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# *The Birth of the Old Federalism: Financing the New Deal, 1932–1940*

JOHN JOSEPH WALLIS

The relative importance of federal and local government was reversed between 1932 and 1940. This changing composition of government expenditures by level of government accounts for the rise of “big” government during the Depression. State governments expanded their fiscal activity, maintaining their share of total government expenditures. Utilizing data on federal grants and state and local expenditures, I find that the relative decline of local governments and sustained growth of state governments can be explained by the financial and administrative provisions of the federal New Deal programs.

**T**HE 1930s are widely and rightly regarded as a turning point in the history of the American economy. At the source of this watershed is the growing role of the government in the economy. This paper examines an important change in government structure during the Depression: the transformation between 1932 and 1940 of a fiscal system dominated by local expenditures with relatively small amounts of intergovernmental transfers into a system dominated by federal expenditures with large amounts of intergovernmental transfers.<sup>1</sup> Despite the common perception that the growth of “Big Government” began in the 1930s, government expenditure growth during the decade was not, in historical perspective, exceptionally rapid. The fundamental change in government structure during the 1930s was the shift in expenditures from local to state and federal levels and a new emphasis on expenditures for public and agricultural relief. I show that this changing pattern of expenditures (both by level and function) at the state and local level can be explained by financial provisions of the federal government programs.

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<sup>1</sup> The best contemporary accounts are Jane Perry Clark, *The Rise of a New Federalism* (Columbia, 1938) and V. O. Key, *The Administration of Federal Grants to States* (Chicago, 1937). See also George C. S. Benson, *The New Centralization* (New York, 1941) and Henry J. Bitterman, *State and Federal Grants-in-Aid* (Chicago, 1938). For a current view of New Deal federalism see James T. Patterson, *The New Deal and the States* (Princeton, 1969). All of these studies focus on the national and state responses to the New Deal separately, rather than on the interaction of national, state, and local governments, the focus of this paper.

The paper is divided into four parts. The first examines the division of expenditures by level and function for the 1930s. The second part details the administration of the major New Deal programs. The third presents a hypothesis about the effects of federal government programs on state and local expenditures and tests it against actual expenditures during the 1930s. The final section presents some conclusions.

#### GOVERNMENT EXPENDITURES BY LEVEL AND FUNCTION

The notion that the growth rate of government expenditures relative to the growth rate of the economy accelerated after 1932 is belied by Figure 1. The figure presents a standard measure of the size of government, namely, non-military government expenditures at all levels as a percentage of GNP.<sup>2</sup> Between 1902 and 1922 the government share of GNP rose from 6.9 percent to 12.6 percent (an annual growth rate of 3 percent). It rose at a slightly slower rate between 1922 and 1940 when it reaches 20.5 percent (an annual growth rate of 2.5 percent). Expenditures continued to grow after the war, although at a slower rate. The New Deal continued a general trend towards more active government, a trend already in evidence by 1913. Government expenditures did grow

<sup>2</sup> These figures, and most of the data in the paper, were taken from U.S. Department of Commerce, *Historical Statistics on Government Finances and Employment* (Washington, D.C., 1969), hereafter referred to as *Historical Statistics on Government*. Unless otherwise noted, all data on national, state, and local government expenditures are from this source. The figure is essentially the same if revenues are used, or if, prior to 1942, military expenditures are included.

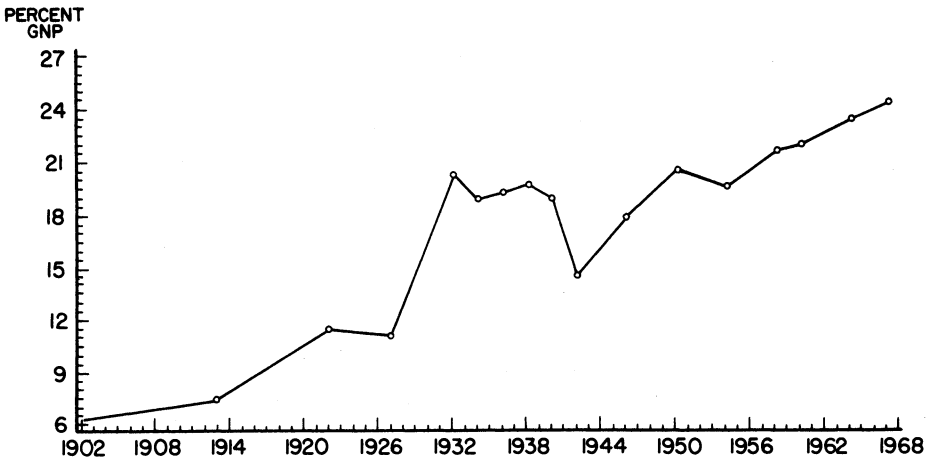


FIGURE 1  
TOTAL NON-MILITARY  
GOVERNMENT EXPENDITURES AS A SHARE OF GNP,  
1902-1967

Source: *Historical Statistics on Government*, Table 3.

significantly during the Depression, but not at a faster rate than they had in the first 30 years of the century. The extraordinary jump in the government share between 1927 and 1932 was a result of an extraordinary fall in GNP (from \$97 billion to \$59 billion) rather than an extraordinary rise in government expenditures. By this measure it was Hoover who presided over the growth of big government. Roosevelt merely consolidated his gains.

Rather than an acceleration in the growth rate of government expenditures, the growth of "big" government in the 1930s was a result of a change in the relative importance of big and little governments. Figure 2 plots expenditures by level of government as a share of total government expenditures. Between 1932 and 1940 the shares of government expenditures originating in federal and local governments are almost exactly reversed. Prior to 1932 relative shares for each level were roughly 50 percent local, 20 percent state, and 30 percent federal. After 1940 relative shares were roughly local 30 percent, state 24 percent, and federal 46 percent. The 1940 shares have remained fairly stable down to the present day.<sup>3</sup> The growth of federal government expenditures

<sup>3</sup> The relation between national, state, and local expenditures is slightly different when intergovernmental expenditures are attributed to the receiving government rather than the originating government or when revenues are considered, but the basic shift in the 1930s still dominates either series.

