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The Next Decade in State and Local Government Finance: A Period of Adjustment

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☐ THE 1980s WILL BE A PERIOD of fiscal adjustment for state and local governments. The formerly rich states will be struggling to bring their *relative* quality of public services down to a level they can afford; the formerly poor states will be struggling to raise service levels in response to the demands of their new populations; and all will be trying to adjust to a higher rate of inflation and a slower growing U.S. economy. The lessons on getting along with less will painfully be learned by more than a few state and local governments.

How will changes in the U.S. economy affect state and local government finances in the 1980s, and what governmental policy responses will be necessary? To answer these important questions, we first consider those national economic and demographic factors that may shape the outlook, then discuss the essentials of a national urban policy and of the possible adjustments by state and local governments. We conclude with a guess at what the next few years in state and local government finance will hold.

AUTHOR'S NOTE: *This chapter is an expansion of Chapter 6 of my "State and Local Government Finances and the Changing National Economy," prepared for the Special Study on Economic Change of the Joint Economic Committee.*

FACTORS SHAPING THE OUTLOOK

That state and local governments everywhere are facing problems of adjustment is a reflection of the changing structure of the U.S. economy. A slowing national income growth and a shift in its regional distribution, a continuing high rate of price inflation, a changing population structure, changes in federal budget and federal grant policy, and a new voter resistance to big government and regulation, all exert important pressure on the financial condition of state and local governments and all call for some form of policy response. In truth, the changes are less recent than some policy analysts should be willing to admit—the slower rate of income and population growth has been recognized for several years, as has the ongoing pattern of regional shifts in population and economic activity. But old fiscal habits die slowly, and adjustments take time. The growth in government is just beginning to slow and the realities of long-term retrenchment are only now taking hold in some jurisdictions in the declining regions. The reverse is true in the growing regions where increasing costs and the pressures to upgrade services are beginning to affect state and local government budgets.

NATIONAL ECONOMIC GROWTH

The prognosis for the 1980s is for real GNP to grow more slowly than in the 1960s and 1970s. Between 1970 and the first quarter of 1980, real GNP growth was positive in seven years and averaged 4.5%. For the ten years of positive growth rates in the 1960s, the average was 4.1%. Certainly the next two years will not begin to approach this rate. The administration has projected a real GNP decline in 1980 and a real growth of only 2.0% in 1981 (Congressional Budget Office, 1980).

Few will hazard outright projections of GNP five or ten years in the future, but some indirect evidence casts doubt on the believability of 4% to 5% real growth rates for the early 1980s. The administration estimates that to achieve a 4% unemployment rate by 1985 and a 3% inflation rate by 1988, annual productivity increases of 2.5% and real GNP growth rates in the range of 4.5% to 5.0% will be required. To the extent these long-term inflation and unemployment targets are not attainable, slower real income growth will result.

The Bureau of Labor Statistics made baseline projections of a 3.2- to 3.6% annual real growth rate in GNP for the 1980s. These projections require that inflation slow to 5.5% in the early 1980s and to 4.4% by the end of the decade and that the unemployment rate gradually fall from a projected level of 5.3% in 1981 to 4.5% by 1990 (Saunders, 1979: 12-24). The Congressional Budget Office (1980) has simply assumed (calculated) a 3.8% growth rate "so that by 1985 the unemployment rate would return to approximately the current level (5.9 percent)" [1980: 2-5]. The Joint Economic Committee (1980: 30-32) assuming productivity increases in the 1.5- to 2% range, sees the long-term rate of real GNP growth to be in the 3- to 3.5% range. From almost every vantage the conclusion seems to be the same. For at least a few years, the U.S. economy will grow more slowly than it did during the past two decades.

One important reason why the more optimistic scenarios such as the real-growth targets set by the administration may not be reached is that the inflation rate will likely remain high in the 1980s. The underlying causes of inflation have been building for more than a decade and cannot be swiftly corrected—indeed, the President's 1980 *Economic Report* recognizes this in pushing back its timetable for lowering the rate of inflation. Moreover, some major causes of inflation are a result of world events—oil pricing, production decisions, and crop failures—and are neither controllable by domestic policy nor predictable. The prospects for easing price increases in the 1980s might also be viewed in terms of the components of inflation. The major contributors in recent years have been energy, housing, food, and medical costs. Neither federal policy nor international events would cause us to expect a dampening in any of these components of general price increase. Reischauer's review (this volume) of forecasts supports this pessimism—he expects the 1980s to be characterized by relatively slow economic growth, high rates of inflation, high levels of unemployment, rapid nominal wage growth, and high interest rates.

This combination of slower real growth and inflation will put new pressures on the budgets of state and local governments.

Forecasts for the state and local government sector are not generally available, though the Bureau of Labor Statistics' (BLS) projection model is an exception. Under their baseline employment expansion assumptions, they expect the sector to decline between 1980 and 1985 in employment (12% of total employment to 11.6%), purchases of goods and services (12.6% of GNP to 11.1%), and personal taxes (3.2 to 2.9% of GNP) [Reischauer, this volume]. Whether or not the relative declines in state and local government activity will be this steep, it would seem reasonable to assume that taxes will be off their post-1975 annual real growth rate of 4.3%. If the past few years is representative and if tax limitation movements do not further slow tax revenue growth, a 3.5 to 4 percentage real GNP growth could imply a state and local government tax revenue growth of 2.7 to 3.1% per year.

The resulting revenue gap will not likely be made up by increased federal assistance. To the contrary, if the federal grant share of GNP remains constant, a 3.5- to 4.0 percentage real GNP growth will bring an annual increase in Federal grants of 4.6- to 5.3%. Even this projection, which seems optimistic, is for a growth well below the 7.3 percentage annual real increase of the period 1975-1978.

