Federal Policy

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Federal policy took a new turn in the 1980s. Priorities shifted toward stimulating private sector productivity and growth, with increased after-tax returns to capital offered as the primary incentive. The policy instruments designed to achieve this goal include anti-inflationary macroeconomic policy, deregulation, investment tax credits and accelerated depreciation and, in 1986, federal income tax reform. To finance this program, federal policies shifted resources away from redistributing income, fighting unemployment, and aiding state and local governments. While the extent to which these policy changes accomplished their economic goals is debatable, it is fact that federal domestic spending has fallen and that the federal deficit has increased. As a percentage of Gross National Product (GNP), federal spending excluding defense and interest expenditures fell by almost one percent between 1980 and 1985 after rising four percent in the previous decade; during the same period, the deficit increased from 2.2 percent to 4.8 percent of GNP.¹

This chapter is about the potential consequences of these federal policy shifts for New York City's economy and public finances. The underlying theme of the chapter is that in coming years municipal priorities will be set in a different context. These federal policies include aid cuts which promise that state and local governments will pay more of their own way; and they include changes in income tax
policies, particularly as a result of the 1986 reforms, which raise the "price" in the form of effective tax rates that individuals and businesses must pay for state and local government services. These higher prices promise long-run reductions in the scale of state and local government spending. Moreover, the performance of the New York State economy and fiscal decisions made in Albany will limit the freedom with which municipal officials can respond to altered federal policy. Municipal priorities, in short, increasingly will be shaped by external events rather than internal objectives.

The first section of the chapter describes some of the potential impacts of federal aid cuts and tax reform on the City of New York and, where relevant, the State of New York as well. The next section focuses on the New York City economy and on the determinants of its performance, since its capacity to withstand some of the indicated consequences of new federal policy is a key variable that local officials should consider in fashioning longer term policy responses. The final section suggests some general policy guidelines that City officials should consider in their new policy-making context.

**FEDERAL POLICY CHANGES**

To date, most discussion of the local effects of federal aid cuts and tax reform has focused on short-run issues. Federal aid cuts have forced City officials to exercise a form of triage in deciding which cuts can be tolerated and which require the substitution of municipal funds. Federal tax reform has created a so-called "windfall" of additional state and local revenues. The federal reforms combined a broadening of the tax base by withdrawing deductions and a decrease in rates; because state and local income taxes are linked to the federal base, these governments receive additional revenues unless they also act to lower rates. Consequently, short-run state and local policy decisions have concentrated on whether and how to return the windfall.

Municipal officials have not yet seriously addressed the potential long-run effects. One explanation for this delay may be the City's flush fiscal condition. Why alter policies when surpluses from current operations are available to prepay future bills? Another reason may be that the federal policy message is one that locally elected
officials simply do not want to hear: federal policies will complicate municipal finances and thus force elected officials to ask voters if they are willing to pay the price of higher local taxes to maintain current services.

Perhaps a more relevant delaying factor is uncertainty about how individuals, business leaders, and officials of other governments—of the State of New York in particular—will respond to the federal policy changes. Will tax reform lead investors to shift their capital out of real estate or municipal bonds? As the lower tax rates increase the after-tax incomes of wealthy New Yorkers, how will they utilize their new resources? Will the State pass on reductions in federal aid to local governments, and how will New York City fare? Because these are complicated questions for which there are no clear answers, local officials may be postponing policy changes while awaiting evidence of the responses.

FEDERAL AID REDUCTION

Real or inflation-adjusted federal grants to state and local governments (in 1982 dollars) fell from $109.7 billion in 1978 to an estimated $90.2 billion in 1987, or from 3.6 percent of GNP to 2.5 percent. As a result, state and local governments have become more dependent on their own revenues sources. In the same period, federal assistance dropped from 26.5 percent of total state and local outlays to an estimated 19.1 percent.\(^3\) It is important to note that much of the reduction in federal aid took place in federal fiscal year 1982. Since then, real federal grants have grown almost two percent a year, mostly under entitlement programs which have expanded three percent yearly in real dollars.\(^4\) The pattern since 1982, however, may reflect only a temporary resurgence; both the Reagan administration and the Congressional Budget Office have projected real reductions in federal aid to 1990.\(^5\)

How will New Yorkers fare in the competition for what is likely to be a smaller amount (in real terms) of federal aid? Historically, at least, New York's governments have been affected less severely than governments in the rest of the nation, as evidenced by the differential growth rates in federal aid shown in Table 3.1. For all state and local governments, real federal aid fell an average of one percent annually in the 1978-85 period compared to a 0.1 percent decline for governments in New York; the City's annual 2.3 percent decline was
TABLE 3.1
Average Annual Percentage Change in Selected Indicators of Economic and Fiscal Activity, 1970-78 and 1978-85

<table>
<thead>
<tr>
<th></th>
<th>New York City</th>
<th>All Local Governments in the U.S.</th>
<th>All New York State Governments</th>
<th>All State and Local Governments in the U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Federal Aid¹</td>
<td>18.4%</td>
<td>19.3%</td>
<td>7.4%</td>
<td>7.3%</td>
</tr>
<tr>
<td></td>
<td>-2.3%</td>
<td>-5.2%</td>
<td>-0.1%</td>
<td>-1.0%</td>
</tr>
<tr>
<td>Real Tax Revenue¹</td>
<td>1.4</td>
<td>1.7</td>
<td>0.9</td>
<td>2.6</td>
</tr>
<tr>
<td></td>
<td>0.8</td>
<td>0.4</td>
<td>1.3</td>
<td>1.5</td>
</tr>
<tr>
<td>Real Personal Income¹</td>
<td>-1.1</td>
<td>2.1(2)</td>
<td>0.3</td>
<td>3.1</td>
</tr>
<tr>
<td></td>
<td>2.1</td>
<td>2.5</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Nonagricultural Employment</td>
<td>-1.8</td>
<td>2.5</td>
<td>-0.2</td>
<td>2.5</td>
</tr>
<tr>
<td></td>
<td>1.1</td>
<td>1.7</td>
<td>1.4</td>
<td>1.7</td>
</tr>
</tbody>
</table>


**Notes:**
¹ Federal aid and tax revenue deflated using the implicit GNP deflator for state and local purchases, and personal income deflated using the overall implicit GNP deflator.
² Personal income for New York City available only to 1984.
less than one-half of the 5.2 percent reduction for local governments nationally.

