways, school buildings, and enterprise structures. These ratios both for highways and for schools show marked variations reflecting both changes in the financial condition of governments and the growing importance of federal and state grants-in-aid. Since accrual accounting conventions presumably exert more influence in the case of capital formation by public enterprises than in other state and local capital outlays, one might have expected more stability in the debt to value ratio for enterprise structures (including sewage systems, for these cannot readily be separated out). The expectation does not appear to be well founded.

c. Orderly and disorderly finance. In general we have not inquired whether the borrowings governments have engaged in have been justified. But it has seemed necessary to note that there have from time to time been various instances of clearly unjustified deficits and thoroughly disorderly finance. And in some of these there has been outright corruption. Among the most extreme instances of disorderly finance during the last fifty or sixty years are those that accompanied the Florida land boom of the 1920's; and the Coral Gables case stands out as one that was clearly characterized by corruption.

From time to time there have been instances of disorderly finance; but on the whole there has been a definite tendency toward greater orderliness. Indeed, there have been very substantial improvements in fiscal and other administrative procedures; and the quality of the personnel responsible for financial administration at all levels of government has been raised to a point that warrants saying public financial administration seems in process of becoming a profession.

One aspect of improved fiscal procedures is improvements in government accounting. Perhaps it is reasonable to look forward to future progress in accrual accounting for state and local enterprises—conceivably even for general government—that will make the connection between new capital expenditures and the increment in net debt more like that in the field of private business.

d. Financing by different units of government. During the nineteenth century disorderly state finance, especially during the 1830's and in the South after the Civil War, led first to serious financial distress and then to measures designed to prevent its recurrence. These measures in general took the form of constitutional restrictions on state borrowing. State borrowing during the first fifty years of the nineteenth century had apparently been a great deal more important quantitatively than borrowing by local government units. One unintended result of the constitutional restrictions was that local debts grew so rapidly during the second half of the century that by 1902 they were seven-eighths of the total.⁹ And municipal debts alone were such a large fraction of this total—nearly three-quarters—that “municipal bonds” became a synonym for all state and local obligations.

With the rapid growth of local government borrowing came instances of disorderly local government finance. Many of these were followed by financial distress, particularly after the crisis of 1873; and again there followed measures to restrict borrowing, this time the borrowing of local governments. Some of these restrictions were written into state constitutions, some were incorporated in state statutes, and some in municipal charters.

⁹ That is, of total gross state and local debt less sinking fund assets.

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The special district is, among other things, a device for considerably relaxing restrictions on borrowing power. It also serves to relax other restrictions, notably restrictions on taxing power. And it serves as a means of realizing the main advantages of consolidating specific functions of local government units—schools, water supply, sewage and fire protection systems, ownership of levees, bridges, toll highways, etc.—while avoiding the various serious political and legal obstacles to outright consolidation of the municipalities or other units involved. It is little wonder that school and other special districts, though of almost negligible importance at the turn of the century, have come to account for nearly a third of the total indebtedness of all local governments and about two-thirds of the long-term school debt as of 1951.

If the special district makes it possible to realize important economies of large-scale operation without outright consolidation of the local units involved—even when the units are in different states—it has also made possible a great deal of small-scale operation. Of the nearly 114,000 local government units in the United States in 1952, school and other special districts accounted for almost 80,000. Still there was a substantial amount of consolidation during the two preceding decades; the number of school districts was reduced by almost 50 per cent.

Economies in borrowing and in collecting taxes are among the significant economies resulting from large-scale operation. The past forty or more years have seen the development of another device for realizing this kind of economy—the grant-in-aid. No doubt the advantages of borrowing and taxing on a larger scale have contributed significantly to the growth of both federal and state aid programs. Another factor, more important in the case of federal than of state programs, is that the grant-in-aid has proven a convenient way to promote standards in the performance of functions by the aid-receiving governments and to decrease inequalities in performance among them. In 1950 federal aid to states represented some 17 per cent of state nonfinancial receipts,¹⁰ while state aid to local governments amounted to about two-ninths of local government nonfinancial receipts.¹¹ Aid seems to have been a smaller proportion of the receipts of the larger cities than of other local units ever since the start of state programs. Federal aid has tended in a general way to be a larger proportion of state revenue in those states where per capita personal incomes are relatively low.

e. Emergency borrowing. Most, but not quite all, long-term debts of state and local governments have been incurred to finance capital outlays. Non-capital-formation borrowing has in general been occasioned by

¹⁰ State withdrawals from the Unemployment Compensation Fund are excluded from both numerator and denominator of this ratio.

