1979

Federal Policy and the Fiscal Outlook for Cities

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Recommended Citation

Bahl, Roy W. Bernard Jump, Jr., and Larry Schroeder. "Federal Policy and the Fiscal Outlook for Cities" in Fiscal Crisis in American Cities: The Federal Response, edited by L. Kenneth Hubbell, Cambridge, MA: Ballinger Publishing Co., 1979.

Fiscal Crisis in American Cities: The Federal Response

L. Kenneth Hubbell,
Editor

Ballinger Publishing Company • Cambridge, Massachusetts
A Subsidiary of Harper & Row, Publishers, Inc.

This book is printed on recycled paper.

International Standard Book Number: 0-88410-491-5

Library of Congress Catalog Card Number: 79-614

Printed in the United States of America

Library of Congress Cataloging in Publication Data
Main entry under title:

Fiscal crisis in American cities—the Federal response.

Based on papers presented at a conference held in Washington, D.C. in mid-June 1978.

Includes bibliographical references.

1. Intergovernmental fiscal relations—United States—Congresses. 2. Grants-in-aid—United States—Congresses. 3. Revenue sharing—United States—Congresses. 4. Municipal finance—United States—Congresses. I. Hubbell, Loren Kenneth.
HJ275.F553 336.1'85 79-614
ISBN 0-88410-491-5

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Chapter 1

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The urban fiscal problem was as popular a topic in 1965 as in 1975, but the nature of the discussion, like the severity of the problem, differed markedly. The burning urban fiscal issues of the mid-1960s were city-suburb disparities in public service levels and fiscal capacity congestion and urban blight, heavy concentration of the poor and badly deterioriated neighborhoods in the central city, and early signs of a worn-out urban infrastructure.[1] Little attention was paid to the possibility that financial problems in some communities could become so severe as to take them to the brink of default. Indeed, as late as 1968 the major rating agencies were struggling with the hypothetical problem of assigning several levels of default probability when all major local government securities were thought to be of investment grade. Some of the urban fiscal issues of the 1960s were even more pressing at the midpoint of the next decade; city-suburb fiscal disparities had widened, poverty in the urban ghettos had deepened, and the urban infrastructure had continued to deteriorate. But by 1975 there were new issues as well. A high rate of inflation and the influence of public employee unions had shifted the pressure on public expenditures away from the demand side—citizen requirements for adequate public service levels—and onto the supply side where costs became the primary consideration. Other notable differences were that a recession had devastated the economies of many old central cities and left some doubt about their future economic roles, regional shifts in economic activity had compromised the financial position of even some state governments, and the financial collapse of New York City had demonstrated that default could indeed occur. The new factors resulted in shifting federal policy emphasis toward short-term financial measures (e.g., CETA, ARFA, Local Public Works) while the more fundamental long-term reforms, particularly public welfare, remained on the shelf.

The purpose of this chapter is to assess the fiscal outlook for cities in light of this history and current federal policy. In the next sections, the events leading to the 1975 crisis are discussed and the outlook is considered in a context of the important federal and local government fiscal responses during the 1975-1978 recovery period. Finally, some principles for a more appropriate federal urban policy are discussed. Because this subject, the urban fiscal problem, is much more commonplace in the Northeast and the industrial Midwest than elsewhere in the country, emphasis is given to the existing situation and prospects for the declining cities in these regions.

THE SOURCES OF THE PROBLEM: 1962-1975

There were three major sources of the urban fiscal problem that led to the crisis conditions for many cities and some states in 1975:[2] the recession that accelerated the decentralization of employment from central cities and from the declining regions; inflation; and public employment and employee compensation growth.[3]

Economic Base Decline

An examination of the New York City case—perhaps the extreme example of the more general problem—underlines the importance of relating the fiscal health of a city to the basic health of its economy. From a peak of 3.8 million in 1969, employment in New York City declined virtually without interruption to a level of 3.4 million by June 1975, an 11 percent drop The employment decline has not been as precipitous since 1975, but the downward trend has continued. During the 1969-1975 period, employment in the nation grew by more than 20 percent and since 1975 has continued to increase. If employment in New York City had grown at the national rate between 1969 and 1978, New York City would have upward of 750,000 more jobs than it now has. The city government revenue loss represented by this job loss is substantial, an amount that would easily eliminate the city's current deficit.[4]

While it must be acknowledged that many of New York City's problems are unique and that New York City's situation is always an exaggeration of what is occurring elsewhere, the problem of a declining economic base is present in many large metropolitan core cities across the country. Those in the Northeast appear to have fared worse than the newer southern and western central cities, but all have experienced employment suburbanization as industries have moved to newer, more spacious facilities closer to their suburban employees. It is difficult to document central city employment trends because no public or private agency collects data on employment in cities. Sacks has adjusted Census Journey-to-Work data to estimate employment in city areas and finds a stereotypic pattern. Between 1970 and 1975, northeastern cities lost employment at an average annual rate of 2.0 percent; midwestern cities declined at 1.6 percent annually. Meanwhile, southern cities grew at 3.2 percent and western cities at 1.6 percent.[5]

One possibility for documenting central city employment decline is the Census Bureau's *County Business Patterns*, but these data limit comparisons among central cities to those ten that are coterminous with county areas.[6] An analysis of these city-county areas for the 1965-1972 period shows that New York, Philadelphia, and St. Louis all experienced employment declines. Between 1973 and 1974, six of the ten were losing employment, and the four gaining counties—Indianapolis, Jacksonville, San Francisco, and Nashville— are conspicuously outside the declining regions.[7] With the recession between 1974 and 1975, all ten counties lost employment. (There are no more recent data to compare these central counties.) The employment situation was only slightly better in the metropolitan areas in which these ten counties are located. During the 1974-1975 recession, eight of the ten metropolitan areas lost employment.