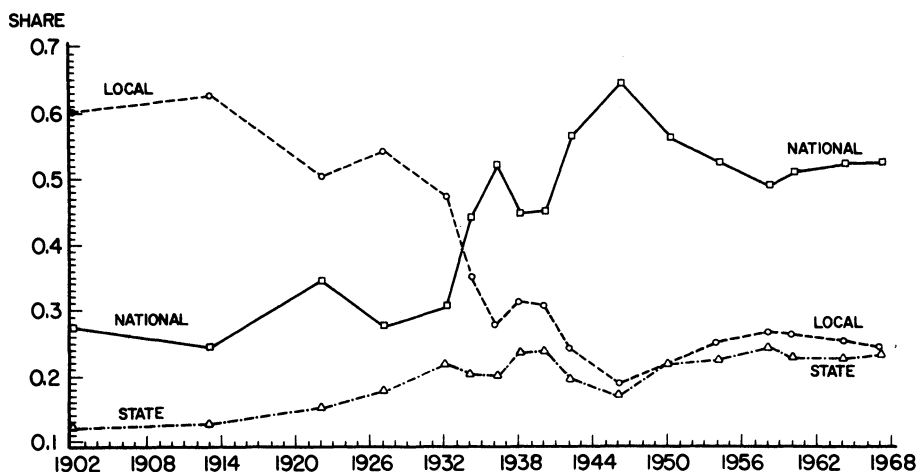


FIGURE 2  
SHARE OF TOTAL NON-MILITARY GOVERNMENT EXPENDITURES,  
BY LEVEL OF GOVERNMENT,  
1902-1967

Source: *Historical Statistics on Government*, Tables 3, 4, 6, and 7. All intergovernmental grants are attributed to the government level making the grant and deducted from gross expenditures of the level receiving the grant. Years with observations are 1902, 1913, 1922, 1927, 1932, 1934, 1936, 1938, 1940, 1942, 1946, 1950, 1954, 1958, 1960, 1964, 1967.

relative to local governments is the legacy of the depression, not an abnormally high level of total government expenditures.

The shift from local to federal expenditures is also apparent in the dollar value of expenditures by level of government. Between 1932 and 1940 federal expenditures grew by 136 percent (\$4.3 billion to \$10.1 billion), state expenditures grew by 75 percent (\$2.5 billion to \$4.5 billion), and local expenditures grew by only 3 percent (\$5.6 billion to \$5.7 billion). Total government expenditures grew by 64 percent (\$12.4 billion to \$20.4 billion).<sup>4</sup> Although local expenditures stayed virtually constant, both federal and state expenditures grew. State expenditures actually grew rapidly enough to increase their share in total government expenditures marginally despite the enormous growth in federal expenditures.

The dramatic reversal in the importance of federal and local governments raises two questions. Why the enormous expansion of federal government activity after 1932? This, of course, is the \$64 question: "Why the New Deal?" I will suggest some answers to this question later. The other question is more tractable. Why, given the historical dominance of local government in the United States, do state governments expand their activity at a rapid rate after 1932, while local government expenditures, in dollar levels, remain virtually constant?

To understand the change, we begin by looking at changes in the purpose of government expenditures. Table 1 provides information on the change in total expenditures at each level of government that is attributable to particular government functions between 1932 and 1940. The data express changes in expenditures for individual functions as a percentage of the change in gross expenditures. Expenditures are divided into two types: intergovernmental and direct expenditures.

The expenditure categories in the table are taken from the census classifications found in *Historical Statistics on Government Employment and Finance*. These categories, however, obscure several important elements of federal and, to a lesser extent, state and local expenditures. The problems involve the classification of direct and intergovernmental expenditures and the definitions of several functional categories.

The Treasury Department classified all "cooperatively administered" grants to state and local governments as either direct or indirect grants. Direct grants involved the legal transfer of funds to lower governments

<sup>4</sup> The figures in the text are for net state and local expenditures: total expenditures minus revenues from other levels of government. The gross figures on expenditure growth are: state growth of 84 percent (\$2.8 billion to \$4.5 billion) and local government growth of 20 percent (\$6.4 billion to \$7.5 billion). Non-military federal expenditures grew by 138 percent (\$3.6 billion to \$8.4 billion). These gross state and local figures, as well as the non-military federal expenditures, are the basis for calculating the percentage of total growth attributable to individual government functions in Table 1.

TABLE 1  
 PERCENTAGE OF TOTAL EXPENDITURE GROWTH ATTRIBUTABLE TO  
 EXPENDITURE FUNCTIONS, FEDERAL, STATE, AND LOCAL GOVERNMENTS,  
 1932-1940<sup>a</sup>

<i>Function</i>	<i>Federal</i>	<i>State</i>	<i>Local</i>
Intergovernmental			
Education	2.9	12.7	—
Highways	b	4.3	—
Relief	5.6	16.5	—
NEC <sup>c</sup>	4.7	2.3	—
Total Intergovernmental	13.2	35.8	—
Direct			
Education	3.5	4.1	17.6
Highways	11.7	-2.1	-8.5
Relief	3.2	21.7	19.8
Natural Resources	47.7	.1	2.1
Insurance Trust <sup>d</sup>	4.7	22.0	2.0
Interest	6.4	2.0	-7.9
Housing and Urban Renewal		—	17.6
Public Utilities		—	43.7
Liquor Stores	—	9.4	.7
Other and Unallocable	12.8	.1	b
NEC <sup>b</sup>	-3.9	6.9	12.9
Total Direct	86.8	64.2	100.0

<sup>a</sup> Changes in dollar expenditures for each function are expressed as a percentage of the change in gross dollar expenditures at each level. See footnote 5 for gross expenditure levels.

<sup>b</sup> Less than .05 percent.

<sup>c</sup> Not elsewhere classified, this is not the same as "other and unallocable"; this measures excluded expenditure categories.

<sup>d</sup> Insurance Trust expenditures include employee pensions and retirement and, at the state level, unemployment compensation payments.

Source: U.S. Department of Commerce, *Historical Statistics on Government Finances and Employment*, Tables 3, 5, and 6.

whereas indirect grants were jointly administered but remained the legal property of the federal government.<sup>5</sup> The census classifies direct grants as federal intergovernmental expenditures and indirect grants as direct federal expenditures. Unfortunately this introduces a large bias into the census's measure of the magnitude of the "intergovernmental" portion of federal expenditures. Table 2, columns (1) and (2), compares census intergovernmental grants with Treasury figures for cooperatively administered grants.<sup>6</sup> The growth in cooperatively administered grants is

<sup>5</sup> Cooperatively administered programs varied widely in their administrative structure. It was not necessarily the case that the direct grant programs allowed the state and local governments more flexibility than the indirect grants. The administration of the major programs is discussed in some detail in the following section.

<sup>6</sup> The Treasury data were collected by the Office of Government Reports for the years 1933 to 1939, and the Treasury Department of 1932 and 1940. For additional analysis of these data, see Leonard Arrington, "Western Agriculture and the New Deal," *Agricultural History* (Oct. 1970), Don Reading, "New Deal Activity and the States 1933 to 1939," this JOURNAL (Dec. 1973), and Gavin Wright, "The Political Economy of New Deal Spending: An Econometric Analysis," *Review of Economics and Statistics* (Feb. 1974).

astounding: from \$250 million in 1932 to \$3,922 million in 1940. They account for 75 percent of the growth in non-military federal expenditures between those years, as is indicated in the bottom row of the table. The census definition understates the size of intergovernmental grants by a factor of four.

