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THE URBAN IMPACT OF FEDERAL POLICIES: THEIR DIRECT AND INDIRECT--ETC(U)

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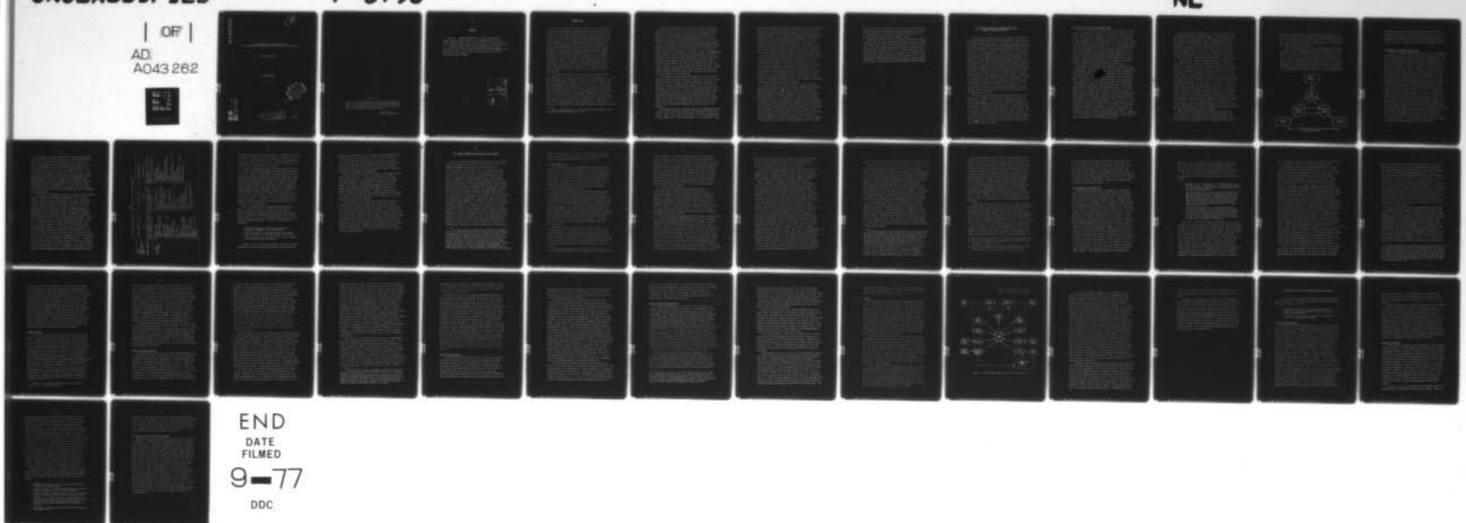

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(6) THE URBAN IMPACT OF FEDERAL POLICIES:
THEIR DIRECT AND INDIRECT EFFECTS ON THE LOCAL PUBLIC SECTOR

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(11) January 1977

(12) 42p.

296 600

(14) P-5793

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Santa Monica, California 90406

PREFACE

This paper summarizes portions of a study of urban impacts of federal policies, being conducted at the Washington Office of the Rand Corporation under a grant from the Charles F. Kettering Foundation.

An earlier version of the paper was presented at the Public Policy Forum of the Joint Center for Political Studies, Washington, D.C., December 20, 1976, under the title, "Federal Policy and the Urban Public and Private Economy."

INTRODUCTION

One of the more promising recent developments in the urban field is the growing recognition by researchers and practicioners alike that federal urban policy must be defined much more broadly than it has been in the past. The proposition has become widely accepted, perhaps with greater alacrity by local officials than federal policymakers, that the federal influence on cities involves much more than a handful of explicitly urban programs--more even than the whole array of federal programs that channel funds to urban jurisdictions and their citizens. Spokesmen for the urban public interest groups now refer as a matter of course to the "implicit" or "hidden" urban policy of the federal government.* These terms are meant to encompass not only expenditure programs, but a spectrum of federal actions ranging from tax policy to macroeconomic policy to regulation of business to enforcement of the civil rights laws. All these have been recognized as factors that affect the well-being of urban centers and their residents and that should be taken into account in formulating a comprehensive national urban policy.

But although this broadened view of federal urban policy has become established in rhetoric, it has not yet been assimilated into the policymaking, policy analysis, or policy-proposing processes. There is an intellectual gap between the comprehensive view of federal policy that urban spokesmen now espouse and the much narrower set of proposals that they regularly offer as solutions to urban problems. For the most part, the list of action proposals still emphasizes the most direct and explicit forms of urban aid. The automatic response to fiscal problems of the cities is to ask for more federal grants to local governments. The response to the problem of urban unemployment is to advocate direct federal job creation programs. Federal policies that operate less directly, less immediately, or less visibly have gotten much less attention.

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*See, e.g., National League of Cities, "State of the Cities: 1975--A New Urban Crisis?" Washington, D.C. 1976.

A matter of particular concern is that the locational incentives created by federal policies have not been stressed by those seeking federal intervention on behalf of the cities. On this subject, the disjunction between diagnosis of the problem and prescription of solutions is clear-cut. The standard explanation of the economic difficulties of central cities and of the urban Northeast as a whole is that a constellation of federal policies--highway programs, housing subsidies, the welfare system--created incentives for businesses and middle-class households to move to the suburbs or to the "sunbelt" and for the poor to concentrate in the central cities. This diagnosis rests on the power of the locational incentives created by federal programs. Yet, few recent policy proposals have reflected the concept that locational incentives continue to operate and that it may be possible to alter them to work in favor of, rather than against, the cities. When it comes to prescription, many "solutions" seem to depend on the unrealistic assumption that federal programs and federal aid flows can change, but that the locational choices of people and businesses will somehow remain unaffected.

The consequences of neglecting locational incentives and other indirect effects of federal actions can be serious. One is that viable alternatives may be foregone. Another, perhaps more important, is that policies may be adopted without regard to their long-term consequences. There are many instances of urban programs that had long-run effects different from, or counter to, what was intended. They include highway programs that generated unanticipated patterns of development, welfare programs that increased poverty concentrations in the cities, and housing programs that facilitated and encouraged middle-class flight. In all these cases, indirect effects on locational choices ultimately overshadowed the direct effects of the programs.

Policymakers have good, practical reasons for emphasizing programs that work directly and that aid people and businesses already in the cities. Some of the reasons are political: The direct programs seem to be quicker acting. They are more visible to the electorate. They usually place funds in the hands of local public officials, who can use the money to ease their fiscal and staffing problems and who stand to reap political benefits from fund disbursement. But there are also cognitive reasons. It is much easier to understand and design direct aid policies and to analyze their short-term effects than it is to work out locational incentive schemes and trace the long-term consequences of more subtle modes of intervention. The difference is between, on one hand, asking "who gets how much" from an aid program and, on the other hand, seeking to determine how the aid recipient's behavior will change over time because of his altered circumstances.

At this time, an analytical framework does not exist within which the full range of federal urban policies--including the indirect policies--can be formulated or evaluated. The problem is not so much that empirical information is unavailable on the effects of specific interventions (although such information is lacking, more often than not), but that a general conception has not been developed of the relationships between various kinds of federal policies and the urban outcomes that they are intended to affect. Without such a general framework for thinking about policy impacts, it is virtually impossible to do the kind of strategic analysis that is needed if a coherent, comprehensive urban policy is ever to emerge.

For some time now, I and several of my colleagues at the Rand Corporation have been working on a study that addresses the cognitive problem outlined above. Supported by a grant from the Charles F. Kettering Foundation, we have undertaken a survey of what is known about the impacts on the urban economy of a broad array of federal programs and policies. The study has two closely related purposes. The first is to construct a conceptual framework for analyzing effects of federal actions on the cities. This entails selection of relevant urban outcomes, identification and classification of the various types of federal policies, and--most important--tracing of the network of cause and effect relationships that links the policies to the outcomes. The second purpose is to determine from selective reviews of the relevant literature (a) what is known about each of the major linkages in the network, and (b) where there are significant gaps in existing information about policy effects. The study is now in its final stage. We have completed the literature reviews and assembled our findings. The remaining task is to develop an integrated presentation of the conceptual scheme and the concrete research results.

My purposes in this paper are to outline our conceptual approach, to demonstrate how we have worked within the general conceptual framework to examine the effects of federal policies on specific urban outcomes, and to sketch some potential applications of the approach to the development of federal urban policy. I believe that this type of analysis, when further refined, can contribute to the formulation of a richer array of policy alternatives than currently exists. It also may provide a framework within which policy analyses can be conducted of the indirect and long-term urban repercussions of federal programs.