The import of all this is clear. State and local governments will have less resources available in the 1980s—the overall rate of revenue increase could fall by as much as one-fourth if the real GNP growth rate stays in the range of 3.5- to 4%.

Some areas will be hit harder than others by this slow national growth and by the cutbacks in the real amount of federal aid to state and local governments. The slower-growing industrialized states in the Northeast and Midwest could experience very little real growth under this scenario and central cities in those regions will be the hardest pressed. Governments in this region could well face revenue growth rates lower than the national rate of inflation—a combination of slow, real national growth and declining regional shares. Many of the growing states will not escape from the revenue effects of the national slowdown. Those growing states without substantial energy resources will face a more drastic reduction in their *rate* of revenue increase than will many of the Northern states who have already entered a period of fiscal austerity.[1]

The other side of the coin is inflation, and to some extent inflated tax bases offset the dampening effects of slow economic growth. But property taxes are not so responsive to inflation, and continued inflation and taxpayer resistance will eventually force rate reduction or indexation for more state government tax systems. These factors will probably hold back inflation-induced revenue growth so that it will not offset the losses due to slower growth. The more significant effects of inflation on state and local government budgets are likely to occur on the expenditure side. If the pattern of recent years holds, rapid increases in costs will account for most if not all of state and local government expenditure increases. This implies little or no increase in the real level of services offered.

Higher rates of inflation also promise two structural changes in state and local government spending. The first is that with soaring material and supply costs, a more labor-intensive public sector might seem feasible. The clamor of the past decade for increased productivity by capital-labor substitution may diminish in favor of arguments for more policemen and fewer cars and the like. The other major structural change is the extent to which capital formation in the state and local government sector will slow even further. Rising material costs, rising interest rates, and the ease of deferring the renovation and maintenance of the capital stock could all contribute to further reducing the rate of investment by governments in renewing their infrastructure.

REGIONAL SHIFTS IN ECONOMIC ACTIVITY

The slowing of national economic growth will be more than offset in some regions by the inmigration of economic activity. In the older, declining regions, it will be reinforced. There are prospects for people and jobs moving to the newer region, a trend that should continue through the end of the century. Estimates of regional populations and income growth by the Department of Commerce (Water Resources Council, 1974; Bureau of Economic Analysis [READ], 1977) and regional population and employment growth by the Oak Ridge Laboratory (1977; Olsen et al., 1977) agree. Census population projections offer a similar prognosis (Bureau of the Census, 1977).

But no matter how sophisticated the model, the projections are an extrapolation of past trends and will not pick up major turning points. One might question whether there are factors at work beginning to slow these regional shifts.

Evidence of a new equilibrium? There is some evidence and logic to argue that the growing and declining regions are approaching a new economic equilibrium. One line of argument would consider the limits to growth in some parts of the Sunbelt—water and the ability to provide services to accommodate a large population increase. Another would consider the relative cost of doing business. Labor costs may now be growing as fast in the South as in the North, and there is some evidence that the overall cost-of-living is rising faster in the South. Weinstein (1979) reports that between 1972 and 1978, the BLS's level of living index rose by 66.4% in southern cities in the sample but only 56.6% for cities in the Northeast. A continuation of this differential rate of price increase will drive up relative labor costs in the South and could be reinforced by increasing union strength—a natural consequence of manufacturing moving to the newer regions. The increasing cost of Sunbelt living may improve the attractiveness of northern plant locations, but the convergence is painfully slow.

One might speculate that the rate of taxation is becoming similar and therefore will slow regional job shifts.[2] This would be little more than speculation. Tax burdens have not become more uniform across the 50 states, though a few high income-high taxing states have cut taxes or slowed their rate of growth relative to personal income, while some low-taxing states have increased effective tax rates to fill backlogs of unmet services and respond to increasing population and income. For example, the declining states of New York and Ohio reduced their relative tax burdens from 1975 to 1977, while growing states such as California and Colorado had relative tax burden increases. Yet, for the most part, the declining states had relative increases in tax burdens and the growing states had relative declines. This result is not at all inconsistent with a slowing rate of increase in taxes in high-income states—the problem is that financial capability grew even slower. The reverse was true for many of the growing states—they did not increase taxes fast enough to keep pace with growth in their taxable capability.

The effects of the energy crisis on regional shifts in economic activity are anything but clear, but the net effect may well accelerate the decline. The prospects for higher energy prices and uncertain supplies in northern and midwestern states suggest a bias in the locational decisions of energy intensive firms toward the growing regions. And rising energy prices can produce a bonanza in energy tax revenues for some state governments. This could substantially ease any fiscal pressures on those states and remove one bottleneck to their continued growth. On the other hand, the rising cost and more limited use of air conditioning could deter southern economic growth.

Two other factors argue against regional convergence. One is that markets have shifted away from the older regions, and to the extent jobs follow people, the job share in the declining regions may still have a way to go. Finally, there is the question of consumer taste or relative preferences for northern versus southern living. The current pattern of migration would suggest a comparative advantage to states that can offer more sunshine and less congestion.

There may indeed be forces operating to slow regional shifts by raising the comparative advantage of the older industrial states. If so, these turning points are too recent to be detected. A more likely prospect is for a continuation of the Sunbelt shift of the 1970s.

Fiscal adjustments. Regional movements of population and economic activity will pressure state and local governments to adjust their fiscal behavior. For some northern states the scenario will be continued, long-term retrenchment. As a state like New York attempts to bring per-capita expenditures (40% above the U.S. average) into line with per-capita income (4% above the U.S. average) the central issue becomes how to *lower* the level of public services relative to other states. Few states, and especially New York State, have experience with such matters.

