CHAPTER 4

Devolution

THE APPROPRIATE ROLE of the Federal Government in the U.S. economy has been a fundamental issue in this past year's debate over the budget. At issue are both the role for government in general and the division of responsibility between Federal and State governments. Chapter 1 of this *Report* addressed the question of the broader role of government. This chapter addresses how responsibilities might best be apportioned among the levels of government.

This Administration has dedicated itself from the outset to making government work better. Improving the efficiency of government requires a rational division of responsibility among Federal, State, and local entities. Today many support the notion that, in several policy areas, authority ought to be devolved from Federal agencies to States, localities, and individuals, to foster more creative and responsive solutions to the problems of diverse communities.

This Administration has been at the forefront of efforts to empower State and local governments by removing impediments to innovation and experimentation in public health, welfare, public housing, and environmental protection, and by reducing the proliferation of Federal unfunded mandates. But devolution of responsibilities must be done carefully, to ensure that national objectives are still met. In particular, a profound national interest lies in maintaining a social safety net, to guarantee at least a minimum standard of living for today's vulnerable families, and in promoting investment in education, research, and infrastructure, to ensure high living standards for tomorrow's families. The Federal Government also has a clear interest in ensuring that all of its expenditures, including those over which States and localities have some degree of control, are spent in the manner intended. Devolution that merely inserts an extra level of bureaucracy makes little sense: in many cases it is far better to empower individuals directly than to dispense funds to State and local governments on their behalf.

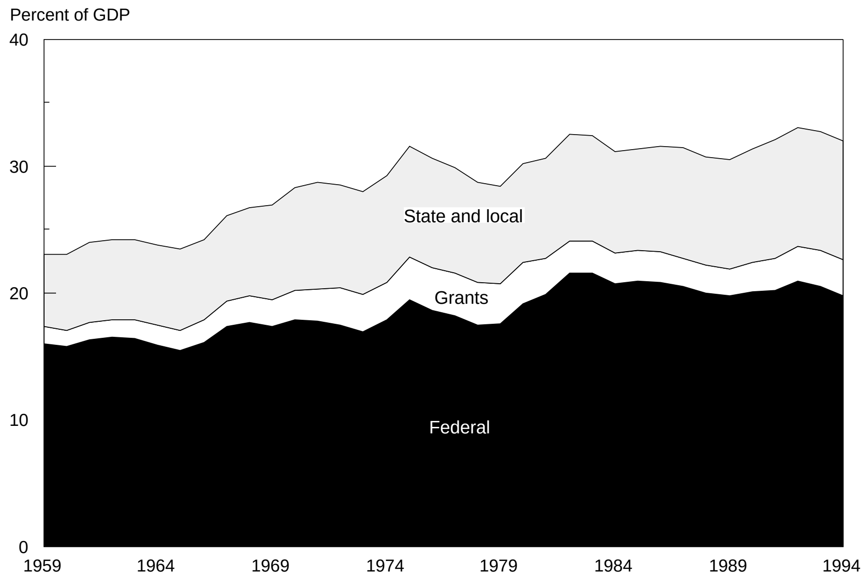
FACTS ON FEDERALISM

Despite major changes in our economy and in government programs over the past 25 years, the roles of the States and the Federal Government in the economy have remained relatively stable.

TRENDS OVER TIME

Total government expenditures—Federal, State, and local—have rose slowly as a share of gross domestic product (GDP) over the past three decades, from roughly 28 percent in the early 1960s to over 34 percent today (Chart 4–1).

Chart 4-1 **Expenditures by All Levels of Government**
Government expenditures in relation to the broader economy have climbed slowly over the past three decades.



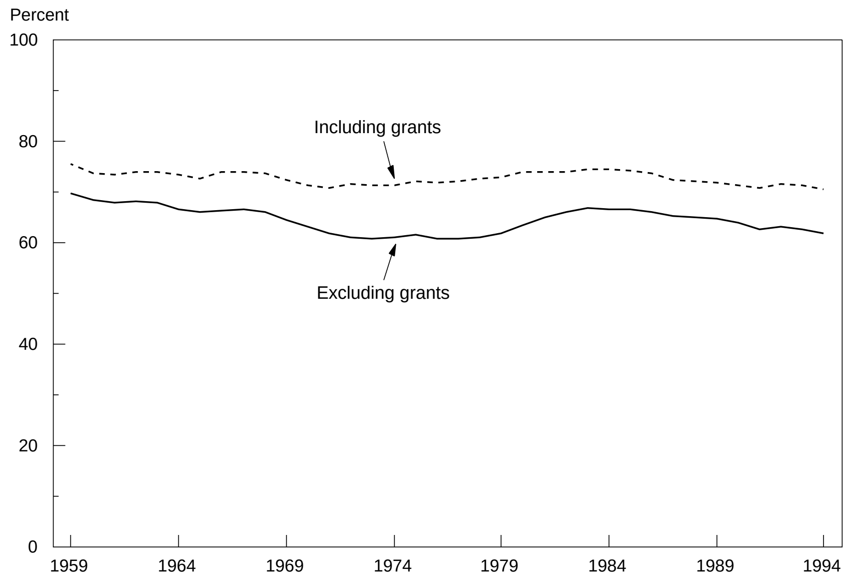
Note: Grants are Federal grants-in-aid to State and local governments.
Source: Department of Commerce.

