THE NEW FEDERALISM: AN ECONOMIST'S VIEW

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> *Measures adopted to produce greater equality are, however, exceedingly unsuitable for local authorities. The smaller the locality the more capricious and ineffectual are likely to be any efforts it may make to carry out such a policy. It seems clearly desirable that all such measures should be applied to the largest possible area, and that subordinate authorities should be left to act, like the individual, from motives of self-interest.*
>
> Edwin Cannan (1896)

> *Financial assistance to the poor is a legitimate responsibility of States and localities.*
>
> President Reagan (1982)

In his State of the Union address, President Reagan identified the basic premise of the New Federalism: "During the past 20 years, what had been a classic division of functions between the Federal Government and the States and localities has become a confused mess. Traditional understandings about the roles of each level of government have been violated." The source of the problem has been the intrusion of the federal government into many state and local matters with a consequent blurring of the responsibilities for providing various public services. Such sharing of functions "results in neither the Federal or other levels of government being respon-

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sible." In response, the President proposed "to clean up this mess" and to initiate "a major effort to restore American Federalism."

A determination of the proper structure of the federal system requires a coherent view of the appropriate roles of different levels of government. I shall turn first in this paper to the general issue of the assignment of functions in a federal system and subsequently to a description of the administration's proposals and an analysis of their likely effects on the functioning of state and local (and particularly urban) governments. I should emphasize at the outset that the analysis involves both positive and normative elements: At certain points, I seek *solely* to describe or predict the consequences of various components of the New Federalism proposals, while at other junctures I attempt to pass judgment on these prospects based on a prescriptive model of fiscal federalism.

The Division of Functions Among Levels of Government

Like the President, I have never been very comfortable with the popular "marble-cake" perspective on federal forms of government, which sees the functions of the public sector cutting across the layers of government in largely unpredictable and unsystematic ways. This view is neither very helpful in setting forth prescriptions for the vertical structuring of the government sector nor, I believe, fully satisfactory in describing its operation. Admittedly, the division of functions among levels of government is not subject to a precise and unchanging definition. But we can, from an economic perspective at least, propose some general guidelines that possess both normative and positive significance.

The standard textbook in public finance posits three economic functions for the public sector as a whole:

(1) The macroeconomic stabilization function, consisting of the use of various policies to stabilize the economy at high levels of employment with reasonable price stability;

(2) The distribution function of amending the market-determined distribution of income and wealth to one which better satisfies our objectives of social equity (particularly of providing adequate assistance to the poor);

(3) The allocation function, which entails the provision of certain goods and services (like national defense and a system of courts) that for various reasons would not be forthcoming at appropriate levels from the private sector of the economy.

The peculiarly federal problem in this framework is the proper assignment of these functions to different levels of government.[1] Although there exists considerable controversy over the proper conduct of macroeconomic stabilization policy, there is general recognition that the responsibility for this first function must rest with the central government. Monetary control must be exercised at the central level; likewise, there is little potential for decentralized levels of government to use their fiscal instruments of spending and taxation to smooth explicitly cyclical fluctuations in levels of output and employment. Cyclical swings in economic activity are generally national in scope, and only the federal government has the policy tools to deal with them.

Likewise, there are serious constraints on decentralized levels of government in the pursuit of income redistribution. The high degree of mobility within national borders implies that one jurisdiction cannot tax a certain group significantly more heavily than elsewhere without creating incentives to move. A city, for example, that undertakes an aggressive program of taxation to provide generous support for the poor exposes itself to an influx of low-income households to take advantage of this support and an exodus of the well-to-do to escape relatively high tax bills. In short, mobility within a federal system imposes real constraints on the scope for decentralized redistributive policies. A community may wish collectively to establish what it sees as adequate support for its low-income residents, but be unable to do so because of the prospective movement of economic units that such a program would encourage. In this way, mobility may effectively prevent a community from doing what its members want to do.

At the same time, I don't wish to overstate the case. There is obviously some potential for modest redistributive programs. Moreover, as the size of the jurisdiction increases, the scope for assistance to the poor tends to expand; states obviously have greater possibilities for such policies than do individual municipalities. Edwin Cannan's position (noted at the outset of the paper and based on British experience with the locally administrated Poor Laws) may, perhaps, be too strong. Yet the point remains that the scope for decentralized programs for support of the poor is circumscribed. Even where the costs of mobility are, in fact, sufficiently high to allow significant income transfers, the *perceptions* of state and local policymakers as to possible detrimental results can be sufficient to rule out their

[1]For a more detailed treatment of the assignment issue, see Wallace Oates, *Fiscal Federalism* (New York: Harcourt Brace Jovanovich, 1972), chap. 1.

adoption. Simply the threat of business and higher-income residents relocating (or not entering the jurisdiction in the first place) in response to relatively high levels of taxation exercises a sobering restraint on tax policy. State and local governments are acutely aware of the problem of tax competition.