The share of total federal aid distributed to New York governments rose from 10.2 percent in 1978 to 10.8 percent in 1985; New York City's share of federal aid to local governments increased from 5.8 percent to 7.2 percent. These relative gains occurred despite an increase in New York's per capita income relative to the national average and a decrease in its share of the nation's total population.

One reason why New York governments have fared relatively well in the competition for declining federal aid is the concentration of their support in federal welfare funds. While real federal grants to the New York State government increased 1.5 percent a year between 1978 and 1985, its welfare grants rose almost four percent a year. By 1985, New York State's share of all federal welfare assistance reached 16.2 percent, and these funds comprised more than two-thirds of New York State's federal aid. New York City, because of its large welfare population, also does relatively well in the competition for aid dollars from both the State and federal governments. New York City receives 72 percent of State welfare grants; 46 percent of the City's federal aid is devoted to social services.

A second reason New Yorkers have avoided some of the consequences of federal aid retrenchment is their strong representation in Congress. New York's per capita federal aid was $644 in 1985, 45 percent above the national average, notwithstanding the fact that its per capita income was 16 percent above the national average. Excluding public welfare, New York's per capita federal aid was four percent above the national average. The number of New York's representatives, their congressional seniority, and their membership on the House Ways and Means and Senate Finance committees are cited by many as factors contributing to the City's (and State's) competitive advantage in securing federal aid.

Will New York continue to do as well? Probably not. First, as noted before, both total federal grants and welfare assistance are projected to fall in real terms. Second, welfare reform—perhaps finally in the offing—may result in tighter eligibility requirements. Third, the 1980s have seen a shift toward the use of formulas for allocating federal aid, a structural change that was designed to reduce the advantage of states like New York whose officials are skilled at "grantsmanship." It is doubtful that a state with per capita income 16 percent above the national average and a national popula-
tion share of eight percent will continue to receive 11 percent of total federal aid. Sooner or later, New York's share of federal aid is likely to be brought into greater conformity with its financial capacity and population share. In this connection it should be noted that New York's congressional strength, which has helped shield the State and City from federal aid retrenchment, is threatened by continuing relative population loss and, accordingly, by the next reapportionment of the House of Representatives.

Nevertheless, State and City officials continue to be cautiously optimistic in their assumptions about federal aid. The State's Division of the Budget anticipates real growth of more than two percent yearly to 1991; most of the increase will be passed on to local governments. The City's Office of Management and Budget forecasts that projected financial gaps will be covered partially by incremental State aid increases of $200 million per year. City officials are also optimistic in assuming that "...the 1988 federal budget will more closely resemble Congress' budgetary priorities than the President's." However, they do anticipate a sharp drop in direct federal aid after 1988, which to some extent reflects the federal policy of passing a larger share of its aid through state governments. City officials also assume that cuts in federal assistance will not result in increased City spending, that is, that the City will not substitute its funds.

It is always difficult to know whether the City's financial planning in the "out years" represents its best estimate of things to come or simply a contrivance designed to apply maximum pressure on those who can ease the City's financial problems. Taking their words at face value, however, City officials may be underestimating the negative local fiscal effects of federal (and State) aid policy.

FEDERAL TAX REFORM

The centerpiece of the 1986 federal tax reform is reduction of the top marginal tax rate and introduction of a "two-rate" system of 15 and 28 percent. The key point is that reductions in federal tax rates decrease the value to taxpayers of federal deductions for state and local government taxes and municipal bond interest. Considering that the top marginal tax rate was 70 percent as recently as 1980, it is clear that the "price" of state and local government services has increased dramatically for itemizers who previously could shift a much larger share of their state and local taxes to the federal govern-
ment. The price effect is reinforced by the elimination of deductibility of state and local government sales taxes.¹⁷

As noted earlier, these potentially serious long-run consequences have been neglected in local policy discussions because of the short-run “windfall” effects of federal tax reform. This presented State and City officials the choice of keeping the windfall or returning it by reducing state and local tax rates. New York’s officials already have made their choices. The State government will return the windfall, estimated at more than $2 billion, through income-tax relief.¹⁸ When fully implemented in 1991, the State actions will reduce the top rate on earned income from nine percent to seven percent and the top rate on unearned income from 13 percent to seven percent.¹⁹ In effect, this reinforces the federal tax reform of treating capital gains in the same way as other income and responds to the increased “price” of State income taxes by lowering them.

New York City officials also provided personal income tax relief. The top marginal tax rate will be reduced from 4.3 percent to 3.4 percent by 1989. For businesses, the City cut corporate tax rates and eliminated the gross receipts tax on gas, steam, and electricity for industrial enterprises. The City’s reform plan will return most, but not all, of its windfall.²⁰

With these decisions taken, City and State officials now should consider the appropriate longer run response to the new federal tax code. However, the long-run impacts are mixed and do not provide a clear basis for formulating City fiscal policy. The potential negative effects include less revenue growth, more competition with the suburbs for State aid, more competition with other states for industry, and less help for the urban poor. More optimistically, the tax reforms may stimulate national and local economic growth; this would expand the local tax base and might be sufficient to offset the potential negative effects.