A second problem arises when expenditures are allocated between functions. For example, Works Progress Administration (WPA) grants to states for work relief were not treated as relief payments. WPA expenditures were instead divided between the functional categories on the basis of the purpose of the project, such as highways, public buildings, or natural resources.<sup>7</sup> Table 2 also provides an alternative tabulation of the growth in expenditures by function (for cooperatively administered programs) in four major categories. The major change between Tables 1 and 2 is for relief expenditures; they account for 44.4 percent of growth as classified in Table 2 and only 8.8 percent of growth in Table 1 (direct and intergovernmental combined). Most of the relief

<sup>7</sup> WPA expenditures account for all of the increase in national direct highway expenditures and a significant portion of the increase in direct natural resource expenditures.

TABLE 2  
NATIONAL GRANTS TO AND EXPENDITURES WITHIN STATES, UNDER  
COOPERATIVE ARRANGEMENTS WITH STATES, 1932-1940  
(millions of dollars)

Year	Census (1)	Total (2)	Relief (3)	Works (4)	Agric (5)	Hwy (6)
1932	214	250	—	108	13	186
1933	190	432	154	196	12	161
1934	1,803	2,857	2,126	356	303	219
1935	2,197	3,649	2,221	459	664	272
1936	1,015	3,969	2,343	618	573	221
1937	818	4,273	2,405	624	636	331
1938	790	3,518	2,047	504	431	217
1939	1,031	4,794	2,671	691	743	185
1940	967	3,922	2,188	521	865	171
Expenditure Growth 1932 to 1940	—	74.5%	44.4%	8.4%	17.3%	0

Note: FERA Grants also include grants for the Civil Works Administration in 1934.

Sources: Column (1) *Historical Statistics on Government*.

Columns (2)-(6),

1933-1930, Office of Government Reports, Vol. 10.

1932 and 1940, Annual Report of the Secretary of the Treasury.

Column (3) Relief includes grants for WPA, SSA, FERA, CCC, Federal Surplus Relief Corporation.

Column (4) Works includes all PWA grants, Rivers and Harbors, and Public Buildings.

Column (5) Agriculture includes AAA, Soil Conservation Service, Agriculture Extension Work, and Agricultural Experiment Stations.

Column (6) Highways includes Bureau of Public Roads, Public Roads Administration, and various allocations to Emergency Highway grants.

expenditures in Table 2 come at the expense of natural resource and direct highway expenditures in the census classifications. Those categories include large amounts of WPA and Civilian Conservation Corp (CCC) expenditures that should properly be considered relief expenditures. Also important at the federal level were agriculture, 17.3 percent of growth in expenditures, and public works, 8.4 percent of growth.

A similar adjustment should be made at the state and local levels, but the task is impractical. Even without such an adjustment the expansion of the relief programs is duplicated at the state level. Table 1 indicates that the major areas of growth in state expenditures were public relief, both direct, 21.7 percent, and intergovernmental, 16.5 percent; insurance expenditures, 22 percent (of which 20 percent is unemployment compensation); and education, 16.8 percent.

At the local level the single largest growth item is public utilities, 43.7 percent. The remaining growth is concentrated in three areas: public relief, 19.8 percent, education, 17.6 percent, and housing and urban renewal, 17.6 percent. The growth in education and public relief, however, was financed completely by intergovernmental grants. When federal and state grants to local governments for those functions are netted out, local spending from local funds on these two items actually decreased.

To summarize the changes in government expenditures between 1932 and 1940: 1) The bulk of the growth in federal expenditures, 75 percent, came in cooperatively administered programs. 2) A major component of increasing government expenditures at each level of government was public relief. At the federal level growth came in programs that were cooperatively administered with state and local governments. State expenditures from own funds increased while local governments were able to increase relief expenditures and simultaneously to reduce their own funds devoted to relief. 3) Rising federal expenditures on public works had little measurable effect on state and local expenditures, although some amount of public works expenditures at the state and local levels might more appropriately be considered relief expenditures (for WPA projects, for example). 4) Rising expenditures for education were concentrated exclusively at the state level, primarily as intergovernmental grants to local governments. These grants enabled local governments to increase expenditures on education while spending less of their own funds for that purpose. 5) Finally, the large federal expenditures for agricultural price supports were not matched by rising expenditures at the state or local level.

#### FINANCING AND ADMINISTERING THE PROGRAMS

The pattern of expenditures by level of government for these programs is closely related to the kinds of arrangements used to finance the



expenditures. In general, when the federal government created fiscal incentives for larger state or local expenditures these expenditures increased, whereas state or local expenditure decreased when it was possible for state and local governments to substitute federal grants for their own tax dollars. This section focuses on the administration of programs in agriculture, public relief (including unemployment compensation), and public works.

The most important agricultural program was the Agricultural Adjustment Administration (AAA).<sup>8</sup> The AAA operated a variety of price support and crop limitation schemes to control farm output and raise farm incomes. The programs were, by their nature, dependent on central control. Crop production quotas determined by state governments would not be effective for agricultural products with national and international markets. Nationwide production goals for each crop were set by the Secretary of Agriculture. Each state's allotment (and therefore the amount of benefit payments it received) depended on its share of the national crop, and states could not affect their allotment by spending more or less for AAA programs.

Once established by Washington, however, crop quotas were implemented by state and local officials. The pivotal employee was the county extension agent, usually a state employee but often responsible to local farm groups.<sup>9</sup> The benefits a farmer received and the crop he was allowed to market without penalty were based on contracts entered into by the county agent. The Department of Agriculture actively encouraged local decision making and administration; on numerous occasions the decision to continue a price support program was made by the farmers themselves through a referendum. AAA programs account for 17 percent of federal government growth between 1932 and 1940, and none of the state or local growth.

Where state and local governments had little or no incentive to participate financially in the agricultural programs, the relief programs required their participation. The major relief agencies were the Federal Emergency Relief Administration (FERA), the Civil Works Administration (CWA), the Civilian Conservation Corp (CCC), the Works Progress Administration (WPA), and the Social Security Board (SSB).<sup>10</sup> The FERA, CWA, CCC, and WPA programs combined elements of public

<sup>8</sup> See Edwin G. Nourse, Joseph S. Davis, and John D. Black, *Three Years of the Agricultural Adjustment Administration* (Washington, D.C., 1937), Edwin G. Nourse, *Government in Relation to Agriculture* (Washington, D.C., 1940), and Theodore Saloutos, *The American Farmer and the New Deal* (Ames, 1982).