In addition to this constraint on decentralized income redistribution, there is a second kind of economic argument for a basic central role in the funding of income-maintenance programs. This argument is based on the presumed concern of individuals with the alleviation of poverty in all parts of the nation. In the economist's jargon, assistance to the poor possesses some of the properties of a "public good" in that such assistance in one state confers not only benefits directly to the recipients themselves, but also contributes to the well-being of the non-poor across all states.[2] From this perspective, support from the central government becomes the instrument through which the national concern with poverty expresses itself in the income-maintenance programs in the individual states.

Finally, on purely equity grounds, one can contend that a "fair" resolution of the poverty problem requires central-government participation. Poverty is, in a fundamental sense, a national problem; its level and geographical pattern are inextricably interwoven with a diverse set of national economic and social policies. Moreover, the poor are unevenly distributed across the nation; in 1975, for example, the incidence of poverty in several southern states was more than twice that in states like Massachusetts and Minnesota. And it is precisely those states with the highest incidence of poverty that have the least fiscal capacity or ability to provide for the needs of the poor. To place the responsibility for support of the poor with the states and localities implies widely divergent levels of assistance for low-income households across jurisdictions or substantially different tax burdens on the non-poor. In this way, it seems unfair to allow certain higher-income individuals to avoid their share of the burden of financing income-maintenance programs by locating in states or localities with a relatively low incidence of poverty. A fair system, in this view, requires central funding of assistance to the poor that spreads the burden evenly over the non-poor residents of the nation.

[2]For a rigorous formulation of this argument, see H. Hochman and J. Rodgers, "Pareto Optimal Redistribution," *American Economic Review* 59 (September 1969):542–57. In this formulation, the income levels of the poor enter directly into the utility functions of the non-poor; contributions to the poor by one individual (or one state) thus produce external benefits in that they increase the utility of the other non-poor. This creates the usual sorts of free-rider problems associated with the provision of a public good.

The raison d'être for decentralized government is found in the allocation function. For various services of primarily local interest, there is a compelling case for local provision in accordance with the tastes or preferences of local residents. As de Tocqueville observed over a century ago, "In great centralized nations the legislator is obliged to give a character of uniformity to the laws, which does not always suit the diversity of customs and of districts."[3] Decentralized provision of such services tailored to local preferences can significantly enhance well-being as compared with a "unitary" solution requiring uniform levels of services across all jurisdictions.[4] State and local governments are in a better position to respond to the specific needs of their constituencies for a wide range of services, including localized transport systems, refuse collection, police and fire protection, etc. At the same time, there are, of course, certain "public goods" that are national in character (national defense and foreign policy being the classic cases); for this class of goods and services, the central government must determine levels of provision.

The perspective that emerges from this economic approach to the structure of the federal system is one in which the central government assumes the primary responsibility for the stabilization and distribution functions and in which the allocation function is shared in such a way that different levels of government provide those services whose range of benefits and costs are confined to the residents of their respective jurisdictions. In this way, a federal system can succeed, in de Tocqueville's words, in "combining the different advantages which result from the magnitude and the littleness of nations."[5]

The New Federalism: The Reagan Proposals

With this economic perspective on fiscal federalism as background, I turn next to the specifics of the administration's program for the restructuring of the U.S. federal system. The Reagan effort to redefine and clarify the respective roles of the different levels of government is embodied in four proposals:

1. A "swap" of the federal role in the support of the Aid to Families with Dependent Children (AFDC) and Food Stamp Programs in

[3]Alexis de Tocqueville, *Democracy in America* (New York: Vintage Books, 1945), vol. I, p. 169.

[4]For an exercise in the measurement of these welfare gains, see D. Bradford and Oates, "Suburban Exploitation of Central Cities and Governmental Structure," in H. Hochman and G. Peterson, eds., *Redistribution Through Public Choice* (New York: Columbia University Press, 1974), pp. 43–92.

[5]De Tocqueville, p. 168.

exchange for full federal assumption of the costs and administrative responsibility for Medicaid (which provides health care for low-income households). All of these programs are currently shared by the federal government and the states on a matching basis, with the federal share ranging from 50 to 77 percent.

2. A "turnback" to the states and localities of a variety of existing federal programs in the areas of education and training, social services, transportation, and community development.

3. The consolidation into more broadly defined "block" grants of a large number of specific categorical grant programs. Proposed block grants include child welfare, training and employment, rental rehabilitation, welfare administration, vocational and adult education, education for the handicapped, and rehabilitative services.