The Federal Government accounts for the largest share of this spending. In 1993, if expenditures on State and local grants are included, the Federal Government accounted for 69 percent of total government spending. As Chart 4–2 shows, this share has not changed dramatically over the past 25 years: the Federal share of expenditures rose from 67 percent to 72 percent between 1970 and 1984, but has shrunk back to 69 percent since then.

COMPOSITION OF SPENDING

The Federal Government's major responsibilities include national defense, Social Security, and Medicare. States and localities have

Chart 4-2 **Federal Expenditures as a Share of Total Government Expenditures**
The Federal Government's share of all government expenditures has been relatively stable.



Source: Department of Commerce.

primary responsibility for public education, police and fire protection, and sewerage and sanitation. Highways are generally maintained by States and localities, but funds for new construction are largely provided by the Federal Government. Medicaid and some welfare programs are jointly financed by the Federal and State governments but administered by the States. Table 4–1 documents the current division of responsibility between the Federal Government and State and local government.

This division of responsibility has evolved gradually. Public roads and support for the needy, for example, are two areas where responsibility has traditionally rested with States and localities, but in both areas the Federal Government has assumed an increasingly important role. The Highway Revenue Act of 1956 created the Highway Trust Fund and dedicated the revenue received from taxes on diesel fuel and gasoline to this fund. These funds were used to build the interstate highway system, which has changed the face of America.

The growth of the Federal role in welfare arose in part out of the widely shared view that all children, no matter where they were born or who their parents were, should be entitled to certain basic standards of nutrition, housing, and health—common decency in a country as rich as the United States demanded no less. Although the acceptance of this national obligation was fundamentally a

TABLE 4–1.—*Composition of Government Spending, 1993*

Spending by function	Percent of non-interest expenditures	Percent of expenditures financed with Federal grants
Federal Government:		
National defense	26.6	
Social security	23.4	
Medicare	13.2	
Veterans benefits and services, welfare and social services, and housing subsidies	9.0	
Civilian and military retirement	4.9	
Other	22.9	
State and local government:		
Education	37.5	4.7
Medicaid	15.9	57.9
Welfare and social services	8.0	58.0
Highways	7.5	26.1
Police and fire protection	6.2	.8
Corrections	3.7	.7
Water, sewerage, and sanitation	1.5	15.5
Other	19.6	19.7

Note.—Data are on a national income and product accounts (NIPA) basis, and are as published in the Survey of Curent Business, September 1994. No later data are available.

In this table, Federal grants-in-aid to State and local governments are not included in Federal Government expenditures.

Source: Department of Commerce.

moral decision, it was supported by self-interest, in the recognition that the cost to society of *not* providing these minimal standards—in terms of lost wages, higher crime rates, and the like—could be very high.

THE RATIONALE FOR A FEDERAL ROLE

The reasons for the creation and expansion of these Federal programs provide considerable insight into the forces that drive the expanded Federal presence in American society. Yet a sensible allocation of responsibilities for governments in the future must be based on more than historical precedent.

Some might make the case that the Federal Government should do nothing other than national defense. After all, States and localities are better able to tailor their programs to meet the different needs and preferences of their residents, and competition among the States may enhance efficiency and innovation, just as it does in the private sector. But this view ignores the benefits of Federal action in a number of areas. The enumeration of powers given to the Federal Government under the Constitution suggests that our forefathers, even in the early infancy of the Republic, recognized the advantages of Federal involvement across a broad range of endeavors. The economic strength of the United States rests in part on our vast national market, fostered not only by the free flow of commerce without artificial trade barriers, but also by national standards and a national transportation and communications system.

Economists have sought to identify some general principles that would elucidate a "rational" division of responsibilities between levels of government. At least four categories of arguments justifying Federal action can be identified.

THE NEED FOR UNIFORMITY

Although diversity among State government programs is often desirable, in some cases the benefits of uniform government action across the States tip the scale toward Federal involvement. Uniformity of standards and regulations may improve efficiency. For example, uniform rules for interstate commerce preserve one of America's strengths: our large national market. Conflicting State regulation could fragment this market and impede producers' ability to take advantage of economies of scale. Likewise, uniformity in minimum safety net benefits would guarantee that all needy Americans, regardless of where they lived, enjoyed at least a certain level of well-being, and would avoid distorting and inefficient movements of households in response to differences in benefits.

DIRECT SPILLOVERS

Actions taken or not taken by States sometimes affect residents of other States. Residents of a State might be willing to tolerate pollution of their ground water, but the contaminated water could seep across State boundaries and harm residents of other States. States may also engage in activities that unintentionally benefit the residents of other States. For example, one State's successful innovation in its schools can lead the way for other States to reform their education systems, and States' efforts to prevent communicable diseases can benefit the health of nonresidents. Similarly, when States invest more in education, and incomes rise as a consequence, they confer a positive benefit on all taxpayers: the Federal Government reaps some of the rewards of the higher incomes in the form of higher Federal tax revenues. When the policies of one State affect the residents of others, for good or for ill, States may lack the right incentives to provide an appropriate level of public services, because the effects of policies on nonresidents may not factor strongly in their decisionmaking.

THE EFFECTS OF POLICY-INDUCED MOBILITY

The freedom of people and firms to move at will from State to State promotes competition among State governments. Although this competition can enhance the efficiency of government, it can also make it difficult for States to pursue certain worthwhile policies. For example, the fear of welfare-induced migration may cause States to reduce welfare benefits to a level below what they would otherwise provide. Similarly, State competition for jobs may limit the generosity of unemployment insurance programs.