The particular details of this employment decline cannot be carefully documented from available information published by the government even on a county basis. However, there is some evidence that it is not primarily due to interregional firm migration but rather to a much higher death rate than birth rate of firms. Jusenius and Ledebur, using Dun and Bradstreet establishment data for the 1969-1974 period, point out that 20.5 percent of jobs in the northern region were lost because of closure of firms while only 8.9 percent were gained back because of new firm births.[8] The fiscal consequences of lost firms may be even more severe than employment loss due to firm contractions for local governments that rely heavily on the property tax. Property tax assessments probably respond little to employment fluctuations over the business cycle since assessment of such properties is usually made on a reconstruction cost rather than an income basis and since reassessment lags are notoriously long. Firm closures, on the other hand, affect assessments if the property is abandoned or if the use of the building changes substantially.[9]

These data are far from conclusive, but what they show is that the economic base of central counties as well as the base of the metropolitan areas in the declining regions are either growing very slowly relative to the rest of the country or are in absolute decline. One might guess that the situation is even worse for central cities in general. If employment loss is due primarily to firm closure, then a much higher death rate of firms probably occurred in central cities than in suburbs over the 1969-1975 period.

Inflation Impacts[10]

The national economy has experienced a wide variety of inflationary pressures during the past fifteen years. These inflationary pressures can affect the financial fortunes of the state and local sector although their exact impact is not easily estimated. None of the generally available price indexes are designed to measure changes in the cost of providing government services, and as a consequence such indexes serve only as crude indications of the impact of inflation on the prices of goods and services acquired by governments. Furthermore, there is no regularly published index that takes account of the effect of inflation on revenues although it is clear that a general increase in the level of prices can also inflate the nominal value of many of the tax bases relied on by state and local governments. For example, inflation increases property values, the value of a given quantity of retail sales, and the nominal levels of personal and corporate income.

The years between 1967 and 1972 were marked by a steady but not excessive growth in price levels. Prices paid by state and local governments increased by approximately 23 percent during the period, which is to say that some one-quarter of the growth in state and local outlays could be attributed to inflation. The period was one of substantial expansion in the total size of state and local spending with some of the growth accounted for by increases in real compensation. But a much greater proportion of the increment was due to additions to the work force and enlarged purchases of supplies and materials—both of which imply growth in the level of services provided.

During the period 1972-1976 prices behaved erratically. Between 1972 and 1974 the Consumer Price Index (CPI) for all goods and services rose 17.88 percent, and the Wholesale Price Index (WPI) of a commodities rose a massive 43.42 percent. But as neither the CPI nor the WPI focuses on the effects of inflation at the state and local level, we have computed inflation indexes for state and local government expenditures and revenues for both 1974 and 1976. These are shown in Table 1-1.

The revenue inflation indexes indicate how the own-source 1972 revenue base would have increased solely in response to inflationary pressures. The expenditure inflation index indicates how total expenditures in the several levels of government would need to have grown simply to keep real expenditures at their 1972 levels. For example, if the estimated increase in the nominal values of municipal tax bases between 1972 and 1974 had been taxed at 1972 effective rates, the revenues raised by municipalities would have increased by about 15 percent (revenue inflation index—115.4, see Table 1-1). On the other hand, if municipalities had maintained 1972 levels of services and compensated employees and transfer recipients in accord with increases in the cost of living, expenditures would have increased by about 25 percent (expenditure inflation index—125.4). Similarly, by 1976 the indexes show that the 1972 revenue base for municipalities would have grown 30 percent

Table 1-1. State and Local Governments' Expenditure and Revenue Inflation Indexes, 1972-1976[a]

	Expenditure Inflation Indexes (1972 = 100)		*Local-Source Revenue Inflation Indexes (1972 = 100)*	
	(1) 1974	*(2) 1976*	*(3) 1974*	*(4) 1976*
States	125.4	140.8	116.6	128.3
Counties	125.4	140.5	116.7	133.3
Municipalities	125.4	140.6	115.4	130.7
Townships	125.6	141.5	114.8	130.7
School districts	125.0	138.4	119.2	138.8
Special districts	125.7	142.5	113.3	124.2
All state and local	125.3	140.2	116.9	129.6

Source: Roy Bahl, Bernard Jump, Jr., and Larry Schroeder, "The Outlook for City Fiscal Performance in Declining Regions," in *The Fiscal Outlook for Cities: Implications of a National Urban Policy*, Table 6, p. 21.

[a]The indexes were computed using the methods and data sources described in David Greytak and Bernard Jump, *The Effects of Inflation on State and Local Government Finances, 1967-1974*, Occasional Paper No. 25, Metropolitan Studies Program, Maxwell School, Syracuse, New York, 1975. The 1974 entries are slightly different from those in the Greytak and Jump paper because of using revised data here.

over its 1972 level while expenditures would have increased 40 percent over their 1972 levels without even considering any change in level of composition of labor and nonlabor inputs.

Several implications can be drawn from these estimates. (1) As measured by these indexes, the impact of inflation during the 1972–1974 period was nearly equal to that which occurred during the entire previous five years, 1967-1972. (2) Expenditures were much more responsive to inflation than were own-source revenues at both the state and local levels during the 1972–1974 period. (3) While both indexes continued to increase during the 1974–1976 period, the relative cooling of inflationary pressure did allow inflation-induced increases in state-local revenue bases to nearly keep pace with the pressures of inflation on expenditures.

Another way to describe these inflationary effects is to consider the implications for state and local governments' purchasing power. In Table 1-1, division of columns (3) and (4) by (1) and (2) yields estimates of purchasing power indexes based on 1972 revenue bases. For example, relative to 1972 revenue bases, municipal revenues in 1974 would purchase 8 percent less in city government expenditures (index = 115.4/125.4 = 92.03). The calculations show that during the period 1972–1974 the purchasing power index fell nearly 7 percent for all state and local governments. For the 1974–1976 period the overall state and local government purchasing power index remained almost constant. For municipalities even a very slight rise in the purchasing power was noted.[11]

Since both the expenditure and revenue inflation indexes computed here are based upon 1972 expenditure and revenue structures, realization of lowered pressures of inflation on the fisc requires a tax structure capable of producing revenues in accord with the effects of inflation on the tax base while maintaining compensation levels constant in real terms. The reliance upon property taxes, with assessment lags quite common, suggests that the indexes here understate that overall effect of inflation on municipal government revenues. Furthermore, for declining cities it is possible that property values did not keep pace with the general rates of increase in property values experienced throughout the nation, thus adding further to fiscal pressures.

