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PREFACE

This study deals with the financial interrelationships between Federal programs and state governments. It is hoped that the information contained in it will be useful for policy-makers concerned with the role of the national space program in a post-Vietnam context.

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It is the hope, indeed the expectation, of many people that the end of the war in Vietnam will quickly set in motion massive increases in Federal civilian expenditures. Often it seems that visions of block grants and tax sharing dance in our heads, while taxes even turn negative in these dreams.

It is easy enough to conjure up visions of so-called fiscal dividends and peace dividends totalling over $40 billion in the year after peace is achieved. As we are all aware, our progressive income taxes bring forth rapid expansions in Federal revenue, about $12 billion a year at current levels of income and economic activity. Also, we are spending about $30 billion a year in Vietnam. Hence, even when making some allowance for built-in increases in Federal spending -- for such items as wage increases required under existing statutes and veterans' pensions and similar rising but firm commitments -- at first blush it would appear that shortly after peace in Vietnam is attained the fiscal millenium will arrive.

If the perennial role of the economist is to be the wet blanket, then I am afraid that I will run true to form this morning. However, I believe that the forecasts and analysis that I will be presenting will not constitute sad news, but rather a realistic appraisal. As best as I can, I will try to describe the budget potentials as well as the fiscal limitations that we are likely to face.

Like most forecasts, these are based on some key assumptions. Mine are quite simple: I assume that the incoming administration will practice fiscal responsibility while dealing with the major problems that the Nation faces. Now I am not forecasting that the budget will be neatly and exactly balanced each year.

But neither am I forecasting the reappearance of a $25 billion deficit, such as was incurred this past year. I am assuming essentially a national economy with fairly steady growth in business activity, where GNP posts gains in the neighborhood of 4 percent a year and unemployment stays down to about 4 percent and where prices no longer rise with the rapidity that we have witnessed during the last few years.

Well, what are the fiscal implications of all this? In answering that question, I find it necessary to examine the various pressures on the Federal budget during the period following peace in Vietnam.

The Federal Budget Outlook

On the revenue side, the major item that warrants our attention is the recently enacted surcharge. It seems likely that the surcharge will be allowed to expire soon after the end of the war. Upon closer examination that turns out to be a very significant action. The surcharge is raising about $10 billion a year. In the year that it lapses we then lose an amount of revenue almost equal to the annual fiscal dividend. Of course in the subsequent years, we would expect to achieve new fiscal dividends.

That still leaves us the $30 billion peace dividend and, after all, that is quite a respectable sum. Well, before we start spending it, I suggest that we take a longer and harder look at the military budget. To begin with, we must realize that any estimate of the cost of the Vietnam War -- whether made by the Pentagon or anyone else -- is essentially a guess. I say this simply because the way the Pentagon keeps their books, they can give us very accurate reports on how much they spend for aircraft, missiles, ships, etc., but they cannot tell us precisely how much of the funds for aircraft, for example, were devoted to Vietnam. Essentially, then, the $30 billion annual cost of Vietnam, which is the figure most frequently used, is the difference between the current level of total military spending (about $80 billion) and the prewar military budget (about $50 billion).

If there is any prediction that I can offer with considerable confidence, it is that the military budget will not decline to the $50 billion levels that we experienced before the Vietnam War. For one thing, we have had substantial inflation during the past four years and hence large increases in the prices of the equipment that the military buys and in the wages and salaries that it pays. Thus, just to devote the same amount of real resources to defense programs as prior to the war would require a substantially higher level of expenditures than in 1965, before the Vietnam buildup. This new base is likely to be in excess of $60 billion a year. With the continuing level of international tensions, and especially the recent actions by the Russians, it is hard to see how we would do any less than maintain at least the 1965 level of military effort.