INEQUALITY OF RESOURCES

States that are poorer than the average, or that are experiencing temporary downturns, are able to raise less revenue, yet have to spend more than other States to provide services for the needy. Clearly, only the Federal Government can transfer resources among the States. Not only does such redistribution help poorer States, but financial assistance from the Federal Government that increases during economic downturns can also help to stabilize regional economies. This assistance can be given through a number of channels: direct transfers of cash or in-kind benefits to lower income individuals, grants to lower income States or localities, matching grants to State or local programs for the needy, or direct provision of public services in poor communities. The role of the Federal Government in transferring resources to States and localities is more complicated, both in theory and in practice, than is often recognized, and will be discussed at greater length below.

These rationales for a Federal role are not mutually exclusive, and sometimes it is their interaction that makes a strong case for a Federal role in policy. For example, national safety standards, when desirable, might evolve on their own, were it not for spillovers. States could simply agree to a set of voluntary standards, and each State would weigh the benefits and costs of complying. In doing so, however, it would ignore the costs it might impose on others. A State might adopt more lax safety regulation for its cars, but then when its cars cross over into another State, the other State bears part of the costs. Federal action is therefore needed to ensure uniform national standards that avoid these spillover effects.

DEVOLUTION OF POLICYMAKING RESPONSIBILITY

Determining which level of government should be responsible for a particular program or activity is a delicate balancing act. It requires weighing the benefits of innovation, greater responsiveness, and competition that State and local control offers against the rationales for Federal involvement just outlined. Sometimes the answer is simple and obvious: either purely Federal control and financing or purely State control and financing. But many cases call for a sharing of responsibilities.

All government activities have three basic elements: policymaking, financing, and administration. These activities can be apportioned between the Federal Government and State and local governments in various ways. The current debate centers largely on how the policymaking role for programs that receive financing from the Federal government should be shared. At one extreme, the Federal Government could provide funds to States with no strings attached—States would not even be told on which programs to spend the money. Such an arrangement, used in other countries and in the past in the United States (where it was called "general revenue sharing"), is not currently under consideration. Instead the debate has focused on whether to convert existing programs into block grants (grants that can be used to fund programs in broad policy areas) and on how much discretion to allow States in determining how those grants should be used.

This Administration strongly supports enhancing the role of States and localities in policymaking. In many areas—job training, community development, and welfare, for example—enhanced flexibility for States and local communities is likely to yield better results. But it is important that this enhanced flexibility be provided in a way that protects the national interest. For all the reasons cited earlier, some Federal role in policy may need to be maintained. Furthermore, the Federal Government has a significant role in financing programs, it also should have some role in policy in order to ensure accountability.

ENSURING GOVERNMENT ACCOUNTABILITY

The Administration is committed to ensuring that government funds are spent wisely, whether the Federal Government or States and localities are doing the spending. A problem with revenue-sharing arrangements or pure block grants is that the level of government making the policy decisions is no longer the one responsible for financing the program. This separation of functions may increase the likelihood that taxpayer money is not well spent. Indeed, some evidence suggests that States spend money they receive from the Federal Government differently from funds they raise themselves—and restrictions on spending imposed by the Federal Government do not account for all of the difference. Thus, the availability of Federal highway money results in more spending on highways than States would otherwise undertake, even though, at the margin, most States pay 100 percent of each additional dollar of highway spending (Box 4–1). Evidently, State taxpayers are content to give government officials more discretion over funds coming from Washington than over funds contributed by their own State tax dollars.

This is a two-edged sword. On the one hand, it means that the Federal Government can influence the pattern of State spending more easily than it might otherwise: Federal money may not just

Box 4–1.—Federal Grants and the “Flypaper Effect”

The Federal Government provides substantial grants to States and localities—over $228 billion in 1995. Most of this grant money can be used for projects that these governments might otherwise fully fund themselves, and most do not require that the State or locality contribute any matching funds. Because these grants can simply serve to free up State and local government funds for other uses, they can be viewed as equivalent to pure transfers of cash from the Federal Government. From an economic perspective, then, one would expect States and localities to spend these grants in the same manner as they would any other increase in income. For example, States might allocate 5 to 10 cents of each grant dollar to increases in their spending, and the rest would simply be used to reduce State taxes.

Researchers have consistently found, however, that Federal grants have much larger effects on State and local government spending than this logic would suggest. Recent studies find that the actual increase is on the order of 40 to 65 cents on the dollar. This result has been dubbed the “flypaper effect”: the money sticks where it hits. Moreover, not only does State and local spending increase when Federal grants increase, but the money tends to remain in the program area for which the grant was intended: grants for education tend to increase education spending, grants for infrastructure tend to increase infrastructure spending, and so on. Some of the grant money is used to finance other areas of government and to finance tax cuts, but such “leakages” are much smaller than economic theory would predict.

substitute for State money, as many critics of block granting have feared. (And, as is discussed later in the chapter, it is precisely the Federal Government’s desire to influence patterns of State spending that justifies a Federal role at all.) On the other hand, if the substitution of Federal for local funding leads to less diligent monitoring by taxpayers, the money may not be well spent.

Federal actions can also impose costs on the States. And just as States may spend Federal money more readily than money raised through State taxes, so the Federal Government may spend State money more readily than funds raised through Federal taxes. Federal legislation that raises States’ costs—so-called unfunded mandates—has recently received considerable attention. Legislation passed in 1995 attempted to address some of the most important problems posed by unfunded mandates (Box 4–2).