Rising Public Employment and Public Compensation

That public employment costs have been the major source of increase in state and local government expenditures is well documented. Clearly the growth in these costs was a major source of the fiscal problems facing large cities by 1975. While recession had depleted financial capacity, inflation had stimulated increases in public employee compensation. What is not well documented is whether public employee wage and benefit gains were "exorbitant" and a result of union power.

There are two questions pertinent to the argument that public employment compensation increases during the 1960s and early 1970s were out of line. The first is whether the increases were high relative to the private sector and the rate of inflation; the second, whether any differential rates of increase were due to a "catch-up" of public with private sector pay.

The catch-up thesis is based largely on myth since average wage levels in the state and local sectors have for some time exceeded those in the private sector (see Table 1-2). However, the gap has begun to narrow because of a recent acceleration in private sector

Table 1-2. Comparative Levels of Public and Private Compensation (Calendar Years)

		Private Sector	*Federal Civilian*	*State and Local Government*
Average wages and salaries per full-time equivalent employee				
	1962	$ 5,082	$ 6,239	$ 5,017
	1972	8,590	12,676	8,916
	1975	10,690	15,195	10,862
	1976	11,486	16,201	11,572
Average annual supplements to wages and salary in full-time equivalent employee				
	1962	$ 482	$ N/A	$ 431
	1972	1,150	1,497	1,110
	1975	1,706	2,442	1,619
	1976	1,904	2,809	1,848
Total compensation per full-time equivalent employee				
	1962	$ 5,564	$ N/A	$ 5,448
	1972	9,740	14,173	10,026
	1975	12,396	17,637	12,481
	1976	13,390	19,010	13,420

Source: U.S. Department of Commerce, Office of Business Economics, *The National Income and Product Accounts of the United States, 1929-1965*, Tables 6-2, 6-4 and 6-7; *Survey of Current Business*, July 1976 and July 1977, Tables 6-5, 6-6, 6-8, and 6-9.

N/A - Data are not available.

compensation. Still the remaining advantage lies in higher average wages and salaries in the public sector, while fringe benefits have tended to remain higher in the private sector during the past decade.[12]

If the increment in public employee compensation cannot be justified on grounds of achieving some parity with the private sector, it seems appropriate to examine these increases in light of the rate of inflation during this period. As may be seen from Table 1-3, the state-local sector increased average wages and salaries at a rate greater than the national inflation rate over most of the decade ending in 1973. Between 1973 and 1975, however, state and local government employees suffered real declines in average wages—even greater than those suffered by all private sector employees. For fringe benefits,

Table 1-3. Indicators of Public Employment Cost Increases

	State and Local	*State*	*Local*	*Municipalities*
Average annual growth in full-time equivalent employment				
1962-1972	4.5%	5.3%	4.2%	3.2%
1972-1973	3.7	2.4	4.2	3.9
1973-1974	2.9	4.2	2.4	0.9
1974-1975	2.5	3.4	2.2	0.7
1975-1976	1.1	2.0	0.7	-1.7

	All Industry	*Private Industry*	*Federal Civilian*	*State and Local Government*
Growth in wages and salaries per 1 percent increase in CPI				
1962-1972	1.7%	1.6%	2.2%	1.8%
1972-1973	0.98	0.97	1.05	1.06
1973-1974	0.68	0.73	0.42	0.54
1974-1975	0.93	0.96	0.85	0.87
1975-1976	1.24	1.28	1.14	1.12
Growth in average annual supplements per 1 percent increase in CPI				
1962-1972	2.8%	2.8%	N/A	3.0%
1972-1973	2.5	2.5	2.1%	2.0
1973-1974	1.1	1.1	1.7	1.4
1974-1975	1.6	1.6	2.3	1.4
1975-1976	2.1	2.0	2.6	2.4

Source: Table 1-2 and U.S. Bureau of the Census, *Public Employment in 1976*, Table 2, as reported in Roy Bahl, Bernard Jump, Jr., and Larry Schroeder, "The Outlook for City Fiscal Performance in Declining Regions," in Roy Bahl, ed., *The Fiscal Outlook for Cities: Implications of a National Urban Policy* (Syracuse, N.Y.: Syracuse University Press, 1978).

however, the trend shows increases well above the inflation rate in both the public and private sectors.

It is much more difficult to establish benchmarks for determining whether state and local government wages and salaries were exorbitant. Increases at a rate greater than the private sector may reflect only a changing preference for a greater package of public services or may reflect the productivity differences inherent in the public versus private sector production processes. In any case, the data in Table 1-3 indicate that the public sector grew at a greater rate than the private sector over the decade ending in 1972 and during most of the period thereafter.

Whether these employment and compensation increases are justified or not, it is clear that they placed considerable pressure on state and local government budgets. To the extent that this pressure was due to compensation rather than employment increases—and this would appear to be the case for the 1972-1975 period—the resulting expenditure increase was likely to be much greater than the service level increase.

THE CURRENT FISCAL SITUATION

There have been no more New Yorks in the sense of defaults of federal emergency loan guarantees. Somehow, in the face of declining economic bases, inflation, and rising public employment costs, cities have managed to postpone or avoid financial crisis. The most important of the compensating factors that have allowed even the most distressed cities to remain solvent are national economic recovery, increased direct federal assistance, and a combination of deferred expenditures and cutbacks in the scope of public sector operations.