Moreover, many upward pressures on the non-Vietnam part of the military budget already are visible. Considerable deferred maintenance and depleted inventory positions will need to be taken care of. There are also other "built-in" increases. For example, under existing law, the pay of the armed forces and of civilian employees of the military establishment is scheduled to rise by over $2 billion between the fiscal years 1969 and 1970. Also, several weapon systems are in early stages of production and the large expenditures are scheduled to come in the next year or so. Examples include a number of nuclear carriers and destroyers, the Poseidon and Minuteman III missiles, and the Sentinel anti-ballistic missile system.

This is all aside from the future consequences of any decisions that soon may be made on the future composition of our arsenal of weapon systems. One indication of Congressional concern is the recent report of the Preparedness Investigating Subcommittee of the Senate Armed Services Committee. Reflecting a year of detailed study and hearings dealing with strategic forces, the committee urged, "Prompt decisions should be forthcoming for the deployment of additional and more modern weapon systems and improvements to existing weapon systems..."

The committee specifically recommended rapid development of a new long-range bomber and an accelerated research and development effort on an advanced ICBM. It also has underway studies of limited war requirements for tactical aircraft, missiles, and ships; hence, similar recommendations to those on strategic forces may be forthcoming in the near future.

Thus, should peace in Vietnam be achieved early in 1969, I would estimate a total peace dividend closer to $10 billion than the $30 billion figure we hear so much about. In a sense that would just about replace the fiscal dividend that we would lose when the surcharge is lifted. Hence, the immediate post-Vietnam fiscal outlook is not one of great liberality, but of many difficult choices which will have to be made in allocating our large Federal revenues among an even larger array of alternative claims on these funds.

Federal Aid to the States

To those of us who recall ancient history, prior to the Vietnam War there was considerable public discussion of the fiscal dividend which was going to be brought about by the combination of a rapidly growing economy and a progressive Federal income tax. We were even beginning to get some support for a fairly novel use of the growth in Federal revenues, above the built-in cost increases of ongoing Federal programs. Supposedly, we were going to use the money for block grants to the states -- financial aid with no strings attached, or at least not with many.

Although Democrats like Heller and Pechman publicized the idea, it was Republicans like Laird, Goodell, and Javitz that introduced bills and tried to put the concept into practice. Under various labels, tax sharing or block grants seemed to be becoming a bi-partisan concern.

Then came the Vietnam War and the dreams of a fiscal dividend turned into the reality of a massive budget deficit. But much also has happened on the domestic front during these past three to four years. Urban-racial-poverty matters have become a pressing area of concern. The solutions offered -- sometimes it seems that the number of solutions equals the number of poor people -- do not generally involve block grants to the states. In fact, many of them do not involve the states at all.

Guaranteed annual income schemes, negative income tax plans, community action programs, tax incentives to private industry, mass urban transportation systems -- all of these involve Federal agencies dealing directly with municipalities or private organizations or individual citizens.

Why are the states being slighted? There seems to be a variety of reasons. Obviously, some Federal agencies find it easier to deal directly with the ultimate beneficiary, or at least think that it is. Others believe it is more efficient to eliminate the middleman -- the states in this case. But perhaps the most important reason for wanting to bypass the states is at least partially of your own doing.

It is the rare state government that convincingly shows that it is really interested in the problems of its urban citizens, particularly the urban poor. I will agree that to some extent this is a question of image rather than reality and also that major differences exist among the states.

Yet, one indication of the non-urban orientation of state governments is so obvious that we take it for granted or just overlook it. Where are our state capitals located and, hence, where do legislators meet to carry on the state's business and where do so many of the administrators of state programs live and work? With no disrespect intended, I point out that we find the capitals of many of our largest states, some of those with the heaviest concentration of urban-racial-poverty problems, to be relatively small or medium size cities, facing in a sense a different set of problems and concerns. Just go down the list -- New York - Albany; Illinois - Springfield; Pennsylvania - Harrisburg; New Jersey -

Trenton; Missouri - Jefferson City; Texas - Austin; Wisconsin - Madison; Michigan - Lansing. These cities certainly are not insignificant townships; yet neither are they the metropolises of one million or more which have been featured so prominently in the news of urban unrest and agitation.