A CONCEPTUAL FRAMEWORK FOR EXAMINING EFFECTS OF FEDERAL ACTIONS ON THE CITIES

The problem in developing a conceptual scheme of the relationships between federal policies and urban conditions is that there are a great many outcomes of interest, a large number of federal policies to consider, and a complex network of relationships between the policies and the outcomes. Some of the more important effects of federal actions on the cities are indirect. Typically, there are multiple channels of federal influence on particular urban outcomes and multiple links in the causal chains between policies and effects. For instance, a federal pollution control program may raise the costs of doing business in a city, thereby discouraging investment, reducing employment, and lowering the local business tax base; meanwhile, the same policy may make the area more attractive to residents, increase the demand for housing, and raise the residential tax base. Even when the level of abstraction is kept relatively high, so that the detailed provisions and parameters of policies and the fine structure of outcomes do not enter into the analysis, the complexity of the system makes it infeasible to examine the full range of urban outcomes or the full range of federal policies simultaneously. It is necessary to break down the problem into manageable components. However, this must be done in such a way that an integrated view of the system will not be lost.

The conceptual scheme described here was developed after consideration of a number of approaches to organizing the issues and the research literature. It represents a compromise between approaches that emphasize the structure of federal policies and those that center on a taxonomy of urban outcomes. It also reflects what is primarily an economist's view of the urban system. However, this disciplinary perspective characterizes the structure rather than the substance of the analysis. We have conducted a multidisciplinary literature review. Only a general outline of the conceptual framework is presented here. More detailed accounts may be found in the reports cited later in the paper.

THE URBAN ECONOMY AS A THREE-SECTOR SYSTEM

First, we conceived of the urban economy as consisting of three distinct but interacting sectors: (1) the private business sector, (2) the residential, or household, sector, and (3) the urban public sector. Each sector is inhabited by a different type of operating or decisionmaking unit. In the business sector, the basic unit is the individual firm; in the residential sector it is the individual household; and in the urban public sector it is the local government (the term "local government" includes not only municipalities, but also such other jurisdictions as counties and school districts). Conceived of in this way, the problem of analyzing federal policy impacts on cities becomes transformed into the somewhat more concrete problem of analyzing federal impacts on the behaviors of business firms, households, and local governments in urban areas.

One purpose of the three-sector breakdown is to permit us to consider only a subset of urban conditions, or urban policy outcomes, at any one time. When we examine the effects of federal policies on the business sector, for example, the main outcomes of interest are levels of economic activity, income, employment, wages, and investment in urban areas. In the residential sector, the principal outcome variables are the size, composition, and spatial distribution of the population, the make-up of the housing stock, and the match among people, housing units, and geographical areas. In the urban public sector, the major outcomes are the level and mix of public services and the magnitude and composition of the tax burdens imposed upon residents of urban areas. Of course, one can argue endlessly about which are the "ultimate" outcomes of policy and which are only intermediate or intervening variables--e.g., is the quality of public services important "in itself" or only insofar as it affects the willingness of people and businesses to locate in the cities? Fortunately, it is not necessary to resolve such controversies. Once relationships among the key variables within each sector are understood, it is not difficult to focus attention on whichever variable is salient in the context of a particular policy debate.

For many policy analysis purposes, it is less important to know how Federal actions affect absolute levels of outcome variables than how they affect relative conditions in different kinds of places. What counts in assessing federal impacts on demographic patterns, for example, is the relative concentration of different population subgroups (classified by income, race, family structure, etc.) in urban and suburban areas, in cities of different sizes and types, and in different regions of the country. Whenever federal policy outcomes or impacts are referred to below, it should be understood that the term takes in this geographical dimension of outcome variation.

The three-sector conceptual model also makes it possible for us to deal with only a subset of federal policies at any one time. This is not to say that there is one group of federal policies that affects only residential outcomes, a second group that affects economic activity, and a third that affects local public services and taxes. On the contrary, the whole point of this approach is to allow for the possibility that federal actions that appear to be aimed at one sector or to have their initial impacts in one sector may have indirect effects of comparable importance in other sectors. For instance, the rate at which business activity has shifted from central cities to suburbs has been influenced *directly* by federal highway construction programs and federal support for development of suburban water and sewer systems. It has probably been influenced even more strongly, but *indirectly*, by such federal policies as tax benefits and subsidies for home ownership, which have encouraged shifts of population (consumers and workers) to the suburbs. Under our conceptual scheme, we would treat these federal interventions in housing as policies that have initial impacts in the residential sector, but that subsequently affect business location patterns via indirect, intersectoral linkages.

Adherence to the distinction between the direct and indirect federal policies can yield significant analytical economies. One can concentrate on the subset of federal policies that have initial effects in, say, the residential sector, recognizing that it will also be necessary to take account of the effects on residential location patterns of federally induced changes in the business and local public sectors. The key point is to separate the effects of federal policies that impinge directly upon a sector from the effects of policies that have their initial effects elsewhere.

The three-sector approach is illustrated schematically in Figure 1. Outcomes in the three-sectors are shown as affecting one another. Different clusters of federal policies are shown as having direct impacts on each sector. For instance, the effect of a federal action that influences housing choices directly, such as a housing subsidy program, would be represented by the arrow labeled "a" in the diagram. The effect of a federal policy that exerts an influence on housing choices by altering conditions in the public sector (e.g., a program of aid to education that improves urban schools, thereby making urban

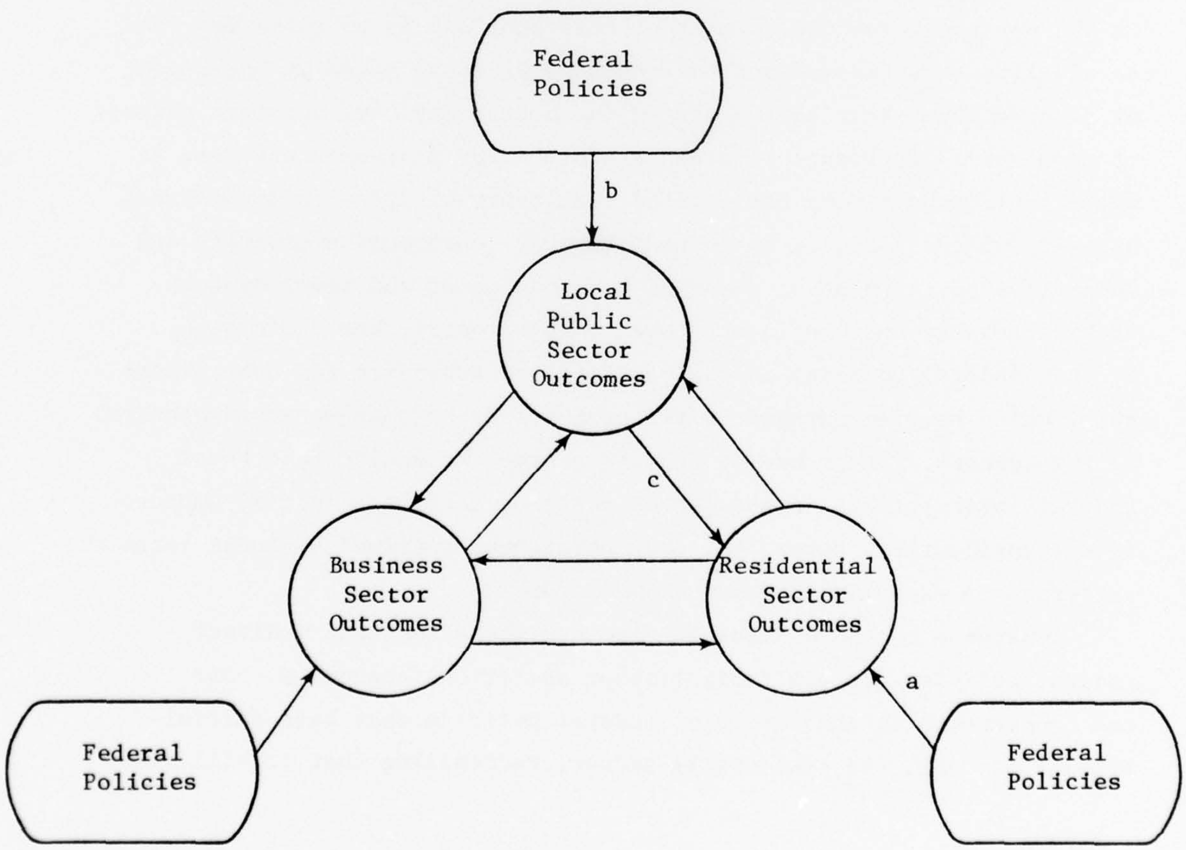

Figure 1. Schematic Diagram of the Three-Sector Approach to Urban Impact Analysis

locations more attractive to families with children) would be represented by the pair of linkages labeled "b" and "c." The task of analyzing impacts of federal policy on the urban system can be subdivided into investigations of the three sets of direct impacts, such as "a" or "b," and the various intersectoral linkages, such as "c."

