

# *Devolution: The New Federalism— An Overview*

**I**n recent years, a growing number of scholars and policymakers have concluded that the federal government has become too large and powerful, intruding into affairs better handled by states and municipalities. Based on this premise, they have argued for a reduction in federal aid, the conversion of matching grants to block grants, greater flexibility for states in implementing federally funded programs, and curtailment of federal mandates. Their program is popularly referred to as “devolution,” the “devolving” of federal responsibilities to lower levels of government. The controversy that devolution has generated is the latest chapter in a debate over optimal intergovernmental arrangements that is as old as the nation itself.

Last September, the Federal Reserve Bank of Boston and the National Tax Association organized a one-day colloquium on the devolution movement. In attendance were experts on intergovernmental relations; business executives; former and current local, state, and federal policymakers; and leaders of national interest groups and private social service organizations whose constituents are significantly affected by devolution. In one session, participants focused on the devolution movement’s fundamental tenets; its philosophical, political, social, and economic origins; and its progress to date in achieving its goals. In another session, they assessed devolution’s probable impact on the behavior of states and municipalities, especially the capacity of lower levels of government to assume devolved responsibilities. During both sessions, participants vigorously debated devolution’s merits, drawbacks, and likely future course.

The only point that virtually all participants agreed upon was that the devolution movement has not proceeded very far. Most participants agreed that a mix of federal control and state and local autonomy was desirable, the optimal arrangements varying from function to function. They tended to reject extreme centralization and decentralization of governmental responsibilities. Participants disagreed over the move-

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ment's advantages and disadvantages, its probable success in achieving its goals, and the likely behavior of states and municipalities under a more devolutionary scenario.

### *I. The Objectives, Roots, and Current Status of Devolution*

John Kincaid opened the deliberations by presenting his paper, "The Devolution Tortoise and the Centralization Hare." He specifies six objectives of devolution: "(1) more efficient provision and production of public services; (2) better alignment of the costs and benefits of government for a diverse citizenry; (3) better fits between public goods and their spatial characteristics; (4) increased competition, experimentation, and innovation in the public sector, (5) greater responsiveness to citizen preferences; and (6) more transparent accountability in policymaking."

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Kincaid distinguishes devolution from similar but subtly different transformations such as "decentralization," "delegation," and "deregulation." Devolution connotes a surrender of a function by a superior government to a subordinate government that is generally complete, permanent, and of "constitutional magnitude." As such, strictly speaking it cannot occur between the federal government and the states under the U.S. Constitution. Since our federal system is one of dual sovereignty, in which the federal government and the states each have constitutionally specified powers, the federal government lacks the authority to devolve responsibilities. Kincaid concludes that what is currently referred to as devolution is more accu-

rately called "restoration" or "rebalancing" of powers between the federal government and the states to conform more closely to what the authors of the Constitution had in mind. To underscore the degree of imbalance, he notes that, while the Constitution specifies only four criminal offenses punishable by the federal government, today it can punish individuals for more than 3,000 different felonies.

After clarifying terms, Kincaid analyzes factors, both proximate and remote, that have stirred interest in rebalancing the federal system. The most significant, immediate factor was the attainment of a majority by the Republican Party in both the House and Senate after the 1994 midterm elections. The GOP's assumption of congressional control, combined with the election of 32 Republican governors, brought to power men and women committed to realizing long-frustrated Republican desires to limit federal power.

Kincaid's paper traces the roots of the rebalancing movement further back to the suburbanization of America; migration to the Sunbelt; spreading disillusionment with the federal government and skepticism regarding its long-run fiscal capacity; increasing respect for state and local governments; and a groundswell of support around the world for decentralization, deregulation, and free enterprise. He argues that, since suburbanites value local autonomy, they are especially receptive to doctrines advocating a weakening of federal authority. The growing proportion of the nation residing in the suburbs and "exurbia" has therefore bolstered the devolutionary cause. For similar reasons, the migration of Americans to the South and West, regions that have historically championed states' rights, has also engendered support for devolution.

A spreading disrespect for the federal government, evident in recent public opinion polls, has also promoted sentiment for restoring state powers. The electorate is particularly concerned that the federal government lacks the fiscal resources to sustain its wide array of programs. Kincaid also sees the decline of the federal government's popularity partially as a reflection of the revenge of the "silent majority"—a revolt against the perceived growth of federal programs designed to protect various minority interests. In his view, the silent majority is receptive to devolution because it would transfer powers and functions to levels of government more in touch with the majority's wishes.