Such an adjustment is not only slow, but it is complicated by a number of factors:

- Inflation is driving up costs faster than revenues, accentuating real service level declines.

- Slower real income growth cuts into an already thin margin of revenue coverage.
- Many northern states are characterized by highly decentralized fiscal systems, hence it is difficult for the state government to plan for or control the aggregate level of state and local government spending and taxing.
- Because of jurisdictional fragmentation, the fiscal position of central cities in the declining regions is likely to be hurt a great deal more than that of suburbs, i.e., much of the costs of retrenchment are ultimately paid by low income families.
- There are important psychological barriers to retrenchment–residents find it much easier to adapt to lower taxes than to adapt to lower public service levels.
- The strength of public employee unions, fixed debt and pension commitments, a backlog of needed infrastructure improvements, and the existing near-crisis financial conditions of many cities make substantial retrenchment especially difficult.

The net result of all this is that while regional shifts in economic activity demand that the formerly rich states bring their fiscal activities into line with their new, relatively low levels of income, the retrenchment probably involves a period of public sector atrophy in the North. This means that governments probably will not and cannot cut back service levels in the absolute, but if they do not raise tax burdens or expand the quality and quantity of services and spend just enough to keep real per-capita expenditures approximately constant, in time the rest of the country will catch up. This is long and slow and implies making public service levels *relatively* worse, but it is the kind of adjustment most likely to occur.

The growing regions will also face fiscal adjustment problems. On the one hand, there is great rural poverty in the South and Southwest and the need to use substantial amounts of the revenues from growth to deal with these problems. Then there are the pressures from growing population and income to expand infrastructure, improve school and health systems, deal with water shortages and environmental problems, and control land use. The growing regions would seem more equipped (than most northern States) to deal with these pressures for a number of reasons:

- Resources are growing because of regional shifts, even though national growth is slowing, and because state tax structures in the growing regions tend to be more inflation-sensitive than those in the Northeast and Midwest.
- Governmental finances tend to be more state dominated and therefore more controllable.
- Many urban areas are not characterized by fragmented local government structures.
- Some states will experience substantial revenue growth with rising energy prices.

On the other hand, there are state and local government financial problems ahead for southern states. Much of this increase in spending could come in the form of a catch-up in average wages, hence expenditures may rise more rapidly than public service levels. Employment levels relative to population are already higher in southern than northern states, as are levels of per-capita debt.

DEMOGRAPHIC CHANGES

Major changes in the national demographic makeup will continue through the year 2000. Fertility rate reductions and mortality rate declines have combined to push the nation toward a zero population growth, an increasing concentration of the elderly, and a declining proportion of school-aged children. Concomitant with these trends has been an increasing rate of household formation. The potential effects of these changes on state and local government finances could be significant. Unfortunately, this is a virtually untouched research area, hence we can but pull together some disjointed evidence and speculate about fiscal implications.

Expenditure effects. A slower population growth has uncertain implications for productivity, labor force participation, and the growth in GNP, hence the implications for state and local government revenues are uncertain.[3] But a slower population growth rate would seem to imply less pressure on the expansion of public services and therefore less pressure on public budgets. For some services, this is intuitively clear. Education, roads and streets, and water and sewer services quickly come to mind. Yet

he situation is considerably more complicated. First, the ques-
ons must be carefully framed. How does a slower versus a
aster rate of population growth, *ceteris paribus,* affect state
nd local government finances? What are the fiscal implications
f slower population growth for particular jurisdictions and for
he aggregate financial position of the state and local govern-
nent sector?

A lower (rather than a higher) national growth rate might be
ranslated into actual population declines in some older regions
ınd central cities. On the surface this would alleviate some
evere budgetary pressures. Yet the literature is uncertain about
he effects of changing population size on public expenditure
evels. Consider first the growing cities and states. Despite a
great deal of discussion about the possibility of scale economies in the provision of local public services, there is little or no hard evidence to suggest that larger cities could deliver services any more cheaply on a per-person basis than could smaller cities (Bahl et al. 1980). One would conclude from this that a greater rate of population growth, *ceteris paribus,* means a greater increase in expenditures. Conversely, the loss of city or state population does not guarantee an expenditure reduction because there are many offsetting factors, e.g., inflation, mandates, and the simple creation of excess capacity in the city plant. Muller (1976: 82-83) has shown that per-capita common function expenditures between 1969 and 1973 for 14 declining cities rose by 51%, as opposed to 59% for 13 growing cities. As a percentage of personal income, he found the growth to be even greater for the declining cities. The determinants of public expenditure change are far too complicated to allow any precise estimates of the cost savings of a slower population growth rate. We can guess that an increase in the rate of population growth, *ceteris paribus,* increases expenditures and vice versa. But we do not have a feel for the magnitude of that effect in different types of jurisdictions.

If the question is whether slower population growth, *ceteris paribus,* reduces the aggregate level of state and local government spending, the answer is probably that it does. A faster population growth would not only generate more service demands but it could stimulate more migration.[4] The *movement* of population, as much as the size of population, increases costs, i.e., servicing a new suburban population may increase public sector costs by a greater amount than the cost reductions resulting from outward migration from an old neighborhood.

While differential rates of population growth may have significant budget effects, the more important effects on public expenditures are likely to come from the changing composition of population. The compositional changes most important in this respect are the increasing proportion of the elderly, the declining number of school-aged children, declining urban densities, and declining urbanization.