DETERMINANTS OF OUTCOMES IN EACH SECTOR

Even with the system subdivided three ways, it is not feasible to proceed directly to the analysis of effects of specific federal policies on sectoral outcomes. There are still too many policies to consider simultaneously within each of the sectors. Additional structuring of the problem is required. The approach we have taken is to divide into two steps the task of relating the policies to the outcomes within each sector. The first step is to identify the major determinants of key urban outcomes. The second step is to analyze the federal policies that affect each major determinant. In this way, the problem of relating policies to consequences can be disassembled into several dozen manageable pieces. For instance, the determinants of the level of private economic activity in a given area include such things as the local labor supply and the availability and cost of freight transportation. Of the many federal policies that affect business location decisions, it is possible to identify some that operate specifically on the labor supply (e.g., federal manpower and training programs and enforcement of the wage and hour and occupational safety laws), and some that affect the characteristics of local transportation systems (e.g., highway construction grants, subsidies for railroads and airports, and regulation of freight rates and services). It is at this level that questions of cause and effect attain enough specificity to be researchable. Once the main determinants of outcomes have been identified and specific policies have been connected with specific determinants, it becomes reasonable to search the research literature for findings about the direction and magnitude of the policy impacts.

In our study, the effort to identify major outcome determinants was itself guided by the urban literature. In the case of the local public sector, the most relevant literature is the large body of work on determinants of state expenditure and tax choices. In the case of the business sector, it is the voluminous literature on industrial location. In the case of the residential sector, it is more difficult to identify a single core field of research. There are several fundamental areas of inquiry, including studies of the housing market, of residential choice, and of interregional and intrametropolitan migration. Although the task varied in complexity among the sectors--it was easiest for the local public sector and most difficult for the residential sector--we were able to assemble lists for all three sectors of the main factors that have been touched on by researchers.

The table on the following page (Table 1) lists the major determinants of outcomes in the business, residential, and local public sectors. There are ten to twenty items on each list. Some of the variables listed are obviously influenced very strongly by federal policy. Examples of these are the amount of outside aid to local governments (in the public sector column), housing subsidies and tax benefits (in the residential column), and transfer payments to individuals (in both the business sector and residential columns). Other variables are influenced to a lesser degree by federal actions, but in every case there is at least some federal involvement. There are a few instances in which a great many federal policies come to bear on a single variable. An example is the "amenities" item in the residential column of the table. Many kinds of neighborhood amenities affect the demand for housing in different parts of urban areas. The federal policies that affect levels of amenities include such diverse things as antipollution programs, grants for law enforcement activities, and enforcement of open-housing laws. A considerably more detailed substructure than can be shown in the table is needed to deal with that cluster of federal policies. Also, a single federal policy may have multiple effects. An example is the system of federal grants for income maintenance programs, which simultaneously affects

Table 1

MAJOR DETERMINANTS OF OUTCOMES IN THE THREE SECTORS OF THE URBAN ECONOMY

SECTOR:	Private Business Sector	Residential Sector	Local Public Sector
DECISIONMAKING UNITS:	Firms	Households	Local governments
MAJOR OUTCOMES:	Output, investment, employment, wages: magnitude, composition, and spatial distribution	Population and housing stock: magnitude, composition, and spatial distribution	Public services: level, mix and distribution Taxes: level and composition
MAIN DETERMINANTS OF OUTCOMES:	Demand for output Consumer demand Population characteristics Income from economic activity Transfer payments Personal taxes Business demand (for intermediate goods) Public demand Federal purchases State/local purchases Factor supply Supply of labor Access Transportation of goods Transportation of persons Supply of raw materials Supply of energy Supply of land Supply of capital funds Public services and taxes Amenities Subsidies and restrictions Technology	Demand for housing Income (including transfer payments) Socioeconomic characteristics Neighborhood characteristics Access/transportation Amenities: physical and social Public services and taxes Housing subsidies and tax benefits Availability and cost of mortgage credit Supply of housing Factor supply Housing construction Housing operation Public infrastructures Supplier subsidies and tax benefits Availability and cost of credit Production and marketing restrictions	Revenue sources Local revenue base Residential/personal Business *Tax spillovers* Outside aid Federal and state grants Revenue subsidies (tax expenditures) Expenditure demands "Need" factors (population characteristics) Service costs Service spillovers Scope of local service responsibility Mandated expenditures

the budgetary positions of local governments, the demographic make-up and demand for housing of the urban population, and the supply of low-skill labor to the private sector. To determine how federal income maintenance policy affects the cities, it would be necessary to take into account all three channels of influence.

Note that a distinction is made in all three columns of the table between supply-side and demand-side influences on the behavior of a sector. This is of considerable analytical importance in appraising the effects of federal policies and the interactions among them. In some instances, the same federal policy will affect both the demand and supply sides of a market. One example is the dual effect of federal monetary and credit policy on the availability of construction credit to housing suppliers and the availability of mortgage credit to housing consumers. Another is the effect on both the demand for urban public services and the size of the per capita local tax base of federal policies that encourage the poor to migrate to cities. Recognition of the potentially offsetting or reinforcing multiple impacts of such policies is essential to an analysis of their overall effects.

What is accomplished by the taxonomic scheme summarized in Table I? I would argue that it contributes in two ways to the development of a comprehensive view of federal urban policy. First, it breaks down a grossly overbroad question--how do federal policies affect cities?--into several dozen questions that are potentially answerable by research. These are questions like the following:

- How do federal policies affect the magnitude of the residential component of the urban tax base?
- How do they affect the local labor supply in different types of cities, or in different regions of the country?
- How do they affect the relative costs of freight transportation in central cities and suburbs?

Although the ultimate analytical objective would be to develop quantitative answers to questions like these, it is useful at the outset just to identify the points at which federal policies impinge upon the urban system, to define the key intervening variables, and to trace the channels by which the policies may affect the urban situation. Second, the conceptual scheme outlined here contributes by providing a framework within which information on the effects of individual federal policies on particular outcomes or intervening variables can be assembled and aggregated.

The next step in the analysis is to examine the linkages between specific federal policies or policy proposals and the variables represented in Table I. Not surprisingly, little of the relevant information appears in the literature in forms that are directly usable. Most studies of business and residential location, for example, are motivated by concerns other than the influence of federal policy on locational choices. Therefore, we have had to rely a great deal on indirect inference and extrapolation of findings to be able to say anything about many of the linkages that our conceptual model tells us are relevant.

It is not possible to summarize the full analysis of policy-outcome linkages in a paper of this size. What I have chosen to do instead is to convey the flavor of our approach by selecting only one of the three sectors for further discussion. I have chosen the local public sector for this illustration. The reasons for this choice are (1) the relative simplicity of the network of federal policy effects pertaining to that sector, and (2) the predominance of public sector concerns in much of the recent public discussion of urban problems. Despite the public sector emphasis, this illustration serves to demonstrate the importance of intersectoral relationships in the urban economy and the central role of locational incentives in the arsenal of federal urban policies.