4. The creation of a "Federalism trust fund" from which the federal government would earmark the revenues from certain excise taxes and the windfall profits tax on oil for use by the states. This fund will eventually be phased out and will disappear after 1991 leaving the states the option of imposing their own excises to replace these funds or, alternatively, of cutting their spending.

This set of proposals reflects the administration's contention that the federal government has intervened in matters in which it has no legitimate business. In particular, the evolution of an elaborate system of categorical grants (with existing federal grant programs in excess of 500 distinct entities) has produced an intergovernmental fiscal system of "bewildering complexity." It is the view of the President, as expressed in his State of the Union message, that "this massive Federal grant-making system has distorted State and local decisions and usurped State and local functions." The thrust of the New Federalism is thus a move toward devolution, a move to disengage the federal government from its involvement in a broad range of domestic programs. As Governor Babbitt of Arizona has stated, "Congress ought to be worrying about arms control and defense instead of potholes in the streets. We might just have both an increased chance of survival and better streets."

The Administration's View of Fiscal Federalism

On first examination of the administration's proposals against the backdrop of our economic guidelines for the assignment of functions, there is one striking discrepancy: the proposed shift to the state and local sector of full responsibility for AFDC and Food Stamps. In fact, it is hard to find any rationale for the proposed swap of AFDC and

Food Stamps for full funding of Medicaid. Assistance to the poor is one area where federal support seems essential. This has been recognized by economists and political scientists of both parties. Richard Nathan, former assistant director of OMB and a Republican who generally supports the movement toward decentralization and the use of block grants, argues:

> The best long-run answer is to have the policies for transfer payments made at the national level, with the Federal government providing equalized grant-in-aid payments to state governments which administer some of these payments. . . . [Unrestricted grants to states for welfare] would isolate the most controversial and vulnerable group of welfare recipients. It could result in competition by the states whereby some states would hold down benefits and tighten eligibility standards in ways that could eventually result in higher concentrations of the poor in the states with the most adequate welfare benefits. . . . The fact that people and jobs move in a free society is the underlying reason why the burden of financing welfare benefits should be shared on an equitable basis by the society as a whole.[6]

In short, this is one facet of the New Federalism that involves a fundamental misunderstanding of the appropriate roles of different levels of governments – a misunderstanding that may well undermine efforts to provide adequately for the poor. The likely response at the state and local level will be a scaling down of such assistance; Senator Moynihan, putting it more strongly, sees it as effectively "abolishing" AFDC. While the administration's dissatisfaction with the deficiencies of existing welfare programs is easy to understand, it is crucial to recognize at the same time that the appropriate response is reform of these programs at the *federal* level, not the abdication of federal responsibility for assistance to the nation's poor.[7] A far more sensible "swap" is the one suggested by the National Governor's Association and the National Council of State Legislatures: full state responsibility for roads, police, and schools in exchange for federal assumption of welfare.

[6]Claude E. Barfield, *Rethinking Federalism* (Washington, D.C.: American Enterprise Institute, 1981), p. 71.

[7]A case for decentralization of public assistance to the poor has been made on the political grounds that federal programs are subject to "irresistible pressures" for redistribution. State and local government responsibility for this function, so the argument goes, is essential to hold these programs in check. The thrust of this argument, however, appears to be undercut by recent experience: Real levels of federally supported welfare programs have declined substantially over the past decade. Measured in constant dollars, the average monthly AFDC benefit, for example, declined by 56 percent between 1969 and 1980. Ibid., pp.72–3.

The administration's case for clarification and decentralization of "allocative functions" rests on firmer ground. The uncoordinated evolution of categorical grant programs has resulted in an enormously complex and overlapping system of intergovernmental grants that is badly in need of reform. The legitimacy of each of these programs on economic grounds must rest on the existence of a compelling national interest that transcends the concerns of state and local decision-makers. Undoubtedly, many existing categorical grant programs could not pass this test. It is, however, beyond the scope of this paper to examine these programs case-by-case to determine which among them can satisfy this criterion. Instead, I shall turn more broadly to the administration's proposals for grant consolidation and turnback as the basic mechanisms for the transition to the New Federalism. I begin with some background on the design of intergovernmental grants-in-aid.

The Economics of Intergovernmental Grants[8]

From an economic perspective, a system of intergovernmental grants has three objectives:

1. The encouragement of those state and local activities (e.g., basic research) whose benefits extend beyond jurisdictional borders;

2. The "equalization of fiscal capacity" to permit each jurisdiction to provide satisfactory levels of key public services with a level of fiscal effort that is not discernibly greater than that in other jurisdictions;

3. The establishment of a more efficient and equitable tax system for the public sector as a whole through some degree of revenue sharing (which effectively substitutes federal tax revenues for those from more distorting and regressive state-local forms of taxation).