Economic Recovery

There can be no question but that the recovery of the national economy, with lower rates of both inflation and unemployment, has played an important role in maintaining the fiscal viability of large cities. It is important to point out, however, that even with recovery central cities may not regain former levels of economic activity as rapidly as suburban areas, and that cities in the Northeast and industrial Midwest may gain relatively less and recover more slowly than cities in other parts of the country.

There are a number of a priori reasons why core areas do not share equally in national growth during periods of recovery. During a recession industries with declining employment reduce activities relatively more where operating costs are higher and where physical plant is oldest (i.e., in declining regions generally and in central cities specifically). The process does not reverse itself during the recovery. Expansions have been occurring where comparative costs are lowest—in the growing regions, suburbs, and nonmetropolitan areas. The same pattern appears true for the birth and death of firms. Firms die rapidly in the central city during recession, but new firms open more rapidly in suburbs during recovery. As a result, one would expect central city areas to suffer greater employment losses during a recession and make less employment gain during a recovery than suburban areas. The problem of central city failure to recover is compounded if the city is located in the Northeast or industrial Midwest. The manufacturing-dominated urban economies that face high production costs, particularly for energy, are likely to share least in a recovery.

Unfortunately, any discussion about central city economic performance during the recovery must be heavily speculative. There simply are not adequate data covering the period since 1975 to enable a tracking of the changes in central city employment and income through the most recent recession and subsequent recovery. However, the relatively poorer performance of central cities during a previous recession and recovery is borne out by a study of the 1969–1972 period.[13] Though the 1969-1971 recession was less severe and the 1971-1972 recovery not as sustained as the latest recession-expansion, the results of this study support the basic premise that private sector employment in core areas declines more during recession and recovers less during expansion. The results show that only core counties[14] had absolute losses in employment during the 1969–1971 period and that during the recovery they gained employment at about half the rate of other counties (i.e., other central counties, suburban counties, and nonmetropolitan counties). Even these results likely overstate the relative performance of central city economies since the central county often contains suburban areas that are growing more rapidly than the central city. In sum, the lesson from the last cycle is that core areas do gain in the absolute from national growth but continue to fall behind relative to the rest of the country.

While core areas generally will benefit least from the recovery, some central cities will benefit a great deal less than others during such a recovery. Particularly those central cities in growing regions and those with areawide boundaries (county or metropolitan areas) should benefit proportionately more. Again referring to the Oak Ridge study, core counties in the northeastern and midwestern census regions fared worse in the last recession *and* recovery. These regions encompass a majority of the most "distressed" American cities.

Ideally, we would trace the pattern of core areas through the present cycle to determine if the thesis that core areas in the Northeast and Midwest regions recover least and slowest is valid. Data are not available for such an analysis, but as noted above, employment in ten central counties and their Standard Metropolitan Statistical Areas (SMSAs) fits this pattern for the recession period; during the recovery the SMSA employment trends also fit the pattern. Though this is only superficial evidence, it is alarming because it suggests that the most distressed cities and areas are sharing least in the present recovery.

Direct Federal Assistance

A major reason large central cities have performed above expectations is the massive inflow of direct federal aid to cities. The Advisory Commission on Intergovernmental Relations (ACIR) reports that in many cases direct federal grants now account for more of the financing of total current expenditures than do own-source revenues.[15] For example, the ratio of direct federal aid as a percentage of own-source revenue averages 57.3 percent for St. Louis, Newark, Buffalo, Cleveland, and Boston and 51.8 percent for Baltimore, Philadelphia, Detroit, Chicago, and Atlanta (1978 estimates).

Most of this increase in direct aid is the Carter Administration's Economic Stimulus Package, the key elements of which are Anti-Recession Fiscal Assistance (ARFA), Local Public Works (LPW), and Public Service Employment (PSE). A recent U.S. Treasury report describes the aid flow under these three programs to forty-eight large city governments, classified by degree of fiscal strain, and shows a high degree of targeting in the distribution of funds.[16]

Such data leave little doubt about the critical importance of these programs to the basic financial health of large city governments. To say that they are being relied on to finance current operations is a gross understatement. Their curtailment, in money or real terms would seriously compromise the financial position of these governments.

Service Level Cutbacks and Expenditure Deferrals

A third reason for the relatively strong performance of central cities during the past three years has been their willingness to attempt to maintain costs at a consistent level and even to try to cut back public service levels. This has taken a number of forms, including reductions in public employment, elimination of certain programs, and the deferral of capital facility maintenance and replacement.

Examination of employment trends during the last few years reveals a slowdown in the number of employees added to state and local government payrolls, which is in sharp contrast with most of the post-World War II period when nonfederal public employment expanded at rates greatly above those for private industry and the federal government. For example, annual employment growth between 1962 and 1972 averaged 4.5 percent for the state-local sector compared with a private industry growth rate less than one-half that rate (see Table 1-3).

Since 1972, however, the reins appear to have been drawn on state-local government job expansion. Average annual employment growth between 1972 and 1976 fell to about one-half the rate for the ten years preceding, and in 1976 state and local government employment grew by only 1 percent. Even more drastic than the curtailment of job growth for all nonfederal governments has been the abruptness with which municipalities have clamped down on the growth of their work force. After growing at an average annual rate of 3.2 percent between 1962 and 1972 and another 3.9 percent in 1973, employment by municipalities grew by quite modest amounts in 1974 and 1975, actually declined by 1.7 percent in 1976, and at the end of 1976 stood at a lower absolute level than in 1973.

Anyone familiar with the enormous job cutbacks carried out by New York City might assume that the New York City employment reductions were swamping the employment statistics for all municipalities, producing a statistical aberration. Yet inspection of the employment records for large cities shows that actual reductions in large city work forces are not uncommon and have not been for several years. But though the phenomenon of shrinking municipal government work forces has been manifesting itself in several major cities for longer than just the last couple of years, 1976 (the last year for which data are available) was a noteworthy year in that more than half of the twenty largest cities in the United States reduced the number of employees on their payrolls.