THE FEDERAL GOVERNMENT AND THE LOCAL PUBLIC SECTOR

The list of outcome determinants in the "public sector" column of Table 1 indicates that there are basically two ways that the federal government can influence the services and taxes of local governments in urban areas. One is by changing the financial resources available to the local governments (or the terms under which they are available); the other is by modifying the pattern of demands for local government outlays. Local revenue sources consist of the various tax bases from which jurisdictions derive "revenue from own sources" and grant revenue from the federal government and the states. The demand for local government outlays may be decomposed into three factors: (1) "need-related" characteristics of the local population and area (defined further below), (2) costs of public services, and (3) the range of services for which local governments are responsible. The overall fiscal condition of a locality can be summarized by comparing its revenue resource with the service demands placed upon it. This concept of fiscal condition, or fiscal well-being, of a locality can be defined in a precise, quantitative manner.* For the present purpose, however, all that is necessary is to recognize that federal policies aid local governments financially insofar as they tend to raise the local tax base and/or the amount of available outside aid, and to hurt them financially insofar as they tend to make the urban population more demanding of services, to raise service costs, or to expand the scope of local responsibility. The question is which federal policies exert these

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*In our study, we argue that the fiscal conditions of different cities, or of the same city at different times, should be quantified by comparing what we call their *fiscal opportunity schedules*. These are mathematical expressions relating the levels of services that cities can provide (taking into account service costs and the nature of the population to be served) to levels of local fiscal effort. Using this method, it is possible to measure the fiscal well-being of each city relative to that of other cities and to measure the rate at which each city's condition is improving or deteriorating. The details are given in S. M. Barro, *The Impact of Federal Policy on Urban Fiscal Conditions*, The Rand Corporation, R-2114-KF (forthcoming).

kinds of leverage and to what degree. In this section, we provide a factor-by-factor summary of the types of federal policies that influence each major determinant of urban fiscal outcomes.

THE LOCAL REVENUE BASE

The revenue base of a local jurisdiction consists mainly of the assessed value of residences and businesses within its boundaries, but also of other taxable economic magnitudes, such as income, payrolls, and retail sales. The per capita revenue base is the most important single measure of a locality's access to revenue for financing public services. Although a large amount of state and federal revenue flows to the local public sector, revenue from own sources still accounts for approximately 62 percent of all general revenue of local governments in metropolitan areas.*

The federal government can affect the urban tax base by adopting policies that increase the per capita value of the housing stock, that stimulate business activity and capital formation in urban areas, or that augment per capita incomes in urban areas by other means. From the point of view of local officials, nearly all such federal policies are *indirect*--i.e., they do not involve transactions between federal and local governments. The main exceptions are federal transfer payment programs administered by local authorities and federally supported public employment programs, both of which combine grants to localities with stimulation of taxable economic activity. Most of the other policies that affect the per capita local revenue base have their initial effects in the private residential and business sectors of the urban economy.

Among the federal policies that affect the residential or personal components of the tax base--i.e., the amount of taxable residential property in a jurisdiction and the levels of taxable income and retail sales--a logical distinction can be made between those that affect the economic circumstances of a given urban population and those that affect the make-up of the urban population itself. The policies in the former group include overt housing subsidies; less explicit

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*U.S. Bureau of the Census, *1972 Census of Governments*, Vol. 5, *Local Government in Metropolitan Areas*, Washington, D.C., 1975, Table 9.

housing subsidies, such as those provided by federal tax deductions for local property taxes and mortgage interest; and income maintenance programs, which augment the power of low-income people to purchase housing as well as other goods. All these are policies that have their initial impacts in the household sector. In addition, the taxpaying ability of a given population can be increased by policies that have their initial impacts in the private business sector and that stimulate employment and earnings. Federal policies in these categories have generally been adopted for the express purpose of raising the economic well-being of urban residents and other citizens. While that is not equivalent to a goal of raising local fiscal capacity, it is a closely related objective.

In contrast, the federal policies that have helped to induce major changes in urban populations during the last few decades were generally adopted for entirely different purposes and without anticipation of their demographic consequences. While attempting to accomplish a variety of social goals, ranging from improving transportation to redistributing income to the poor, the government created incentive systems that affected the attractiveness of cities relative to suburbs and regions relative to one another. Moreover, the locational incentives have been different for members of different socioeconomic groups.

The most frequently cited examples of policies with strong locational effects include the federal highway programs, which have encouraged suburbanization and movement away from the urban Northeast; the provisions of federal housing programs that tend to favor one type of locality over another--e.g., tax and subsidy programs that favor owner-occupied housing and new construction and that are therefore skewed towards suburbs and growth regions; the provisions of the welfare laws that have resulted in much higher benefit levels in the urban Northeast than in other parts of the country, and thereby encouraged the concentration of the poor; and even enforcement of antidiscrimination laws in public schooling and housing, where such enforcement has taken forms that stimulate White and middle-class flight from the cities. The effects of these policies on local tax bases seem almost incidental compared to their overall economic and social consequences. Nevertheless, these and other federal actions that aided post-war suburbanization and the more recent sunbelt migration must be counted among the major sources of the current fiscal problems of the cities.

The research literature bearing on federal impacts on the urban population and its economic well-being cannot be reviewed or even summarized here. However, two major findings should be mentioned because they pertain specifically to the bridge between the private economy and the fiscal condition of the local public sector.

First, although it is possible to distinguish, in principle, between policies that affect the economic situation of the existing urban population and those that affect the urban population mix, it is apparent that some federal actions have both effects. What is significant about this is that the two effects may operate in contrary directions. For example, it might seem that the various indirect subsidy programs for housing (tax deductions, FHA mortgage insurance, etc.) could only exert a positive effect on the urban tax base. However, that neglects the locational incentive effect. As the indirect subsidy programs are now designed, they tend to favor types of housing that are more commonly found in suburbs than in cities--i.e., owner-occupied homes and newly constructed dwelling units. Therefore, although the subsidies benefit some city residents, they also provide inducements to other residents, especially in the middle- and upper-income groups, to move to the suburbs. It is not evident whether the net impact on the per capita residential tax base in the cities is positive or negative. Similarly, the effect of federal income maintenance programs on the per capita income of city residents, and thus on the per capita urban tax base, might seem to be unambiguously positive; but this is true only if the population of transfer payment recipients remains constant. If the present geographically uneven welfare system has induced poor people to concentrate in the central cities, as many contend, and if the influx of the poor has contributed to middle-class flight, then the net impact of the welfare system on per capita income and property value in central cities could well be negative. These are only two examples of programs whose longer-run locational effects may run counter to the initial effects of financial aid.

Second, although federal policies can increase local fiscal capacity either by aiding existing residents or by encouraging demographic changes that are fiscally favorable, the potential of the first approach is limited compared to that of the second. The revenue loss sustained by a city when a middle-class household is replaced by a poor one can be only fractionally offset by income maintenance payments and housing subsidies. This would still be true even if considerably more generous transfer payment programs than now exist were enacted into law. Moreover, the discussion thus far pertains only to the effects of demographic change on the revenue side of city budgets. For reasons explained below, the same population shifts that tend to reduce the per capita residential property tax base are also likely to increase per capita service demands, thereby compounding the fiscal problem.

The foregoing points underscore the importance of locational incentives as determinants of urban economic conditions. The key principle is that the residential tax base is economically, if not physically, portable. Other things being equal, residential property values reflect housing consumption expenditures, which reflect residents' incomes. A federal policy that tends to reduce the per capita income in cities relative to other places, either by inducing people with above-average incomes to move out or people with below-average incomes to move in, will almost inevitably result in a relative decrease in urban fiscal capacity.*

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*The following qualifications should be noted: First, housing expenditures reflect family size and composition as well as income. The phenomena of middle-class or White flight and inmigration of the poor and minorities entail simultaneous changes in the income and nonincome variables. Second, the response of the tax base to changes in the socioeconomic make-up of the population (and especially the *rate* of response) depends on the conditions of housing supply in each area. The same rate of relative decline should not be expected in areas that are experiencing absolute growth and those that are experiencing decline in the demand for housing units. Third, the emphasis on *relative* fiscal capacity is important. The downward influence on housing values in particular cities attributable to demographic change is likely to be much weaker, except in the most severely affected cities, then the upward influences that have caused housing

Very similar remarks can be made about the federal impact on the business component of the urban tax base. The federal government has affected, and continues to affect, business property values and payrolls in urban areas through policies that alter the relative attractiveness to private firms of urban, suburban, and nonmetropolitan locations and of different regions of the country. The central empirical question here is how federal policies have affected the relative economic growth rates of the different areas. Although conclusive proof is difficult to assemble, there is evidence that the federal role in such areas as highway and rail transportation, provision of local public infrastructure, regulation of the labor market, and tax treatment of investments has contributed both to centrifugal tendencies within metropolitan areas and to the shift of economic activity to the sunbelt.* Here too, policies that were established with no intent to affect the public sector have significantly undercut the ability of central cities and older urban regions to sustain themselves.