Revenue Growth. Whether the revenue-enhancing “income effects” of expected economic growth or the revenue-dampening “price effects” of lower federal tax deductions and rates will dominate is now an open question. The outcome, however, will condition whether the City’s budget outlook should be expansionary or contractionary.

Consider first a scenario that includes slower revenue growth. The higher price of State and City taxes for those who itemize deductions will, all else being equal, reduce the demand for municipal services.
Research has not identified the precise magnitude of the price effect, but it is likely to be consequential.\textsuperscript{21} A reasonable hypothesis is that the increased cost of local government will lead to more resistance to tax increases, particularly locally, because New Yorkers pay higher taxes and itemize more than taxpayers generally.\textsuperscript{22} Increased local resistance to tax increases coupled with indicated federal aid cuts suggest that the supply of State revenues available for local aid also will be reduced.

Remember, too, that the 1987 State and City tax reforms will reduce the responsiveness to economic growth or the "elasticity" of their tax systems. The reforms reduce rate progressivity (and hence revenue increases due to "bracket creep") and eliminate the higher rate on unearned income. Since income from property sources, notably dividends, interest, and rents, is the fastest growing component of personal income, lower tax elasticity is the likely result. The City's phase-out of the gross receipts tax on energy sales to businesses also will reduce the elasticity of the City's tax structure, though, again, the hope is that this will be offset by the stimulus to economic activity.

Federal tax reform also may dampen the growth of City property tax revenues. Lower marginal income tax rates and the disallowance of so-called "passive" real estate losses as offsets against regular income reduce subsidies both to housing consumption and investment. On the consumption side, this may reduce the demand for homes among itemizers which, in turn, would reduce growth in real estate values and the property tax base.\textsuperscript{23} On the investment side, removal of tax preferences for new plant and equipment may discourage new construction, as important a source of growth in the property tax base as reassessment.

On a more positive note (for New Yorkers, at least), federal tax reform should reinforce investment in the service sector, including finance. This may be anticipated because the new tax code removes investment subsidies, which benefited manufacturers disproportionately since they invest relatively more in plant and equipment. Negative effects on manufacturers will be felt more deeply in upstate New York than in the city. (However, this may mean that the Buffalos of New York will have a stronger claim on State support than New York City.) An even bigger economic stimulus may be expected from the federal, State, and local reductions in the top marginal tax rate. In theory, this should lead to greater investment among those with
the highest propensity to invest, the long-run effect of which might be to offset the aforementioned negative effects of reduced business investment tax subsidies.

**Increased City-Suburban Competition.** Another consequence of federal tax reform could be increased competition between New York City and its suburbs for a smaller pot of State aid money. This could result if (a) there is slowed growth in State revenues, and/or (b) the "price" of local government services rises more in suburbs than in central cities.

If the growth in State revenues slows as a result of federal aid and tax policies, then history suggests that State aid to localities will grow even more slowly.\(^{24}\) Indeed, State aid to localities as a percentage of total State spending decreased from 40 percent in 1980 to 33 percent in 1985.\(^{25}\)

The second half of the story is that it will be more difficult for local officials to use property taxes to offset the slack from slowed growth in federal aid and State income tax revenues. This will be especially true for suburban elected officials. Because capital-intensive firms, which increasingly locate in the suburbs, already will have experienced a significant tax increase by removal of investment tax preferences under the 1986 federal tax reform, they will strongly resist further local tax hikes. Tax increases also will be opposed staunchly by homeowners whose benefits from property tax and home interest deductibility were reduced by the federal reforms. The net cost of their State and local taxes has been estimated to increase by as much as ten to 20 percent,\(^{26}\) which contrasts with the effect on (largely non-itemizing) renters who will benefit disproportionately from income tax relief. Since more than 70 percent of suburban housing is in owner-occupied dwellings (compared to less than 30 percent in New York City), suburban residents will experience property tax increases disproportionately.\(^{27}\)

This skewing against suburban property owners—individuals and firms alike—will cause them to increase their pressure on State officials for relief in the form of increased aid, especially school aid. Such proposals are not likely to fall on deaf ears in the suburban-dominated State legislature. Since the residents of cities do not suffer as much as suburbanites from the federal reforms related to property taxes, suburbanites may have a strong case for compensatory changes in State allocations. Moreover, if the increased State
aid is "funded" from cuts in social programs, New York City residents will be doubly-damned.

City-suburban competition also involves competition for people. City residents, particularly high-income itemizers whose children attend private schools, as a result of federal tax reform may have more incentive to relocate to New York area suburbs (where property tax rates are higher, but public schools are better) or to suburban areas in other states where income taxes are lower. Although there is disagreement on the importance of this impact,\textsuperscript{28} this decentralizing phenomenon will be accelerated if, as hypothesized above, the State increases the suburban share of its education aid.

\textit{Interstate Competition.} The adverse consequences of New York City's high tax burdens will be exacerbated by federal tax reform. The general competitive position relative to New York of states with lower taxes, fewer itemizers, and no income taxes will be improved. Before the State and City income tax reforms were announced, estimates were that federal tax reform would cause high-income New York City residents to experience a five percent tax increase, whereas they would enjoy a four percent reduction if they lived in New Jersey or Connecticut.\textsuperscript{29} The Advisory Commission on Intergovernmental Relations estimated that New York State residents would experience a nine percent increase in personal income tax liabilities if the State made no windfall adjustments; it classified New York as one of 14 states whose residents would have a "large" increase.\textsuperscript{30} The State and City tax reforms in 1987 helped reduce the tax burden of New Yorkers, but from the perspective of competition the key issue is whether other state and local government responses to the 1987 windfall involved even greater cuts. If so, New York taxes may be even more burdensome.