<sup>9</sup> Clark, *New Federalism*, p. 205.

<sup>10</sup> For the WPA see Donald S. Howard, *The WPA and Federal Relief Policy* (New York, 1943) and Arthur MacMahon, John Millet, and Gladys Ogden, *The Administration of Federal Work Relief* (Chicago, 1941). For the CCC see John A. Salmond, *The Civilian Conservation Corp* (Durham, 1969). A great deal of information on the WPA can be found in Works Progress Administration, *Final Report on the WPA Program, 1935-1943* (Washington, D.C., 1946) and the annual *Report on the Progress of the WPA*, published between 1936 and 1943. The Social Security

works with public relief through the administration of large work relief programs, but I will consider work relief as a form of public relief.

All of the relief programs, except the CCC, were jointly financed by federal, state, and local governments. Each program required explicit or implicit matching of federal funds for state and local contributions.<sup>11</sup> From the very beginning Congress and national relief officials were concerned that state and local governments should bear their share of the relief burden, and they therefore utilized matching grants. When matching formulas were not explicitly legislated the allocation of federal relief funds between the states was fraught with political tension caused by federal efforts to elicit state and local expenditures.<sup>12</sup> In the cases where explicit matching grants were written into the authorizing legislation (the Social Security categorical relief programs, early FERA grants, and loosely into a large part of the WPA grants), it was clear that national grants to a state were dependent on state and local relief expenditures. In the remaining programs, FERA, CWA, and part of the WPA grants, it was also apparent (although not legally mandated) that the national policies were to reward states with larger expenditures by making larger relief grants.<sup>13</sup> Relief expenditures account for 44.4 percent of federal government growth and 38.2 percent of state government growth between 1932 and 1940.

Unemployment compensation demonstrated an even stronger instance of Congress's making funds available to state governments contingent on their behavior. A 3 percent payroll tax was placed on employers, and 90 percent of this tax (2.7 percent of payrolls) was

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programs and their early development are described in detail in Natural Resources Planning Board, *Security, Relief, and Work Policies* (Washington, D. C., 1942). See also Arthur J. Altmeyer, *The Formative Years of Social Security* (Madison, 1966) and Paul M. Douglas, *Social Security in the United States* (New York, 1936). Annual information on the Social Security programs can be found in the United States Social Security Board, *Annual Reports (1935-1942)* (Washington, D.C.).

<sup>11</sup> There was a type of WPA project that did not require a state or local sponsor, these were the "federal" projects. The WPA federal projects were primarily white-collar projects and arts projects (theater, history, literature, and so on). After 1939 Congress almost completely eliminated WPA federal projects.

<sup>12</sup> The debate over the "political" uses of WPA funds became highly charged several times. In 1938 the race for a Kentucky Senate seat was fought over the alleged use of WPA to support the Roosevelt candidate. Later investigations did find abuses of WPA funds, not by Hopkins (the WPA administrator) but by the candidate. It also came out that his opponent had abused highway expenditures for the same political purposes. These kinds of charges were a permanent part of relief expenditures under FERA and the WPA. See Searle F. Charles, *Minister of Relief, Harry Hopkins and the Depression* (Syracuse, 1963), MacMahon, Millet, and Ogden, *Federal Work Relief*, especially Ch. 12, and Howard, *WPA*, pp. 746-52.

<sup>13</sup> The actual allocation policies followed by FERA and the WPA were never firmly set down. Occasionally this caused friction with Congress, which pressured Hopkins unsuccessfully to reveal exactly how he was distributing the funds. See Senate Report No. 1, 76th Congress, 1st. Session, as well as the discussion in Howard, *WPA*, pp. 586-604, and MacMahon, et. al., *Federal Work Relief*, pp. 222-25. Their general conclusion is that both FERA and the WPA did match implicitly. I test this proposition directly in the following section.

returned to states with approved unemployment programs. Since Congress allowed a variety of different unemployment insurance schemes, the payroll tax amounted to a 2.7 percent gift to each state. States would lose the gift if they did not have an approved program, since the payroll tax would be collected in any event. By 1940 every state had an approved program, accounting for 20 percent of state growth and none of the growth in federal or local governments.

The relief programs shared two characteristics between 1932 and 1940 in addition to the general matching policy. The first was the designation of the state as the fiscal unit that received federal funds. For example, the Social Security Act provided for matching grants of \$1.00 for every dollar of expenditures in a state on approved Old Age Assistance programs, whether the funds came from state or local sources. The distribution of funds within the state, however, was not necessarily based on local contributions. This was also true with the FERA and WPA grants. This policy characteristic is important, because it weakened the incentive for extended local expenditures that would have been created by giving matching federal grants directly to local governments.

The other shared characteristic of all the relief programs was the location of important administrative responsibilities at the state and local level. For example, the Social Security Act prohibited the Social Security Board from denying a state matching funds on the basis of personnel policy, thereby placing the patronage benefits of the Social Security programs firmly in state hands. It was always the case that the selection of relief recipients was either a state or local government responsibility; even the WPA had to choose work relief recipients from a list of qualified applicants certified as needy by the local relief agency. As was the case with AAA price supports in which federal programs were administered locally, public relief in the New Deal was very much a "federal" program.<sup>14</sup> Important decisions about who would receive how much relief for how long were left, either by law or in practice, in state and local hands.

The relief programs, then, distributed federal funds between the states on a matching basis, either through a formal rule or an informal administrative practice. The actual administration of relief involved a complex organization in which each level of government made important administrative decisions.

The final group of programs, public works, is more heterogeneous. It contains several programs that were predominantly national and these

<sup>14</sup> As Howard wrote, "A further cause for regret on the part of those who would like to see federal agencies create jobs wherever they appear to be needed is the limitation imposed upon the WPA by Congress which prevents the employment of workers in any given area unless local or state agencies can be induced to initiate projects and contribute a substantial proportion of their costs." Howard, *WPA*, p. 546.

will not be discussed here.<sup>15</sup> Of primary importance for present purposes are the highway programs, the Public Works Administration (PWA), the Rural Electrification Administration (REA), and the United States Housing Authority (USHA). Prior to 1932 highway expenditures had been a major source of growth in state expenditures, one that the federal government had stimulated by matching grants. After 1933 the federal government began to finance a larger share of highway expenditures, but it switched the allocation of highway funds from matching basis to a formula based on a combination of population, geographic area, and miles of rural post roads. By the use of the formula the highway grants effectively eliminated any incentives for states to spend their own funds to obtain larger federal highway grants.<sup>16</sup>

The PWA was originally intended to be the public works arm of the National Industrial Recovery Act. The PWA was empowered to make a combination of grants and loans to state or local governments for a variety of public works projects. Since state or local governments had to finance a percentage of project cost, the PWA used a matching principle in distributing funds.<sup>17</sup>

The remaining two programs were established to promote particular kinds of activity at the local level. REA made low interest loans with generous repayment provisions to local governments to promote rural electrification. The USHA made a combination of loans and grants to local governments to encourage low-income housing, and the agency also continued to subsidize rents in those projects when the housing was completed.<sup>18</sup> In both these cases, the federal government attempted directly to lower the cost to local governments of electrifying rural areas and building low cost urban housing. As the figures presented in the previous section indicate, local governments did respond to these incentives: Public utilities and urban renewal and housing are the two areas in which local expenditure from own funds increased between 1932 and 1940 (43.7 percent and 17.6 percent of local growth, respectively).