A factor that makes it difficult to analyze the impacts of particular federal policies on the urban tax base is that changes in residential location and business location patterns are closely linked. Demographic changes imply changes in labor supply and consumer demand, both of which are important determinants of business location decisions. Shifts in the geographical pattern of business activity imply changes in the location of employment opportunities, which is a major determinant of the locational choices of households. There are two consequences of these interactions: First, the underlying cause and effect relationships are obscure--does industry follow people or do people follow industry? Researchers have not yet succeeded in disentangling these complex, dynamic relationships.** Hence, the available estimates of

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prices to rise all over the country. Therefore, the demographic effect is likely to be evidenced only by differences in the rate of housing price increases in different areas.

*See Roger J. Vaughan, *The Impact of Federal Policies on Urban Economic Development*, The Rand Corporation, R-2025-KF, February 1977.

**The research issues are discussed in ibid., chapter IV.

the magnitudes of policy impacts are suspect. Second, there is no clear-cut distinction between federal policies that affect the business component of the local revenue base and those that affect the residential component. It is usually clear in which sector the initial impact occurs, but the linkages between the two sets of outcomes are so strong that anything that affects urban demography is liable to affect urban business activity, and vice versa. Further exploration of these intersectoral connections is a high priority item on the urban research agenda.

THE AVAILABILITY OF OUTSIDE AID

Federal decisions about the form, distribution, and funding level of grants to state and local governments have a relatively direct effect on the revenue available to urban local governments. The term "relatively direct" is used advisedly. Although it may seem that there is an unbroken connection between a federal decision to increase grant expenditures and an increment in funds available to the local public sector, that is not necessarily so. What is too often omitted from discussions of federal grants is the role of the states. At present, only a minor fraction of all federal aid--on the order of 20 percent--flows directly from Washington to local jurisdictions. The most prominent direct aid programs are General Revenue Sharing and Community Development Block Grants. The bulk of federal intergovernmental aid flows initially to state governments and the bulk of the intergovernmental revenue of the local sector takes the form of state subventions. Although some of the so-called state aid to localities is really passed-through federal aid, the relationship among the three levels of government is not as simple as the pass-through notion suggests. In such important program areas as welfare, education, and highways, what flows to the local level is commingled federal and state money. The significance of the states' involvement is that the local fiscal impact of a change in federal grant programs may depend, in part, on how state governments respond. State budgetary decisions may either offset or augment the impacts of federal aid on local budgets. Also, where states have some discretion over the distribution of federal aid funds, the fraction that goes to cities, as opposed to suburbs and rural areas, may depend on state preferences and state behavior.

The fiscal effects of intergovernmental aid to local jurisdictions depend on three sets of characteristics of the federal grant programs:

1. *The form of aid.* Major aspects of the form of grants are (a) whether they are categorical or block grants, (b) whether they are project or formula grants, and (c) whether they are lump-sum or matching grants.
2. *The distribution of aid.* In the case of formula grants, the key issue is the nature of the distribution formula: What measures of local "needs" for assistance does it contain? What allowances does it make for interjurisdictional variations in revenue-raising ability, fiscal effort, and service costs? In the case of project grants, the central issues are the procedures and criteria used in choosing among grant applicants.
3. *The "strings" attached to aid.* The important characteristics of the constraints, or "string" attached to grants are (a) how narrowly the use of aid funds is circumscribed, (b) the degree to which grantees are actually required to use resources for projects or activities that they would not have chosen to support themselves, and (c) the degree to which grant requirements are enforced.

During the last few years, those characteristics of grants have changed in ways that have significantly affected the relative positions of urban areas. Other proposals for change, which could have impacts of similar magnitude, remain on the federal agenda. Under the headings of "revenue sharing," "block grants," and "grant consolidation," there have been major shifts from relatively narrow, targeted grants to more general-purpose grants, from project grants to formula grants, and from detailed and specific to broader criteria for distributing funds. Major legislative events have included the enactment of General Revenue Sharing (GRS) legislation in 1972; the replacement of urban renewal, model cities, and other targeted urban programs with Community Development Block Grants (CDBG), also in 1972; and the passage of the Comprehensive Employment and Training Act (CETA) in

1973. Block grant legislation has also been proposed in the education, health, and housing fields, but not accepted by the Congress.

The changes in federal aid programs have affected the central cities and the older urbanized regions in several ways. The trend toward formula grants has neutralized the advantage that large cities enjoyed in project grants competitions because of their greater access to technical expertise. The shift from specific to broad allocation criteria has tended to spread out grant funds, instead of concentrating them in the areas with the most severe problems. Under the CDBG program, for example, suburban counties that did not qualify for categorical urban funds are entitled to block grants. The formulas contained in the GRS and block grant legislation have certain features that generally favor Southern and rural areas over the urban centers of the Northeast: Typically, such formulas provide extra funds to low-income areas, but they do not adjust for the significant cost of living differentials that exist among regions and between urban and rural areas. Also, they do not contain factors that reflect the deteriorated physical conditions of many urban areas or the obsolesence of the private and public capital stock; nor are the overall fiscal burdens on the cities taken into account, even in formulas that contain indices of local revenue-raising ability. There are some offsetting points: Some grant programs, notably General Revenue Sharing, contain fiscal effort factors, which tend to help the more urbanized areas. Certain new grant programs may be especially helpful to cities, notably the antirecessionary countercyclical aid and public employment programs. Also, the loosening of categorical restrictions may have given cities greater leeway to use their intergovernmental revenue in ways that seem desirable from the local perspective. Still, the recent changes in the grant system have probably had negative effects on the cities' relative fiscal position, even where increases in federal funding have prevented absolute reductions in amounts of aid.

There is no lack of awareness at the local level that the federal grant system is a major element of the implicit federal urban policy. Despite what was said above about the role of the states, the intergovernmental grant is still the most certain and direct instrument available to the federal government for affecting the fiscal position of the local public sector. It is presumably for this reason that most policy proposals from the mayors and other urban interest groups are requests for expanded funding of existing grants or for the creation of new forms of intergovernmental aid for cities. However, there seems to have been some imbalance in the attention that has been given to various aspects of grants. Local public officials have focused mainly on grant programs that are explicitly aimed at cities, such as the antirecessionary programs mentioned above. In comparison, less attention has been devoted to the urban implications of the design characteristics of grants that support broad social programs. The funding levels of the general social programs are so much larger than those of explicit urban programs that relatively narrow changes in the former's eligibility criteria and distribution formulas may have as much impact on urban fiscal conditions as the enactment of whole new programs of explicit urban aid.

Of course, the urban impacts of intergovernmental grants extend beyond their immediate effects on local budgets. Grants play a dual role in the urban economy. From the perspective of the public sector, grants are a source of revenue and, in many cases, a source of expenditure obligations.[*] At the same time, from the perspective of the private business sector and the household sector, the grant-aided programs modify the economic environment in each urban area. By influencing local transportation systems, local public infrastructures, and levels of social services and income maintenance payments in each area, the grant programs create significant locational incentives for both businesses and households. A matter of some concern, from the standpoint of urban policymaking, is that the short-run budgetary impacts and the longer-run locational impacts of grant programs may

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[*] Grant programs can generate expenditure obligations (a) when there are matching requirements (assuming that the grantee would not otherwise have devoted equivalent funds to the aided program), (b) when there are binding constraints on the uses of grant funds (i.e., the grantee is forced to spend more for the aided program than it would have spent in the absence of earmarking provisions), and (c) when grant provisions force the localities to incur higher costs than they would have otherwise (e.g., when certain service standards have to be met as a condition of eligibility for aid).

work in opposite directions. Examples of such possibilities abound in the literature: Grant-financed transportation improvements may attract more traffic, making urban congestion worse after than before. Increased support for income maintenance and social services may relieve the local fiscal situation in the short run, but may attract so many new applicants that greater burdens are created in the future. The attractiveness of grants to hard-pressed local officials is such that it is difficult to draw attention to perverse long-run consequences, much less to forego programs that may, after all, not have the hypothesized unpleasant aftermaths. A major contribution to more comprehensive urban policymaking at the federal level would be to give fuller consideration to the long-run locational effects as well as the short-run fiscal benefits of grant programs when changes in such programs are proposed. As it is, there is a tendency in times of fiscal stress to emphasize the latter exclusively, with the result that unanticipated and unwanted locational effects can emerge.