While doubts about the federal government have grown, so has confidence in the capabilities of state and local governments. Kincaid attributes state and

local governments' rising star to the increasing variety of groups represented in their work force and their leaders; the small scope of their geographic jurisdictions relative to that of the federal government; the requirement that state constitutions be amended by popular vote; "supermajority" requirements in many states on many matters; and the provision in many states for citizen initiative, referendum, or recall. States have gained further respect by professionalizing their legislatures, establishing four-year terms for their governors, strengthening their judiciaries, and eliminating gerrymandered legislative districts. State and local bureaucracies have become more efficient and are capable of delivering a wider array of services.

Last, but not least, Kincaid attributes the rise of the "devolution" movement in the United States simply to the international appeal of the idea itself. Movements favoring decentralization, devolution, deregulation, and the like have spread throughout the world. The idea's worldwide popularity has enhanced its influence in the United States.

Kincaid proceeds to evaluate the degree to which devolution has actually occurred. He concludes that the movement's progress has been extremely limited. While some actions and decisions taken by Congress, the Clinton Administration, and the Supreme Court have preserved or augmented state powers, others have curtailed them or enhanced those of the federal government. The title of Kincaid's paper reflects the reluctance with which federal policymakers have relinquished powers to the states and their eagerness to retain influence over them. He summarizes the nation's devolutionary trend as a "discernible crawl toward some rebalancing of the federal system . . . in the Congress, the Presidency, and the Supreme Court."

Congress has furthered devolutionary objectives with such initiatives as the Temporary Assistance for Needy Families (TANF) block grant, other consolidations of various categorical grants into block grant form, the Unfunded Mandates Act of 1995, and the child health insurance grant to the states created by the Balanced Budget Act of 1997. Further evidence of devolutionary progress includes the sharp reduction in federal aid to state and local governments over the course of 1978 to 1990 and the continued shrinkage since 1990 in categories of aid other than payments to individuals. Yet, as Kincaid points out, 618 categorical grants were funded in federal fiscal year 1995, compared to only 15 block grants. Congress has continued to attach all manner of conditions to federal aid. Even TANF, according to Kincaid the "primary specimen"

of devolution, imposes maintenance of effort conditions, stipulates time limits and work requirements for welfare recipients, penalizes states for failing to comply with rules enforcing federal child-support laws, and requires states to spend some federal funding on sex-education programs stressing abstinence.

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In the Executive Branch, President Clinton has implemented some directives, independent of congressional legislation, designed to reduce the red tape raising the compliance costs of grant recipients and to lower the incidence of unfunded mandates. The Clinton Administration has been fairly aggressive in attempting to form "performance partnerships," in which state agencies help their federal counterpart to design performance standards for federal programs and rules. In return, the states gain more flexibility in meeting the standards that they help to devise. The Clinton Administration has also proposed consolidation of a total of 271 categorical aid programs into various block grants, especially in the areas of transportation and housing. Yet, Kincaid notes, President Clinton has also supported the imposition of several federal mandates on the states that further politically popular causes such as gun control.

With respect to the U.S. Supreme Court, Kincaid analyzes several recent rulings pertaining to the "constitutional game of federal-state power balancing" that favor the states. In reviewing the various lines of reasoning used by the Justices, he finds them to be narrowly applied, based on uncertain precedent, and supported only by narrow majorities. The Court has not explicitly overturned its 1985 decision in *Garcia v. San Antonio Metropolitan Transit Authority*, which denied the states the right to seek redress from the Court for federal encroachment on state powers under the authority of the Tenth Amendment of the Constitution. Nevertheless, Kincaid concludes that "the Court

has breathed new life into constitutional federalism through emerging doctrines pregnant with implications for future umpiring more supportive of state sovereignty."

Why has devolution proved to be a "tortoise" compared to the centralization "hare"? Kincaid cites political, administrative, and philosophical reasons. All devolutionary plans would create winners and losers. The potential losers have been sufficiently powerful and politically adept to thwart legislation calling for more extensive restoration of powers to the states. The intense, focused opposition of interest groups has been more than sufficient to neutralize the more general, diffuse support for devolutionary principles. Ironically, one especially powerful, politically active group with potentially much to lose from devolution is state officials. Uncertain about how much federal assistance they would actually receive if devolution were to proceed, many have been among the most ardent defenders of the status quo.

In addition, Congress and the President have had difficulty resisting opportunities to claim credit for programs that enjoy a high degree of support among the public at large, such as civil rights, environmental protection, middle-class entitlements, and crime control. This is true even though one might argue persuasively on economic or constitutional grounds that the programs should be crafted and administered at the state or local level. Unfunded mandates are especially attractive to elected federal policymakers because they further popular causes without requiring the federal taxpayers to pay for compliance.