#### HYPOTHESIS AND TESTS

The foregoing review of the major New Deal programs provides the basis for the central hypothesis of the paper. State and local expendi-

<sup>15</sup> The TVA and the regular rivers and harbors projects were not cooperatively administered and are not discussed here.

<sup>16</sup> See Bitterman, *State and Federal Grants-in-Aid*, for a discussion of highway programs.

<sup>17</sup> Kerwin Williams, *Grants-in-Aid Under the Public Works Administration* (New York, 1939).

<sup>18</sup> United States Housing Authority, *Housing and Urban Redevelopment* (Washington, D.C., 1940) and Federal Housing Administration, *A Handbook on Urban Redevelopment for Cities in the United States* (Washington, D.C., 1941). For the REA see, D. Clayton Brown, *Electricity for Rural America: The Fight for the REA* (Westport, 1980).

tures increased when the financial provisions of the federal programs created an incentive for expanded state and local activity. The federal relief programs, FERA, WPA, Social Security, and unemployment compensation alike, created incentives for state expenditures through matching grants or tax breaks. This explains both the continual growth of state governments and the shift in the composition of state expenditures towards relief programs. State relief expenditures account for almost 60 percent of state growth.

At the same time local governments were decreasing expenditures from their own funds for relief. Local expenditures for categorical relief did not automatically result in matching funds or, more importantly, reductions in local expenditures did not automatically reduce federal and state grants for relief. Given the substantial increase in federal and state expenditures for relief, local governments could reduce their relief expenditures while local residents actually received larger amounts of public assistance. The two areas where local governments did expand—public housing and public utilities—were both areas in which the federal government created loan/subsidy programs explicitly designed for local governments. This section tests this “incentive” hypothesis. The results indicate that the financial incentives offered by the federal programs did have an important effect on state and local government expenditures.

There is a large public finance literature on the effect of federal grants on state and local expenditures.<sup>19</sup> The major issue has been the differential effects of unconditional block grants (cash) and conditional matching grants on state and local expenditures. The distinction between the two involves the income effect of the block grants and the price effect of the matching grants.<sup>20</sup> Although there are several theoretical approaches to the problem, all the empirical work follows the same basic form. State expenditures (the same applies to local expenditures) are assumed to be a function of federal grants and a number of economic and demographic characteristics of the states: income, education, urbanization, unemployment, racial composition, dependency ratios, and population density. A typical equation system of the following form is estimated:

$$SE_i = a_s + b_1NG_i + b_iX_i + e_s \quad (1)$$

$$NG_i = a_n + c_1SE_i + c_iZ_i + e_n \quad (2)$$

<sup>19</sup> See Gramlich’s article “Intergovernmental Grants: A Review of the Empirical Literature,” in *The Political Economy of Fiscal Federalism*, edited by Wallace E. Oates (Lexington, 1977) for an extensive review of the grants literature. Recent work has utilized more complicated theoretical and empirical techniques than those used here. See Stanley L. Winer, “Some Evidence on the Effect of the Separation of Spending and Taxing Decisions,” *Journal of Political Economy* (Feb. 1983), 126–40, and Martin C. McGuire, “A Method for Estimating the Effect of a Subsidy on the Receiver’s Resource Constraint: With an Application to U.S. Local Governments,” *Journal of Public Economics* (Aug. 1978), 25–44.

<sup>20</sup> See the theoretical exposition in James A. Wilde, “Grants-in-Aid: The Analytics of Design and Response,” *National Tax Journal* (June 1971), 143–55.

where  $SE_i$  is state level (or state and local level) expenditures per capita in state  $i$  ( $i = 1, \dots, 48$ ),  $NG_i$  is per capita national grants to state  $i$ , the  $X_i$  and  $Z_i$  are economic and demographic control variables, and  $e_s$  and  $e_n$  are the error terms in the state and federal equations.

The usual test concerns the sign and magnitude of the coefficient  $b_1$ . For matching programs  $b_1$  should be positive: The price effect leads states to increase expenditures as the matching effectively lowers the costs of additional expenditures. For block grants the sign of  $b_1$  depends upon the income elasticity of demand for the program in question.<sup>21</sup>

Most studies do not explicitly consider equation (2). Instrumental variables are used for the first stage estimates of  $SE$  and  $NG$ , which are then used in the 2SLS estimates of equation (1). For our purposes, however, equation (2) is as interesting as equation (1). State and local governments had considerable influence over the administration of federal programs during the New Deal. The sign and magnitude of  $c_1$  and the other  $c_i$  provide important information on the response of the federal government to state and local behavior.

Fortunately, the determinants of federal grants to the states during the New Deal, the  $Z_i$ , have been the subject of several studies, the most suggestive by Gavin Wright.<sup>22</sup> Wright attempted to test the hypothesis that Roosevelt used the allocation of national grants to strengthen his chances of reelection. Wright constructed a measure of political productivity designed to capture the potential electoral votes that a dollar of national grants would generate in each state. He used this measure to explain cross-sectional differences in federal grants by fitting the following equation:

$$NG_i = a_w + d_1PP_i + d_2V_i + d_3W_i + e_w \quad (3)$$

where  $NG_i$  is per capita national grants between 1934 and 1940,  $PP_i$  is his measure of political productivity,  $V_i$  is the standard deviation of the Democratic share of the presidential vote between 1888 and 1928, and the  $W_i$  are control variables.

The measure  $PP$  incorporates information from 1888 to 1928 on the Democratic shares of the presidential vote. In brief, the closer the state's historical voting trend is to 50 percent Democratic, the more likely that a small shift in voters will turn the election towards Roosevelt.<sup>23</sup> Wright also incorporates the variability of the Democratic

<sup>21</sup> See Gramlich, "Intergovernmental Grants."

<sup>22</sup> Gavin Wright, "The Political Economy of New Deal Spending: An Econometric Analysis."