Only 5 out of the 50 state capitals are located in a metropolitan area with a population of one million or over. In contrast, almost two-fifths of the Nation's total population lives in these metropolises.

It does not take much imagination to figure out that if urban-related problems are considered to be one of the Nation's most pressing domestic areas of public business, and growing proportions of Federal taxpayers are living in these areas, that state governments which are oriented in such large measure to the concerns of rural and smaller cities will have difficulty in convincing large portions of the public that they are the most attractive instrumentalities for dealing with these problems and hence for receiving the bulk of the funds devoted to these problems. Certainly, I do not see sufficient Federal funds simultaneously for block grants or tax sharing plus a negative income tax plus major new Federal expenditure programs dealing with domestic welfare and developmental needs. In a sense, these proposals are different ways of achieving the same or similar objectives. In any event, the budgetary situation is most likely to force the Nation to choose among them.

I offer you these remarks with the greatest reluctance, because I strongly believe that the states are the backbone of our Federal system. The inability or unwillingness of some states to face up to the major domestic problems in a meaningful way can only result in a weakening of our Federal form of government.

Already the competitors for Federal funds and national attention are numerous. Private corporations oriented to meeting the needs and requirements of the Federal Government offer an array of sophisticated services, ranging from operating Job Corp camps to designing urban transportation systems to retraining the unemployed. Nonprofit institutions are running regional educational laboratories, conducting anti-poverty programs, and offering to do research and development work on virtually every national ill, real as well as imagined. Within the public sector itself, Federal agencies and local governments all represent alternative mechanisms for dealing with nationwide problems.

When we examine the new activities funded by the Federal Government in the last decade or so, the cumulative bypassing of the states is seen to be substantial -- the war on poverty, mass transportation, housing, etc., etc.

It is in the light of these developments that I personally find tax sharing and block grants so attractive -- they would help to restore greater fiscal balance to our Federal form of government. However, I believe that we will only succeed in getting public support of this approach if indeed we can convince the public that it truly represents state assumption of responsibility as well as of funds -- that in choosing the mechanisms for conducting the public business and achieving major national objectives, the Nation would be wise to give the states a larger role than at present.

The general concept of distributing available Federal funds to the states goes back to early American history. In his second inaugural address, President Thomas Jefferson suggested a general program of Federal aid to the states, to be used for such purposes as "rivers, canals, roads, arts, manufactures, education, and other great objects within each state." The lag between presidential recommendation and congressional action was quite considerable even then. It was not until 1837 that the Congress did vote to distribute surplus funds. It did so on an approximately per capita basis. The $37 million so allocated was more than double the annual budget in those days. Considerable interest in general distribution of Federal funds to the states arose again in the 1880's, but did not result in any Federal action.

State Shares of the Alternative Federal Aid Plans

As we know, a variety of alternative ways of channeling Federal funds to the states have been suggested in more recent years. Some would mainly expand tied or program grants. Others would make use of the grant-in-aid device but would combine the hundreds of separate grants into a relatively few, each covering a major program area. Proposed innovations in Federal-state relationships of a more basic nature include, in addition to block grants, proposals for tax sharing, tax credits, and combinations of these new approaches. Of course, there are those who ostensibly would aid the states by having the Federal Government relieve them of the responsibility for various functions or programs; some direct Federal expenditure programs do of course reduce the pressures on state treasuries.

My own research to date reveals that each of these suggested methods of Federal assistance to the states has advantages as well as disadvantages. Direct federal expenditures might help to expand some important public programs but they bypass completely both state and local governments. Tax credits may reduce taxpayer resistance to state and local rate increases, but they would not directly help state or local treasuries.

Tax sharing and block grants provide for the allocation of public funds among programs to be made by each state, which presumably is more familiar with the needs and desires of its residents than the national government. However, little or no provision is made for the burgeoning financial requirements of counties, school districts, and cities and towns, at least under the pure form of block grant. Of course, the block grant proposals with equalization and pass-through features do deal with this latter question, but that involves some Federal strings.