Box 4–2.—The Unfunded Mandates Reform Act

The Unfunded Mandates Reform Act, enacted in early 1995, will restrict the ability of the Congress to impose costly mandates on States, localities, and tribal governments. This legislation requires the Congressional Budget Office (CBO) to analyze the costs of any proposed mandates on State and local governments. Mandates certified by the CBO as costing States and localities $50 million or more in any of the first 5 years after becoming effective are not permitted. However, majority votes in both the House and the Senate can waive this prohibition. The CBO also is required to estimate the cost of any mandate on private companies which exceeds $100 million in any year over this same 5-year period.

The unfunded mandates legislation was enacted to restore equilibrium to the relationships between Federal, State, and local governments. For too long, Washington has placed overly burdensome mandates on States and localities. The new law rectifies this imbalance but also permits mandates that are in the national interest. For example, some unfunded mandates may be designed to control cross-jurisdictional externalities. A State that dumps garbage in a river, polluting the shores of a neighboring State, causes an externality every bit as important as that generated by a private firm. The law provides a flexible way of addressing unfunded mandates: it requires the disclosure of relevant information, without being overly prescriptive. With a majority vote, the Federal Government could, for instance, still proscribe States from dumping garbage in ways that adversely affect neighboring States. To do so imposes costs on States, but these are costs that they should rightly bear.

The legislation also requires Federal agencies to assess the qualitative and quantitative costs and benefits of any proposed regulatory actions that would result in annual expenditures of $100 million or more by State, local, and tribal governments or the private sector before promulgating such actions. Agencies must ". . . [1] identify and consider a reasonable number of regulatory alternatives and [2] from those alternatives select the least costly, most cost-effective or least burdensome alternative that achieves the objectives of the proposed rule," or explain their decisions if a different action is adopted. Finally, the legislation requires the Advisory Commission on Intergovernmental Relations, an independent agency, to make recommendations on paring existing mandates.

DEVOLUTION AND THE PROVISION OF PUBLIC SERVICES

In many cases, government action can correct inefficiencies in the private market—so-called market failures—and so improve the overall allocation of resources. As discussed in Chapter 1, to correct market failures, government may need to provide certain goods directly (so-called public goods), adopt or enforce standards that apply to other goods (such as safety standards), or encourage, through subsidies or regulation, private firms to provide goods that would otherwise be underprovided (i.e., those with positive externalities). All of these activities can be viewed as providing public services.

State and local governments have many advantages in providing these public services. They can more easily address the differing needs and preferences of particular communities. For example, building codes should reflect local weather and geological conditions, and communities should be able to choose their own level of community services. Having a number of communities with different mixes of services (and of taxes to pay for them) improves overall efficiency, if people can choose to live in the jurisdiction that best meets their needs and desires.

Competition among localities can enhance this efficiency by making it easier for people to hold their local government accountable for the decisions it makes. For example, if a city, by operating efficiently, is able to maintain a high level of public services with relatively low taxes, residents of nearby cities may demand equally efficient government from their policymakers—and use the threat of relocation to the efficient city to make their demands resonate.

But the problems described above require some Federal role in the provision of many public services. Uniformity of regulations or of standards, such as safety standards, can improve the effectiveness and efficiency of certain policies. A uniform set of minimum water and air quality regulations ensures that all Americans, regardless of where they live, have clean air to breathe and water to drink. Cross-jurisdictional spillovers also can be important. Some types of public services, like national defense and subsidies to scientific research, need to be provided by the Federal Government because the spillovers from government action are so large. Public services and goods, like national defense, that can only be provided effectively at the national level are called *national public goods*. Those whose benefits accrue exclusively to residents of a particular locale are called *local public goods*.

Between purely local and purely national public goods are many intermediate cases: many public services create some spillovers, but still much of the benefit accrues within the community. Highways are a prominent example. Many highways are used primarily by residents of the State where the highway is located. But these highways also provide significant benefits to out-of-State residents who travel on them and who purchase goods that have been transported on them. If State residents had to pay for all the costs of building highways in their State, their choices regarding highway construction might take into account only the benefits they expect for themselves. Thus they would construct fewer roads with smaller capacity than would be socially desirable.

MATCHING GRANTS

One method used to solve this problem is the categorical matching grant, in which the Federal Government pays a fraction of the overall costs of the program. For example, the Federal Government could match additional State spending on a 1-to-1 basis, or on a 2-to-1 or 4-to-1 basis. Ideally, the match rate would be set so that the fraction of the total costs paid by the States equals the fraction of the total benefits that accrue to their residents. Under such a financial arrangement, the decision on the *level* of expenditures can be delegated to the States. Because the spillover effects are taken into account in the "price" States have to pay, they will set the level of expenditures at an efficient level.

In practice, however, a large share of Federal grants for public infrastructure, education, and social services is not in the form of matching grants, but rather in the form of categorical unmatched grants (grants that provide funds for particular purposes, such as education of the disabled or tuberculosis control, but do not require States or localities to put up any of their own money). Furthermore, while there are grant programs that do require States to spend their own funds in order to receive Federal money, many are in the form of capped matching grants, which place a ceiling on the total amount that the Federal Government will pay. From an economist's perspective, capped matching grants are much like categorical grants. Once the cap on Federal grants is reached, State and local governments bear the full cost of additional projects. And since, for many capped matching grant programs, States likely do spend more than the amount required to receive the maximum allowable Federal grant, the grants probably do little to change the incremental costs of projects, but simply allow States and localities to shift resources to other projects. Capped matching grants may thus insufficiently address the problem of underspending arising from cross-jurisdictional spillovers. Surprisingly, however, evidence indicates that categorical grants and capped matching grants do stimulate a significant amount of additional investment in the targeted activities (Box 4–1), although they also serve to free up State funds for other purposes. Open-ended matching grants, which would change the marginal cost to States, could have significantly greater effects on State spending decisions, because they would affect the prices faced by the States at the margin.