Congress's stubborn predilection to preempt state law reflects to some degree a desire to enhance nationwide economic efficiency and international economic competitiveness through interstate uniformity. These considerations have made Republicans at least as aggressive "preemptors" of the states as Democrats, especially in such policy areas as state product liability, food and drug labeling, Internet taxation, and medical malpractice laws.

Underlying the retention and expansion of federal power in many areas, even in the face of what Kincaid terms "a discernible crawl" toward devolution, has been a fundamental change in the way America views itself. Kincaid argues that, during the 1960s, the United States began to think of itself less as a union of sovereign states and more as a union of individuals. Supreme Court decisions requiring "one person, one vote" (*Reynolds v. Sims* 1964; *Wesberry v. Sanders* 1964) in the creation of legislative districts were instrumental in fostering this change. The devel-

opment of nationwide media organizations and party primaries also contributed. The major consequence of these developments was a severing of historical electoral ties between members of Congress and their state and local political party organizations, leading U.S. representatives and senators to depend on and to respond to their voters directly, rather than indirectly through state and local officials. Kincaid argues that these developments contributed more to centralization of power in the hands of the federal government than either the New Deal or the Great Society.

Kincaid concludes by evaluating two widespread concerns of devolution's opponents: the dangers of intensified interstate competition and the potential inability of states to take on functions devolved from the federal government. According to the former concern, states would fail to take over devolved social responsibilities for fear of becoming a magnet for welfare migrants. They would compete with each other for employers by cutting social welfare programs and offering tax subsidies. Kincaid asserts that predictions of such a "race to the bottom" are prema-

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ture and probably unfounded. He sees little evidence of a race to the bottom in welfare programs and environmental protection since the introduction of devolutionary initiatives in these policy areas. The potential for destructive competition in welfare is constrained by TANF provisions allowing states with high benefit levels to give migrants during their first year in-state the lower benefits they received in their previous state of residence. With respect to environmental protection, fostering a high quality of life has proved to be a more compelling competitive strategy than lowering taxes at the cost of environmental degradation. Kincaid maintains that competition in the form of state and local subsidies, especially in the form of tax abatements and low-cost loans, is already rampant. If such forms of competition were suppressed, states would find other, equally deleterious

avenues through which to compete, such as vying for increased federal aid through lobbying and other forms of political pressure.

With respect to the states' ability to assume devolved responsibilities, Kincaid argues that they can be as capable as its citizens want them to be. Tax and expenditure limits, which constrain states' fiscal capacity, could be removed should voters want state government to pick up where the federal government leaves off. In a devolutionary scenario, voters might support an expansion of state programs if they believe that they can hold state governments more accountable for their actions than the federal government.

In sum, Kincaid finds compelling arguments in favor of devolution but powerful political forces retarding its progress. In his view, while the devolution movement may proceed further, the federal government will continue to preempt the states in many policy areas and to impose conditions on its intergovernmental assistance. Of the three branches of government, the judiciary is the most likely to further the devolutionary cause.

#### *Panelists' Comments*

In reacting to Kincaid's paper, **David Beam** offered his perspective on the roots, likely extent and duration, and desirability of devolution. He questioned the degree to which the recent political successes of the Republican Party have been responsible for the rise of devolutionary sentiment. Some key intergovernmental proposals in the Contract With America, such as curtailment of unfunded mandates, were nearly enacted by the preceding Congress and enjoyed support among governors even when the majority were Democrats. In his view, disillusionment with all levels of government, not just the federal government, lies behind the devolution movement. He lamented this cynicism, arguing that it reflects a fundamental misinterpretation of constitutional intent. He maintained that, although the nation's founders sought to limit the national government, they wanted it to be effective within its restricted sphere.

Beam doubted that the current devolution movement will significantly alter current federal-state relationships, noting that interest in reforming those relationships intensified and waned under Presidents Eisenhower, Nixon, and Reagan. Each reform campaign fell far short of its ambitious objectives. Beam asserted that recently enacted devolutionary proposals, such as welfare reform, are not clearly supported

by economic, political, or administrative theory. Policy analysts have long held that redistribution should be a national function, while economic development should be a state and local function.