¹¹ This computation includes state-collected, locally shared taxes.

various emergencies. There was borrowing after both world wars to finance veterans' benefits. There was borrowing during the 1930's made necessary by the depression. Also there has been some borrowing—a quite small amount in the aggregate—in connection with floods, hurricanes, and other disasters.

Table 8 gives total nonfinancial receipts and expenditures of state and local governments and the aggregate net deficit. The deficit does not show any clearly cyclical variation except during the 1930's. Before this decade the property tax provided so large a part of total nonfinancial receipts that it is not surprising these receipts were cyclically quite insensitive. And while for states cyclically sensitive taxes have since become important, their influence on the total of nonfinancial receipts was not sufficient in 1949 and 1954 to make these two stand out as recession years in Table 8. Even if state and local governments assume no further responsibilities for countercyclical fiscal operations than they have to date, increasing reliance on cyclically sensitive taxes may conceivably involve them in recession deficits in future.

f. The general trend. It is tempting to say that there has been a long-term upward trend not only in state and local total debt but also in debt per capita. We think the most significant question in regard to trend relates to net debt, and particularly for this basis it is difficult to be definite about the trend on either an aggregate or a per capita basis.

From the 1890's to 1930 certainly both trends were markedly upward. The immediate response of state and local governments to the industrial revolution was a vast increase in expenditures, both capital and current. And with their total expenditures growing somewhat more rapidly than total gross national product, state and local governments had extensive recourse to borrowing.

During the great depression of the 1930's, borrowing was often difficult; pressure for small and balanced budgets was strong; and after 1933 federal aid helped to finance a moderate increase in expenditures. There was little increase in net debt during the decade.

Then during the war receipts grew; expenditure increases were restrained. By 1945 aggregate net debt was reduced to a negligible amount. And at the end of 1954 it was only \$6.5 billion, about what it had been thirty-four years earlier.

3. *The Record of Federal Financial Requirements*

In times past there have been federal debt issues identified as serving to finance particular capital expenditures, like the issue of bonds that helped finance the purchase and construction of the Panama Canal. But there have been no such issues since the 1930's. As of December 31, 1954, more than 90 per cent of the federal net debt had been incurred during war

emergencies and practically all the rest of it had resulted from the contracyclical nonfinancial deficits of the 1930's. No doubt both the war expenditures and the depression expenditures that were financed in part by these debts include physical capital formation outlays. But obviously this is not the main fact about the debts. The main fact is that they were incurred during emergencies to finance very rapid increases in expenditures on a wide variety of objects.

The proportion of expenditures that were deficit financed was smaller during the Civil War than during the War of 1812,¹² smaller during World War I than during the Civil War, and smaller still—though more than half—during World War II. This general downward trend reflects in part improved fiscal procedures.

But, if the United States were to have another major war-financing problem to deal with, and if there were to be, as there was not during either world war, a firm administration policy of pay-as-you-go in which Congress acquiesced, there would still be difficulties in fiscal procedures that would make it unlikely such a policy could be fully realized. In particular there is the difficulty that while Congress has shown a willingness during an emergency to relax its control over appropriations so as to expedite the legislative process, it has not been willing to expedite the process of handling revenue bills. Conceivably this kind of legislative process could be expedited by putting tax rate changes and tax base changes in separate bills; or, if Congress were prepared to accept a more radical approach, the need for legislative speed could be diminished by formula-flexibility taxation.

The international aid extended during and after World War I and during World War II added to the emergency expenditure totals that were financed in part by borrowing. Aid can be expected to involve recourse to borrowing when it contributes to a sharp increase in expenditures; and so far as the borrowing is concerned, it makes no difference whether the aid takes the form of grants and adds to the nonfinancial deficit, or the form of loans that add to the federal portfolio of financial assets. But an aid program that is not too unevenly distributed over a period of years, as has been the case in the years following World War II, need not occasion borrowing.

The federal government has gradually come to assume some measure of responsibility for "recovery and relief" in connection with business recessions, even for maintaining a high and stable level of employment. The degree to which such a responsibility is recognized seems itself to be inversely correlated with the cycle, but there has been a definite trend toward making the responsibility broader and more categorical.