Although it would require a detailed analysis city by city to determine why the number of large cities involved in employment reductions has increased, it seems logical on an a priori basis to infer that this reflects attempts to compensate for the combined effects of economic base deterioration and the fiscal pressures brought about by abnormally severe inflation and a recession. It is virtually axiomatic that many of the country's largest cities have long been struggling to keep their budgets under control as they witness an exodus by employers and higher income residents. It is reasonable to suspect that inflation and recession hit the public sectors of larger cities harder than they did other types of government, thereby adding another reason for municipal employment carrying a relatively larger burden of adjustment than state and local public employment generally.

Another kind of expenditure deferral is the postponement of replacing obsolete capital stock, or even the discontinuance of adequate maintenance. This is especially serious in the most fiscally pressed central cities where the capital stock is older and investment has lagged.[17]

While such deferral measures temporarily enhance the fiscal health of these cities, they also mean that the most dependent segments of the population receive fewer or less adequate public services and that the cities will have to contend later with even more obsolete and deteriorated capital stock.

THE OUTLOOK

Detailed and useful quantitative projections of the fiscal health of state and local governments simply have not been made. However, in line with the discussion above, the four general factors that will shape the likely course of events are the state of the national and regional economies, the likelihood of continued substantial infusions of federal aid, the ability of governments to continue to cut services through employment reduction and capital expenditure deferrals, and the resurgence of a movement back to the city together with a changing composition of the urban population. Two other factors could affect the outlook: the possibilities of a taxpayer revolt and the role that state governments choose to play in dealing with the urban fiscal problem.

State of the Economy

Two major determinants of the fiscal health of a local government are expansion in the level of economic activity in the area and the rate of increase in prices. It is not clear that the future course of either factor will work to the advantage of distressed regions and governments. While such federal policies as tax cuts may stimulate the national economy enough to sustain economic growth into the early

1980s, whether the large cities in the declining regions can share fully in this growth seems doubtful in the absence of other more region-specific stimulative policies. There seems no reason to believe that general economic growth will reverse or even slow the flow of employers and population from the "Snowbelt" to the "Sunbelt." Furthermore, as noted above, general economic expansion is unlikely to increase the relative attractiveness of large cities as sites for private employment vis-à-vis suburban or outlying areas.

On the other hand, if continued economic expansion stimulates the economy enough to set off a new surge of inflation at rates close to those experienced in the early part of the decade, there seems to be little doubt that the distressed governments will be able to avoid "sharing" in such inflation. As has been shown, during the previous inflationary period public sector expenditures were more responsive to price level increases than were own-source revenues. Thus one could argue that while the expansionary macroeffects are unlikely to produce uniform benefits across regions or across central city and noncentral city areas, the effects of price increases are likely to be uniformly distributed across regions and subregional areas.

This implies that continued national recovery, while it may improve the fiscal position of Northeastern and Midwestern local governments by stimulating employment and income, will probably have an even more favorable effect on the local government fisc in the growing regions. Hence continued growth in the economy over the next three to five years will likely result in pressuring governments in the declining region to reduce their public sectors to a size more in conformity with the taxpaying ability of their private sector resources. If the rate of inflation does not increase, this may mean tax reduction, but if prices rise, any savings from employment reduction may be offset by an acceleration of compensation rate increases.

Federal Aids

Probably the major factor influencing the fiscal performance of governments in the declining region is continuation of the inflow of direct federal aid to cities. In 1978, Comprehensive Employment and Training Act (CETA), local public works, and countercyclical grants were distributed in above average per capita amounts to governments in the northeastern and midwestern regions. To give some idea of the current importance of these programs, the Treasury Department estimates for the forty-eight largest cities show that withdrawal of all three programs would call for a tax increase equivalent to 16 percent of own-source revenue or for an equivalent reduction in expenditures.[18]

The entire stimulus program is due to expire at the end of September 1978 although its expiration is not a realistic possibility. It is realistic, however, to expect that the package will not continue to produce revenue increases at the same rate as during the past three years. The programs were enacted as part of an economic stimulus program for the national economy and the need for such stimulus is now largely gone.[19] Moreover, a combination of large state-local sector surpluses and a federal deficit is not likely to result in congressional sympathy to expand the program.

The Potential for Service Level Reductions

If the pattern of the past three years were to continue, local governments would continue to reduce employment, postpone capital spending, and cut back services. If inflation rates do not accelerate much, tax cuts may also follow. State and local policymakers are becoming increasingly sensitive to the charge (substantiated or not) that a major cause of the relative decline of the region is due to the relatively high taxes already borne by residents and firms.[20] While tax bases may expand as the general economic condition of the region improves, it is unlikely to expect that these policymakers will further increase tax rates. The recent California vote has made discretionary tax increases all the more unpopular and unlikely. The real issue had been whether expenditure growth could be controlled enough to permit tax reduction; it may now be how much expenditure increase will be permitted by tax ceilings.

On the expenditure side there are major dilemmas in the face of fiscal pressures. While cutbacks in public employment levels constitute one option that apparently is being used, unless major increases in the productivity of the remaining employees can be achieved the quantity or quality of public service outputs are likely to suffer. Furthermore, this policy option ignores the resistance from public employee organizations to further cutbacks in the levels of such employment and to relatively low increases in compensation. There is also the major public policy question of the equity effects of such cutbacks since the primary beneficiaries of such services, especially in the central cities, tend to be economically disadvantaged.

Some observers hope decreased expenditures can be achieved via decreased or smaller increments in compensation levels. But this too seems unlikely in the near future, especially if inflationary pressures or increases in real wages are experienced in the private sector. Even if some public employee organizations appear to have moderated their demands recently in response to fiscal pressures, it is unlikely that such restraints can continue for very long.