**David Ellwood's** comments focused on the origins and devolutionary implications of the TANF

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*Ellwood noted that the welfare program no longer is just about redistribution; an important goal is to facilitate the transition from welfare to work. Some federal role is still appropriate, given the wide disparities among states.*

*Fox maintained that interstate disparities in service levels are appropriate if they reflect differences in preferences, and that interjurisdictional competition can enhance efficiency in service delivery.*

*Modahl reminded participants that the authors of the Constitution purposely imposed constraints on the power of the federal government, wary of the potential for all levels of government to misuse their "legal monopoly on coercion."*

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program. He traced TANF's origins to a mixture of political compromises and normative concerns. In crafting welfare reform, Congress considered three principal plans, one imposing time limits and work requirements but otherwise maintaining the status quo, one imposing severe federal conditions on wel-

fare aid, and one, the closest to the devolutionary ideal, giving states wide discretion in spending their federal welfare dollars. The version ultimately enacted reflected elements of all three plans. At the same time, President Clinton was persuaded by the argument of many governors that states would be more effective in reforming welfare, given that during the early 1990s their programs had been more innovative and successful than the federal government's. Although Ellwood agreed with Kincaid that devolution has not proceeded very far, he asserted that TANF grants states much more leeway than is generally recognized.

In support of partial devolution of the welfare function, Ellwood noted that it no longer is just about redistribution. Rather, an important goal of current welfare policy is to facilitate the transition from welfare to work. What arrangements are best suited to realize this goal may vary from state to state and city to city. A decentralized approach may therefore be more successful.

On the other hand, Ellwood asserted, some federal role in welfare is still appropriate, given wide disparities among states in wealth, per capita income, and the incidence of poverty. In light of these disparities, he believes that a "race to the bottom" is a real threat. Tensions among the states could become especially severe during a sharp recession. Under such conditions, lacking countercyclical federal assistance, states with low per-capita income would be especially hard-pressed to maintain welfare benefit levels and support systems crucial to a successful welfare-to-work transition.

**William Fox** maintained that several concerns of devolution's opponents are misplaced. If devolution leads to interstate differences in service levels, such disparities are appropriate if they reflect differences in preferences. He was not concerned that devolution might lead to more interjurisdictional competition, because such competition can enhance efficiency in service delivery. Nor did he accept the argument that the distribution function is best performed by central governments while the allocation function is best carried out by state and local governments. In the past, economists argued that only central governments could effect stabilization policy. Just as policymakers have questioned this argument in recent years, so they should question the notion that distribution should be primarily a federal concern. However, Fox did warn about the potential for severe cutbacks in welfare spending in a recessionary environment. He urged policymakers to enact contingency plans now, spelling out how benefits would be cut should the economy contract.

However desirable devolution may be in theory, Fox argued, it will not occur or will be detrimental in practice if state and local governments continue to lack the ability to control their own revenue sources. Interstate tax competition precludes subnational governments from levying taxes on production, but, given federal constraints, they lack the ability to tax consumption in an effective, comprehensive manner. In an age of electronic commerce, consumption is becoming an increasingly interstate phenomenon and, therefore, one controlled by the federal government. Through legislation and court decisions, the federal government has constrained the ability of states and municipalities to tax the consumption of goods and services consumed within but produced outside of their borders. The share of transactions comprising taxable consumption that possess this characteristic has risen dramatically in recent years, in tandem with growth in electronic commerce. As a result, sales tax rates have risen sharply to maintain revenues in the face of a shrinking tax base. If this trend continues, without federal legislation enabling states to tax a wider swath of interstate commerce, they will lack the fiscal capacity to assume devolved federal responsibilities, even if they want to assume them.

Like John Kincaid, **William Modahl** reminded the colloquium's participants that the authors of the U.S. Constitution purposely imposed constraints on the power of the federal government. Underlying these constraints is a philosophy wary of the potential for all levels of government to misuse their "legal monopoly on coercion." Implicit in our current federal arrangements—distinguished by a strong, intrusive federal government—is the notion that a powerful, centralized institution can enhance citizens' welfare through good planning. The central government is assumed to be the source of action and innovation, the citizens passive recipients of government largesse and beneficiaries of governmental wisdom.

Modahl contended that this vision is fundamentally flawed. While the challenges posed by two World Wars and the Great Depression may have necessitated some centralization, the realization of this vision has ultimately spawned disillusionment and discontent. The goal of the devolution movement is to realign intergovernmental arrangements with the competing vision, shared by the nation's founders, of a string of communities of civically active, independent citizens. In this paradigm, governmental functions are performed at the lowest feasible level in order to unleash the most creativity and innovation in the public sector. Modahl at-

tributed the lack of progress in resurrecting this vision to a poorly informed public that gives little thought to normative issues of governance. However, based on the first tentative steps toward devolution, he is optimistic about the future.