There is another key difference among these various plans. The share that each state would obtain varies, often substantially. These variations are not random; fairly clear allocation patterns emerge when we compare the different proposals.

High income states tend to benefit more from tax sharing and tax credits than from the other forms of Federal aid being considered. For example, Michigan would receive 8.6 percent of the tax sharing funds and exactly half of that, 4.3 percent, under straight block grants. New York State would receive almost 18 percent of tax sharing and about 9 percent of block grants distributed on a per capita basis. Under tax sharing, the state shares would correspond to the proportion of Federal income taxes collected in the state.

The states that would receive larger proportions of tax sharing funds than of the other alternatives are as follows: Delaware, New York, Illinois, Michigan, Rhode Island, and Ohio.

Under tax credit schemes, the direct beneficiaries would be the individual taxpayers who could deduct a portion of their state income taxes from their Federal income tax liability. The states (technically their citizens) who would benefit most from tax credits are Connecticut, New Jersey, Massachusetts, and Pennsylvania.

In contrast, the low income states would tend to benefit most from the version of the block grant proposal which has an equalization feature. Such is the case of Mississippi, which would receive 2-1/2 percent of the block grants and only 3/10 of one percent of tax sharing. Similarly, South Carolina would obtain 2-1/2 percent of block grant funds and 4/10 of one percent of tax sharing proceeds.

The states that would obtain larger amounts of funds from block grants (with an equalization feature) than from the other proposals are Idaho, New Mexico, South Dakota, West Virginia, Georgia, North Carolina, Louisiana, Kentucky, Tennessee, Alabama, South Carolina, Arkansas, and Mississippi.

One group of states -- mainly those with per capita incomes close to the national average -- would tend to benefit most from the status quo. That is, they receive larger shares of Federal funds from existing program grants than they would from the various suggested changes. One example is Oklahoma, which receives 2.2 percent of existing grants and would obtain only about half of that from the alternatives.

The states that would receive larger shares of existing program grant funds than they would of newer forms of Federal aid are as follows: Nevada, Alaska, Missouri, Oregon, Wyoming, Nebraska, Iowa, Minnesota, New Hampshire, Montana, Utah, North Dakota, Vermont, Maine, and Oklahoma.

Yet another group of states might be considered as benefiting more from direct Federal programs than from Federal funds channeled through the states. The region surrounding the national capital is a prime example. Federal government civilian employees in Maryland and Virginia account for slightly over one-fifth of the Federal civilian payroll. In contrast, these states get about 4 percent of existing grants and would receive 4 percent of tax sharing funds.

The various states that currently account for larger portions of Federal employment than of the other alternatives are as follows: California, Maryland, Washington, Hawaii, Colorado, Arizona, and Virginia.

The final category of states contains those that would benefit most by a straight per capita distribution of Federal funds, that is by a straight block grant with no strings attached. These states are Indiana, Wisconsin, Kansas, Florida, and Texas.

Conclusion

There is another and perhaps more positive way of examining the question of Federal-state fiscal relations. In the absence of a national decision to embark upon a major new effort of Federal aid to the states in the post-Vietnam time period, there may be considerable possibility of our not obtaining anything close to an optimum allocation of public resources in the United States.

The possibility certainly exists that the nation may use up potential increases in national revenues for "worthwhile" but relatively lower priority Federal programs, while state and local governments are forced either to defer relatively more worthwhile projects for lack of funds or to increase taxes which have adverse effects on economic growth or taxpayer equity. Hence, simply reacting to specific Federal program demands, as the savings from peace in Vietnam and the consequent fiscal dividends are realized, may result in losing an important opportunity for reallocating public resources.

A deliberate decision to use Federal funds to strengthen state and local governments may succeed in raising the overall level of public services or reducing the need to expand the combined level of taxation in the United States. It would also constitute, I believe, an important step toward achieving what President-elect Nixon has envisioned as "a streamlined Federal system, with a return to the states, cities and communities of the decision-making power rightfully theirs."