

Effects of The New System of Fiscal Federalism on Local Economic Development Efforts: A Test Case

John E. Peck, Economics, Indiana University, South Bend, Indiana
Thomas R. Swartz, Economics, University of Notre Dame, Notre Dame, Indiana

Abstract

Although Congress has never officially endorsed President Reagan's plan for a "New Federalism", it is apparent that our system of fiscal federalism has undergone massive changes in recent years with Federal grants as a percentage of state and local own revenue falling since 1978 on a yearly basis. This paper considers the impact of the changing fiscal federalism upon local economic development efforts using South Bend, Indiana -- a rather typical community in the manufacturing belt -- as a case study.

Introduction

The modern economic history of nearly all local communities has been shaped in part by a changing system of fiscal federalism. The changes have derived, for the most part, from differing policies of our national administrations and by the changing "mood of the country". As a case in point, in October of 1972, President Nixon signed into law the "State and Local Fiscal Assistance Act." This act of legislation, popularly known as General Revenue Sharing, was indicative of the generosity to be bestowed upon local governments by both the federal and state governments and was described at the time as "an idea whose time had come". It was also the cornerstone of President Nixon's policy of "New Federalism" -- a policy designed to give states and local governments greater decision-making responsibilities while at the same time giving the federal government greater revenue responsibility for funding local needs. These were the "golden years" of fiscal federalism. The U. S. Congress passed new spending programs and numerous state legislatures adopted new tax programs with apparent ease. More importantly, in terms of addressing the urgent needs of local communities, both federal and state governments created a melange of new grant programs for local government -- again without obvious difficulty. The Economic Op-

portunity Act, Medicaid, Title I and II of the Elementary and Secondary Education Act, the Manpower Training and Development Act, Community Development Block Grants, the Law Enforcement Assistance Act, and the Economic Development Administration were all born in the 15 year period from 1964 to 1978. By 1978, local governments were receiving 76 cents in federal and state aid for every dollar that they generated with local taxes and fees.

In recent years, however, the nation has witnessed a radical reversal in its system of fiscal federalism -- such that within the upcoming ten years it is quite possible that the federal government's financial support of state and local activities could return to about the same level as existed during the second Eisenhower Administration. Among other causal factors, the mood of the country has changed. Spurred by the passage of Proposition 13 in California during the summer of 1978, state after state passed new controls that worked to regulate (or further regulate) local government's taxation and spending prerogatives. During this period of "tax revolt", 51 new revenue and expenditure controls were enacted throughout the various states, and 54 personal income and sales tax reductions were passed by state legislatures. Concurrently, fed-

eral grants to state and local governments began to fall. In 1978, federal aid equalled 32.1% of state/local revenue. By 1981, the percentage had fallen to 28.4%.

From local government's perspective, the worst was yet to come. During the 1981-83 recession, occurring early in the Reagan first term, state governments were forced to reverse their new-found austerity policies. Instead of tax decreases, 58 state tax increases were enacted. This reversal was the product of three events: the new administration's programmatic cuts; the decline in federal aid to state and local governments, which by 1984 had fallen to 22.2% of state/local revenue; and, the revenue shortfalls and expenditure demands resulting from the 1981-83 recession.

When the clouds of the recession had passed, local governments found that federal and state support for their activities had shrunk dramatically. At the same time, the federal government was promising that it would continue to pursue its policy of new, new federalism by continuing to reduce its share of state and local expenditures. Similarly, state governments signalled a smaller and smaller commitment to helping finance local expenditure. The net result, of course, was for local government to face clear funding alternatives: either pick up a greater portion of the fiscal burden on its own; cut programs; or, work out some combination of the two.

Accordingly, the nation has in fact established a new, new system of fiscal federalism. If local governments are to share a larger and larger portion of the cost of providing basic governmental services, it must be expected that some of these governments will encounter difficulties in meeting their new responsibilities, unless their economies can be counted upon to enhance the pool of public resources through the process of economic development. The economic development process, however, is a competitive process wherein communities are often pitted against each other in efforts to attract and retain local industries. Accordingly, in this environment of new, new federalism, intercity competition for business location and jobs will heighten. The economic survival of the fittest communities is at stake, and all eyes will be focused on local governments. During these "years of uncertainty", while intergovernmental transfers now ac-

count for only 64 cents of each dollar generated locally, state governments are systematically lifting the controls that were earlier placed upon local units. How local governments will now respond to this new, new system of fiscal federalism and how successful they are is of critical importance for the future economic viability of local communities across the nation.