What would be the outlines of an economic development policy for New York State and City that was designed to recapture losses in competitive position resulting from the federal tax reform? With respect to taxes, the top priority would be to lower marginal tax rates in the top brackets to reduce what many believe is the chief deterrent to New York locations.\textsuperscript{31} Another potentially effective tax policy would be to "reimburse" some of the losers in federal code reforms, particularly manufacturers. With respect to expenditures, priorities would be shifted toward infrastructure investments, which help industry generally, and to industry-specific uses such as investments
in the scientific capacity of universities in order to stimulate and attract "high-tech" activities.

The "cost" of such an economic development policy may be measured in budget terms, including those competing social programs which are not financed as a result of these economic development initiatives. From the perspective of the New York State budget, the implication is that cities such as New York would suffer because these economic development policies are neither pro-urban nor pro-poor.32

Of course, new economic development policies prompted by increasing competition may succeed; that is, they could stimulate economic development in the state and in the city and thus expand the local tax base sufficiently to finance new social programs. Nevertheless, the short-term effect of such policies includes less spending for traditional urban services.

Effects on Poor People. Will federal tax reform help or hurt New York City's large and growing poor population? This question, too, is hard to answer at present. The urban poor are affected only indirectly by federal tax reform, since they typically do not pay income taxes. Thus, potential indirect effects are key. One is that the long-run income elasticity of the reformed federal income tax will be lower, which suggests that its yield will be lower unless offset by national economic growth. This implies, in general, less federal revenue to allocate, which in turn implies (as discussed earlier) federal aid cuts generally and for income-maintenance programs in particular. The State and City tax systems also will be less income elastic, with similar implications for urban social spending. These fiscal prospects do not bode well for solutions to the already grim poverty problem, particularly in New York City. Recent proposals to alleviate poverty call for major new spending to improve the basic living conditions for poor New Yorkers, but the State and City may not be able to raise the new funds without jeopardizing economic viability.33

On a more optimistic note, State and City windfall reforms removed many low-income New Yorkers from the tax rolls. Beyond that, the stress on fiscal restraint and other economic development measures are expected by proponents to stimulate growth in the national and local economies—raising the lot of the poor like boats on a rising tide. However, New York City's record in the past decade, as well as that of other cities, suggests that this is wishful thinking.34
Economic expansion, if it occurs, is likely to be in the service sector, where the skills mismatch between resident laborers and local jobs appears to be growing even more substantial. And if tax reform accelerates the relocation of manufacturers, the attendant “upgrading” of the local economy may cause the city’s poor to face even greater employment problems.

PERFORMANCE OF THE LOCAL ECONOMY

How should City officials evaluate the contingencies of the new federal policies? Should they adopt a bullish outlook, as is their wont historically, or should they see the future through darker glasses? The more optimistic outlook requires that the stimulus to economic growth from “supply side” and other new federal policies be sufficient to offset the negative direct fiscal impacts. The prospects for the local economy under new federal policies require careful consideration.

There are grounds for, and advocates of, the view that New York City’s economic outlook is good. A series of recent studies anticipate continued employment and population growth, though slower than in the rest of the nation, and personal income growth approximating the national average. New York City’s current economic structure and comparative advantages underlie the optimists’ view. As both a key port and financial center in the burgeoning global economy, New York City is thought to be well positioned to capitalize on the new international economic order that is emerging. New York City’s advantages also are seen as including agglomeration economies growing out of its specialization in financial services and in headquarters location, plus the fact that New York City is a very large consumer and business services market in its own right. Moreover, international population flows provide a large number of foreign immigrants willing to work for relatively low wages.

But there are strong grounds for a less sanguine view of the city’s economic future. The City’s taxes remain far out of line, and it has resumed “big spending” policies after the hiatus of the late 1970s and early 1980s. Whether the marginal utility of added spending still justifies continued expansion is by no means clear. Given the growing size of City (and combined State-City) taxes relative to the
overall economy, there is reason in logic and history to be concerned about their effect on economic development.

Endogenous factors aside, the City's economy also is affected by exogenous factors or developments over which neither State nor City officials have much influence. While the New York City economy may be less sensitive than it once was to the traditional business cycle, because of structural changes—primarily its shift to advanced business services sold abroad—it is more sensitive to international economic development in general and to U.S. trade policy in particular. As Matthew Drennan points out in Chapter One of this volume, the city's economy has benefited greatly from expansion in international trade. Arguably, the city's economy even benefits from national trade deficits owing to its role in processing imports and servicing investment of "recycled" dollars. Federal policies designed to improve the nation's trade balance, including a fall in the dollar's value, may be counterproductive locally.

New York City's prospects can be assessed along three dimensions—population, employment, and public finance. In each case recent trends provide a useful basis for considering prospects in a climate of changed federal policy.

**POPULATION**

New York's dramatic population losses in the 1970s are well documented. The state as a whole lost nearly 700,000 persons, entirely because of New York City's population decline from 7.9 million to 7.1 million (Table 3.2). The New York City suburban and upstate populations grew slightly. The population decline of the 1970s was caused overwhelmingly by people relocating from New York City (as opposed to unusually high death rates or low birth rates). The outmigrants were disproportionately higher-income whites from 20-35 years of age who had above-average education and who moved to the so-called "sunbelt" states. Not only did New York have one of the nation's lowest immigration rates, but those relatively few who entered came disproportionately from foreign shores.