REVENUE SUBSIDIES

Until recently, very little attention was given to the implicit subsidy to the state-local sector provided by the federal income tax system. During the last few years, however, the concept of federal "tax expenditures" has been developed and brought to national prominence. Tax expenditures are special provisions of the internal revenue laws that reduce the tax liability--by means of deductions, credits, or exemptions--of specified groups of taxpayers or of individuals or firms engaged in specified types of activity. These provisions can have allocative and distributional effects that are equivalent to those of overt federal spending for the same purposes and beneficiaries. About $16 billion of federal tax expenditures in fiscal year 1976 can be interpreted as expenditures on behalf of state and local governments.* These consist of the federal revenue losses attributable to the deductability of state and local taxes from federally taxable income and the exemption from federal income taxation of municipal bond interest. Although these benefits are received initially by individual taxpayers, there is reason to believe that they work, at

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*_Budget of the United States Government, Fiscal Year 1977_, Special Analysis F, "Tax Expenditures."

least in part, to augment state and local revenue from own sources. The basic mechanism--and the reason for referring to the tax expenditures as "revenue subsidies"--is that the special provisions lower the effective "price" to local taxpayers of supporting state and local government. An individual who pays a dollar of local property tax may receive back 20 to 50 cents in the form of a federal income tax reduction, depending on his tax bracket. There are both theoretical and empirical grounds for believing that this makes it easier for local jurisdictions to impose taxes than it would be otherwise and that tax receipts are correspondingly higher. This is not to say that local revenues are augmented by the full amount of the federal revenue losses. A partial effect is more likely. Nevertheless, there is a multibillion dollar federal subsidy to the local sector that is not reflected in conventional tabulations of intergovernmental aid.

The federal tax expenditures on behalf of state and local governments do not loom large relative to the $60 billion or so per year that the federal government distributes as grants-in-aid. However, a different comparison is instructive. The General Revenue Sharing program, enacted in 1972, was hailed as the first major federal commitment to general-purpose support of the state-local sector. That program distributes approximately $7 billion per year. The federal tax expenditures total more than twice as much--all of it for use with no "strings" by local taxing jurisdictions.

"NEEDS" FOR PUBLIC SERVICES

Far more attention has been given to the federal government's role in augmenting the revenue of the local sector than to its influence on the level of demand for local expenditures. As explained above, that demand can be decomposed into three factors, one of which represents the "needs" of the local population for public services. The term "needs" requires explanation. As used here, it does not refer to any sort of absolute service requirement, but rather to the *relative* levels of demand for local public services by households with different characteristics. For instance, a household with school-age children "needs" more services, other things being equal, than a household with no children because it has a demand for local elementary and secondary education; a low-income household has greater than average "needs" because it receives transfer payments and consumes social services that higher-income households do not consume; an automobile-owning household represents more service "needs" than an otherwise similar household with no car because the former household makes use of streets and roads. Other household characteristics that may be related to service demands include family structure (e.g., whether there are two parents in the home), the ages of household members, and the form of housing tenure. In addition, there are two sets of nondemographic variables that would have to be taken into account in a full discussion of service needs: One is the characteristics of local business and industry that affect per capita levels of public service consumption by the business sector--e.g., industrial demands for water and sewer services and police protection. The other is the physical characteristics that can cause service demands to vary among areas even in the absence of demographic or business structure variations--e.g., differences in climate and topography.

One can conceive of an index of relative per capita needs for services that reflects the proportions of high and low service-consuming households or individuals in each locality. Such an index would be constructed by assigning appropriate weights to each relevant demographic characteristic. One method would be to base the weights on the average costs of local services consumed by each class of citizen. For instance, if it costs $500 per capita, on average, to support all local services other than public schooling, and if schooling costs $1000 per pupil, then each public school pupil would receive three times the weight in the need index as each citizen not enrolled in school. Other things being equal, high values of the need index will be associated with large proportions of the population in school, large proportions of poor or welfare-eligible households, large numbers of female-headed households, and so forth.

Any federal policy that induces changes in the population composition of central cities and suburbs, or of different regions of the country, is likely to affect the relative service need indexes of more and less urbanized areas. For the most part, the relevant federal policies are the same ones as were cited earlier as influences on the per capita residential tax base. They include the various transportation, housing, welfare, and economic development policies that are associated with the urban concentration of some socioeconomic groups and suburbanization and southward migration of others. However, the linkages between specific federal policies and levels of service demand are more complicated than the linkages between the same policies and the residential tax base. The revenue base represented by a given household depends upon its income, more than anything else. The service demands of a household are also associated with income, but such other factors as the number of children are also very important. Therefore, when a middle-class family with an income, say, 30 percent above the mean moves from the city to a suburb, the result is a reasonably unambiguous modest decline in the per capita residential tax base; but if the family has children in school, it is not clear whether per capita service demands rise or fall as a result of the move. The question is, does the family's consumption of public schooling outweigh its nonconsumption of public welfare and related social services?* Because of the uncertainty, it is difficult to say precisely what federal stimulation of outmigration from the cities has done to the per capita demands for urban services.

The foregoing point underscores the importance of considering the net fiscal consequences of multiple effects of federal policy. Virtually any federal action that induces a change in the make-up of an urban population will affect both the local revenue base and the level of public service needs. The two effects may be offsetting or mutually reinforcing. The departure of the middle-class family with school children provides an example of offsetting effects. The inmigration of a welfare-eligible family provides a case of reinforcing effects--doubly so if that family also has children in school. Unfortunately, we do not know enough about the relationships between public service demands and demographic variables to compute the net fiscal surplus or deficit

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*This discussion pertains to the impact of population changes on the fiscal position of the whole local public sector, not only the municipal, or general-purpose, category of local government. Typically, the costs of schooling would be borne by an independent local school district rather than the municipality. Welfare costs may be borne by county units rather than cities. Thus, it is possible for a given population change to represent a net gain for the municipality and a net loss for the whole local public sector, or vice versa.

associated with each combination of household characteristics. Still, we do know enough to be able to appreciate that some population shifts associated with federal policies have had significant effects--often adverse ones--on urban budgets.

The question of the net fiscal impact of demographic change is related to several ongoing controversies about federal social policy. One is the debate about welfare reform. If it is true that interstate differentials in income maintenance and social service programs are a cause of the poverty concentrations in the urban northeast, and if those concentrations, in turn, place financial burdens on the cities, then the design of a reformed welfare system could have major fiscal implications for the local public sector. These implications have received relatively little attention in the discussions of alternative reform proposals. An even more controversy-laden subject is federal policy concerning school desegregation. A debate has been going on over the contribution of such policies--especially busing programs--to white and middle-class flight. The potentially significant fiscal effects of the departure of families with school children, on cities as well as suburbs, have received little consideration during these discussions. In both areas, federal actions have been taken, and more actions are likely to be taken in the future, in the absence of information on either their locational effects or the consequent fiscal effects. This should indicate a high priority for efforts to predict both types of effects and to examine carefully the locational incentives implicit in program designs.

COSTS OF PUBLIC SERVICES

The macroeconomic and regulatory policies followed by the federal government affect levels of wages and prices throughout the economy, including the wages of public employees and the prices that local governments must pay for energy, construction, contract services, and other inputs. The macroeconomic policies include the full range of instruments--fiscal and monetary policy, automatic stabilizers, targeted job creation programs, and controls--that federal authorities use to influence rates of economic activity, employment, and inflation.

Regulatory policies include enforcement of the federal laws governing wages and hours and the collective bargaining process and policies that affect prices and supply conditions in specific sectors, such as construction, transportation, and energy.

Although the public sector as a whole has undoubtedly faced difficult adjustment problems because of general price inflation, it is difficult to identify federal policies that have had direct effects on service cost *differentials* among cities, suburbs, and rural areas or among different regions. One input price that federal policy has affected directly is the price of energy, but energy accounts for a very small fraction of public sector spending. To detect the federal influence on the most important component of public sector costs, the wages of public employees, one must look to indirect federal impacts via the private sector. Regional differentials in private wages are attributable in part to federal policies that have affected the course of economic development (e.g., the rate of industrialization) in each region. Wage variations are also attributable, to some unknown degree, to the provisions of labor law that permit regional variations in the legal status and, thus, the effectiveness of unions (e.g., the provision authorizing state right-to-work laws). It is well established that pay scales in the public sector reflect private sector wages. Therefore, to the extent that federal policy has contributed to private wage differentials, it has also contributed to differential public sector costs. However, the overall trend during the post-war period has been toward reduced interregional differences in wages. The effect of this trend should be pro-urban, in the sense that the cost advantages of the less urbanized regions are gradually being eroded.