It can also be argued that the task of surviving in such an environment will be most difficult in those communities that are already burdened by a loss of jobs and income resulting from a deindustrialization of their economies. For the most part, such communities are located in the traditional industrial belt of the U.S. across the midwest and northeast. The authors, having recognized the vulnerability under the new, new federalism of their home community, South Bend, Indiana, -- particularly in light of its extensive economic redevelopment efforts in recent years -- have researched both the dependency of South Bend upon intergovernmental assistance specifically in the area of economic development, and the likely level of increased local effort that would be required to fill the gap. The purpose of this paper, then, is to trace these trends using South Bend as a test case, thereby highlighting this important era in the recent economic history of the community and, more importantly, to share with other communities the dimensions of the problem they face.

Background

South Bend, Indiana is a city of 110,000 inhabitants located 10 miles south of the Michigan state line in the north central part of the state. The South Bend Metropolitan Statistical Area (MSA) encompasses all of St. Joseph County and an overall population of 240,000. Situated along the Indiana Toll Road and the St. Joseph River, the city, which is the St. Joseph County seat, is positioned in the hub of the industrial midwest: 190 miles from Detroit; 270 miles from Cleveland; 140 miles from Indianapolis; and, 90 miles from Chicago. At various times in its history, South Bend has served as home base for dozens of major manufacturing operations including the Studebaker automobile firm, Oliver Farm Equipment, Singer Sewing Machine Co., and the Bendix Corporation.

As late as 1950, the portion of those working

in manufacturing had stabilized at 57 percent of non-agricultural employment. As an analyst of that era concluded: "The most pronounced characteristic of the South Bend urbanized area's economy is its non-diversification. The distinction between a diversified and a non-diversified economy is relative, (however,) the prominence of manufacturing in the South Bend urbanized area clearly distinguishes it as non-diversified." (1) In recent years, however, the dominance of industrial production in South Bend has diminished as one after another of its major manufacturing employers, including Studebaker, Oliver, Singer, and some divisions of Bendix, has closed or chosen to relocate elsewhere. Today, manufacturing employment accounts for something less than 25 percent of the city's employed workers. At the same time, overall employment has risen to record levels as gains in nonmanufacturing and the resulting diversification of the economy have more than offset the loss of manufacturing jobs.

This restructuring of the work force from manufacturing to nonmanufacturing has been viewed, however, with a good deal of apprehension on the part of the community's leadership, given the differential that one generally expects to find between income earned by industrial workers versus their service sector counterparts. It was recently noted that real quarterly payroll per worker in South Bend fell by 7.9 percent between 1956 and 1984.(2) Accordingly, the community took steps in 1980 to develop an economic revitalization strategy and to form a broad based economic development organization whose purpose would be to implement that strategy. The *Community Economic Development Planning Program* (CEDPP) enlisted 253 volunteers -- comprising 9 task forces and 32 study teams -- and representing business, government, labor, education, and the social sectors to join in its all out effort to shore up the area's industrial base. A principal outgrowth of the CEDPP was Project Future, a well financed and well staffed economic development organization whose responsibilities were directed toward three principal areas: attraction of new industry; support of existing firms; and, small business development. A review of the available literature and a nationwide survey conducted by Project Future found that the economic development programs and initiatives established in the South Bend area were pursued as vigorously and successfully

as in the most active communities anywhere in the country.

Given the environment of the "golden years" of New Federalism, the economic development activities of South Bend and St. Joseph County's units of government -- like their most aggressive counterparts nationwide -- had become increasingly dependent upon federal funding sources. The South Bend area had utilized nearly every type of federal program over the time period studied, and beginning in the early 1970's, special project related grants such as Urban Development Action Grants (UDAG's) and Economic Development Administration Grants (EDA's) became the underpinnings of local support for nearly all recent industrial park activities, redevelopment efforts, and major industrial projects.

In the analysis of these developments that follows, the authors have drawn upon the work they helped perform as members of the 1986 *Funding Economic Development Task Force* of the South Bend-Mishawaka Area Chamber of Commerce and Project Future. The "current" data year was 1986 with forecasts provided through 1991.