During the 1930's federal recovery and relief activities took a wide variety of forms. There were moves that were largely of a noncyclical

¹² This statement does not include the deficit financing of the Confederacy.

character, principally some of the financial reforms, labor relations and labor standards legislation, and the establishment of an old age insurance system and three broad special public assistance programs. There were moves allegedly relevant to promoting economic recovery whose effectiveness was questionable: monetary nostrums including a plan for varying the price of gold, autarchic measures designed to encourage a more favorable trade balance, and organizational arrangements for price and wage maintenance.

The principal measures and programs that were really pertinent to the objectives of recovery, relief, and economic stabilization were: the steps taken to bolster up the economy's credit structure and to relieve the distress of defaulting debtors by assuming their debts; direct and work relief programs for the unemployed and special benefits to veterans and farmers; increased public construction; and increased grants-in-aid to state and local governments. To the extent that these measures and programs meant additions to federal purchases of gross national product or transfer payments to state and local governments and to individuals which added to the funds they had available for national product purchases, they provided a fiscal countercyclical bolstering of aggregate demand. But fiscal policy vacillated between the objective of an annually balanced budget and the objective of an effective countercycle, even though there was, on the whole, somewhat greater emphasis on the latter.

In three minor recessions since World War II the chief federal countercyclical activities and developments have been: countercyclical easing and tightening of Federal Reserve credit (but until 1951 Federal Reserve obligations to maintain government bond prices largely precluded an effective tight credit policy); the easing of housing credit underwriting terms, particularly in 1954; the operations of the Commodity Credit Corporation, particularly in 1948-49 and 1953-54; the "built-in" increases and decreases in the volume of unemployment compensation benefits; tax cuts effective in 1949 and 1954; and an increase in national security expenditures in 1949. The national security expenditure increase and, in large measure, the tax cuts may be characterized as not intended countercyclically.

During the decade of the 1930's federal net debt increased by about \$16.0 billion. In 1949 the federal government had a nonfinancial surplus of \$0.5 billion; in the previous year a surplus of almost \$10.0 billion. There was a nonfinancial deficit of \$4.8 billion during the five quarters ending September 30, 1954, but less than \$2.0 billion of this can be definitely attributed to the 1953-54 recession. During the two years ending June 30, 1959, there was a nonfinancial deficit of \$11 billion; this compares with a surplus of \$11 billion during the two years ending December 31, 1956.

4. *A Postscript on Prospects*

The expenditures that have been responsible for most government borrowing in the past—wars, recessions and depressions, and state and local capital formation—will probably continue to be responsible for most borrowing in the future.

What can be said about the prospects for state and local capital formation requirements is quite limited. We may note first five conditions to which it seems likely the total volume of this kind of financing will conform. None of them gives a clear-cut clue regarding the total volume.

One of these relates to community-size and regional debt patterns. It seems reasonable to look forward, though perhaps some time forward, to a gradual trend toward greater uniformity in per capita debts both regionally and by size of community. Whether this will mean a leveling-up process, and a consequent upward trend in net debt, or a leveling-down will depend somewhat on the growth of government financial assets.

The second condition relates to the development of more businesslike accounting and budgetary procedures for government enterprises. It is reasonable to expect that such developments will gradually make the relation between enterprise debt and depreciated value of enterprise assets more like the corresponding relation for nonfinancial private enterprises. Conceivably, too, capital budgeting will develop in a way that will give something of a push in this direction for general government debts and capital investments.

The third condition also relates to the trend toward improvements in the fiscal procedures. This condition involves short-term debt and other elements in liquidity position. The proportion of short-term borrowing that is budget borrowing can quite possibly be expected to increase. More generally, variations in the liquidity position of the individual government unit can be expected, as time goes on, to be dominated more by short-term influences—differences in the seasonal pattern of nonfinancial receipts and expenditures and other differences that are purely temporary, particularly differences between the time pattern of receipts from long-term debt issued to finance a capital outlay and the time pattern of the capital outlay.

The fourth condition relates to taxation. It seems likely that the tax exemption which state and municipal bonds have enjoyed heretofore will continue to constitute an encouragement to such financing.