Finally, some nonlabor expenditures, especially capital spending, might be further delayed; however, the effectiveness of such restraints is questionable. Deterioration of capital facilities such as public transportation, bridges and highways, sanitation facilities, and water production facilities not only have deleterious effects on service levels but also may tend to speed up the exodus of the economic base from the cities. Likewise, price increases in nonlabor inputs, which most likely have low elasticities of demand, tend to make even current nonlabor expenditures difficult to cut back.

Central City Growth

Some would argue that there are factors at work that will improve the relative fiscal capacity of the city. Higher energy and housing costs may make cities more attractive residential locations and more childless couples and singles are potentially city dwellers. There is, however, little evidence that such a movement back to the city is taking place.

There is also the absolute decline in city population and employment that should provide some possibilities for expenditure reduction. Again, the realization of the possibilities in declining cities is not so clear. Peterson found that declining cities spend 60 percent more on a per capita basis for a common set of functions than do growing cities.[21] Muller reached similar conclusions when comparing public employment levels.[22] Peterson also noted that over the 1964–1973 period, city employees per capita increased by 41 percent while population was declining by 10 percent. Per capita employment in growing cities increased by 10 percent over the same period.[23]

A DIRECTION FOR FEDERAL POLICY

The Carter Administration's Urban Policy Statement was intended to be a set of principles for a national policy toward urban problems.[24] The statement was weak, however, in two important respects. It was so general that it did not even imply the approaches to be taken in dealing with urban problems, and it suggested a "spreading" rather than a "targeting" approach to allocating assistance. The first shortcoming probably illustrates a combination of unwillingness to give up the present package of programs and agency responsibilities that in fact constitutes "an urban policy" and an absence of new ideas and approaches. The second weakness is well described by Nathan: "A special benefit to everyone is a special benefit to no one."[25] Unfortunately, we still do not have a national policy toward urban policy; it is therefore not surprising that even the newest federal initiatives may have uncertain and possibly detrimental effects on urban areas.

It is obviously difficult to formulate policy to deal with issues as difficult as those surrounding the urban fiscal problems. If there were magic solutions, they would have appeared long before now. It would therefore not seem inappropriate to propose another set of principles for national urban policy, but to do so in light of some current trends that seem irreversible and in light of the current outlook for urban governments.

Fiscal Adjustment by State and Local Governments

An underlying objective of any policy designed to deal with the fiscal problem of cities should recognize the need for retrenchment in public sector activity in some states. Clearly, federal policy should encourage state and local governments to bring about a better balance between expenditure requirements and taxpaying capacity. In some states in the declining regions the public sector has become "overdeveloped" in the sense that the quality, quantity, and cost of public services provided exceed financing capacity, resulting in taxes that are high, possibly inordinately high, relative to the rest of the nation. Since the economy in these states is growing slowly, the financing gap will continue to widen.

The federal government faces two policy options in such cases. The first is to subsidize the public sector in these states through an increased flow of grants and subsidies. But since these states generally have among the highest public service levels in the country, such a policy would not work toward national equalization of fiscal capacity. It would enable states like New York and New Jersey to maintain high levels of services at the expense of deferring the upgrading of lower service levels in states like Mississippi and Alabama.

The second avenue open is to encourage, reward, and assist the process of fiscal adjustment. State governments in particular must assume leadership in defining a livable fiscal equilibrium between the public and private sectors. During the past decade, personal income in the northern tier of states grew at a rate from one-third to one-fourth slower than that in the southern tier, but revenues raised from their own sources grew at about the same rate in both regions. Either there was no sense of having to match expenditures with resources or expenditures are largely uncontrollable. A better fiscal balance is clearly in the national interest since it may avoid the need for emergency measures of the New York City type, which may be formulated on an irrational basis in haste. On the other hand, the federal government must play a role in cushioning the effects of this retrenchment on the low-income population by targeting aid to distressed cities and by assuming more financial responsibility for the redistribution functions.

There are other desirable features of the fiscal adjustment process, the most important of which is a reexamination of public sector activities and costs. State and local governments have discovered that at least some fiscal retrenchment can be accomplished without serious public service declines. If government payrolls are overinflated and increasing public expenditures have not brought improved public services, then much of the increased expenditures may be primarily a transfer from taxpayers to public employees. Since state and local tax systems tend to be proportional at best and usually regressive and since state and local government employees have average compensations above the private sector, such a transfer would not seem justified on redistributive grounds.

Compensating and Reinforcing Existing Trends

The federal government must play the role of complementing as well as compensating for current demographic and economic trends. Population, employment, and income decline are not necessarily undesirable, and federal policy ought not to focus on reversing or even stopping these trends. Neither is a shrinking public sector undesirable. Indeed, federal policy should encourage some urban governments to reduce the scope and magnitude of public services and public expenditures. Wherever technically efficient, capital grants should encourage repair and maintenance rather than new construction, and current grants should not be designed to stimulate expenditures with local matches or mandates or to encourage local governments to "buy into" new programs. Wherever possible, federal grants should reward public sector reduction in the overdeveloped region.

At the same time it must be recognized that a reduction in public sector activity may have undesirable redistributive effects, particularly as social services are cut back. A major role of the federal government in this case is to compensate central cities during the transition period. This suggests priorities in a national urban policy of shifting financial responsibility for redistributive services away from the local governments and of even more targeting of federal monies to the distressed cities.

Revitalization

A second important principle has to do with the issue of revitalizing central cities. if revitalization means restoring the central city manufacturing base, this simply is not a reasonable expectation. There are good economic reasons for manufacturing decentralization, and federal policies are not likely to reverse this trend. This is not to say that cities should be abandoned or that they no longer have a useful economic function. Rather it is to say that the economic future of central cities does not lie with the productive sector but with the service sector—hardly a novel idea—and, more importantly, that a waiting period is necessary before this economic revitalization can begin. The key to the length of the waiting period is the viability of the local public sector, especially the improvement of education services.