The New, New Federalism

As early as 1981, it was clear that the "golden years" of fiscal federalism had passed -- in South Bend and for the nation as a whole. As will be noted in Table 1, it was in 1981 that state and federal transfers to local governments, as a percentage of each dollar collected locally, reversed their upward trend. Through 1985, the overall figure had fallen a full 19 percent. In assessing the impact of this reversal on present and future economic development efforts, the task force attempted to answer a number of questions grouped as follows: (1) How dependent had the community become upon federal economic development funding? How important had the state been in supporting local development activities? What are the dimensions of recent losses in dollars and cents?; (2) Had the influx of outside (federal and state) funding changed the historic, traditional structure of economic development funding locally?; and (3) In what areas will likely upcoming cuts be made? What kinds of programs are in jeopardy? What is the potential for increased local effort, and

Table 1
Federal & State Aid per \$1.00 of Local Revenue*
Selected Fiscal Years

Type of Gov't	1962	1975	1978	1980	1981	1983	1985
All Local Governments**	\$0.44	\$0.73	\$0.76	\$0.79	\$0.76	\$0.67	\$0.64
Cities	.26	.63	.62	.56	.53	.46	.42
Counties	.60	.78	.80	.81	.77	.63	.59

*A figure of \$0.50 means that for each \$1.00 raised locally, \$0.50 is received from federal and/or state governments. school districts and special districts.

Source: Significant Features of Fiscal Federalism, 1987 Edition, (Washington, D.C.: Advisory Commission on Intergovernmental Relations, 1987, Table 46, p.60).

what level of additional local support would be required to fill the gap?

1. *Dependency on Outside Funding*

With respect to federal funding, it was found that nearly all sources of federal funding were being curtailed or reduced. Affected programs whose elimination or reduction most impact economic development efforts included:

a. *Community Development Block Grants (CDBG)* - begun in 1975, provided a flexible system of federal assistance for activities developed by local governments based on local priorities: property acquisition; rehabilitation of buildings; etc.

b. *Federal Revenue Sharing (FRS)* - a fourteen year program (totaling \$83.5 billion) whose assistance provided funds yearly to virtually every general governmental unit below the federal level for any purpose permissible under state and local law.

c. *Job Training Partnership (JTP)* - provided funds to finance manpower training programs developed and administered by local governments.

d. *Urban Development Action Grants (UDAG)* - established in 1977 to provide cities and urban counties with discretionary grants to supplement local government and private sector financing for major urban rehabilitation projects.

e. *Federal Aid to Urban Highways (FAU)* - providing flexible assistance for the transportation and transportation infrastructure needs of urban areas.

f. *Land and Water Conservation Funds (LWCF)* - offering grants for recreational and conservation land acquisition and development projects.

g. *Airport and Airways Trust Fund (Airport)* - grants to insure the continued development of the nation's airport system.

h. *Small Cities Community Development Block Grants (S/C CDBG)* - funds provided to states for competitive funding of projects in small communities based on objective measures of need.

i. *Economic Development Administration (EDA)* - assistance to economically depressed areas for dealing with economic development and regional economic problems.

j. *Urban Mass Transportation Administration (UMTA)* - project funding, both capital and operations, related to the enhancement of mass transportation systems in urban areas.

Major losses in Community Development funds, Federal Revenue Sharing, and virtually all of these other programs were projected for a total annual reduction in economic development funds of approximately \$15,000,000 -- given the recent average level of yearly funding versus the

task force forecast for 1991:

Highest* - "Golden Years"	\$37,500,000
Average	20,500,000
1986 Actual	12,400,000
1987 Forecast	9,000,000
1991 Forecast	5,800,000

*Not including \$17,000,000 Job Training Partnership (JTP) funds received in 1978.

The expected elimination of Federal Revenue Sharing and a major reduction in Community Development Block Grant funding together represent the greatest loss of federal revenues -- some \$4,094,000 from 1985 to 1987 alone. Table 2 contains detail related to these estimates. A summary of federal funding levels dating from the 1970's, by type and use of funds, along with a 5 year forecast are provided.

With respect to state support, it was found that in recent years the State of Indiana has greatly expanded the number of programs available for use in local infrastructure projects and economic development initiatives. St. Joseph County units of government and local businesses, working through Project Future, accessed business and infrastructure loans, loan guarantees, various grants, training assistance, rail transportation assistance, etc. Analysis of statewide activity revealed that the South Bend/Mishawaka and St. Joseph County area was at the top of the list with regard to competing Indiana communities successfully obtaining state economic development assistance. Table 3 gives a summary of state funding by type and use of funds during the period. As with Table 2, a five-year forecast of activity is also provided. Table 3 provides a breakdown of state funding over the years by category and specific projects funded.