**George Latimer** (moderator of the session) maintained that the nation's high degree of "spatial inequality" is a significant problem whose solution demands considerable federal input. A large number of people in need of employment, especially those residing in the inner city, cannot find jobs near where they live. Latimer questioned whether the free market and state and local governments can solve this problem alone.

## *II. How Will State and Local Governments Respond to the Challenges and Opportunities of the New Federalism?*

**Robert Tannenwald** began the second session by presenting his paper, "Come the Devolution, Will States Be Able to Respond?" His study investigates the following empirical issues, all central to the devolution debate: How easily could state governments and their municipalities expand their fiscal domain should devolution proceed and should they choose to do so? Which states would have the most difficulty? How disparate would be the capacity of states to respond? Would those least able to respond tend to prefer relatively low levels of state and local public services anyway?

Tannenwald begins by explaining why the question posed in the title of his paper is important. Some opponents of devolution fear certain states and municipalities lack the ability and will to assume responsibilities devolved from the federal government. Taxpayer resistance, a dearth of taxable resources, growing public problems traditionally addressed at the subnational level, and interjurisdictional competitive pressures are the most often cited constraints on the ability of state and local governments to enlarge their role in the U.S. federal system. These constraints are especially troublesome to those who believe that many programs currently undertaken by the federal government should not wither away. Evidence that states could and would pick up where the federal government leaves off would mitigate their concerns.

Tannenwald first looks for clues about states' likely fiscal response to devolution in the historical pattern of the aggregate state and local revenue burden. Revenue burden is a measure of general state and

local revenues, net of federal aid, as a percentage of nationwide personal income. The most recently revised data indicate that between 1977 (FY77) and FY94 revenue burden rose by 0.8 percentage point. While this increase might indicate mild support for state and local expansion, the burden of state and local *taxes* declined over this period by 0.7 percentage point. The two fastest-growing categories of state and local revenue were *non-tax* sources—miscellaneous revenue (much of which is interest income) and user fees and charges. The rapid growth in miscellaneous revenues reflects, depending on the year in question, increases in interest rates (temporary windfalls outside of state and local control), expansion of borrowing, and changes in the definition of interest income made by the Census Bureau. Thus, the implications of the historical trend in revenue burden are inconclusive.

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Tannenwald then examines recent trends in the aggregate surplus of state and local governments, reasoning that they might be building up reserves as a contingency against potential reductions in federal assistance. He finds that the ratio of the surplus to spending in the state and local sector has increased since the last recession and has remained at between 4 and 5 percent. However, this percentage has been in long-term decline and pales in comparison to its value 30 years ago. Nevertheless, the recent persistence of the surplus-to-spending ratio in the 4 to 5 percent range differs from the historical pattern, in which the ratio falls sharply one to three years past peak. Perhaps, Tannenwald surmises, states are "bulking up" partially to offset federal aid cuts.

Tannenwald cites evidence that states have amassed deeper reserves and achieved higher surplus-to-spending ratios than local governments. This asymmetry presents problems for devolution advocates in that local governments are at the bottom of the fiscal

food chain. If federal aid to the states were cut, state governments might respond by reducing their assistance to local governments. If municipalities lacked reserves or the capacity to raise taxes, they would be forced to cut spending, in effect bearing the brunt of the reduction in federal aid to the states. States are most likely to cut local aid during recessions, when demand for state social services is high and growth in state revenue especially slow. Federal matching entitlements, such as Medicaid, mitigate recession-induced stress on states by automatically increasing disbursements in response to rising caseloads. The substitution of block grants for open-ended matching grants would make federal aid less responsive to the business cycle, thereby reducing the states' capacity to maintain aid to local governments during economic contractions.

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*Tannenwald estimates the relative fiscal comfort of each state in FY94, defined as fiscal capacity relative to fiscal need. He finds wide disparities among the states.*

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Having analyzed the fiscal strength of state and local governments in the aggregate, Tannenwald then turns to the issue of interstate disparity in fiscal comfort. Many who question the wisdom of devolution are concerned about the potential inadequacy of government spending in fiscally "uncomfortable" states, those with low fiscal capacity relative to the needs of their citizens for public services. They also worry that, should devolution proceed, the least fiscally comfortable states would be at a disadvantage in interstate competition, forcing them into a vicious circle of reduced public services, loss of labor and capital, intensification of their fiscal problems, and further tax increases or further spending cuts. The less the dispersion in fiscal comfort across states, the less likely that further devolution would create or exacerbate such a problem.