One form of proposed federal intervention that could have had a major effect on public sector costs seems to have been sidetracked. That is the proposal for development of a national framework for collective bargaining in the state-local sector. The efforts to enact such legislation were blocked, at least for the time being, by the Supreme Court's decision in *National League of Cities* v. *Usery*, which has been interpreted by some to preclude that form of federal involvement in the affairs of state and local jurisdictions.* This interpretation is not universally shared, and further attempts and consequent court tests may be forthcoming. No matter what the outcome, the growth of public sector collective bargaining is likely to have a major impact on public service costs in the future. The question is only whether federal involvement in the process will be a major contributing factor.

SCOPE OF SERVICE RESPONSIBILTIES

One important determinant of the fiscal well-being of local governments in the range of services for which they are responsible. There are now wide variations, both within and among states, in the pattern of assignment of functional roles and fiscal responsibilities to different levels of government. Functions that are performed by local authorities in some states are performed directly by the state government in others--an important example being administration of welfare. Functions that are performed locally are financed to widely varying degrees out of state government revenue. There are also different divisions of responsibility within the local sector. Public school systems are run directly by municipal governments in a few instances, by county authorities in some states, and by independent local school districts in most of the country. Welfare systems are typically run by county governments when they are not administered directly by states, but a few cities, notably New York, are responsible for their own welfare systems. Any federal action that altered these assignments could have significant financial implications, either for particular classes of governments or for the whole local sector.

There are three ways in which the federal government can act to alter local responsibilities for service delivery and financing. One is by assuming added responsibility itself. There is recent precedent for this in the federalization of certain welfare programs under the rubric of the Supplemental Security Program (SSI). It has been proposed that the other major welfare programs--Aid for Families with Dependent

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*In the *Usery* case (96 S. Ct. 2465, 1976), The Supreme Court ruled that the federal government could not set a minimum wage for state and local employees. State sovereignty was said to transcend the justification for federal involvement under the commerce clause. By extension, this can be taken to preclude other forms of federal involvement in relations between subfederal governments and their employees.

Children and Medicaid--be federalized as well. That would provide several billion dollars of fiscal relief to the state-local sector. Although most of the benefit would accrue initially to the states, there would probably be a significant longer-run "pass-through" benefit to the local sector. Establishment of a national health insurance program could also have a major fiscal impact by shifting to the federal government the state-local share of Medicaid costs and some other costs of public health services and hospitals.

The second potential role of the federal government would be to induce states to assume some of the financial burdens now borne at the local level. Specifically, it has been proposed that the federal government should offer financial incentives to states to take over most or all of the burden of financing public schools (possibly with the federal government assuming some fraction of the burden itself). Since elementary and secondary education consumes the largest share of local revenue, there is probably no single change in the intergovernmental system that could offer more local fiscal relief.

The third possibility is that federal incentives could be offered for changes in local government structure that would reduce metropolitan fragmentation and encourage tax base sharing. There has been limited federal support for the formation of metropolitan area authorities in the past. A number of federal grant programs could be used to provide the incentives for more substantial structural change in the future.

A major change in the scope of local service responsibilities will alter the locational incentives facing business firms and households. Both shifts of responsibilities to higher-level governments and reduction of metropolitan fragmentation would tend to reduce the importance of interjurisdictional fiscal disparities as factors affecting locational decisions. In most instances, the effect would be to reduce the advantages that suburbs now enjoy relative to central cities and rural areas. However, there are places where cities are financially better off than suburbs and where the effects would be in the opposite direction. Direct federal assumption of state or local responsibilities could also affect the relative attractiveness of different regions by reducing interarea differentials in service levels and tax rates. The general effect would probably be to favor the lower-income regions of the country by reducing service and tax differentials that are attributable to differences in "ability to pay."

OVERVIEW

The diagram on the following page (Fig. 2) summarizes the discussion of federal policy impacts on the finances of the local public sector. It depicts the major determinants of the ability of local governments to satisfy the service demands of their residents and the broad categories of federal policy that affect each determinant. The diagram is drawn to distinguish between the determinants of local fiscal resources (the four rectangles along the right-hand side of the figure) and the determinants of demands for local public expenditures (the four rectangles on the left). A distinction is also made between federal policies that impinge directly upon the local public sector and those that operate indirectly via the household and private business sectors or via state government (the indirect policy channels are represented by dashed lines).

The four major elements of local financial resources shown in the diagram are the residential/personal component of the local tax base, the business component of the tax base, grants-in-aid from federal and state sources, and federal revenue subsidies. It is shown that the federal government affects the first two by means of policies that alter the make-up and economic circumstances of the urban population and the level of urban economic activity, respectively. Federal grant policy is shown as operating both directly and through state government to influence the amount of outside aid available to the local sector. Federal tax policy is shown as the source of revenue subsidies to local governments.

On the expenditure side, demands for public services from urban households and businesses are shown as being influenced by the same federal policies as affect the household and business components of the tax base. Direct federal influences on local service costs and the scope of local responsibility are indicated. Also, the joint effects of state policies and federal grant policies on the financial and service obligations of the local sector are suggested by the network of dashed lines at the lower part of the diagram.