2. *Historic Structure of Funding*

While it was certainly the worthy intention of the state legislature to reduce the property tax burden of households when it passed the Indiana Property Tax Control Program, this act also worked to redo the basic structure of local public finance in communities such as South Bend. Indiana's "freeze" on local tax revenues in combination with the rising level of federal support in the "golden years" led South Bend's local governmental leadership to shift the primary

financial burden for economic development initiatives and major capital improvements to federal revenue sources. As a result, local property tax funds that had traditionally been divided between capital accounts and current operations were increasingly funnelled into operations alone. As a result, by 1986 only 4.25 percent (\$2,374,000) of the \$55,845,000 collected from county-wide tax sources (property taxes, local road and street funds, and the cumulative capital improvement fund) was targeted for major capital improvements as opposed to 12.7 percent (\$7,086,000 in constant 1986 dollars) in 1976.

We concluded, therefore, that the community's ability to fund economic development activities and capital (infrastructure) improvements was negatively impacted indirectly by the Indiana Property Tax Control Program -- particularly in the context of declining federal financial assistance -- as local tax resources were diverted from capital improvement accounts. As a result, the community today faces the dilemma of choosing between replenishment of capital funds at the expense of current operations, or of permitting capital projects to languish. Both alternatives have negative implications with respect to efforts associated with the possible attraction of businesses and with economic development efforts in general.

3. *Implications For Future Economic Development Efforts*

In assessing the likely course of federal and state policy in the years to come, it is our conclusion that local communities such as South Bend will not experience increases in intergovernmental assistance in the foreseeable future. With respect to federal funding, there is virtually no indication that efforts begun in the Carter Administration and carried forward by the Reagan Administration to reverse policies of the "golden years" would at this point themselves be reversed. The present political environment supporting the reduction of federal budget deficits through spending cuts suggests that further cutbacks in aid to state and local governments are the more likely occurrence. Writing in the Winter 1988 issue of *Intergovernmental Perspective*, Robert Gleason extrapolates from the trend of the last 10 years to suggest that "...federal grants would amount to about 11 percent of state-local spending in 1998 - roughly the same

Table 2
Federal Funding by Program
St. Joseph County
(\$'s in 000's)

FUNDING INFORMATION	CDBG	FRS	FUNDING SOURCES			UDAG	FAU	OTHER
			JTP					
I. Funding Type								
A. Project	0	0	0			X	X	X
B. Discretionary	X	X	X			0	0	X
II. Funding Use								
A. Business Assistance	2	1	0		2	0		2
B. Training	1	1	2		0	0		0
C. Public Infrastructure	2	2	0		2	2		2
D. Project Future	2	2	1		0	0		0
E. Public Development Agency	2	1	0		0	0		0
F. Operations	2	2	0		0	0		0
G. Special Projects	2	2	0		0	0		2
III. Funding Level								
A. Highest	\$ 5,186 (75)	\$ 4,335 (78)	\$17,000 (78)		\$ 9,900 (82)	\$ 1,300 (N/A)		\$ 3,000 (78)
B. 1986 Funding	3,177	2,831	2,600		-0-	900		-0-
C. Total	50,833 (75-86)	41,170 (75-86)	23,600 (81-86)		19,000 (78-84)	12,100 (75-86)		7,600 (78-83)
IV. Five Year Forecast								
	1987 - \$2,900. Thereafter, 10% reduction for 1988-90	1987 - \$0 Program Eliminated	1987 - \$2,500 1988 - 1990 Estimate 10% cut per year		1987 - \$0 1988 - 1990 \$0 Present funding criteria biased against Indiana cities	1987 - \$900 To be divided among all jurisdictions. 1988 - 1990 Estimate 10% cut per year		1987 - \$0 Special Programs

Table 2
(Continued)

FUNDING INFORMATION	LWCF	AIRPORT	FUNDING SOURCES				UMTA	CAPITAL
			S/C CDBG	EDA	OPERATION			
I. Funding Type								
A. Project	X	0	X		X	0		X
B. Discretionary	0	X	X		0	X		0
II. Funding Use								
A. Business Assistance	0	0	2		2	0		0
B. Training	0	0	0		0	0		0
C. Public Infrastructure	2	2	2		2	2		2
D. Project Future	0	0	0		0	0		0
E. Public Development Agency	0	0	0		2	0		0
F. Operations	0	0	0		0	2		2
G. Special Projects	2	2	2		2	2		2
III. Funding Level								
A. Highest	\$1,457 (80)	\$2,291 (78)	\$ 821 (83)		\$5,000 (75)	\$2,035 (81)		\$1,255 (83)
B. 1986 Funding	162	750	46		108	1,229		586
C. Total	2,833 (75-86)	7,616 (77-86)	2,982 (77-86)		7,300 (75-86)	8,834 (81-86)		4,791 (81-86)
IV. Five Year Forecast								
	1987 - \$0 Competitive funding. This area has good funding record unlikely that 1988-90 much \$	1987 - \$750K Average funding level; Gramm- Rudman reduces amount for 1988 -90 by 10%/yr.	1987 - \$40 Competitive funding - Amt available to state could be reduced 10%		1987 - \$0 1988-90 - \$0 EDA reluctant to fund in this area	1987 - \$1,229 At best, 10% down per year		1987 - \$586 10% reduction per year