Tannenwald estimates the relative fiscal comfort of each state in FY94 (the latest year for which all relevant data were available). He uses methodologies originally developed and refined by the now-defunct

U.S. Advisory Commission on Intergovernmental Relations. He defines *fiscal comfort* as *fiscal capacity* relative to *fiscal need*. Fiscal capacity measures the richness of a state's taxable resources. Fiscal need measures the extent to which a state, through no fault of its own, faces conditions that increase per unit costs of providing state and local public services or augment the scope of services that its governments must provide. Examples of such conditions include a high rate of poverty and a high ratio of school-age children to total population.

Tannenwald finds wide disparities in fiscal comfort. The most fiscally comfortable state, Nevada, enjoyed a comfort level more than twice that of the most fiscally stressed state, Mississippi. The most fiscally comfortable states tend to be those with the highest fiscal capacity, including, in addition to Nevada, Hawaii, Connecticut, New Jersey, Wyoming, and Delaware. The least comfortable states tend to be concentrated in the South. Dispersion in fiscal comfort has narrowed since FY87, the only other year in which estimates for both fiscal capacity and fiscal need have been undertaken. Historical trends in the dispersion of fiscal capacity can be analyzed in more detail, since state-specific estimates of capacity have been undertaken for most fiscal years since FY75. Dispersion has been narrowing since FY88, a trend supporting devolution's proponents.

Tannenwald then uses his estimates of fiscal comfort and fiscal capacity to evaluate the degree of diversity among states in preferences for the level of state and local public spending. He reasons that, in the absence of significant diversity, the intensity with which states exploit their taxable resources should vary inversely with fiscal comfort. This intensity—referred to as tax effort—is equal to actual state and local taxes collected as a percentage of tax capacity. Fiscally comfortable states should be able to achieve a given level of per capita state and local spending with less tax effort than fiscally stressed states. In fact, Tannenwald finds that tax effort and fiscal comfort are uncorrelated, implying that as a whole fiscally stressed states have a preference for relatively low levels of spending. Both sides of the devolution debate can find encouragement in this finding. Proponents of devolution can argue that, with evidence of diversity in preferences, states should be free to vary their spending levels without federal interference. Opponents can argue that, without federal intervention, residents of fiscally stressed states with an acute need for public services would suffer at the hands of their state's tight-fisted majority.



Tannenwald concludes that devolution would bring about a shrinkage in government, not merely a realignment of fiscal responsibilities between levels of government. Fiscally stressed states would experience significant difficulty in assuming devolved functions. If states and municipalities are to play a more prominent role in the nation's federal system, they will probably need new sources of revenue. Whatever level of intergovernmental aid the federal government decides to provide, it should consider distributing it among the states in a more fiscally equalizing manner than it does currently.

### *Panelists' Comments*

The panelists commented not only on Tannenwald's paper but on Kincaid's paper and earlier discussion.

According to **John Donahue**, the shift in fiscal responsibilities from the federal government to the states, other than in the area of social welfare, has been extensive and will probably continue. He noted that from 1980 to 1996 the federal government's domestic spending (net of interest payments and transfers to persons) as a percentage of Gross Domestic Product fell from 4.5 percent to 1.7 percent, while the comparable percentage for state and local spending net of outlays funded by federal aid rose from 8.5 percent to 10.5 percent. He attributed these shifts primarily to federal budget constraints and a decline in public confidence in the federal government (relative to public confidence in other levels).

Like Tannenwald, he doubted that state and local expansion will offset federal shrinkage because of the intensive competitive economic pressures generated by increased business mobility. As evidence, Donahue noted the general shift of state governments away from personal income and business taxation toward sales taxation. As a result, he concluded, devolution will have "weak, ambiguous, and sometimes negative effects on the quality of government." As a general intergovernmental strategy, Donahue advocates a "Fund nationally, act locally" approach, in which the federal government continues to supply a significant level of fiscal assistance to the states, but state and local governments enjoy considerable discretion in designing and implementing programs. Like Ellwood, he felt that the proper mix of fiscal and implementational responsibility is difficult to pinpoint and varies from program to program.

With respect to the academic debate concerning federalism, Donahue distinguished two traditions.