<sup>23</sup> Using Wright's notation

$$E_i = V_i [Pr_1 (D_i > 0.5) - Pr (D_i > 0.5)]$$

where  $E_i$  is the expected gain in the probability of Democratic victory with a 1 percent shift in the distribution towards the Democrats,  $D_i$  is the Democratic share of the vote,  $V_i$  is electoral votes in state  $i$ ,  $Pr$  is the probability of Democratic victory given the historical distribution of the Presidential vote in a state, and  $Pr_1$  is the probability of Democratic victory when that distribution

share,  $V$ , arguing that votes are easier to influence in states with more flexible electoral habits.

The equation estimated by Wright is not quite the same as equation (2), since Wright did not allow federal grants to be contingent on state expenditures. This can be taken care of by including state expenditures in equation (3). The result is a system of two equations describing state and federal expenditures:

$$SE_i = a_s + b_1NG_i + b_iX_i + e_s \quad (4a)$$

$$NG_i = a_n + c_1SE_i + c_2PP_i + c_3V_i + c_iW_i + e_n \quad (4b)$$

where all variables are defined as above.<sup>24</sup>

Wright tested his hypothesis with data on federal government grants between 1934 and 1940. Unfortunately, comparable data on state and local expenditures for the period are not readily available. State expenditures were recorded in the Census series "Financial Statistics of the States," but the series was suspended between 1933 and 1936. No comprehensive figures on local expenditures were collected between 1932 and 1942, and by 1942 the war had begun to affect all of the New Deal programs as well as state and local governments.<sup>25</sup>

The first estimates of equations (4a) and (4b) therefore are pooled time-series cross-sectional data on federal grants and state expenditures for the years 1937 to 1940, the years with comprehensive state data available. The categories considered are total expenditures and grants, expenditures and grants for relief, and expenditures and grants for

is shifted 1 percent towards the Democrats. The political productivity measure is then calculated by dividing  $E_i$  by 1 percent of the total vote in each state:

$$PP_i = E_i / (.01T_i)$$

where  $T_i$  is the total vote in state  $i$ .

<sup>24</sup> These types of equations are usually estimated by 2SLS or 3SLS. In the estimates that follow for state and federal expenditures an error components method is used. This allows the error terms in equations (4a) and (4b) to have both state and time-specific components. This estimator is described in detail in W. A. Fuller and G. E. Battese, "Estimation of Linear Models with Crossed-Error Structure," *Journal of Econometrics* (May 1974), 67-78. These estimates were calculated with the Time Series Cross Section (TSCS) package in SAS.

<sup>25</sup> A limited annual series on local government finances was collected by the census, *Financial Statistics of Cities*, but this series only includes large metropolitan areas. Since large cities have considerable different relations with state and national governments than do small cities, such a sample is not representative of all local governments. In the analysis presented here expenditure data for the states for the years 1937 to 1940 were taken from U.S. Bureau of the Census, *Financial Statistics of States, 1937, 1938, 1939, and 1940* (Washington, D.C., 1940, 1941, 1942, and 1943). State and local data for 1942 were taken from U.S. Bureau of the Census, *Governmental Finances in the United States 1942* (Washington, D.C., 1945). State and local data for 1932 were taken from U.S. Bureau of the Census, *Financial Statistics of State and Local Governments, 1932* (Washington, D.C., 1935). The national grant data were taken from U.S. Office of Government Reports, Vol. 10, for the years 1933 to 1939, and from U.S. Department of Treasury, *Annual Report of the Secretary of the Treasury* (Washington, D.C.) for 1932, 1940, and 1942. The Wright variables,  $PP_i$ ,  $V_i$ , and the  $W_i$  are the same as described in the Wright article. These data were graciously supplied by Wright.

highways.<sup>26</sup> The relief and highway programs offer a marked difference in financial arrangements. Highway grants were made by formula while relief grants were either straight matching or left to the discretion of the relief administrator. The amount of highway funds a state received had no relation to the amount it expended, but the relief funds received by a state depended directly on its contributions. Therefore, the *a priori* expectation is that both  $b_1$  and  $c_1$  will be zero for the highway programs and positive for the relief programs.

The expected relation between total grants and total expenditures is ambiguous. The thrust of this paper is that  $b_1$  will be positive, that the large growth in state expenditures for relief programs positively associated with large federal grants for relief will dominate the state equation. How the federal equation and the estimate of  $c_1$  will turn out, however, is uncertain. Relief expenditures are a large part of federal grants, and the relief programs explicitly used larger federal grants as incentives for states to expand their contributions. On the other hand, there was pressure for the federal government to use grants to equalize the provision of government services across the states.<sup>27</sup> Under strict matching the states that spend the most get the most ( $c_1$  positive). If, however, the federal government attempted to effect equalization, then the estimate of  $c_1$  might be negative. The regression estimates of equations (4a) and (4b) using data from 1937 to 1940 are presented in Table 3.

In the total grant and expenditure estimates, columns one and two, state expenditures represent total expenditures for operation and maintenance, capital outlays, and interest payments net of intergovernmental grants (these intergovernmental grants are the direct grants discussed earlier). Federal grants are grants for all cooperatively administered programs, and include direct and indirect grants. Therefore, the sum of net state expenditures in the state equation and federal grants in the federal equation is greater than total state expenditures reported by the census, by the amount of indirect grants a state received.

As the second column of the table indicates, total state expenditures were positively related to federal grants, consistent with expectations.

<sup>26</sup> Grants and expenditures for agriculture and for unemployment compensation are not considered as separate categories. Although both of these programs are clear examples of how financial incentives of the national programs affect state expenditures, the relation between the two cannot be tested via a regression since there are zeroes on one side of the ledger in both programs.

<sup>27</sup> The question of equalization was at the heart of several debates over policies in Social Security, relief, and agricultural programs. The problem was that the "neediest" individuals usually lived in states with the lowest levels of state and local government expenditure. To equalize the provision of services meant to give states that spent less larger national grants, which of course, created incentive problems. During the New Deal, equalization was not explicitly made a part of the Social Security program. See Altmeyer, *Social Security*, and the discussion in Howard, *WPA*, pp. 533-604.