However, population loss in the 1970s has been replaced by population gain in the 1980s. The state gained 214,000 people between 1980 and 1986, almost all of whom were accounted for by New York City's population growth of 192,000. New York City's annual rate of population growth in the 1980-86 period, 0.4 percent, exceeded that of the Northeastern U.S., but was still below the one
TABLE 3.2
(population in thousands and percentage change in average annual rate)

<table>
<thead>
<tr>
<th>Area</th>
<th>1970</th>
<th>1980</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total New York State</td>
<td>18,241</td>
<td>17,558</td>
<td>17,772</td>
</tr>
<tr>
<td>Population</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Percentage Change</td>
<td>-0.4%</td>
<td>0.2%</td>
<td></td>
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<tr>
<td>New York City</td>
<td>7,896</td>
<td>7,072</td>
<td>7,263</td>
</tr>
<tr>
<td>Population</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage Change</td>
<td>-1.1</td>
<td>0.4</td>
<td></td>
</tr>
<tr>
<td>New York City Suburbs¹</td>
<td>3,737</td>
<td>3,809</td>
<td>3,846</td>
</tr>
<tr>
<td>Population</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage Change</td>
<td>0.2</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>Rest of New York State</td>
<td>6,609</td>
<td>6,677</td>
<td>6,664</td>
</tr>
<tr>
<td>Population</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage Change</td>
<td>0.1</td>
<td>-0.0</td>
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<tr>
<td>Northeast Region²</td>
<td>49,061</td>
<td>49,135</td>
<td>50,019</td>
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<tr>
<td>Population</td>
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<tr>
<td>Percentage Change</td>
<td>0.0</td>
<td>0.3</td>
<td></td>
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<tr>
<td>United States</td>
<td>203,302</td>
<td>226,546</td>
<td>241,038</td>
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<tr>
<td>Population</td>
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<td></td>
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<tr>
<td>Percentage Change</td>
<td>1.1</td>
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</tbody>
</table>


**Notes:**
¹ Includes Nassau, Putnam, Rockland, Suffolk and Westchester counties.
² Includes the Mideast and New England regions as defined by the Bureau of the Census.

percent rate recorded nationally. Continued population expansion is predicted in both the state and city. The New York State Department of Commerce, for example, forecasts a three percent increase in state population between 1985 and 1995.³⁸ Forecasts for New York City also see population growth.³⁹ Population losses of the magnitude experienced in New York City during the 1970s are nowhere foreseen.

While the size of the city's population may grow, virtually all prognosticators see a less “stable” population.⁴⁰ If being well educated, comfortable with the “native” language, and regularly employed are sources of social stability, then the city’s population is likely to be both larger and less stable.

Race and poverty increasingly are important demographic issues.
The racial composition of the population in New York City has changed substantially, with the non-white share approaching 50 percent; greater ethnic diversity is indicated by the fact that post-1965 immigrants account for one of every seven New Yorkers. Fewer children and more elderly also are indicated, which is a matter of special concern. The elderly require expensive public services; many of the city's young people face an uphill road in securing good jobs. Forty percent of the city's children live in poverty; one in three, at least, drops out of public high schools. Will they find good jobs in the city? And if not, will local labor market conditions improve—as classical theory holds—by the poor relocating to areas where they can find employment more easily? With respect to this issue, the theory finds little support in experience.

EMPLOYMENT

A more direct measure than population of the performance of the New York economy is employment. Again, the picture in the 1980s is one of a dramatic turnaround from the dismal situation in the previous decade. In the 1970s, New York City lost jobs at an annual rate of 1.3 percent, and the entire state, again because of New York City, had virtually no job gain. (See Table 3.3.) In contrast, in the 1980-86 period New York City employment increased over 230,000 or 1.2 percent annually. However, the rate of employment growth for New York City remains well below the average for the state, northeast region, and the nation in the 1980s. Thus, the city's relative employment loss continues notwithstanding absolute job growth.

The composition of employment growth mirrors the structural changes in the economy noted earlier—declines in manufacturing and increases in services. (See Table 3.4.) Goods-producing jobs in New York City fell from almost 21 percent of the total in 1970 to 11 percent in 1986, while service employment and closely related jobs in finance, insurance, and real estate jumped from 33 percent to 45 percent. When the largest "service" provider, government, is included, the 1986 services total exceeds 60 percent of the New York economy.

These trends hold for the state as well as the city. Robert Berne and Matthew Drennan have demonstrated that the state's employment growth over the 1976-84 expansion phase was led by producer (or business) services (about 330,000) and consumer services such as health and education (about 160,000). In part because of these
TABLE 3.3

Employment Change in Selected Areas, 1970-80 and 1980-86

(employment in thousands and percentage change in average annual rate)