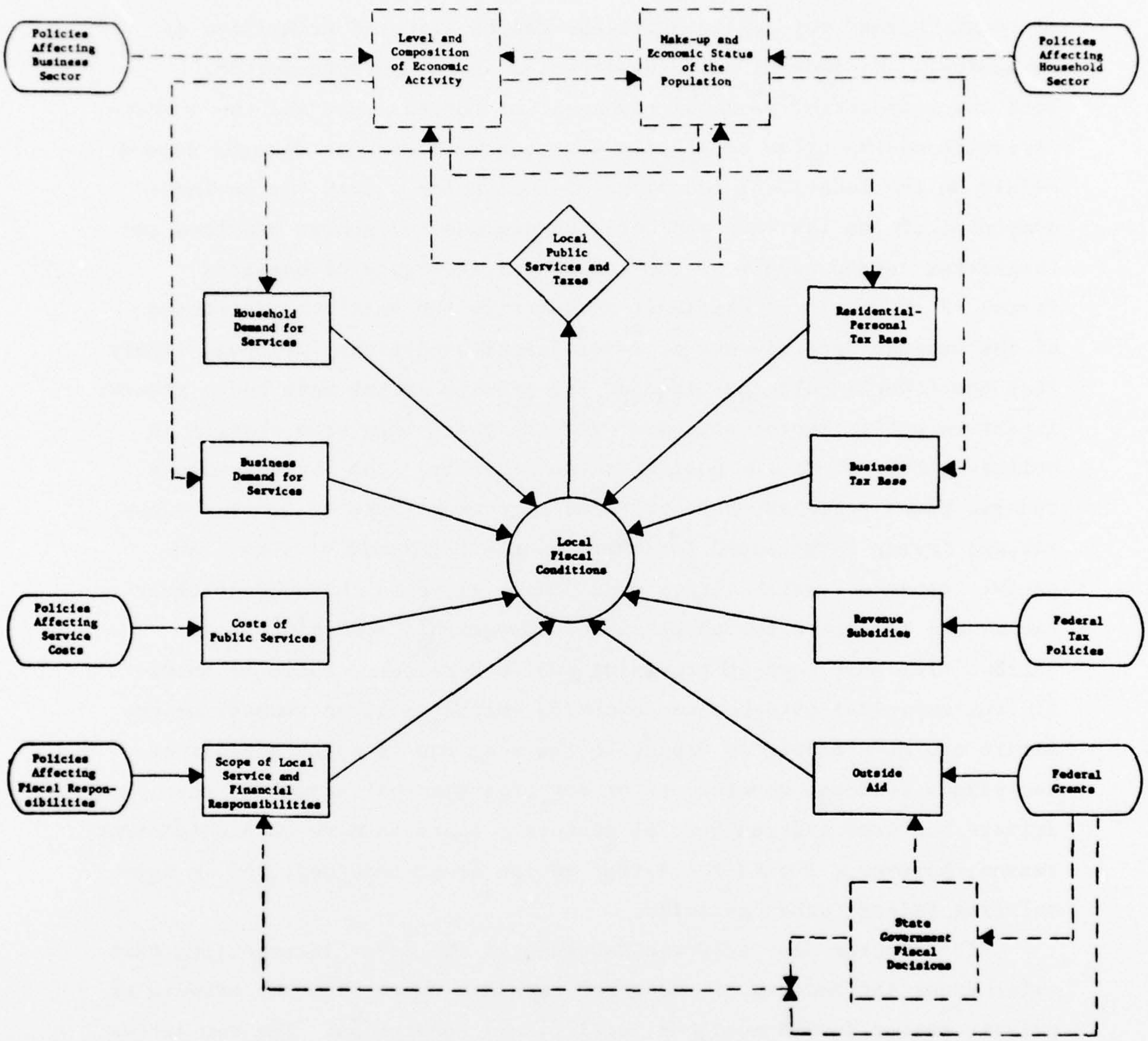

Figure 2. Federal Policy Impacts on the Local Public Sector

The most important point brought out by the diagram is that some of the main determinants of local fiscal conditions--the business and residential components of the local tax base and the level of local "needs" for public services--can be affected primarily, or exclusively, by federal policies directed at the *private* sector. Both the residential/personal component of the tax base and the characteristics of the urban population that generate service demands depend mainly on the locational decisions of households. Both the business component of the tax base and business demands for public services and facilities depend mainly on the locational decisions of business firms. Although it is difficult to quantify the relative importance of the various determinants of local fiscal conditions, it seems likely that the federal policies aimed at the private sector have had a greater impact on public sector outcomes over the years than have changes in policies that affect the public sector directly. The latter--mainly federal grant policies--have provided a growing share of local revenue, but the former have helped to determine the magnitude of local financial resources, which cities must still rely upon the bulk of their funds, and to create the physical and demographic conditions with which cities must cope in providing public services. There is insufficient empirical evidence to determine whether a given federal expenditure can have a greater impact in the long run if spent for direct assistance to local governments or for programs that stimulate the private business and residential sectors. There is more than sufficient reason, however, to give the latter option equal consideration in formulating federal urban policies.

The diagram also acknowledges some of the major interactions that exist among the sectors of the urban economy, apart from the effects of private sector developments on local fiscal conditions. The two arrows connecting the economic activity and population composition boxes at the top of the diagram signify that developments in the business and residential sectors influence one another. This means that federal policies directed at the household sector are likely to affect business location decisions, and vice versa. The implication is that there are virtually no "pure" federal policies capable of influencing only one part of the system without disturbing others. Considerable attention is given to the complex interaction between residential and business location patterns in the portions of the Rand study pertaining to those sectors.

The connections between local services and taxes (the diamond-shaped figure in the diagram) and the economic activity and population boxes represent important feedback relationships between the public and private sectors: On one hand, private sector outcomes affect the resources available to the public sector and the demand for public services; on the other hand, the adequacy of public services and the magnitudes of tax burdens are determinants of both business and residential locational choices. Therefore, any federal policy that improves local fiscal conditions (e.g., an increase in grants) is likely to have secondary effects on the demand for housing and the level of business activity. This further underscores the interrelatedness of the three sectors of the urban system.

IMPLICATIONS FOR THE DEVELOPMENT OF FEDERAL URBAN POLICY

Two general points pertinent to federal policy formulation emerge from the foregoing discussion of the conceptual framework and from the public sector example. They are:

1. The potential importance of indirect federal policies--those that operate via linkages among the different sectors within the urban system.
2. The central role of policies that affect the locational decisions of businesses and households.

INDIRECT URBAN STRATEGIES

An implication of the discussion of federal impacts on the public sector is that too little attention has been given to federal policies that operate indirectly, in comparison with the attention given policies that aid the local public sector directly. The indirect strategies of working to affect the local business residential tax bases or the levels of local demands for services deserve consideration as alternatives to the direct strategies of increased federal financial aid and federal (or state) assumption of local responsibilities. The longer the time horizon, the more attractive the indirect policies seem relative to the direct ones. In the very short run, there is little that can be done to improve the fiscal conditions of urban areas other than to provide direct financial aid. However, if the aid funds go to support current social services, that will do nothing to attract business or to alter the make-up of the urban population in a fiscally favorable direction. In the long run, a federal policy limited to direct aid is likely to be self-defeating. Such a policy cannot eliminate conditions of economic decline or stagnation, and it virtually guarantees that increased amounts of aid will be needed in the future to sustain the urban public sector. This does not mean that there are proven indirect policies waiting to be implemented. We know too little about the determinants of private sector behavior to be able to predict the magnitudes of indirect federal policy impacts, or to be sure that it is possible to design policies of sufficient potency to offset the underlying economic causes of urban decline. Still, the indirect route seems the more hopeful in the long run, and the only route that is likely to help urban governments without making them completely dependent on federal largess.

Because developments in the private business sector and the household sector are closely related, there is considerable scope for creativity in the design of federal urban aid strategies. A policy that succeeds in attracting or retaining business in urban areas is likely to have indirect, fiscally favorable effects on the urban population; a policy that makes urban areas more attractive to middle-income households is likely to have an indirect, positive effect on business activity and investment. This means that policies aimed at improving local fiscal conditions by the indirect, private sector route may be aimed at targets of opportunity in either the business or residential portions of the private sector without regard to whether it is private economic activity or the composition of the local population that the government ultimately hopes to influence.

Locational Incentives

The most important conclusion of the Rand study is that locational incentives ought to be central elements in the development of a more comprehensive federal urban policy. Nearly all the federal activities that are said to have encouraged the suburbanization process and the migration to the sunbelt did so by altering the relative attractiveness to businesses and households of different regions and different parts of metropolitan areas. Even with regard to the public sector, where locational incentives can have only indirect effects, the movements of people and industry in response to federal policy are of critical importance. Where the goal of policy is to affect the private sector of the urban economy, locational effects are of the essence. The objectives of stemming employment losses in central cities and reversing middle-class or White flight can only be accomplished by policies that enhance the relative attractiveness of the urban centers.

Of course, it is easier to advocate that locational incentives be emphasized than to demonstrate how they can be designed. There are two major obstacles to determining the potential effects of alternative locational strategies. One is that so many factors have influenced the pattern of urban development in the last two decades that it is extremely difficult to untangle them and assess their individual importance. Thus, although it is widely agreed that postwar suburbanization was stimulated by a combination of rising incomes, highway construction, housing subsidies, and minority migration to cities, no one has been able to quantify the relative influence of each of these major factors. The second problem is the irreversibility of many locational changes. The suburbs are built and the interstate highway system is in place. Nobody proposes to tear them down for the benefit of cities, even though, in retrospect, we might wish that they had developed differently. The northward migration of the Southern, rural poor is complete--a product among other things, of irreversible changes in agricultural technology. Therefore, even if the historical data yielded all their secrets, it would not be possible to help cities by operating the historical incentives in reverse. Although some may be reversible, for the most part, new locational incentives will have to be designed or discovered.

Recognition of the importance of locational incentives should lead to greater variety in the policy proposals put forth by spokesmen for the cities. Examples of policy alternatives that emphasize incentive effects rather than direct financial aid include the following:

1. Equalization of the tax treatment of housing expenditures by owner-occupants and tenants.
2. Extension of credit for housing rehabilitation and upgrading on terms comparable to credit for home purchases.
3. Revision of federal regulatory policies in the transportation field to eliminate anti-urban biases in services and rates.
4. Elimination of the bias in favor of new development that is inherent in federal water and sewer and other infrastructure grant programs by treating operation and maintenance of existing facilities on the same basis as construction of new ones.
5. Equalization of welfare benefits and social services among geographical areas.

In addition to options like the above, all of which represent modifications of ongoing programs, it is possible to contemplate more thoroughgoing locational policies involving overt subsidies or tax benefits for "pro-urban" locational choices. These are in line with the concept for a comprehensive urban settlements policy, which some would make a central theme in the federal government's future role.

The Importance of the Analytical Framework

Apart from the substantive results, the Rand study has confirmed the importance of working within a well-defined analytical framework when thinking about a comprehensive federal urban policy. The importance of the general framework is supported by two kinds of findings: First, there are categories of federal policy whose impacts cannot be appreciated without tracing complex cause and effect chains among and within the sectors of the urban economy. Since many federal policies impinge upon the same network of relationships within the urban system, it makes little sense to start afresh every time a new policy alternative is to be considered. The type of general approach that we have pursued seems to offer significant analytical economies. Second, there are many federal policies that have multiple effects upon the urban system. In particular, policies sometimes have long-run locational impacts that are unrelated to, or even counter to, both their immediate effects and the intent of the policymakers. An advantage of the general conceptual approach of impact analysis is that it ensures that the longer-run and less direct effects, including the locational effects, will be searched for and considered. The structure of the analytical scheme itself makes such impacts "expected" and reduces the chances that major urban impacts of federal policy will be ignored.