TABLE 3  
DETERMINANTS OF FEDERAL GRANTS AND STATE GOVERNMENT  
EXPENDITURES, PER CAPITA, 1937-1940  
(t-statistics)

Variable	Total		Relief		Highways	
	Federal	State	Federal	State	Federal	State
State	-.35 (1.00)	—	1.73 (2.13)**	—	.05 (.24)	—
National	—	.31 (3.9)***	—	.34 (2.8)***	—	.14 (.77)
Farm	41.8 (1.73)*	—	6.81 (.69)	—	4.57 (1.44)	—
PP	95.3 (1.70)*	—	37.5 (1.63)*	—	35.7 (3.1)***	—
SE	.98 (1.54)	—	.36 (1.89)*	—	.08 (.57)	—
Income 32-29	-.03 (.48)	.06 (2.4)	-.01 (.51)	-.001 (.17)	-.003 (.28)	.03 (3.93)***
Unemp 1937	-2.57 (1.17)	.87 (.75)	1.17 (1.70)*	.18 (.44)	-.47 (1.00)	.31 (.69)
Relief	81.5 (2.37)**	—	—	—	-3.7 (.58)	—
Depend	-192.8 (1.67)*	202 (3.16)***	-5.01 (.15)	36.3 (1.99)**	—	36.8 (1.37)
Fed Land	.66 (4.67)***	—	-.05 (1.25)	—	.08 (2.95)***	—
Income	—	.05 (4.64)***	—	.007 (2.23)**	—	.01 (2.95)***
Urban	—	.41 (2.7)***	—	.04 (1.44)	—	-.03 (.62)
Educ	—	-1.11 (.45)	—	.67 (.97)	—	.16 (.17)
Black	—	.04 (.40)	—	.04 (1.00)	—	.01 (.39)
Density	—	-.04 (4.11)***	—	-.005 (1.71)*	—	-.007 (1.80)*
Cars	—	—	—	—	8.5 (.81)	23.88 (2.25)**
F	6.7	28.5	20.9	15.5	13.2	18.1

Note: \* = significant at 10%.  
 \*\* = significant at 5%.  
 \*\*\* = significant at 1%.  
 n = 192.

Dependent variables are: Column one, total federal grants; Column two, total state expenditures; Column three, federal grants for relief; Column four, state expenditures for relief; Column five, federal grants for highways; Column six, state expenditures for highways.

#### Variable Definitions

- State = Net state expenditures for total, relief, and highway respectively  
 National = Net national grants for total, relief, and highways respectively  
 Farm = Percentage of total population living on farms, average of 1930 and 1940  
 PP = Gavin Wright's political productivity variable (see text)  
 SE = Standard deviation in the Democratic share of the Presidential vote between 1888 and 1928 (see text)  
 Income 32-29 = Change in per capita income between 1929 and 1932  
 Unemp 1937 = Unemployment rate in 1937

The coefficients on the control variables reproduce the usual public finance results. Larger state expenditures are associated with higher income, greater urbanization, and higher dependency ratios. As the positive sign on the change in income between 1929 and 1932 indicates, states in which income fell less during the Depression were states that experienced higher levels of state expenditure at the end of the decade. The negative sign on population density, when controlling for urbanization, is consistent with the idea that geographic dispersion of the population increases the costs of providing government services and therefore leads to lower expenditure levels.

In the total federal equation (the first column), state expenditures do not appear to have a significant effect (in the statistical sense) on federal grants.<sup>28</sup> Values of the control variables are consistent with the results that Wright obtains with a single equation estimate, although the significance levels of the variables are reduced. The Wright hypothesis seems to be robust under a variety of specifications.

In the relief equations (columns three and four) state expenditures include expenditures in all relief programs for operation, maintenance, and capital outlays, net of direct federal grants for relief. Federal grants include all grants made by the Social Security Board and the WPA.<sup>29</sup> Both equations indicate a clear, positive relation between state expendi-

<sup>28</sup> In the regressions the coefficients of primary interest are those on the endogenous variables: state expenditures and national grants. A number of other techniques (including 2SLS and 3SLS) and specifications (including first differences and log linear) were used to estimate these equations, and the only relationship between endogenous variables significantly affected by different specifications was the sign of the state expenditure variable in the national equation. It was positive, negative, and zero under alternative specifications. We cannot say much about the effect of total state or local expenditures on total national grants. On the other hand, the coefficient estimates on the endogenous variables in the relief, highway, and state expenditure equation were quite stable under alternative specifications, although the significance of the results was reduced somewhat in the first difference specification (these results are available on request). We have very little understanding of the national government allocation process, and while the Wright variables, on the whole, do fairly well, they clearly do not capture all of what is going on.

<sup>29</sup> Categorical grants made by the Social Security Board are perfectly matched by state expenditures for categorical relief. The estimates for relief grants and expenditures are qualitatively the same if these Social Security grants and state expenditures are excluded, although including all

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Relief	= Percentage of the population receiving relief payments in July 1935
Depend	= Percentage of the population below age 15 and above age 65, average of 1930 and 1940.
Fed Land	= Percentage of total land area owned by national government
Income	= Per capita income, average for 1935, 1937, and 1939
Urban	= Percentage of the population living in urban areas, 1930
Educ	= Mean years of schooling, 1930
Black	= Percentage of the population that is black, 1930
Density	= Population per square mile, 1930
Cars	= Per capita registered cars and trucks, 1940

Source: See text.

tures and federal grants. A dollar increase in per capita state expenditures led, at the margin, to an increase of \$1.73 in per capita federal grants. A dollar increase in per capita federal grants led to a \$.34 increase in per capita state expenditures. As was the case with the total grants and expenditures, the control variables have the appropriate signs, if sometimes statistically insignificant coefficients.

In the highway equations (columns five and six) the state expenditure variable is per capita state expenditures for operation, maintenance, and capital outlay for highways, net of direct federal grants for highways. The federal equation includes all grants for highways made under highway programs administered by the Secretary of Agriculture.<sup>30</sup> Unlike the relief equations, in the estimates for the highway programs federal grants and state expenditures for highways are not interdependent. This is consistent with the fact that the federal highway grants were made by formula. The coefficients on the control variables in the two equations are, again, reasonable.

The pooled time-series results do not discredit the incentive explanation of the changing level of state expenditures during the 1930s. Federal grants, particularly grants for relief, encouraged states to increase expenditures. On the other hand, highway grants distributed by formula did not lead to larger state expenditures. Total state expenditures were positively related to federal grants, while federal grants were not related to state expenditures. The relation between federal and state activity is, however, only half of the puzzle. The other half is the failure of local governments to grow. The constancy of local expenditures can be explained by the incentive framework, but testing the hypothesis is more difficult than for the states.

One problem is formulating the appropriate specification for the local government estimates. Clearly the structure of federal grants and state expenditures already considered is part of the story, and to that a model of the state grant and local expenditure process needs to be added. Unfortunately, states both receive grants, expend funds, and give grants. What determines whether a state grants funds to local governments or spends the funds directly is not clear, and therefore separate state grant and state expenditure equations cannot be identified. On the other hand, it is not clear whether state grants or state expenditures are the variable to which local governments respond, for example, in

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national relief grants and all state relief expenditures seems to be the appropriate specification, since the WPA reportedly took all relief programs into consideration when making grants. Howard, *WPA*, pp. 597-98.