The fifth condition involves the purposes of borrowing. In the past a major fraction of long-term indebtedness has been incurred to finance road and school construction projects. But in recent years a considerable part of such capital expenditures has been financed by federal and state grants-in-aid and as a consequence put on more or less a pay-as-you-go

basis. Any forecast of future state and local borrowing must therefore take account of the extent to which the further development of grant-in-aid programs may obviate the need for bond flotation financing.

But subject to these conditions, what is the prospect for a definite upward trend in the per capita state and local government indebtedness incurred to finance capital outlays? The upward trend from the 1890's to 1930 was interrupted first by the depression, then by World War II. However, there would seem to be no reason to think that these interruptions are permanent, no reason to suppose that they have permanently reduced the proportion of capital expenditures likely to be financed by borrowing. Still that proportion has been a decidedly variable one in the past. And if one tries to list considerations one should take into account in attempting to project it into the future, two such considerations stand out in our analysis. The proportion of debt-financed capital outlays seems to reflect the ratio of the rate of growth of government expenditures to the rate of growth of gross national product. A high ratio makes for a high proportion. And the proportion can be expected to be smaller to the extent that the capital expenditures are financed by federal—and perhaps also by state—grants-in-aid.

We can be a little more definite about the considerations one should take into account in appraising the prospects for government borrowing in connection with business recessions and depressions.

The effect of the 1929–33 recession on the aggregate deficit of state and local governments shows clearly in Table 8. Apparently the effects in 1949 and 1954 were quite minor. If one asks about the likelihood that some future recession may entail a considerable increase in state and local net debt, there are two main considerations to be taken into account, one that tends to increase the likelihood of such a development, the other working in the opposite direction. We have attributed the fact that there is so little evidence of the cycle in Table 8 largely to the insensitivity of the major tax source to most business fluctuations. But sensitive sources have been becoming relatively more important, and if this trend continues, as it probably will, it will make a future depression deficit more likely.

However, the other consideration may at least in the longer run prove to be overriding. During the 1930's the federal government came to assume practically the whole depression deficit burden. True, it has taken no steps since then that would more fully eliminate cyclical variations in state and local receipts. But the unemployment insurance system means that state payments into the Unemployment Compensation Fund are large when times are good and that state withdrawals are large when unemployment is high. We think it not unlikely that other intergovernment flows of funds will be developed that will help to take the cycle out of state and local surpluses and deficits—perhaps, for example, promptly

and markedly flexible grant-in-aid programs. Quite conceivably such intergovernment flows that vary in volume with the cycle may presently make any considerable amount of depression borrowing—except perhaps for borrowing from the federal government—an extremely unlikely development. But this prospect is hardly an immediate one.

During the decade of the 1930's the federal net debt increased by \$16 billion, the federal loan and security portfolio by \$9 billion. We think that even a minor recession might in future entail a comparable net debt increase. If the federal government should assume a fuller responsibility for keeping the economy operating at a high and stable employment level, this would make such a debt increase all the more likely, particularly if the federal government should come to rely more heavily on a countercyclical fiscal policy in discharging this increased responsibility. Also, such a debt increase during a minor recession would become more likely if the federal government were to assume something like the whole countercyclical deficit burden for all levels of government through some system of cyclically flexible intergovernment nonfinancial flows of funds.

In this latter connection we note that during fiscal 1958 and 1959 the federal government's nonfinancial deficit totaled \$11 billion. But presumably this deficit would have been larger had there not been a pre-recession nonfinancial surplus of \$11 billion in calendar 1955 and 1956. The size of the deficit incurred during the lower stages of a cycle—and of the increment in net debt—must obviously depend in part on whether the federal government has been operating at a deficit before the recession began.

On one assumption these comments, with appropriate modifications, would seem to apply also to the possibility of a severe and prolonged business contraction. We think net debt might increase by a number of times \$16 billion. Also that the amount of federal credit extended to promote recovery and relieve financial distress might be considerably more than \$9 billion. In this connection we should note that there were some \$40 billion of federally underwritten loans outstanding on June 30, 1954. The likelihood of such federal debt and credit increases should be greater the larger the responsibility assumed by the federal government for keeping the economy operating at a high employment level—or for restoring it to a high level—and the larger the extent to which it engages in a countercyclical fiscal policy. The likelihood should be greater, too, in proportion as it assumes more fully the entire countercyclical deficit burden of all levels of government. And in appraising the possible size of the deficit we would need to consider whether the government sector's nonfinancial transactions account was in balance when the contraction started.