<table>
<thead>
<tr>
<th>Year</th>
<th>New York City</th>
<th>New York City Suburbs(^1)</th>
<th>Rest of New York State</th>
<th>New York State</th>
<th>Northeast(^2)</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Employment</td>
<td>Employment</td>
<td>Employment</td>
<td>Employment</td>
<td>Employment</td>
<td>Employment</td>
</tr>
<tr>
<td></td>
<td>Percentage</td>
<td>Percentage</td>
<td>Percentage</td>
<td>Percentage</td>
<td>Percentage</td>
<td>Percentage</td>
</tr>
<tr>
<td></td>
<td>Change</td>
<td>Change</td>
<td>Change</td>
<td>Change</td>
<td>Change</td>
<td>Change</td>
</tr>
<tr>
<td>1970</td>
<td>3,746</td>
<td>1,101</td>
<td>2,310</td>
<td>7,156</td>
<td>18,638</td>
<td>70,880</td>
</tr>
<tr>
<td></td>
<td>-1.3%</td>
<td>-1.3%</td>
<td>2.2%</td>
<td>0.1%</td>
<td>1.0%</td>
<td>2.5%</td>
</tr>
<tr>
<td>1980</td>
<td>3,302</td>
<td>-1.3%</td>
<td>2,544</td>
<td>7,207</td>
<td>20,502</td>
<td>90,406</td>
</tr>
<tr>
<td></td>
<td>-1.3%</td>
<td>-0.4%</td>
<td>1.0%</td>
<td>0.1%</td>
<td>1.0%</td>
<td>2.5%</td>
</tr>
<tr>
<td>1986</td>
<td>3,539</td>
<td>1.2%</td>
<td>2,748</td>
<td>7,906</td>
<td>22,411</td>
<td>100,167</td>
</tr>
<tr>
<td></td>
<td>1.3%</td>
<td>2.9%</td>
<td>1.3%</td>
<td>1.6%</td>
<td>1.5%</td>
<td>1.7%</td>
</tr>
</tbody>
</table>

Business Cycles\(^3\):

| Expansion | 1971-73 | -1.0 | 3.7 | 2.3 | 0.9 | 2.1 | 3.8 |
| Contraction | 1973-75 | -3.7 | -0.4 | -0.8 | -2.1 | -1.4 | 0.1 |
| Expansion | 1975-79 | -0.1 | 3.2 | 2.1 | 1.3 | 2.3 | 3.9 |
| 1980-81 | 1.7 | 1.5 | 0.2 | 1.1 | 0.7 | 0.8 |
| Contraction | 1981-82 | -0.4 | 1.5 | -1.6 | -0.4 | -1.2 | -1.7 |
| Expansion | 1982-86 | 1.4 | 3.7 | 2.3 | 2.2 | 2.4 | 2.8 |


Notes: \(^1\) Includes Nassau, Putnam, Rockland, Suffolk and Westchester counties.


\(^3\) These are approximations of the business cycles since these estimates are based on annual averages of employment; one contraction from the first to second quarter of 1980 was excluded due to its brevity.
TABLE 3.4

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining</td>
<td>0.1%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>-3.7%</td>
<td>- 7.8%</td>
</tr>
<tr>
<td>Construction</td>
<td>3.0</td>
<td>2.3</td>
<td>3.2</td>
<td>-3.7</td>
<td>6.6</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>20.5</td>
<td>15.0</td>
<td>11.0</td>
<td>-4.3</td>
<td>-3.9</td>
</tr>
<tr>
<td>Durable Goods¹</td>
<td>N/A</td>
<td>4.4</td>
<td>3.0</td>
<td>N/A</td>
<td>- 5.0</td>
</tr>
<tr>
<td>Non-Durable Goods¹</td>
<td>N/A</td>
<td>10.6</td>
<td>8.0</td>
<td>N/A</td>
<td>- 3.4</td>
</tr>
<tr>
<td>Trade</td>
<td>19.6</td>
<td>18.6</td>
<td>18.0</td>
<td>-1.8</td>
<td>0.7</td>
</tr>
<tr>
<td>Transportation and Public Utilities</td>
<td>8.6</td>
<td>7.8</td>
<td>6.2</td>
<td>-2.3</td>
<td>- 2.7</td>
</tr>
<tr>
<td>Finance, Insurance and Real Estate</td>
<td>12.2</td>
<td>13.6</td>
<td>14.9</td>
<td>-0.2</td>
<td>2.7</td>
</tr>
<tr>
<td>Services</td>
<td>21.0</td>
<td>27.0</td>
<td>30.4</td>
<td>1.3</td>
<td>3.2</td>
</tr>
<tr>
<td>Government</td>
<td>15.0</td>
<td>15.7</td>
<td>16.2</td>
<td>-0.9</td>
<td>1.8</td>
</tr>
<tr>
<td>Total</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>-1.3%</td>
<td>1.2%</td>
</tr>
</tbody>
</table>


Note: ¹Data not available on a consistent basis for all years.

structural changes, the city and state economies have not been damaged by business cycles in the 1980s as much as in the 1970s, when they were hit harder by recession and benefited less from expansion than the rest of the nation. (Refer to Table 3.3.) While the city and state economies fared better than the rest of the nation during the 1981-82 recession, the 1982-86 expansionary period has seen the city's employment grow at only one-half the national rate, 1.4 percent annually compared to 2.8 percent. In contrast, the New York City suburbs, with annual growth of 2.9 percent, outperformed the U.S. economy in the post-1982 expansion.

As well as the city's economy has performed in the 1980s, trouble signs are now apparent. First, the city's decade-long economic expansion has not sufficiently benefited the city's poor. The incidence of poverty has risen to include nearly one-quarter of the city's population, and the share of New York City residents with jobs is only slightly over 50 percent. Nationally, about ten percent more work and about ten percent less are impoverished. Second, prices in the New York area have risen faster than nationally in recent years, signalling a major competitive disadvantage. Since 1981, area con-
sumer prices have risen nearly one-third faster than the national average.

Third, the data in Table 3.4 signal a loss of diversity in the city’s economy. As one knowledgeable observer put it, “... the City has based its growth on putting more and more eggs into fewer and fewer baskets.” Generally speaking, a heterogeneous industry mix provides an area’s economy with protection against national and, increasingly important, international downturns in business activity. While the New York economy showed some ability to resist a national downturn in the early 1980s, its increasingly prominent international role makes it increasingly susceptible to international trade dislocations.