as during the second Eisenhower Administration."(3)

In an effort to predict future levels of state assistance for local economic development efforts, task force members met with various officials of the State of Indiana. From these discussions, it was concluded that there would likely be no significant increase or decrease in current

levels of support for economic development activities. The state's response to federal cut-backs at the local level has been to refer local communities to their own local resources, rather than provide state funds to meet revenue short-falls.

Accordingly, communities such as South Bend are increasingly faced with the classic economic

Table 3
State Funding by Program
St. Joseph County
(\$'s in 000's)

FUNDING INFORMATION	FUNDING SOURCES					OTHER
	INFRASTRUCTURE LOAN/GRANT	BUSINESS ASSISTANCE LOAN/GRANT	PROMOTION	TRAINING	LOAN GUARANTEE	
I. Funding Type						
A. Project	X	X	X	X	X	N/A
B. Discretionary	0	0	0	0	0	N/A
II. Funding Use						
A. Business Assistance	2	2	0	0	2	
B. Training	0	2	0	2	0	
C. Public Infrastructure	2	0	2	0	0	
D. Project Future	0	0	2	0	0	
E. Public Development Agency	0	0	2	0	0	
F. Operations	0	0	0	0	0	
G. Special Projects	0	0	0	0	0	
III. Funding Level						
A. Highest	\$ 825 (86)	\$ 630 (86)	\$63 (86)	\$1.6		
B. 1986 Funding	825	630	63	-0-		
C. Total	1,887 (82-86)	1,417 (82-86)	68 (82-86)	1.6 (84-85)		
IV. Five Year Forecast						
	1987-90	1987-90	1987-90	1987-90	(Not considered in this analysis. Guarantees made directly to business)	

(No projected increase in state funding for economic development programs)

dilemma: how to match rising needs with dwindling resources. While the alternatives are clear, they seemingly offer unacceptable results -- especially from the standpoint of economic development prospects. The Maxwell School's Roy Bahl aptly outlined the dilemma:

State and local governments could respond to (the new, new federalism) in one of two ways. First, they could attempt to make up for the federal aid reductions by increasing tax rates. Such an action might be taken, for example, to hold public services and public assistance benefits at present levels. If northern and midwestern state and local governments followed this strategy, however, they could worsen their competitive tax position and add to their comparative disadvantage in attracting jobs. The alternative approach would have state and local governments attempting to keep their overall levels of taxation "in line" at the expense of not making up for the loss in federal grants and, in some cases, allowing relative public service levels to fall. The "newest federalism" has placed state and local government politicians in a very difficult position.(4)

If South Bend and St. Joseph County were to attempt to recover its \$15 million average annual loss through a property tax increase, it would be necessary to raise the rate by some 65 percent. Given the State of Indiana's Property Tax Control Program, however, this is not a legally acceptable alternative --even if such a move could

be made politically digestible. On the other hand, the imposition of Indiana's county-wide "local option income tax" in St. Joseph County would require a rate of approximately .008, which is require the maximum allowable increases over a number of years, and would represent more than half of the peak rate allowable under state law.

Conclusion

The data emerging from the record of the Reagan Years do establish one fact clearly: the President has been successful in implementing his policy of new, new federalism. It should be noted, however, that President Reagan's notion of decentralization is much different from President Nixon's earlier call for a new federalism. Both policies philosophically assume that it is appropriate for local governments to make decisions that effect them directly; however, President Nixon intended to share the cost of these activities through general revenue sharing while President Reagan, on the other hand, has intended that state and local governments bear the financial burden as well. And, local governments across the country -- like South Bend and St. Joseph County -- are far more dependent upon their own sources of revenue than in three decades. If these governments are to provide for their current and future needs, whether related to economic development efforts or not, they must

Continued on Page 83