The cycle of suburbanization that lowered fiscal capacity that lowered public service levels that induced more suburbanization that further lowered public service levels simply went too far. The poor education services in central cities may well be the major deterrent to residential relocation in the city, and revitalization of that service—even if it were a focus of national policy—would take a considerable time.

There is another element implicit in the revitalization strategy. By arguing that blue-collar jobs should be held in the city and by targeting employment subsidies in central areas, it is implied that the low-income and unskilled should be held in the central city. This may encourage an industry and employment pattern for the city that is far from its best long-term interest. It is not likely that core cities can continue to retain so large a share of the poor and underprivileged and become truly revitalized.

The Role of State Government

A final proposition is that a national urban policy ought to define the role of state government toward local government fiscal problems. A major mistake of the past has been a failure to coordinate federal and state programs for aiding central cities. Federal programs were structured to take into account two important considerations: (1) the fragmented governmental and financial structures of metropolitan areas and (2) the assignment of expenditure and financing responsibility between the state and its local governments. Yet fragmented local government structure is at the very heart of the urban problem, particularly in the Northeast and industrial Midwest where one would presume the most significant amount of urban aid will be targeted. To provide such aid to these regions without insisting on a better balance between taxpaying capacity and expenditure requirements of local governments in metropolitan areas would be a mistake. It would implicitly reward suburban jurisdicttions that have refused to share taxpaying wealth with central cities. Put another way, it would in effect constitute a penalty to governments elsewhere in the country that have taken positive steps toward the solution of urban problems through tax-base sharing, regional financing, or areawide governance.

A working part of federal policy toward cities should be the requirement of a state government urban policy. Two elements of such a state program are important. The first is provision for regional financing of certain important local services. The objective of income redistribution through provision of higher quality services in central cities is not compatible with high-income suburbs and low-income cities, each financing its own services. Changed annexation laws, tax-base sharing, regional financing, or state government direct assumption with financing based on progressive income taxation are all ways to achieve this redistribution. It is important to note that the above reforms would require legislation initiated at the state government level. Second, with the redistribution objective in mind, there needs to be better coordination among direct federal aid to cities, federal aid that passes through state governments by mandate to local governments, and state aid programs in order to distribute the entire assistance package in a reinforcing and more effective way.

CONCLUSIONS

The most distressed urban governments have avoided emergencies like that in New York City since 1975. But the factors that have led to this measure of fiscal health—national recovery, increased federal assistance, and expenditure cutbacks and deferrals—cannot be relied on indefinitely. This rather bleak fiscal outlook for distressed cities raises four critical issues that might be viewed as central to the formulation of a national urban policy.

The first is the prospect for increases in federal aid to local governments of the same magnitude as during the past three years. Such increases are highly unlikely because there is less need for grants as a national economic stimulus and because the growing surplus in the state-local sector—whether a meaningful measure or not—will not encourage Congress to increase grant assistance from a deficit federal budget. The implications of reducing this aid flow or even slowing the rate of increase are particularly serious for the larger so-called distressed cities that have become dependent on such funds. CETA monies are at least partially substitutive for local resources, and many older cities have become heavily dependent on the counter-cyclical public works program to finance their regular capital works programs.

The second important issue is targeting the largest allocation of funds to the most distressed communities and whether this targeting is a major feature of the Carter Administration's urban policy. While the Carter plan does not contain specifics that would make it possible to evaluate its distributional features, there are early signs that its targeting emphasis might be diluted by increasing the number of eligible jurisdictions.

A third issue is whether national urban policy will be focused on urban revitalization (i.e., trying to reverse population decline and to hold the manufacturing sector in the city) or on facilitating fiscal adjustments to population and economic decline. The size of future federal subsidies is not likely to reverse or even appreciably effect the economic decline of cities in the older industrial areas. While the national recovery of the past three years has improved the fiscal position of even the most distressed cities, it is clear that these cities do not share proportionately in the economic recovery. Though the administration's program is not specific on an economic development strategy for urban areas, the tone of the program suggests a revitalization approach. Little attention seems to have been paid to the possibility of using federal policy to assist local governments in declining areas in making fiscal adjustments during the transition period. Indeed, there are some hopeful signs even for the most distressed cities. Population and school enrollments are declining, thereby lowering service costs and infrastructure requirements, at the same time that the energy crisis and housing costs increase the relative attractiveness of central city residential location. The growing proportions of singles and childless couples in the national population may also improve the comparative advantage of central cities. Even the decrease in the number of manufacturing jobs is not completely negative since it reduces congestion and infrastructure needs.

The federal government's policy ought to reinforce these positive trends. Increased targeting to improve public service levels in hardship cities is one important area of reinforcement, a grant system that subsidizes capital stock maintenance as well as expansion is another, and a recognition that many cities' economic futures are not best served by a program of subsidy to attract and hold manufacturing activities is a third. Such a strategy would concentrate heavily on compensation of the declining central cities and their residents during the adjustment process. The fourth issue is whether these principles of a national urban policy suggest yet another new federalism. There are at least hints that they may. Nathan sees the beginnings of a shift back toward categorical aid and more federal strings and away from revenue sharing and the decentralization themes of the early seventies,[26] while others are concerned about the absence of a plan for an increased and more meaningful role for state governments. The administration's plan mentions the importance of state governments, but the wording is cautious. Finally, there is no firm indication that the federal government will play a role in inducing change in the fragmented pattern of metropolitan government that is at the heart of the fiscal problem of many northeastern cities.

An inescapable conclusion is that the fiscal outlook for cities *and* the effects of the administration's urban program will be largely dictated by the performance of the national economy. And irrespective of that performance, cities, particularly distressed cities, will be caught in the middle. If national recovery continues, these cities will not share proportionately, and they will likely be the big losers as the countercyclical aid programs are phased down. If national growth slows, their economies are likely to be hardest hit, their tax bases most reduced, and their social service expenditure requirements hardest pressed. Such an untenable position would seem to underline the need for an urban policy based on compensation and adjustment rather than revitalization, and on targeting rather than spreading.