A growing elderly and retired population could affect public budgets by causing shifts in social service expenditures and by putting pressure on the financing of retirement needs. The two most likely areas of concern are retirement cost and health care expenditures, though other public assistance programs may also be affected. The pressures brought by an older population on social service expenditures by state and local governments may not be so severe as one might expect. State and local governments spend substantially more on health care for the elderly than for the younger age groups, but less than 9% of total state and local government expenditures are for health and hospitals and about 85% of health expenditures on the elderly are aided. Moreover, one interesting set of projections suggests that growth in the numbers of elderly will be offset by growth in their income (from earnings and social security) leaving the proportion eligible for public assistance essentially unchanged over the next 40 years (Goodman, 1979). A potentially more important pressure on state and local government budgets may come from the problems of financing state and local government pension plans. If a government were operating on a pay-as-you-go basis, or with substantial unfunded liabilities, and if the age distribution of public employees changed in the same fashion as the demographic makeup of the community, then taxes to finance retirement cost expenditures could rise substantially in the 1980s (Munnell, 1980).

There is a bit more evidence, albeit indirect, on the expenditure effects of other types of compositional changes. Empirical work suggests that declining population densities may reduce pending for urban services such as police and fire, and a falling upil-to-population ratio could eventually lead to lower educaional expenditures (Barro, 1978). As welcome as such relief night be, one should not think too quickly about the possible ises of such savings. First, the effects of inflation may more han offset any "quantity" reduction, and anyway there will be ubstantial adjustment costs associated with budgetary shifts, .e., such as from youth to age-related programs. Other "compositional" factors might offset the savings from a slower rate of population growth. The formation of new households will bid up certain costs—sanitation and fire—and the continuing movement of population to suburban and nonmetropolitan areas may cause the unit costs of providing public services to rise.

Revenue effects. The changing growth rate and composition of population will also be felt on the revenue side of state and local government budgets. The subject has not been thoroughly worked and one cannot go to a developed body of literature to support speculation about how changing demographics will change revenue flows. Still, an increasing *share* of the elderly will dampen revenue growth if for no other reason than because of an income effect. Retirees earn less and therefore have less to spend on taxable state and local government items—taxable consumer goods and housing. A related hypothesis is that a dollar of retirement income does not generate the same amount of tax revenue as a dollar of wage and salary or proprietorship income. The elderly receive special relief from state taxes through property tax circuit breakers, their housing choices run toward less expensive housing, and they consume a greater share of income in nontaxable housing, food, and medical care.

Another compositional factor is that the ratio of dependent to productive age group individuals will decline through the mid-1980s but then begin to increase with increases in the elderly and those under-10-years of age. Hence, the rate of growth in real sales and income tax revenues could be dampened by the late 1980s.

The other demographic change with important fiscal implications for state and local governments is the changing number of households. A taste for smaller families, the divorce rate, the postponement of marriage and childbearing, and the declining fertility rate have slowed the rate of population growth but not the formation of households. An example of the magnitude of this effect is New York State where a 9% increase in population is projected between 1980 and 2000, but a 25% increase in households (N.Y. State Economic Development Board, 1978). The fiscal implications have not been carefully studied. At first blush more households within a given population size implies more income earning units and therefore more taxable capability. More property *units* would suggest a bouyancy for the property tax, taxable income should increase, and there should be an increase in the taxable consumption share of income. The counterargument is that more young families may result in an increased stock of lower valued housing units, and there may be relatively little effect on the property tax. The expectation that more household units will increase the aggregate marginal propensity to consume taxable items (because younger families will go into debt to increase their purchase of durables) is debatable at best.[5]

Overall budgetary implications. A priori, the fiscal effects of a changing rate of growth and composition of population are so unclear as to be inconsequential, except perhaps for the costs of adjusting budgets to the new mix of services required. Yet, because some regions will realize these demographic changes more than others, more substantial fiscal effects could emerge. The increasing proportion of the aged and the increasing number of households is a national phenomenon, but the slower rate of national population growth is not being felt to the same extent across all regions. A continuing interregional migration will compensate for declining birth rates in some regions and reinforce natural population decline in others. Particularly the central cities will feel the change in becoming older and smaller but with an increasing number of households. If the fiscal consequences of demographic change turn out to be harmful, it is these cities that will be hurt most.

THE LIMITATION MOVEMENT

It is not likely that the tax revolt movements of 1978 and 1979 signal a permanent reversal in the growing share of government in GNP. But it seems clear that fiscal limitations of one kind or another will be a significant influence on state and local government budgets during the next five years. By mid-1979, 30 state legislatures and the U.S. Congress were considering balanced budget amendments. Some 14 states passed some form of tax or expenditure limitation between 1978 and 1980 (see Matz, this volume). The mood is clearly in the direction of slowing the growth of government at all levels.

The explanations of this dissatisfaction are many (Burkhead, 1979). Increasing taxes would be especially objectionable during inflationary times, when real spendable earnings for most American families have hardly increased. As long as the rate of inflation remains high, the objections from this group of voters will remain substantial, and growth in government will be resisted. In particular, rising property tax rates place onerous burdens on homeowners in that accrued worth may differ markedly from annual income. Shapiro et al. (1979) argued that the high and rising property tax burden was at the heart of the Proposition 13 movement. Yet Matz (this volume) pointed out that limits have been adopted in states *not* experiencing high or rapidly escalating taxes or expenditures. Another source of discontent is what is perceived of as an inefficient public sector—overpaid, underworked, and not responsive to citizen needs. Whatever the reasons for this dissatisfaction, it seems likely that some state and local governments will be tied to personal income growth in what they are allowed to spend.