PUBLIC SERVICES AND DIFFERENCES IN LOCAL RESOURCES

One of the rationales cited above for a Federal role in provision of public goods is that some jurisdictions lack the resources to finance public services at a level deemed adequate by the Nation as a whole. But a lack of sufficient State resources to provide services does not necessarily imply that the Federal Government should provide those services instead. In principle, the Federal Government could, instead of providing grants for public services to poor States, provide income transfers to poor individuals. Just as individuals, not the government, should decide how their income is spent, so too individuals should decide for themselves about the level of consumption of local public goods.

If taxpayers closely monitored their policymakers, the level of public services would not depend on whether resources were transferred to State and local governments or directly to taxpayers, and the transfer of resources to the States would simply substitute for State governments levying taxes. But the evidence cited earlier suggests that the way money is distributed does matter. Direct transfers to individuals force State and local policymakers to justify their choices of public services.

This general principle has two exceptions. First, Americans believe that society has a special responsibility to children, regardless of the economic condition of their parents. Providing *services* that go directly to children, rather than providing cash to their parents, may be a more effective way of making sure that it is children who ultimately benefit. More generally, society may not care so much about inequality of income as about inequality in the consumption of certain goods, and so may prefer to provide these goods instead of cash. To the extent that these goods are public services—like health care, clean water, decent schools, good job opportunities, and safe places for children to play—Federal funding of such services for poor neighborhoods is warranted.

A second reason why it may be better for the Federal Government to provide direct financing for public services is to save on administrative costs. Indirect financing, through Federal transfers to citizens residing within the jurisdiction, involves two steps: disbursing funds to individuals and collecting the money once again at the State or community level. Because each step has its costs, direct transfers to State and local governments may save on overall transaction costs.

BETTER GOVERNMENT THROUGH COMMUNITY AND INDIVIDUAL EMPOWERMENT

Over time, a large number of Federal programs have evolved primarily to meet certain perceived needs that were not being adequately addressed at the State and local level. Although these programs direct attention and resources to real problems, in some cases they leave too little discretion to States and localities in allocating the funds, and Federal paperwork requirements lead States and localities to devote too large a share of their resources toward administrative costs. Furthermore, in some cases these funds could be more effective if they were used to empower *individuals*, by providing them the wherewithal and the information to make appropriate choices, rather than having government—Federal, State, or local—in the driver's seat.

This Administration has put forward a new approach to Federal grants:

- The Federal Government would provide States and local governments with greatly enhanced flexibility: funds from numerous programs would be consolidated, and regulations would be pared back.
- Accountability would be ensured not by restrictions on the use of funds but by performance measures. Programs that live up to their stated goals could receive more funding.
- Individuals benefiting from government programs would also be given as much discretion as possible to choose how those funds should be spent, reducing the possibility that they would be spent unwisely.

One example of this new approach is the Administration's proposed G.I. Bill for America's Workers (Box 4–3). Under the current Job Training Partnership Act, States are provided the funds to obtain training for dislocated workers. Under the Administration's proposal, funds would instead be dispensed directly to individuals, in the form of "skill grants" which they could use for tuition at private or public institutions. States and localities would create one-stop career development centers, which would provide individuals with the information necessary to make good choices about how to use their skill grants, would track participant earnings and job retention, and would work with businesses to help match newly trained workers with jobs. Allowing individuals to make informed choices about what skills to obtain and where to obtain them will ensure that only those institutions that provide high-quality, relevant training will survive.

The Administration has also encouraged legislative efforts, such as the proposed Local Empowerment and Flexibility Act, that would waive programmatic regulations for local communities that have a federally approved "Local Flexibility Plan" from certain Federal laws and regulations that impede their efforts to meet their plan. Similarly, as part of its overhaul of environmental regulation, the Administration has initiated Project XL, which gives responsible companies and other regulated parties the flexibility to replace the requirements of the current regulatory system with their own alternative strategies to achieve better bottom-line environmental results.

These efforts are similar to the project currently under way to revitalize distressed communities: The Empowerment Zone and Enterprise Community (EZ/EC) initiative provides block grants, tax subsidies, and regulatory flexibility to a number of designated communities that have formulated innovative strategic development plans. A major element of these plans, and of the EZ/EC initiative, is the inclusion of performance benchmarks, so that policymakers can learn what works and what does not.

In cases where local control has not done the job, a reconsideration of the intergovernmental partnership is in order. Public housing is one example of a program that needs major change (Box 4–4). In its plan to reorganize the Department of Housing and Urban Development (HUD), the Administration proposed providing greatly increased flexibility to well-performing housing agencies and overhauling those public housing agencies that are chronically troubled. In some cases, residents of severely distressed units will be provided with rental vouchers, which could be used to obtain private housing. After all, individuals have the best incentive to ensure that the dollars they receive for housing are well spent.

DEVOLUTION AND THE SAFETY NET

This country has reached a general consensus that providing a minimum level of subsistence for our most vulnerable citizens, regardless of where they live, is an essential government role. But because differences exist across States—in job opportunities, in family characteristics, and even in views on the appropriate level of support for the poor—States also have a role in providing and administering the safety net.