The analytic tradition, exemplified by Tannenwald's paper, attempts to determine which level of government should do what by applying such normative economic principles as economies of scale and scope, externalities, and allocative efficiency. By contrast, adherents to the constitutional approach, such as Kincaid, maintain that, according to the Constitution,

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*McGovern was confident that state governments have the creativity, independence, and expertise to respond effectively under any devolutionary scenario.*

*Sawhill noted that the substitution of block grants for matching grants will sever the relationship between state welfare spending and federal aid received and will accentuate interstate disparities.*

*Only now, according to Shannon, are we moving away from "lopsided" federalism toward a system in which each level of government does what it does best.*

*Ladd raised the issue of whether local governments are likely to suffer the most fiscal stress in scenarios entailing more extensive devolution.*

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the proper scope of federal action is "quite tightly bounded." Like it or not, the nation has strayed far from the arrangements provided for by the highest law of the land.

**Patricia McGovern** asserted that much of the academic debate of devolution is irrelevant to the actual policymaking process. Drawing on her experi-

ence as a Massachusetts state senator, she advised participants that politicians sense the public's "disconnect" at the federal level and their desire to do things "closer to home." She believed that, because these feelings are widespread and deep, devolution, although slow-paced, will continue to progress. She was confident that state governments have the creativity, independence, and expertise to respond effectively under any devolutionary scenario.

*Should* the states pick up where the federal government leaves off? McGovern was skeptical. States should think carefully about which programs should be kept and which discarded. Some federal programs have become so complicated and wasteful that perhaps the states should just let them die.

**Isabel Sawhill** asserted that the two most significant recent changes in U.S. intergovernmental relations have been the enactment of a long-term plan for eventual reduction in federal aid to state and local governments and the substitution of block grants for matching grants. The potentially adverse ramifications of aid reduction have yet to surface because the strong economy has shrunk welfare caseloads and TANF offers states generous short-term increases in assistance relative to what they would receive under the old AFDC program. However, states would probably lower their levels of welfare benefits if the economy fell into recession, the incidence of single-parent families and poverty among children continued to rise, and the long-run caps on federal discretionary spending began to "bite." The substitution of block grants for matching grants will accentuate likely future reductions in welfare spending by severing the relationship between the amount a state spends and the amount of federal aid it receives. Moreover, this substitution will accentuate interstate disparities in welfare because under AFDC, matching rates were inversely proportional to a state's per capita personal income.

Sawhill identified three underlying widely held beliefs revealed by the successes and failures of the devolutionary movement to date: 1) the era of big government should be ended; 2) decentralization is good; nevertheless 3) it is acceptable to embed moral principles in legislation. As an example of this third position, Sawhill noted the strict workfare requirements imposed by TANF and the underlying public concern about the demise of the work ethic and traditional family values.

**John Shannon** was perhaps the most upbeat of all the colloquium's presenters and discussants. He was not as pessimistic as Tannenwald about the future revenue prospects of state and local governments. He

found that the ratio of state and local general own-source revenue to Gross Domestic Product has risen steadily since the Korean War. By contrast, the comparable ratio for the federal government has trended downward over the same period. While acknowledging Tannenwald's point that state and local revenue growth during the 1980s was partially attributable to ephemeral interest income, Shannon asserted that nonetheless state and local governments have usually obtained the revenue they have needed, one way or another. State and local revenue growth has been all the more impressive because the ability of states and municipalities to tax high-income individuals is limited by the constraints of economic competition. Consequently, they are forced to obtain their revenue from taxes on the politically powerful middle class.

Shannon believed that the current movement to restore the balance between federal and state powers reflects the triumph of the analytic school of policy analysis alluded to by John Donahue. From 1789 to 1933, the U.S. system of intergovernmental relations was dominated by the states, much as the authors of the Constitution envisioned. The Great Depression, World War II, and the Cold War led to a centralization that tipped the balance to the opposite extreme. Only now, according to Shannon, are we moving away from "lopsided" federalism toward a system in which each level of government does what it does best. Like Ellwood, he warned that this sorting out of responsibilities will be a difficult task.

**Helen Ladd** (the moderator of this session) questioned whether the conclusions Tannenwald draws from his empirical analysis are warranted. If the state and local tax burden has fallen since the late 1970s, then perhaps states and municipalities have room to raise taxes if they need more revenue to take on devolved fiscal responsibilities. The damage that a state would do to its competitive tax standing might not be as serious as is often asserted, given that marginal tax rates applicable to high-income taxpayers have fallen in recent years. She urged researchers to analyze interstate differences in marginal tax rates to improve our understanding of the issue of interstate competition.