Fiscal limitations, if they stick, will reduce the discretion of government decision-makers in formulating new programs and taxes and in altering the timing of their own fiscal expansions and contractions. Even though there is an option to switch to user charge financing (a compensating device used in the aftermath of California's Proposition 13), it is clear that local fiscal planning will be more constrained, and new spending initiatives will be bypassed to meet increased spending for "less controllable" budget items.

It is less clear what the effects on aggregate state and local government fiscal activity will be. On the surface, tieing tax and expenditure growth to personal income growth suggests a dampening effect. Yet 13 of the 14 states imposing such limits are in the growing region—only Michigan is a declining state. Hence, even with limitations, a growth in taxes above the national rate of income growth could occur (though one might speculate th it would be even higher without the limitation). Moreover, nearly every case the limitations apply only to state gove ment. In total, the affected governments account for no mo than one-fourth of total state-local government revenue rais from own sources. It is difficult to see how the limitations p se would significantly hold down aggregate state and lo government spending. And, even with state tax limitations it not clear that local spending and taxing would be slowed. T ACIR argues that it would, by 6- to 8% per capita by compa son with nonlimitation states, while Ladd disagrees (Adviso Commission on Intergovernmental Relations, 1977: Lad 1979).

On the other hand, if there were a more widespread adoptio of such limitations, aggregate state and local government taxi and spending would slow but by a significantly greater amou in the declining region. In some states this discipline would b welcome, but it does reduce fiscal flexibility in states whe fiscal capacity is growing more slowly.

Perhaps a more significant effect on the budgets of state an local governments is the possibility of limitations at the feder level. The proposals range from a fixed maximum percentag increase in federal outlays to a ceiling on the ratio of federa outlays to GNP. But all would slow the growth in Federa spending (see Reischauer, this volume). Even without a lega indexing of federal expenditures, the tax revolt movement wil press to balance the federal budget more frequently than ever Some of this balancing will inevitably result in reduced re- sources available for the more controllable federal grant-in-aid programs and in a further dampening effect on state and local government revenues.

The limitation movement at all levels of government gained some momentum in 1978 and 1979, and still more states will probably adopt varying controls on their budget growth. But inflation, public employee wage demands, federal assistance cuts, and slow economic growth will eventually catch up with some limitation states and stall the limitation movement in others. The limitation and austerity concerns of this year could give way to a renewed worry over deficient public service levels by the mid-1980s.

State legislatures will eventually reason that limitations will not address the underlying problem of an inefficient public sector that so rankles many taxpayers, nor is it clear that it will stimulate local economic development as others hope. Further, limitations may cause state and local governments to make revenue-raising adjustments such as increased use of benefit charges and the creation of special districts. Such policies may well be in the public interest under many circumstances, but not likely if their adoption is justified as a way around a formal limitation. The adjustments by state and local governments to circumvent debt limitations, and the efficiency and controllability of the resulting agency arrangements, is a lesson worth remembering.

Limitations are not without virtues. They force the political process to accept the fate of allowing a government to live within its means. Yet this discipline is accomplished at a cost of substantial flexibility in fiscal decision making and may induce some inefficient behavior by the limited government.

REVITALIZATION

Some analysts and many journalists see a revitalization of central cities taking place. It is not usually made clear whether revitalization means increased city population, employment and income, an improved economic position of the central city relative to suburbs, or simply a physical rehabilitation of certain parts of the inner city. Some, who borrow the term "gentrification" from the British, see it as filtering housing (or neighborhoods and retail districts) upward from working class to professional middle class.[6] Whatever the meaning, the implication is that the inner cities of the future will be much less the distressed areas that they now are and that federal policy toward cities ought to be adjusted accordingly. Indeed, some public policy is premised on the ability to induce more employment and residential activity in depressed inner city areas. A national development bank and tax abatements for construction investments in blighted areas are good examples.

The revitalization argument is based on *a priori* reasoning, casual observation, and wishful thinking. It has several elements.

First, changing demographics may favor central cities over suburbs. More singles, childless couples, and elderly in the national population; the increased demand for rental housing, smaller and less-expensive housing; and the convenience of city living (mass transit, convenience for shopping, and so forth) will bring people back to the city. And the deterrent of poor public schools in central cities will be less important for families without children. Second, the energy crisis will favor the city. Workers will move closer to work—and perhaps to where mass transit is available—to avoid the longer and more expensive commute. Third, there is the "bright lights of the city" argument. With more cultural and social activities, cities are exciting places to live, and some new awareness of these benefits will bring back white collar, middle income workers. Finally, there are the agglomeration effects which make the city a competitive location for certain types of white collar and service businesses. As evidence of revitalization, proponents give many examples: A booming Manhattan, Chicago's loop, and Capitol Hill.

Accepting the revitalization arguments as a basis for policy-making is better than wishing on a star. But not much. There is little evidence that city populations are increasing, that—relative to suburbs—their income and employment levels are rising or that their disadvantaged are better off. Indeed, none of these patterns have materialized. Central cities declined in population by about 5% between 1970 and 1978, they declined as a share of metropolitan area population and employment, and the city/suburb per-capita income disparity has actually grown (see Fossett and Nathan, this volume). If there has been a back-to-the-city movement, it has been dwarfed by the effects of those factors stimulating decline. Even the a priori arguments on revitalization seem flawed. There is some appeal to the notion that childless couples and singles see the city as a desirable location, because they are not deterred by poor quality schools and because of proximity to amenities and work. Yet the *postponement* of having children does not necessarily mean that couples will remain childless or that children will not be planned for. Indeed, some have argued that the fertility rate in the United States will soon increase. If this occurs, the quality of the public schools remains a major drawback to city residential location choices. Locations closer to amenities may also be a comparative disadvantage of cities, e.g., most cities cannot compete with the convenience and choice of suburban shopping centers, and the mass transit system is a major inducement in only a few cities.