At the same time, safety net programs—programs that provide assistance to those meeting certain income or asset tests, such as Aid to Families with Dependent Children (AFDC) or Medicaid—present several problems that require some Federal role. One problem stems from the mobility of the population. For example, whenever one State chooses to expand its welfare program—by raising benefits or relaxing eligibility criteria—it may encourage poor people from other States to move in. As they do, the welfare program becomes more expensive, forcing the State either to reduce benefits or eligibility, raise taxes, or both. If the State raises taxes to pay

Box 4–3.—Rethinking Devolution: The Job Training Partnership Act

The history of the Job Training Partnership Act (JTPA) shows that simply shifting accountability and policy discretion to the States does not always improve performance. When enacted in 1982, JTPA was designed as a block grant to the States. JTPA reduced the role of the Federal Government, enhanced the role of the States, and retained a strong role for policymaking and initiative at the local level. However, the program became the subject of a growing number of reports. The General Accounting Office concluded that Federal dollars were being misused, while the Department of Labor's Office of the Inspector General found a serious lack of uniform control and guidance. JTPA's problems led the previous Administration and a coalition in Congress to reassert Federal accountability through a set of new rules and regulations enacted in 1992.

The 1992 legislation was an understandable response, but it made JTPA less flexible. The dilemma facing JTPA is one of the reasons why the present Administration has proposed a G.I. Bill for America's Workers. The new bill is based on a different model, one that replaces bureaucratic accountability with market-driven accountability based on individual empowerment, informed customer choice, and competition among providers. It establishes appropriate and complementary roles for all three levels of government—Federal, State, and local—in the design, implementation, and oversight of effective workforce development systems. It also provides for the close participation of businesses, labor organizations, and local elected officials to facilitate effective training and placement.

for the more expensive welfare program, residents with higher incomes may migrate to other States with lower taxes, again making it harder for the State to finance its established level of benefits. Accordingly, States and localities are discouraged from providing safety net benefits. This phenomenon—sometimes labeled the "race to the bottom"—limits the ability of States to offer their residents welfare benefits that are as generous as they would like in the absence of migration.

The severity of this problem depends on how prone people are to move in response to differences in the generosity of welfare benefits across States. The evidence is inconclusive. Some researchers have found that low-income households are indeed more likely to move from low-benefit to high-benefit States, whereas others have found no evidence of welfare-induced migration. Even when welfare bene-

Box 4–4. Rethinking Devolution: The Case of Public Housing

Since 1937 the Federal Government has invested some $90 billion in Federal housing. The legacy of that investment is mixed. Public housing does provide affordable shelter for approximately 1.3 million households. But many public housing projects are in abject disrepair.

One problem with the current system is the lack of accountability. The discipline of the real estate market seldom extends to public housing. Instead, local public housing agencies administer the public housing stock, subject to the rules and regulations of a distant Federal bureaucracy. Under the reorganization plan for the Department of Housing and Urban Development, well-performing public housing agencies will be given greater flexibility to improve their housing stock, through modernization or demolition, and to attract and retain a broader range of families by setting their own rules for admission to public housing.

But public housing agencies that exhibit persistent management deficiencies will be overhauled. And some projects, such as Chicago's infamous Cabrini-Green, will be demolished. In many cases, residents of demolished units will be given rental vouchers to live in better housing in the private market. Vouchers permit tenants to demand quality housing, and also make it easier for them to seek out gainful employment and jobs that maximize their income, regardless of where they are located. In other communities, a new form of public housing is being tested. Instead of mammoth apartment buildings, small-scale, townhouse-style housing is being constructed that would provide housing to residents with a wide range of incomes. Instead of purely public ownership and management, this housing will be owned and managed by partnerships between public entities and for-profit and non-profit developers.

fits are found to affect migration, the effects are generally small and slow to happen. But even if the effects are small on average, they could be substantial for neighboring States with population centers in close proximity. Furthermore, the studies examining the effects of differences in AFDC benefit levels on migration were all done within the context of the current AFDC program, which does impose some limits on the differences across States. For instance, although average benefit levels and eligibility requirements vary widely, States are required to provide coverage for all families meeting the State income and asset requirements. Interstate competition might be more of a problem if some States imposed rigid time limits on welfare recipiency or denied benefits to certain families while others did not.

Some State legislatures have taken the position that welfare-induced migration occurs and should be discouraged. As a result, under waivers granted by the previous Administration, California and Wisconsin were permitted to create "two-tier" welfare systems, in which new residents on AFDC could receive a different level of benefits than longer term residents of those States. However, some have questioned the legality of the two-tier system: California's waiver was voided by the Court of Appeals, and Wisconsin's is the subject of pending litigation.

Disparities in State resources—particularly in relation to the demands put upon them—provide another rationale for a Federal role. Poorer States feel that they cannot afford the same level of safety net protection that wealthier States can. As in the case of public services, this rationale does not necessarily imply that the Federal Government should finance the safety net programs. Just as the government can help provide public services in two ways, it also has two ways of helping individuals: directly, and indirectly by first giving it to States and communities. The direct method can save on transaction costs, and the resulting empowerment of individuals may enhance the efficiency of the funds. On the other hand, in cases where benefit recipients also require other government help—for example, in finding child care or getting job training—transfers to States or communities to fund such services may prove more effective.

Some States have historically been poorer than others, and these differences are not likely to change any time soon. But in addition to these persistent disparities, shorter term disparities arise from fluctuations in the business cycle. In the past, Federal funding has acted in part as a form of insurance against these shocks, with those States experiencing increases in their poverty population receiving greater Federal funding. To some extent States can insure themselves against *temporary* economic shocks if they maintain "rainy day" funds or if they permit themselves to borrow during hard times. However, political constraints that States face, such as balanced budget requirements, may reduce their ability to insure their safety net programs against adverse economic shocks.