Ladd also called for a dynamic analysis of state and local fiscal capacity, as opposed to Tannenwald's static analysis, to provide insight into the ability of state and local governments to augment their fiscal resources in a recession. Ladd noted that states have been substituting relatively elastic revenue sources for inelastic sources. The result may be a greater-than-expected revenue shock, should the economy con-

tract. Ladd also raised the issue of whether local governments are likely to suffer the most fiscal stress in scenarios entailing more extensive devolution. She wondered whether states would try to shift devolved responsibilities to fiscally strapped local governments.

### III. General Discussion

As noted in the introduction to this overview, the only point generating a consensus among participants was that devolution's progress has been limited. Nevertheless, the general discussion following both the morning and afternoon presentations tended to coalesce around a few themes and issues.

Participants offered several reasons why, for better or for worse, the federal government will probably retain a strong role in our federal system.

- In certain policy areas, especially in taxation and regulation, interstate uniformity significantly enhances economic efficiency.
- A widespread public consensus has developed around certain federal programs, such as those devoted to crime control and promoting "workfare." The public would worry that the programs would be curtailed or lost if the federal government abandoned them.
- Many nonprofit organizations benefiting from current federal programs have become strong, powerful stakeholders favoring federal involvement.
- If devolution proceeded, state governments might fail to solve the intractable public policy problems that have been turned over to them. Some federal officials advocate devolution because they are tired of being blamed constantly for failing to solve many of the nation's ills. After the states become targets for similar criticism (so the argument goes), they will want the federal government to reassume control.
- A widespread belief that interstate competition inhibits redistribution will keep this function in the hands of the federal government.

Considerable discussion was devoted to the ability of state governments to fulfill the role envisioned in the devolutionary paradigm. In general, participants were less sanguine than Patricia McGovern or John Shannon about the capabilities of subnational governments. One participant argued that many states and municipalities were corrupt and inept. However, discussants disagreed on the implications of this as-

essment for the desirability of devolution. Some felt that wide interjurisdictional disparities in integrity and capability militate against geographic redistribution by the central government. People living in places with effective governments do not want to donate money to ineffective governments.

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One participant even questioned the need for state governments, in theory. Ultimately resources should flow from the central government to individuals, who should then bid in the marketplace for needed public goods and services. Intermediate-level governments exist only because of market failures inherent in the allocation of goods, generating externalities. In the analytical tradition described by Donahue, the geographic scope of intermediate jurisdictions should largely reflect the geographic pattern of externalities. The appropriate scope might be municipal, metropolitan, or regional, but not necessarily state.

This theory elicited a sharp response from adherents to the constitutional tradition. They pointed out that the Constitution affirms states' sovereignty and invests them with considerable authority, if only to protect citizens against centralized tyranny. On the other hand, it was pointed out that over the past 40 years the federal government has been the primary defender of liberty against state tyranny, one of the reasons underlying persistent support for federal activism. One participant noted that vouchers were the logical extension of the individualist theory described above. Fraud has plagued food stamps, the largest federal voucher program, an indication of the difficulty of implementing the "Fund nationally, act locally" doctrine.

Participants were divided over the merits and drawbacks of substituting block grants for matching grants. It was agreed that matching grants provide extra incentives to states to increase their spending. Some expressed a concern that the poor would suffer as a result of substitution of block grants for matching grants; others noted that spending on questionable programs could fall, too. Still other participants downplayed the significance of relaxing matching requirements, noting the ingenuity displayed by state governments in diverting federal matching funds from their intended use to a wide variety of purposes.

Several participants shared Helen Ladd's concern about the plight of local governments, should devolution progress. One warned that public education, primarily a local function, might be one of devolution's principal casualties. Another attendee noted the potential problems for New York City under welfare reform. The City has substantial responsibility for welfare, but TANF grants are given to the states. The State of New York, therefore, will determine how much TANF aid flows to the City.

Like the panelists, participants in the general discussion were ambivalent about the potentially deleterious effects of an intensification of interstate competition. One participant stated that, according to a study he had recently completed, the progressivity of a state's tax system exhibits no significant relationship with its rate of economic growth. Another participant, supporting a point made by Patricia McGovern, asserted that states are more impervious to changes in the federal fiscal environment than is generally thought. As evidence, he cited the fact that the elimination of the federal deductibility of state and local sales taxes did not lead states to rely less on this revenue source. One participant, noting that an average of only 3 percent of all households move from one state to another in any given year, questioned whether the American people were mobile enough to induce a "race to the bottom" among the states. Another, pointing out that 3 percent per year meant almost one-third in a decade, concluded that households' geographic mobility is substantial and, therefore, a significant source of competitive pressure on the states.