<sup>30</sup> The national grants do not include grants for highway projects made by either the WPA or PWA. Interestingly, when those grants are included with the formula grants there is a positive relation between state expenditures and national grants. The WPA and PWA did match, and this shows up. The data on project breakdowns is somewhat crude, however, making it difficult to separate expenditures on highway projects, and I do not have a great deal of faith in those results.

education. It is also difficult to identify factors that affect state governments but not local governments since the economic and demographic characteristics of state populations should influence both state and local decision making.

These conceptual problems are further compounded by the lack of detailed information on local government expenditures. In the data available for 1932, local grant income from federal and state governments is recorded, but grants are not divided by function, and thus net local expenditures by function cannot be calculated. In a similar manner, only total capital outlays are reported; outlays for individual functions are not reported.

In light of these difficulties, several alternative specifications were considered. All of them had the same result: Local government expenditures were negatively related to the amount of grants local governments received. The simplest version was a single equation explaining the difference in per capita local expenditures between 1932 and 1942. The difference in national and state grants to local governments is the variable "Aid," and the exogenous variables were used as instruments to obtain a predicted "Aid." As was the case with state expenditures, the empirical results with local expenditures are consistent with the incentive hypothesis. The "Aid" variable has a significant negative effect on the growth of local expenditures between 1932 and 1942.<sup>31</sup>

$$\begin{aligned} \text{Local Exp.} = & - 5.36 - 1.41 \text{ Aid} - .003 \text{ Income} \\ & (.77) \quad (3.61)** \quad (.12) \\ & + 75.64 \text{ Urban} - 376.0 \text{ Black} - .44 \text{ Density} - 75.99 \text{ Depend} \\ & (2.09)** \quad (2.05)** \quad (1.64)* \quad (.49) \\ & + .08 \text{ Local Debt} - 9.77 \text{ Property Tax} \quad N = 48, F = 6.68 \\ & (2.52)** \quad (.63) \end{aligned}$$

\*\* = 5 percent, \* = 10 percent confidence

#### CONCLUSIONS

The 1930s was a decade of dramatic and far reaching change in the nation's political, economic, and social institutions. This paper has examined an important structural shift in the political sector: the growing importance of state governments and the relative decline of

<sup>31</sup> All of the variables are first differences, and are defined as in Table 3. Urban, Black, Density, and Depend are differences in 1930 and 1940 values. Aid, Income, Local Debt, and Property Tax are differences in 1932 and 1942 values. Local Debt is per capita local government debt and Property Tax is the percentage of all local taxes derived from Property Tax. Other specifications included a three-equation system with a national, state, and local equation. Both first differences and levels were used. In all of the specifications there was a negative effect on grants to local governments on local government expenditures.

local governments. The explanation hinges on the new federal government programs of agricultural price supports and a range of public relief services. The evidence indicates that the structure of the federal programs led states to grow and local governments to remain at a constant level of activity.

The shift in the structure of government expenditures between levels of government and functions of expenditure is responsible for the common misperception that the level of government expenditures grew more rapidly during the New Deal than at other times in this century. Total government expenditures did not grow more rapidly in the 1930s than they had between 1900 and 1930, but Big Government, that is the federal government, did expand dramatically relative to state and local governments. Further, for the first time a large segment of the population came to depend directly on government for financial support through the relief programs.

Several important questions have been sidestepped in this paper. First, there is no explanation of the behavior of national expenditures between 1932 and 1940. Why the big jump in 1933? Why the New Deal? Second, the analysis has focused on expenditures to the complete exclusion of taxes. It is possible that compensating movements in national, state, or local taxes could vitiate some of the conclusions drawn here.

Finally, the question of why this particular set of financial and administrative arrangements was chosen has not yet been addressed. As the discussion of the administrative arrangements makes clear, the federal government shared administrative responsibility with state and local governments. Likewise, in the single most important growth area, public relief, federal grants were as sensitive to state expenditures as state expenditures were to federal grants. The structure chosen by Congress and Roosevelt to administer the New Deal was emphatically a "federal" one.

The conclusion of this paper, that a significant portion of the change in state and local public finance during the 1930s can be explained by the actions of the federal government, should not be construed to imply that the federal government called the tune for dependent state and local governments. With the exception of the Civilian Conservation Corp, each of the major New Deal programs was cooperatively administered. Despite their declining relative shares in both revenues and expenditures, local governments made important administrative decisions in the day-to-day operation of the programs. State governments administered the unemployment compensation and categorical relief programs under Social Security with a minimum of federal interference.

Even the brief review of the financial and administrative structure of the New Deal programs indicates the limits placed on the use of discretionary grants by the New Deal agencies. Despite appearances to

the contrary, Congress did not make openhanded grants of funds to Roosevelt and the agencies controlled by the Executive Branch. The effect of the particular financial and administrative arrangements chosen by Congress was to take discretionary control over the allocation of federal funds out of the hands of the Executive Branch and keep that control in Congress (with legislated allocation formulas) or give it to the state and local governments that Congress represented (with explicit or implicit matching).<sup>32</sup>

This interpretation is consistent with a major element in the recent history of the New Deal, which stresses that the New Deal Congresses were not merely “rubber stamps” for whatever policies Roosevelt wanted.<sup>33</sup> It may have been politically wise during the Depression to focus attention, and therefore credit and blame, on Roosevelt, but everybody got a piece of the action. This was true for the local politician influencing who received work relief jobs, for the state official influencing where public works projects would be located, for Congressmen dispensing, indirectly, thousands of patronage jobs, as well as for Roosevelt who could claim credit for spending billions to alleviate suffering at a time of great national crisis. Everybody in government—the federal executive and legislative branches, and state and local officials alike—benefitted from the New Deal.

The structure of federal grants and state and local expenditures that this paper has attempted to illuminate should not be regarded as a historical accident. It was the result of a realignment of the rights and responsibilities of different parts of American government, a realignment in which all of the major political institutions appear to have gained and were therefore willing to support. Understanding the relationship of federal grants and state and local expenditures is a small but integral part of the answer to the question that future scholarship may answer: “Why the New Deal?”

<sup>32</sup> In this light it would appear that Congress would prefer, other things equal, not to give up any of its power to allocate funds. It is interesting to note that the early, albeit unsuccessful, relief bills proposed to allocate relief funds by a formula controlled by Congress. See John Joseph Wallis, *Relief and Unemployment in the Great Depression* (Unpublished Ph.D. Dissertation, University of Washington, 1981).

<sup>33</sup> See James T. Patterson, *Congressional Conservatism and the New Deal* (Lexington, 1967) and Frank Freidel, *FDR: Launching the New Deal* (Boston, 1973), pp. 436–53.

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