THE FEDERAL ROLE IN THE SAFETY NET

All these considerations argue for a strong Federal role in safety net programs. And in fact, most safety net programs are either federally run or run jointly by the Federal and State governments. The Federal Government finances and makes policy decisions for Food Stamps and Supplemental Security Income (SSI, the cash assistance program for the low-income aged, blind, or disabled);

States do have an administrative role in both, however, and many States supplement SSI benefits with their own funds. Medicaid and AFDC—which along with Food Stamps are the largest programs for the nonelderly poor—are administered by the States, but States and the Federal Government share responsibility for funding and for policymaking. Other safety net programs, like housing subsidies and energy assistance, are provided by both the Federal Government and the States.

The Federal share of spending on safety net and social service programs increased with the introduction of Medicaid, SSI, and Food Stamps: from roughly 44 percent of the nationwide total in 1960 to over 70 percent in 1976, and has remained relatively stable since then.

Under current law the Federal Government provides open-ended matching grants to States for Medicaid and AFDC, with the Federal share of expenditures in 1995 varying, from 50 percent to 79 percent, according to State income. This open-ended matching reduces the States' marginal price of providing benefits, giving States an incentive to provide higher levels of benefits than they otherwise would. Federal matching also helps offset the problems of States offering lower benefits for fear of becoming welfare magnets or because of insufficient resources. Yet despite their significantly higher Federal matching rates, poorer States still tend to pay lower AFDC benefits (Table 4–2).

Although the theoretical arguments supporting a Federal role in welfare are strong, almost all observers, including welfare program participants themselves, agree that the welfare system is not working well. For too long, it has undermined the values of work and personal responsibility, not strengthened them.

Welfare policy presents a dilemma with which the Nation has been struggling for 60 years: providing adequate support to low-income families who fall upon hard times, and especially to their children, without generating dependency. Despite a broad consensus that the goal of welfare reform should be to move people from welfare to work, how best to accomplish this goal is still unclear.

In such uncertain circumstances, the potential value of innovation and experimentation is high, and States have shown increasing interest in trying new approaches. This Administration has used waivers effectively to allow States to engage in valuable experimentation. The Administration has made clear that it is open to States' proposals for alternative approaches to providing welfare support. Since January 1993 the Administration has approved welfare demonstration projects in 37 states. In an average month these demonstrations will cover more than 10 million people, or approximately 73 percent of all AFDC recipients.

TABLE 4–2.—*Typical Maximum AFDC Payments for a Family of Three*

[Dollars per month]

State	Three-person family typical maximum	State	Three-person family typical maximum
Alabama	164	Montana	375
Alaska	923	Nebraska	364
Arizona	347	Nevada	348
Arkansas	204	New Hampshire	550
California	607	New Jersey	424
Colorado	356	New Mexico	381
Connecticut	581	New York	577
Delaware	338	North Carolina	272
District of Columbia	420	North Dakota	431
Florida	303	Ohio	341
Georgia	280	Oklahoma	307
Hawaii	712	Oregon	460
Idaho	317	Pennsylvania	403
Illinois	377	Rhode Island	554
Indiana	288	South Carolina	200
Iowa	426	South Dakota	430
Kansas	403	Tennessee	185
Kentucky	262	Texas	188
Louisiana	190	Utah	426
Maine	418	Vermont	656
Maryland	373	Virgin Islands	240
Massachusetts	579	Virginia	291
Michigan	459	Washington	546
Minnesota	532	West Virginia	253
Mississippi	120	Wisconsin	517
Missouri	292	Wyoming	360

Note.—''Typical maximum'' is amount paid for basic needs to a family (including one adult) with no income or special needs in State's highest caseload area.

Source: Department of Health and Human Services.

In their reform efforts, many States have sought to reduce welfare dependency by beginning to experiment with time limits on families' welfare benefits. Others have sought to facilitate the movement from welfare to work by setting strict job search or work requirements, or by providing subsidies to private employers who hire welfare recipients. Many States require recipients to sign "personal employability plans" or "self-sufficiency agreements," with specific goals and deadlines. Failure to meet the deadlines can result in reduction or denial of benefits.

The Administration has reinforced these state welfare reform efforts with other policies that reward work over welfare. In 1993 the President's economic plan cut the taxes of 15 million working families through the earned income tax credit. The Administration has also proposed raising the minimum wage to ensure that, in combination with the Earned Income Tax Credit, a single parent with two children working full-time would escape poverty. The Administration has also strengthened collection of child support, enabling more single parents to support themselves through a combination of child support and work, instead of welfare.

MOVING FORWARD: WELFARE REFORM

The Administration has called for comprehensive, bipartisan welfare reform legislation to impose time limits, work requirements, and tough child support enforcement nationwide. Many in the Congress, believing that the waiver process is still too burdensome and uncertain, have proposed converting AFDC into a block grant program, providing States the flexibility to design their own approaches to welfare reform without the need for waivers from Washington, and putting an end to the open-ended entitlement funding structure.