The energy argument may also be questioned. There are more suburban than central city job locations, hence if the rising price of gasoline induced any population movement, it may well be to suburban locations. Moreover, if the commute to work grew too expensive, other kinds of adjustments might be made: e.g., a four day work week or innovations in communications to minimize necessary personal contact. To the extent movement took place in response to commuting costs, it would likely be blue-collar manufacturing workers moving to suburbs. Some white-collar workers might be lured to the city, but again the quality of the public schools would be an important impediment.

The bright-lights argument is based on a notion of cities being exciting centers of cultural and social activity that make city living more exciting. The impression is true enough, perhaps, for a Manhattan or a Georgetown but would hardly seem to fit a Syracuse or Toledo.

This is not to argue that revitalization is undesirable, that cities should not be brought back. Rather it is an argument for care in defining revitalization and for realism in assessing what can happen in cities during the next decade. Revitalization can mean a conservation of capital facilities, reinvestment in blighted areas, and a general improvement in the quality of city life. This pattern would be perfectly consistent with shrinking population and employment, the displacement of the poor from dilapidated housing in rundown neighborhoods, and the continued loss of manufacturing employment. Revitalization of cities, in this sense, may be a reasonable expectation. But it will not mean a diminished need for federal help in compensating for the economic losses, subsidizing the disenfranchised, and generally getting through a tough adjustment period.

FEDERAL POLICY

The federal government will play a major role in getting state and local governments through the difficult period of fiscal adjustment ahead. The question is whether the federal response will be reasoned and comprehensive or ad hoc and piecemeal. Some general guidelines for the federal response must be worked out, i.e., the kind of strategy one might expect to find in a well-thought-out statement of national urban policy. In its absence, some rough generalizations about how such a policy *might* view the financial problems of state and local governments is offered here. They fall into four areas of question about the appropriate federal response to urban problems; whether the federal government ought to attempt revitalization of declining areas or compensation during a period of financial adjustment; whether inflation and recession ought to be viewed as a part of intergovernmental policy; what role should state governments play in the intergovernmental system, and what will be the Federal policy toward possible big city financial disasters.

COMPENSATION VS. REVITALIZATION

If the administration's urban policy statement of 1978 took any firm position, it was toward a revitalization rather than a compensation strategy (Office of the White House Press Secretary, 1978). The National Development Bank, the targeted employment tax credit, Neighborhood Commercial Reinvestment programs and expanded UDAG funding all seemed to lean toward renovating a deteriorated economic base in distressed cities. At least the rhetoric of federal policy would imply a belief that the declining economies can be revitalized. Yet there is little evidence that such programs work or have any effect on the employment base of declining cities.

A policy of compensation would take a different tack by accepting the notion that market forces are affecting a reallocation of population and income within the country. It would attempt to compensate the most financially pressed governments and families caught in this transition. The goal would be to protect particularly the low income by subsidizing public services and temporary job opportunities while the "emptying out" goes on. Public service job programs, categorical grants in the health and education area, and federal relief for welfare financing would be key elements.

There is a fine line between revitalization and compensation, and we should not confuse the latter with any program to abandon cities or declining regions. As interregional variations in the relative costs of doing business and in market size approach some new balance, movements in population and jobs will slow. A primary role of federal policy is to assist the most distressed governments during the adjustment. Hence, subsidies to hold businesses in a region are not an appropriate part of a compensation strategy if the business will leave (or cease operations at present levels) when the subsidy is removed. "Transition" grants to states (such as New York) with an overdeveloped public sector are appropriate if they are tied to longer-term reductions in the level of public sector activity. Capital grants to renew the city's infrastructure are also appropriate, if the infrastructure investment is based on a "shrinkage" plan. Finally, relocation grants and labor market information systems are perfectly consistent with such a strategy, because they facilitate the outward movement.

THE BUSINESS CYCLE AND INTERGOVERNMENTAL POLICY

The business cycle and inflation have dramatic effects on the financial health of state and local governments. Indeed, the severity of the last recession pushed New York City over the edge and brought many other local governments and at least one state dangerously close to fiscal insolvency. Because swings in economic activity induce substantial changes in fiscal health, an explicit recognition of business cycle effects in federal intergovernmental policy is necessary.

In a sense, this was done with countercyclical aid and the stepping up of other components of the economic stimulus package in the last recovery, but it was done ad hoc rather than as part of a coordinated federal, intergovernmental policy. The basic objectives of the Comprehensive Employment and Training

Act (CETA) were training and employment of the disadvantaged and then countercyclical stimulus. Local public works were meant to stimulate state and local government construction. Some would argue that both became general purpose fiscal relief programs, and that neither stimulated the economy (Cook, 1979; Gramlich, 1978). Indeed, if the purposes of these programs were training and economic stimulus, neither was a success.

Apparently, little was learned from this experience about the relation between countercyclical policy and national urban policy. In fact, with the U.S. economy in another recession, there is not a firm countercyclical policy.

If business cycles were linked to intergovernmental policy, an essential feature of the system would have to concentrate on more distressed jurisdictions. This raises the thorny problem of identifying those communities most hurt by recession and the severity of the recession in the various regions. The evidence of the past two recessions seems clear—the older manufacturing belt in the Northeast and Midwest was hit hardest (Nelson and Patrick, 1975; Rosen, 1980). Expectations are for a similar regional effect in the next recession (Zamzow, 1980).