Fourth, there is some indication that New York City is losing its historic competitive advantage in office jobs to the surrounding metropolitan area. Ten years ago, the city held nearly one-half of the jobs in the region; but in the past ten years, it has accounted for only approximately one-quarter of the total employment increase. A number of relocation decisions in 1987 by major New York City businesses—some to the suburbs and others outside the region—underscore this trend. In the 1977-86 period, the advanced business services sector grew 49 percent in New York City, but the increase in the region outside of New York City was 77 percent. Technological innovation, particularly as it affects so-called “back-office” employment, in all likelihood will decentralize this function even more in the years ahead.

PUBLIC FINANCE

Improved economic performance in the 1980s did not bring New York’s public finances into a more favorable comparative position. In 1978, state and local governments in New York State imposed $156 in taxes for every $1,000 of personal income, the highest rate in the nation (except Alaska); this level was 42 percent above the national average. By 1985, state and local taxes in New York had declined slightly, to $150 per $1,000 of personal income, but were still 41 percent higher than the national average. In the 1980-85 period alone, the average New Yorker experienced a real tax increase of $278, compared to $119 in the rest of the nation. The result: New York’s per capita tax burden rose to 59 percent above the national average in 1985, up from 51 percent in 1978. The previously
discussed windfall-induced tax cuts by the State and City governments in 1987 may have altered these relationships somewhat, but in what direction and magnitude are not clear due to the absence of comparative data on other state and local government responses.

The City's finances show a similar pattern. (Refer to Table 3.1.) Local taxes grew faster than employment and income in much of the 1970s, but this pattern was reversed during the fiscal crisis period and continued through the early 1980s. Beginning in fiscal year 1984, however, the situation again was reversed. Local taxes once again began to shrink disposable private income. Between 1983 and 1988, municipal taxes are projected to rise from 9.8 percent to 10.2 percent of local personal income.\(^45\)

Why did City or State officials not seize the opportunity presented by economic growth in the 1980s to bring government spending and taxes more into line? The dominant explanation, at least in New York City, is rooted in its fiscal crisis, and the widely held belief that expansion of government activity in the 1980s was necessary to restore "things" to their pre-fiscal crisis levels, including the size and pay of the municipal workforce. This was reflected in municipal budget priorities during the 1980-85 period. (See Table 3.5.) The number of City employees grew at an annual rate of 1.6 percent in the 1980-85 period compared to declines of 1.7 percent and one percent in the 1970-75 and 1975-80 periods, respectively. The growth rate in New York City in the 1980-85 period was more than five times higher than the national average for local governments. New York City's payroll per municipal employee (adjusted for inflation) grew 2.7 percent annually in the first half of the 1980s. This growth rate also is high in comparison with localities in the rest of the state and the nation. Since labor costs account for well over one-half of the City's budget, the expansion of staff and their real pay in the 1980-85 period places enormous constraints on the City's future fiscal options.

**RESPONDING TO FEDERAL POLICY**

It is likely that the federal government will continue to reduce its aid payments to state and local governments. Some contend that a Democratic White House would reverse federal aid policy, but
### TABLE 3.5

*Trends in Employment and Payroll in New York City Government, All Local Governments in New York State, and All Local Governments in the United States, 1970-1985*

<table>
<thead>
<tr>
<th></th>
<th>Average Annual Percentage Change</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Employment</strong>¹</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New York City</td>
<td>-1.7%</td>
<td>-1.0%</td>
<td>1.6%</td>
</tr>
<tr>
<td>New York State</td>
<td>0.4</td>
<td>-0.7</td>
<td>0.9</td>
</tr>
<tr>
<td>United States</td>
<td>3.6</td>
<td>1.6</td>
<td>0.3</td>
</tr>
</tbody>
</table>

| **Real Payroll per Employee**² |       |       |       |
| New York City           | -0.4% | -3.9  | 2.7    |
| New York State          | -0.3  | -3.5  | 2.0    |
| United States           | -1.6  | -1.5  | 1.1    |


**Notes:**¹ Employment includes full- and part-time workers.
² Total payroll deflated using the implicit GNP deflator for state and local purchases.

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Remember that it was a Democratic president, Jimmy Carter, who initiated the now decade-long trend in order to help resolve the federal deficit. That deficit, larger than ever, will continue to prevent significantly larger amounts of federal revenues from reaching state and local government coffers.

The City of New York has been fortunate to receive disproportionate federal aid—more than either its relative wealth or population would indicate. This is attributable to continued growth in welfare assistance, the City's influence in Congress and, finally, its lobbyists' "grantsmanship" skills. Welfare reform and the shift to formula-driven grants may alter New York City's relatively favorable position in the competition for what is projected to be even less federal aid.

The overall effects of the other major federal policy initiatives—income tax reform—are harder to predict. The 1986 federal tax reform had the effect of raising local taxes and probably exacerbated the already unfavorable burden of higher-income New York City taxpayers. It put investment in manufacturing on a "level field" with other business investments, which may accelerate local employment decline in goods production. It reduced subsidies for investment in rental housing and non-residential buildings, which may
dampen growth in the real estate tax base, as well as increase the housing budget of many New Yorkers. The city’s poor are likely to suffer indirectly from tax reform—by reduced employment opportunities in manufacturing and by cuts in social programs that may be necessary to offset slowed revenue growth. The hope—both nationally and locally—is that the new tax law and other factors will be a great boost to economic growth, but the stimulative effect of these incentives remains uncertain.

