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DISCUSSION OF FINANCING STATE AND LOCAL GOVERNMENT SERVICES IN A CYCLICAL ECONOMY*

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Drs. White and Musser bring an important new insight: given recent and prospective variations in inflation and income growth, stability must become an important criterion for assessing alternative local and state government fiscal systems. The 1960s was an expansionary period for U.S. and world economies. Equity, growth and efficiency appeared to be appropriate and sufficient criteria for evaluating local and state tax and expenditure systems. The economic turmoil of the 70s, however, makes it obvious we were a bit over-optimistic. Stability must be added to our list.

Instability of local and state government revenues and expenditures does entail social costs. It can result in reduced services in such vital areas as education, health, housing, welfare, fire and police protection, and agricultural research and education. Capital projects may have to be aborted, reducing services and wasting already expanded funds. In the context of Tiebout's hypothesis, sudden shifts in output of public services or tax rates may cause a movement away from optimum household location. This, of course, assumes that demand for public goods does not decline with decreases in real income. To the extent that recession results in reduced demands, some reduction in services may also be appropriate. Nevertheless, given current institutional rigidities, such a calibrated adjustment is not possible even if the appropriate reduction could be specified.

The White and Musser position, funding counter-cyclical programs as the proper domain of the federal government, is to be supported. Because the federal government alone can utilize deficit financing, and economic policy necessarily must be centrally managed and coordinated, it is the only viable alternative. This, of course, does not obviate the necessity for local and state governments to undertake counter-cyclical expenditures financed by the federal government. The validity of the President's current proposals to spin-off social programs currently funded and administered by the federal government to local and state governments becomes questionable. State and local governments lack fiscal flexibility and resources to operate these programs, particularly during periods of economic slow-down which may lead to intensification of economic recessions as local and state governments are forced to reduce expenditures.

The authors' proposal that grants-in-aid be utilized to moderate the impact of cyclical fluctuations in the economy also is valuable, but justifies further refinement. Their suggestion that grants should fluctuate with regional differences in economic activity needs further development into a specific set of proposals which are politically viable. This may be very difficult given the federal bias towards treating each area of the country equally.

The authors point out growing uncontrollability of local and state expenditures resulting from relative decline in road and highway expenditures. These conclusions are drawn from comparisons of 1970 and 1972 data with 1960 data. Does the decline reflect efforts of local and state governments to postpone road construction in years of fiscal difficulty or does it reflect a secular change? Moreover, relative decline in "controllable" expenditures is not sufficient basis for concluding that declining controllability presents serious problems. If the amount of controllable

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expenditures remains greater than likely decline in revenue, decline in controllability becomes insignificant.

The authors call for deficit financing, stabilization reserves, and grants-in-aid to dampen effects of business cycles. The feasibility of estimating, with even modest accuracy and timeliness, expected duration of expansionary and retractive cycles suggested for implementing these programs is questionable. The recent track record of the economics profession suggests that such an endeavor will be subject to an intolerable margin of error. If these policies depend on feasibility of accurate forecasting beyond a few quarters, they must be regarded as impractical. In fact, by making available combinations of these approaches, accurate, long-term forecasting can likely be omitted and high social costs of variations in expenditures still be avoided. Further research and policy evaluation is needed to design a program package which provides needed flexibility over a wide range of possible contengencies.

One could become quite troubled by Table 5 which the authors use to evaluate controllability of local and state expenditures. What is their data source? To what extent do observed patterns reflect prior expenditures rather than current budget limitations? Do they reflect isolation markets for inputs rather than fund limitations? Surely the authors would be the first to agree that further analysis is needed. But do they have a solid basis for even the rather limited conclusions they draw? An affirmative answer is not obvious.

White and Musser note the need to desegregate state and local governments when analyzing certain budgetary categories. This can be taken one step further. Local communities must be desegregated if aggregation error is to be avoided. Cyclical fluctuations will impact differently on local and regional economies which are dependent on very different mixes of industries. Traditional rural communities still dependent on agriculture and property taxes can be anticipated to suffer only small revenue reductions during an economic downturn. Rural communities with a diversified economic base, and drawing revenues from sales or income taxes, may find their revenues much more variable. Moreover, these type communities will require different policy, both in kind and quantity.

Business cycle fluctuations will also have differential impacts among communities providing different combinations of services. I would hypothesize that the income elasticity of demand for various public services is inversely correlated with controllability of expenditures for these services. In other words, as disposable income of a community rises, the relative importance of capital creating expenditures declines and the importance of labor intensive personal service expenditures increases. As a result, controllability of public expenditures in higher income communities would be less than for poorer communities. If my hypothesis is correct, wealthier communities will suffer more from business cycles and require more, and possibly different, forms of counter-cyclical assistance.

There is some danger of over reacting to instability of the economy. It appears clear that if local governments attempt stability by limiting revenue sources to those with low elasticity they will reduce their potential to respond to increasing demand for services and exacerbate the local impact of recessions. If demand for uncontrollable expenditures is income elastic and greater than elasticity of controllable expenditures, then local government will have to depend on elastic revenue sources to obtain sufficient funds to provide these services, or continually increase tax rates. Moreover, if Baumol's hypothesis that the rate of technological change in public services is slower than in other segments of our economy is correct, then increasing revenues will be required just to maintain a constant level of service [1]. Thus, a policy in which local governments continue to increase their dependence on elastic revenue sources, and look to the federal government with its deficit financing capability for counter-cyclical assistance, seems most appropriate.

To conclude, White and Musser have presented a stimulating paper. They have clearly demonstrated the importance of the problem and the need for additional research.

REFERENCES

[1] Baumol, W. J. "Macroeconomics of Unbalanced Growth: The Anatomy of Urban Crisis," *American Economics Review*, 57:415-426, 1967.