An ambivalence—at the federal level—about the "proper" role of state government in state and local government finances may exacerbate some of the problems created by inflation and a slower growing economy (Break, 1980). State governments raised 58% of all state and local government taxes, made 40% of direct expenditures, and accounted for 72% of federal aid in FY 1978. Yet state government is approaching a new crossroads—a redefinition of its fiscal role. The past decade has seen two important, but contradictory, influences on state governmental financing and delivery of services. The first concerns the states' relation to the Federal government and its place in the intergovernmental system. Total grants-in-aid have quadrupled since 1970, but much of this growth has been in direct federal and local grants, with the states being bypassed. In 1978, local governments were directly receiving 28% of total federal aid to state and local governments; in 1970, the figure was 13%. This policy of direct federal-local relations is not inconsistent with the view from some state capitols that city financial emergencies are as much federal as state governmental responsibilities.

Now, as the end of the general revenue sharing authorization approaches, the administration has recommended eliminating the state share. Whether or not state governments have brought this change on themselves by abrogating their responsibility toward urban governments is debatable, but the drift toward reducing the importance of state government in the intergovernmental process is real enough.

There is also a continuing shift of financial responsibility from local to state governments. The state government's share of state and local government taxes rose from 50.7% to 58.5% between 1965 and 1977, and the state's share of direct expenditure increased from 34.9- to 39.9%. The state aid share of total state expenses remained constant between 1965 and 1978, but the state governmental share of health, education, and welfare direct spending increased markedly. States may not have done all that they should to lift the financing burden from the local property tax, and too little may have been done about city and suburb fiscal disparities, but the trend toward more state fiscal responsibility has continued. A combination of local government tax or expenditure limitations, a more elastic state government tax structure, and high rates of inflation could accentuate this trend.

In fact, the increased federal-local aid flow may have slowed the trend of state financial assumption. Before 1975, state aid had behaved as though it were a highly elastic tax, i.e., for every 1% increase in personal income, there was a 1.6% increase in state aid to local governments. That responsiveness fell to 0.96% in 1976 and 0.69% in 1977.

With resources limited, it is imperative to develop a less ambiguous federal position about the role and responsibility of state governments. Is fiscal centralization to be encouraged? And should states—as a prerequisite to federal assistance—be required to deal with the city and suburb disparities problem?

DEFAULT AND EMERGENCY LOANS

Financial emergencies, if not default, lie ahead for many large cities. If it does nothing else, a national urban policy ought to outline the Federal response. Dealing with New York City ad hoc was excusable: There had been little reason to be concerned with municipal default since the depression. In many respects, the New York City crisis of 1975 was a special case.[7] But how many special cases can there be before a policy response must be made? Cleveland and Wayne County have much in common with New York City in the weakness of the underlying economy, as do many of the other cities commonly appearing on the distressed lists.

Two questions are essential in formulating a federal policy for distressed cities. The first involves defining the conditions necessary for Federal intervention, i.e., what avenues must be exhausted before emergency federal subsidy is warranted? The second is what adjustments must the city make as a condition of receiving the aid. Neither question was clearly thought through, and neither is in the administration's urban policy statement.

On the first issue, one might query the state government having a prior responsibility for city financial problems. Should there be an emergency loan to New York City when New York State runs enough of a surplus to cut taxes? Some would argue that the Clevelands and Detroits are primarily the business of the Ohios and the Michigans, and federal bailouts are a last, desperate resort. The view from the statehouse is likely to be quite different. State governments could well argue that a combination of local autonomy, Federal mandates, and direct federal-local aids have taken much of the control of local fiscal excesses out of their hands. Federal actions stimulated the local fiscal and may have created some of the risk of default, hence, the federal government should participate as at least an equal partner in the bailout. The state argument is strong. To require states to shoulder more responsibility for the fiscal problems of their local governments, the federal government must be less ambiguous about the role of state government in the intergovernmental system. If states are to have first claim on filling the financing gap of cities facing financial emergencies, they might reasonably argue for more control over services level mandates and resources passing through to the local level. If cities' financial conditions are to be viewed independently of state government, then a set of criteria for local fiscal actions that must be taken prior to federal intervention should be established. These might include emergency tax levels, program and employment cutbacks, a wage freeze, and perhaps debt rescheduling.

The second issue is how much must local governments alter their fiscal behavior to continue receiving the emergency loan or grant, and how will the fiscal improvements be monitored? The most important question to be resolved is how the federal government will distribute the burden of an austerity program. Employee layoffs and wage freezes will lay much of the burden on public employees, program cutbacks and tax increases on citizens, and bond repayment stretch-outs or moratoriums on bondholders. A federal policy accomodating a bailout in a period of emergency will implicitly or explicitly make such choices.

Another alternative is to make it clear that the federal government will not rescue cities from default, even in the case of the most severe emergencies. Even as a statement of national policy it would be difficult to make this believable with the history of New York City, Lockheed, and Chrysler. But if local and state governments were convinced that a borrower of last resort was not available, their financial practices may become much more conservative and their fiscal strategies more adverse to risk. Whether that would be in the national interest is precisely the sort of question a reasoned national urban policy would address.

STATE AND LOCAL GOVERNMENT POLICY

A national urban policy is essential. State and local government financial problems will materialize in the 1980s, and a reasoned federal response will be imperative. Yet most of the required adjustments will fall to state and local governments, and the majority are neither distressed nor flush.

The fiscal fates of state and local governments will be determined largely by factors outside their control—inflation, the performance of the national economy, and the level and distribution of federal grants. Still, state and local governments have considerable discretionary powers to influence their financial health during this period of adjustment.