But an assumption underlies these comments, and indeed also the comments on the deficit prospects for minor recessions. It will doubtless

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be agreed that the deficit incurred would increase with the degree of the business contraction that federal actions have to cope with. Yet we assume that federal actions, including countercyclical operations that involve running a deficit, can reduce the degree of contraction, even convert it into a business upswing. If so, the degree of contraction attained at the trough of the cycle and consequently the amount of the countercyclical deficit depend upon how promptly and how vigorously the antirecession actions are taken.

We noted that during the 1930's there was a conflict between the objective of a balanced budget and the objective of an unwavering, sizable fiscal countercycle. No doubt this conflict of objectives continues. And, to the extent that it does, prompt and vigorous actions during the early months of a cyclical downswing are made less likely. So are actions that might involve a \$16 billion nonfinancial deficit, especially if this should mean a substantially larger budget deficit. It is easy to understand why the prospect of such deficits would generate opposition to a countercyclical program that involved tax cuts or works program and grant-in-aid step-ups. The idea of alternating budget deficits and surpluses with the downs and ups of the cycle so as to achieve a balance over the cycle could only avoid opposition to such countercyclical actions if there were some way to implement it. At present there are no fiscal procedures to implement such a balance-over-the-cycle fiscal plan.

However, a capital budget system under which the additional countercyclical works and grants expenditures during the lower phases of each cycle would be charged to capital account and amortized over, say, the next ten years would help to implement a balance-over-the-cycle fiscal plan. And it is at least conceivable that a capital budget system could be devised that would smooth the cycle out of budget receipts as well as budget expenditures, so that, if the "smoothed" receipts balanced the "smoothed" expenditures every year, the difference between the cumulative total of "unsmoothed" budget receipts and that of "unsmoothed" budget expenditures would have no secular trend either up or down.

Such a capital budget system would make prompt borrowing during a recession more likely. But if it facilitated countercyclical action that proved effective, it would not necessarily increase the total amount of recession and depression borrowing.

What can be said about the prospects of future wartime borrowing is necessarily entirely hypothetical, except that we can confidently predict that state war-connected borrowing will be confined to financing veterans' bonuses. Should there be another war, or other wars, the amount of borrowing entailed would obviously depend on the size of the conflict or conflicts. Federal net debt increased by about \$175 billion during World War II, but scarcely at all during the Korean War. Beyond this not a

great deal can be said. It is reasonable to expect that the pay-for-more-of-it-as-you-go trend would continue, but it would be extremely unlikely that all or nearly all the cost of a major war would be met out of current receipts. And of course wars have been getting more expensive and the value of the dollar is less than it was in 1940.

These considerations regarding the prospects of wartime borrowing and countercyclical borrowing do not by themselves throw much light on the question whether the prospect is for an upward or conceivably for a downward trend in federal net debt. This question is largely one of the influences making for and against a program of debt retirement.

In Chapter VIII we concluded that such retirement of emergency-incurred federal debt as has occurred seems for the most part to have been inadvertent. And we noted that a program of retiring the existing federal net debt would be likely to arouse both special interest group opposition and a more general opposition to the cyclically depressing influence the inauguration of such a program would entail.

Inadvertent debt retirement has been possible in the twentieth century as it was in the nineteenth. Thus the tax cuts during the 1920's were so slow they did not prevent a decade of surpluses. But, since income taxes have replaced customs duties as the main revenue source, it has become less likely. And the same considerations that make it improbable that any substantial part of existing federal net debt will be retired make it probable that, in the absence of fiscal procedures which might prevent such a cumulative tendency, future business cycles will often add to the net debt total.

We do have one such fiscal procedure now—the exclusion of social insurance fund transactions from budget receipts and expenditures. Because of this exclusion the increment in net debt since 1937 has been less than the cumulative budget deficit would otherwise have made it by the amount of the growth in social insurance fund balances. That these balances will continue to grow is by no means certain. But if and insofar as they do, the exclusion of social insurance funds will help to keep down the net—but not the gross—federal debt.

Another possible development that could work in the same direction is that of a federal capital budget system that not only would make an annual provision for debt retirements to implement an approximate balance-over-the-cycle program but would also include provisions to implement a gradual retirement of at least all emergency debts incurred after the inauguration of this capital budget system. In the absence of such provisions the most likely prospect would appear to be a gradual accumulation of emergency debts.