NOTES

1. For a good discussion of the problems of that period, see Alan Campbell and Seymour Sacks, *Metropolitan America* (Glencoe, Ill.: The Free Press, 1967).

2. We at the Maxwell School have developed most of these points in more detail in Roy Bahl, Alan Campbell, David Greytak, Bernard Jump, Jr., and David Puryear, *The Impact of Economic Base Erosion, Inflation and Employee Compensation Costs of Local Governments*, Occasional Paper No. 23 (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, 1975); and in Roy Bahl, Bernard Jump, Jr., and Larry Schroeder, "The Outlook for City Fiscal Performance in Declining Regions," in Roy W. Bahl, ed., *The Fiscal Outlook for Cities: Implications of National Urban Policy* (Syracuse, N.Y.: Syracuse University Press, 1978).

3. Financial mismanagement, often cited as the major cause of the difficulties experienced by many cities, was more a response to these underlying pressures on city budgets and to an overassignment of local public services.

4. We have estimated that the loss of a job due to firm closure costs the

New York City government approximately $800. See Roy Bahl, Alan Campbell, and David Greytak, *Taxes, Expenditure and Economic Base: A Case Study of New York City* (New York: Praeger Publishers, 1974); and Roy Bahl and David Greytak, "The Response of City Government Revenues to Changes in Employment Structure," *Land Economics* 52, 4 (November 1976).

5. Seymour Sacks, "Estimates of Current Employment Trends and Related Information for Large Cities," paper presented to the National Urban Roundtable, Washington, D.C., March 1978.

6. These data also have the disadvantage that they exclude government and proprietorship employment. Furthermore, there is a substantial publication lag of approximately three years.

7. The remaining three cities-counties are Baltimore, Denver, and New Orleans.

8. Carol Jusenius and Larry Ledebur, "Documenting the Decline of the North," paper presented at the 1977 Conference of the Committee on Taxation Resources and Economic Development, Cambridge, Massachusetts, October 1977.

9. See Roy Bahl and David Greytak, "The Response of City Government Revenues to Changes in Employment Structure."

10. This analysis of inflation impacts is drawn from the work of David Greytak and Bernard Jump, Jr., *The Effects of Inflation on State and Local Government Finances, 1967-1974,* Occasional Paper No. 25 (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, 1975); and Greytak and Jump, *The Impact of Inflation on the Expenditures and Revenues of Six Local Governments, 1971-1979* (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, 1975); and Greytak and Jump, "Inflation and Local Government Expenditures and Revenues: Method and Case Studies," *Public Finance Quarterly* 5, 3 (August 1977); and from some extensions in Roy Bahl, Bernard Jump, Jr., and Larry Schroeder, "The Outlook for City Fiscal Performance in Declining Regions."

11. It is, of course, impossible to conclude from these aggregate indexes that individual cities realized inflation-induced increases in both revenues and expenditure similar to those found for all municipalities. Only city-level studies could attempt to answer that. For examples of the use of estimates of the impact of inflation on individual units of government, see David Greytak and Bernard Jump, *The Impact of Inflation on the Expenditures and Revenues of Six Local Governments, 1971-1979* (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, 1975), and Edward M. Cupoli, William A. Peek, and C. Kurt Zorn, "An Analysis of the Effects of Inflation on Finances in Washington, D.C., 1972-1975" (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, forthcoming).

12. Of course, these averages are not "cleaned" for occupational or educational background differences of state-local versus private sector workers. To the extent workers in the state-local sector are on the average more productive than those in the private sector, these statistics may be consistent with a "catch-up" argument.

13. Kathryn Nelson and Clifford Patrick, *Decentralization of Employment*

During the 1969-1972 Business Cycle: The National and Regional Record (Oak Ridge Tenn.: Oak Ridge National Laboratory, June 1975, p. 15).

14. Core counties are metropolitan counties (a) containing the central business district of a central city and (b) located in SMSAs with population in excess of 100,000.

15. Advisory Commission on Intergovernmental Relations, *Intergovernmental Perspective* (Winter, 1976).

16. *Report on the Fiscal Impact of the Economic Stimulus Package on 48 Large Urban Governments* (Washington, D.C.: U.S. Department of the Treasury, Office of State and Local Finance, January 23, 1978).

17. For a discussion of the problems of urban capital obsolescence, see George Peterson, "Capital Spending and Capital Obsolescence: The Outlook for Cities," in Roy W. Bahl, ed., *The Fiscal Outlook for Cities: Implications of a National Urban Policy*, (Syracuse, N.Y.: Syracuse University Press, 1978).

18. "*Report on the Fiscal Impact of the Economic Stimulus Package on 48 Large Urban Governments*" (Washington, D.C.: U.S. Department of the Treasury, January 1978).

19. Robert Reischauer, "The Economy, the Federal Budget and the Prospects for Urban Aid," in Roy W. Bahl, ed., *The Fiscal Outlook for Cities: Implications of a National Urban Policy* (Syracuse, N.Y.: Syracuse University Press, 1978).

20. An example being the recent move by the New York State legislature to decrease income tax rates, especially in the upper income brackets in hopes of encouraging executive decisionmakers to remain within the state.

21. George Peterson, "Finance," in William Gorham and Nathan Glazer, eds., *The Urban Predicament* (Washington, D.C.: The Urban Institute, 1976), pp. 48-50.

22. Thomas Muller, *Growing and Declining Urban Areas: A Fiscal Comparison* (Washington, D.C.: The Urban Institute, 1976), pp. 39-40.

23. Peterson, "Finance," p. 50.

24. "New Partnership to Conserve America's Communities," Office of the White House Press Secretary, March 27, 1978.

25. Richard P. Nathan, "The Outlook for Federal Grants to Cities," in Roy W. Bahl, ed., *The Fiscal Outlook for Cities: Implications of a National Urban Policy* (Syracuse, N.Y.: Syracuse University Press, 1978).

26. Ibid.