The recent positive demographic and economic trends in the city are not as solidly based as many people believe. Population growth revived in the 1980s, but “troubled” New Yorkers comprise an even greater share of the total. Employment expansion in the 1980s has been impressive, stronger than most prognosticators believed was possible, but it has trailed the national rate and not improved significantly employment prospects for the city’s most disadvantaged people. New York City’s advantageous personal income record, where increases exceeded regional and national rates in the first half of the 1980s, may be a misleading basis for optimism. An unusually high 37 percent of New Yorkers’ personal income is “unearned,” arising from transfer payments (16 percent) and returns on capital (21 percent). Nationally, the comparable figure is under 32 percent.46 And New Yorkers are obliged to devote an unusually high share of their income to their municipal government. If municipal taxpayers do not get their “money’s worth” for comparatively high (and rising) local taxes, then the local government itself will become an increasingly significant drain on the local economy.

There are other ominous uncertainties. The strength of the dollar is suspect, the economy is due for a downturn, and the City’s rapid expenditure increases of recent years may not match up well with the lower elasticity of its post-windfall tax structure. In addition, the City’s ability to call on Albany to make up for fiscal shortfalls through State aid may be reduced by increased competition with the New York suburbs for State aid, and by a slower growing State budget.

All this implies that City leaders should adopt a more conservative fiscal policy. Expansionary policies in the early 1980s may have been required to restore pre-fiscal crisis conditions, but likely federal policy effects mean that future expansion will be possible only by increasing local tax burdens. One way of escaping this dilemma is for City officials to think in terms of new approaches to public finance and management. Greater reliance on user and benefit charges
rather than general taxes is indicated; beyond that, the City needs to ensure that its policies of spending more for its workforce pay off in improved public service. If better public management is unable to improve services, then the City should look to privatization of those services where greater efficiencies are indicated.

Most of all, however, foreseeable trends and significant uncertainties point to the need to consider expenditure retrenchment. Municipal services now cost more because federal subsidies have been removed, and future growth in the city's economic base is not likely to support continuing budgetary expansion.

NOTES


5. To reach this result, federal aid projections were deflated using the GNP deflator as forecast by the Administration and CBO. See U.S. Office of Management and Budget, op. cit., "Special Analysis H," Table H-7, p. H-22; Congress of the United States, Congressional Budget Office, The Economic and Budget Outlook: An Update (Washington, DC: Congressional Budget Office, August 1986), Table II-8, p. 63; and U.S. Congress of the United States, Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 1988, (Washington, DC: Congressional Budget Office, February 1987), Table II-2, p. 16.


8. Federal grants for public welfare accounted for 68 percent of total federal aid to New York State in 1985 versus 57 percent in 1980. The comparable figures for all state governments are 46 percent and 40 percent, respectively. See *State Government Finances*, 1980 and 1985 editions, op. cit., Tables 7 and 5, respectively.

9. *Governmental Finances in 1984-85*, op. cit., Table 29, p. 79; and *Local Government Finances in Major County Areas: 1984-85*, op. cit., Table 6, p. 30.


16. Including the surtax for high-income individuals, the top marginal rate is 33 percent.

17. One estimate is that the “price” of state services will increase eight percent because of the total elimination of deductibility of the sales tax. See Dennis Zimmerman, “Federal Tax Reform and State Use of the Sales Tax,” in *Proceedings of the 79th Annual Meeting of the National Tax Association-Tax Institute of America*, November 9-11, 1986, pp. 325-331.


20. The total windfall to the City has been estimated at $245 million, and the return at about $200 million. See New York State Financial Control Board, *Federal Tax Reform and New York City: Estimating the Windfall and Impact on Tax-Exempt Financing*, November 21, 1986; also see *New York City Financial Plan, Fiscal Years 1988-91*, op. cit., Table 4, p. 14.


22. The New York State Budget Director reported that “some 44.7 percent of New York returns claim itemized deductions on their federal returns, compared with 35.1 percent nationally—percentages that have been increasing over time for the state and the nation.” R. Wayne Diesel “Federal Tax Reform: The Impact on New York State,” *Citizens Budget Commission Quarterly*, Vol. 5 (Summer-Fall 1985), p. 2.

24. This theme is developed in Cynthia Green, "State Aid" in Setting Municipal Priorities, 1986, op. cit., pp. 92-93.

25. U.S. Bureau of the Census, Governmental Finances, 1979-80 and 1984-85 editions. This does not necessarily mean that New York City has received a slower flow of State aid. The City has relied heavily on State assistance to fill its projected financing gap in the form of increased State grants for education, the Human Services Overburden Program, and the State take-over of long-term health care. In fact, State assumption of local responsibilities has the statistical effect of lowering the share of State spending devoted to local assistance, but has the actual effect of aiding City finances.

26. These estimates are based on a simulation of federal, State and local taxes paid by middle- and upper-income New York City renters and suburban homeowners before and after the full implementation of federal, State and local tax reform. The simulation results are available from the author.


37. For an earlier version of this analysis, see Roy W. Bahl, The New York State Economy: 1960-78 and the Outlook, Metropolitan Studies Program, The Maxwell School, Occasional Paper No. 37, (Syracuse, NY: Syracuse University, October

38. New York State Data Center, Official Population Projections, op. cit., Table 3, p. 12.

39. The Port Authority, op. cit., Table 20, p. 36; New York State Data Center, op. cit., Table 3, p. 13; and New York City Planning Commission, Capital Needs and Priorities (New York City: New York City Planning Commission, 1986), Table 1, p. 1.

40. For example, see Commission on the Year 2000, New York Ascendant (New York: The Commission, June 1987), particularly pp. 51-70.


42. This discussion of trouble signs relies heavily on Samuel M. Ehrenhalt, "Looking to the 1990s: Continuity and Change," July 1987.

43. Ibid., p. 28.