Converting AFDC to a pure block grant could have a number of effects. First, under pure block grants, States would no longer receive additional funding for increases in benefits arising from economic downturns or population growth, making it more difficult to provide needed benefits. Second, under a block grant program, States would receive a fixed amount of money from the Federal Government, independent of the level of State expenditures. The elimination of the Federal matching program would mean that States would no longer receive extra Federal money when they raised benefits, nor lose Federal support when they cut benefits. This change in incentives (which would be greater for low-income States since they now have the most generous Federal match rates) might induce some States to cut their welfare spending.

On the other hand, converting AFDC to a block grant program would also mean that States that managed to get people off welfare and into jobs would realize all the resulting welfare savings. Under the current program most State job training expenditures are not matched, even though the Federal Government receives a large fraction of the resulting welfare savings.

In any reform of the welfare system, the Administration has consistently argued for crucial safeguards to promote work and responsibility and to protect children. It has insisted on a strong maintenance-of-effort requirement so that States keep their welfare spending at adequate levels, and sufficient resources to pay for child care so that recipients can leave welfare and go to work. Finally, the Administration has required that additional resources be made available to States during economic downturns. Under the current system, this occurs automatically through the Federal match, but an adequately financed contingency fund with an effective trigger mechanism could also accomplish this goal.

Because the current system frustrates taxpayers and recipients alike, the Administration plans to work with the Congress to enact a bipartisan welfare reform bill. As part of its 7-year balanced budget proposal, the Administration has proposed repealing the AFDC program and replacing it with a new Federal program with strict time limits on welfare benefits. The new program would require parents to go to work after 2 years or lose their benefits; after 5 years benefits would end unconditionally. States would enjoy new flexibility to tailor their welfare systems to local conditions. At the same time, the plan would provide vouchers to protect children whose parents reach the time limit. Because the Federal government would continue to match State welfare spending, States would be protected in the event of economic downturns or caseload growth.

MOVING FORWARD: MEDICAID

This Administration has insisted upon maintaining the Federal entitlement to Medicaid, for two main reasons. First, this Administration believes that all Americans should be guaranteed access to quality medical care, regardless of income or State of residence. Second, the Medicaid program is not performing badly: it needs reform, not repeal. Although overall Medicaid expenditures have been increasing at a rapid rate, part of this increase is attributable to legislated increases in the eligible population.

This Administration's insistence upon maintaining the guarantee of health care coverage for poor families in no way contradicts its commitment to flexibility, innovation, and experimentation. The President's plan expands State flexibility in administering Medicaid programs, but maintains protection for beneficiaries and for States facing population growth or economic downturns. To this end, the Administration is committed to working in partnership with the States to test new approaches to Medicaid through the waiver process. The Administration shares States' interest in developing innovative delivery systems, improving quality of care, and expanding coverage to uninsured Americans. To date, the Administration has approved 12 comprehensive health care reform demonstrations. These waivers have allowed States to greatly increase their use of managed care, to subsidize health insurance for employed but uninsured workers, and to expand Medicaid eligibility by eliminating asset tests and increasing income limits. Furthermore, the Administration has granted 14 States Medicaid waivers as part of larger welfare reform projects. These waivers enable States to continue providing essential health care services while encouraging independence from welfare. The Administration's 7-year budget plan would give States further flexibility to modify their programs. In particular, it would no longer require States to obtain a waiver in order to expand coverage to any person whose income is at or below 150 percent of the poverty line, to use managed care plans to provide health insurance to their Medicaid population, or to move people from nursing homes to home- and community-based settings. The plan also repeals the Boren Amendment, thus allowing States greater flexibility in establishing their provider payment rates.

THE CHALLENGES OF DEVOLUTION

This Administration is committed to making government more efficient and effective. Designing government programs so that activities are performed at the appropriate government level—Federal, State, or local—is one of the most difficult challenges associated with this task. Although in many areas the answers are clear—national defense is a Federal responsibility, whereas sewage treatment and water supply are local responsibilities—in many other areas the advantages of Federal responsibility must be balanced against the advantages of State and local responsibility. Federal grants to fund certain public services can reduce the problems of spillovers, but if the sense of accountability for Federal funds is different from that for funds raised through State or local taxes, Federal grants may be spent unwisely. Restrictions on the use of Federal funds may reduce this problem, but they may also impose significant administrative burdens and severely limit State innovation.

One approach to solving this problem is to ensure accountability through results-oriented measures, rather than through conventional rules and regulations. A results-oriented approach allows States much more flexibility without severely hampering efficiency. The Administration has proposed using this approach in housing, job training, the environment, welfare, and numerous other policy areas. Subjecting government expenditures to this discipline is likely to be the best way to improve government efficiency. Furthermore, when possible, government should use the private market directly. For example, individuals can be provided housing vouchers that permit them to live wherever they choose, and those in need of job training can receive funds to pay for training at the institution of their choice. In this way, individuals are provided the wherewithal to choose what is best for them, and only those providers that bring desirable services to market at the lowest cost—whether it be rental housing or job training—will survive.

States must also be provided with greater flexibility where no consensus has emerged on how to accomplish the goal. In these cases, experimentation and innovation by the States could prove invaluable. But this enhanced flexibility must be provided in a way that protects the national interest and advances the objectives of the programs. What is appropriate in one program may not be appropriate in another. In some cases the solution may entail Federal regulation as a "default option," with wide latitude for waivers to allow for State and local adaptation. In other cases, block grants with little Federal policy involvement may be called for.

Devising policies that ensure accountability and that protect the national interest, while also allowing for flexibility, adaptability, and innovation at the State, local, and individual levels is a great challenge. What worked in the past may no longer work today. Carefully balancing the advantages and disadvantages to find the right mix of policies is vital if government is to work at its best.