The most popular reform is to offer a program for increases in productivity. It is popular because it does not cost the taxpayer, can be used as a basis to reward public employees, and, best of all, its success or failure cannot be measured. The need for, and possibilities of, state and local government employee increases in productivity make great material for discussion, but do not balance budgets. A related issue is whether the tone of the productivity discussion might change with rising materials and energy costs. Heretofore much of the attention had centered on whether capital could somehow be substituted for labor, thereby increasing output and reducing the use of the relatively expensive labor factor. If materials and energy costs continue to rise at present rates relative to labor costs, the enthusiasm for new technologies in the public sector may cool.

A second strategy is the use of tax and subsidy policy to stimulate regional economic development (Schroeder and Blackley, 1979a; Schmenner, 1978; see also Wasylenko, this volume). State and local governments in growing and declining regions attempt to improve their competitiveness as a business location by offering various kinds of subsidies, e.g., tax abatements, tax holidays, subsidized loans, grants of land, and the like. Whether these subsidies have actually contributed to local economic development is as debatable as the issue of whether the induced revenue gains from new business have exceeded the expenditure costs.

Retrenchment–adjusting public service levels and the growth in expenditures to reflect the ability to finance–is probably the most important strategy for governments in declining regions. It involves cuts in service levels and employment, a more realistic look at the kinds of compensation and benefit levels that can be afforded, and a careful conservation of those capital resources available. With the latter, one would expect to see a great deal more emphasis placed on maintenance and renovation of the existing capital stock than on the construction of new capital facilities.[8] The austerity programs in some cities have included these kinds of adjustments, but other public policies have been surprising. Relative tax burdens have gone up in the declining region, the fiscal limitation movement has pretty much been limited to the Sunbelt, and public employment rolls in the declining region have expanded in the past two years.

In the growing regions, local governments also face serious adjustment problems requiring them to carefully plan the growth in their budgets. The problems essentially are how much a government should grow and how fast this growth should occur. The mistakes of governments in the older region might be avoided if the long-term expenditure implications of fiscal decisions are evaluated against the potential long-term growth in the local resource base. Fiscal planning and forecasting is a new art, but is being used effectively in many cities, especially those in the growing region (Bahl and Schroeder, 1979).

The most pressing fiscal adjustment problems are keeping the development of infrastructure in step with population and employment growth. With rising material and capital costs and the prospects for less federal aid, this could become a serious bottleneck to growth. At the same time, there is the danger of allowing growth to become too rapid and uncontrolled, leading fiscal development beyond the possibility of careful, long-term budgetary planning.

STATE AND LOCAL GOVERNMENT FINANCES: THE NEXT FIVE YEARS

The principles of a national urban policy and optimal fiscal adjustments by state and local governments are more wishful thinking than realistic expectations. The likely performance over the next five years will involve a series of financial crises and ad hoc federal responses. The following would not seem an unreasonable scenario:[9]

- The national economy will go through a recession and begin a period of slow real growth. Inflation rates will remain high.
- Some local governments—mostly, but not exclusively, large cities in the North—will either default or be unable to meet their expenditure commitments. A round of public employee lay-offs—reminiscent of 1975/1976—will probably take place.
- Despite the recognition of capital obsolescence problems, the quality of the capital stock, especially in the older regions, will continue to deteriorate. Higher interest rates, inflation, reduced federal aid, and pressing financial problems will push state and

local governments to further "defer" capital construction, maintenance, and renovation.

- With rising energy prices, some of the oil- and gas-rich states will experience extraordinary revenue increases and amass considerable surplus funds.
- The next five years will see another catch-up in public employee compensation rates (Grosskopf, this volume). This lagged effect of recent year's deferred compensation increases will be further stimulated by the currently high inflation rate and will account for virtually all of the public expenditure increases of some jurisdictions. The increase in average wages will be especially rapid in the South, where average wages are relatively lower, and where unionization is increasing.
- *Relative* levels of tax burdens will rise in many states in the growing regions in response to increasing costs and service quality and will decline in the Northeast as austerity programs begin to take hold.
- The limitation movement will not significantly slow the rate of state and local government spending after the early 1980s.
- Federal policy toward state and local government finances will remain ad hoc, and there will be no guiding principles. The overall level of federal grants (in real terms) will likely decline and less targeting might be expected during the next five years as the growing region more forcefully makes its point about rural poverty.

These guesses would be altered by either a coherent federal policy toward state and local government finances or by a better performing U.S. economy. In the last analysis, there could be no better national urban policy than a low inflation rate and a strong growth in GNP.

NOTES

1. For state-by state-projections of this slowdown, see Bahl et al. (1979).
2. This may be little more than speculation, since there is no evidence that taxes have a significant effect on the growth of regional employment (Wasylenko, this volume).
3. For a discussion of the possibilities, see Clark and Menefee (forthcoming).
4. Assuming that a faster population growth implies a faster real GNP growth rate.

5. There is no consensus in the literature on consumption about the effects of a changing age distribution on the marginal or average propensity to consume. For a summary, see Russell (1979).

6. See Salins (1979) for a useful discussion of gentrification; and see Allman (1978) for an optimistic view of urban conditions.

7. New York City was unique in its size, the broad range of functions for which it had responsibility, and the excesses in its financial management, particularly its short-term borrowing practices. On the other hand, New York City was not at all unique in its declining economic base, loss of population, rising "dependent" population, and slow-growing tax base. For a discussion of the "uniqueness" of New York during this period, see Bahl et al. (1975).

8. For an example of the results of carefully managing the capital stock in a declining city (Cincinnati), see Humphrey et al. (1979).

9. For another view of the future, see International City Managers Association (1979).

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