It is important to recognize that these goals require quite different types of grants. To encourage certain programs with benefits on a national scale, the federal granting authority must adopt specific categorical grants that are carefully targeted on the individual activity. This calls typically for some form of matching grant that reduces the cost of the program to the recipient and thereby creates an incentive for its expansion. In contrast, equalizing grants and revenue sharing are not intended, in principle, to stimulate expenditures on specific programs (or in general). These objectives require unconditional or "lump-sum" grants that come to the recipient with no

[8]For a systematic analysis of the economic role of intergovernmental grants, see Oates, *Fiscal Federalism*, chap. 3.

strings attached. In summary, we should expect a properly designed system of intergovernmental grants to include matching-grant programs that would encourage increased outputs where substantial "spillover benefits" exist and unconditional grants with larger allocations directed to those states or localities with relatively small tax bases.

As noted earlier, the New Federalism places heavy reliance on another form of grant: block grants.[9] The administration proposes to consolidate many narrowly defined categorical grant programs into block grants under which the federal aid is authorized for a broad range of activities within which the recipient chooses how to use the funds. The chief characteristic of block grants is the budgetary discretion they allow the recipient; state and local agencies would identify problems, design programs, and allocate monies within the broadly defined functional areas of the block grants.

Political scientist Michael Reagan contends that block grants represent a "reasonable compromise between the values of categorical grants and shared revenues" and that "such grants may be a useful way of centralizing policy while decentralizing administration and permitting considerable local choice and decision making on particular programs."[10] This description is, however, a bit misleading. An economic perspective suggests that in terms of their effects, block grants are typically equivalent to revenue sharing. Because of the "fungibility" of funds, block grants are effectively lump-sum monies; in general, there are no real (or binding) constraints on their use. Suppose, for example, that someone gives me $100 per month to spend on food. It is a simple matter, if I want to use these funds for other purposes, to substitute the grant for $100 of my own income that I would otherwise have spent on food consumption. I can then use the $100 for whatever I please so that it is as if the funds came with no strings attached. Likewise, block grants to state and local governments can easily replace state-local revenues that would have been used for these programs; the grant funds are thus effectively available for other programs or for state-local tax relief.

The one qualification to this equivalence condition is that block grants can constrain state and local budgetary decisions in the case where the grant exceeds the total that the recipients would have chosen to spend in the broad functional area of the grant. While this may occasionally occur, it must surely be the exception rather than the rule, particularly if the recipient exercises any budgetary inge-

[9]Barfield presents a useful discussion of the recent experience with block grants.
[10]*The New Federalism* (New York: Oxford University Press, 1975), p. 63.

nuity. The basic point, then, is that block grants should be viewed as essentially equivalent to revenue sharing. This is not to say that they are undesirable, but only that they should be seen for what they are.

The Effects of the New Federalism on the State-Local Sector

The proposed grant consolidation and turnbacks of programs to the states and localities might be thought to stimulate budgetary activity at these levels as state-local agencies step in to fill the formerly federal role in providing various services. Closer study, I think, suggests otherwise. In particular, the evidence indicates that existing federal grant programs have induced a significant budgetary response at state and local levels; the restructuring of the grant system will, I shall argue, eliminate much of this stimulus with a substantial contractionary impact on state and local budgets.

First, the consolidation of categorical grant programs into block grants (even if the dollar level of grant monies were unchanged, which they are not) would lessen the stimulative impact of the federal grant system on state-local expenditure. Economic theory, supported by a number of empirical studies, finds that categorical, matching grants induce a significantly larger budgetary response than nonmatching, lump-sum aid.[11] Matching grants for specific programs not only provide funds but, at the same time, lower the unit cost or price of the supported services and limit opportunities for the funds to leak into state or local tax relief. The empirical estimates, moreover, suggest that the magnitude of this stimulative effect is quite large, much larger than the effect of unconditional grants on state and local spending. Thus, the shift in the structure of the intergovernmental grant system away from categorical to block grants should, in itself, reduce the expansionary impact of federal grants on state-local budgets.[12]

Second, the eventual turnback of programs, along with sources of funding, is likely to have a net contractionary effect. The argument

[11]For a useful survey of the empirical work on the budgetary effects of intergovernmental grants, see Edward M. Gramlich, "Intergovernmental Grants: A Review of the Empirical Literature," in Oates, ed., *The Political Economy of Fiscal Federalism* (Lexington, Mass.: Heath-Lexington, 1977), pp. 214–240.

[12]This reduction in the stimulative effect of grants will probably be cushioned somewhat in the transition period by the existing clientele for the categorical-grant programs. States and localities may find, in the short run, that they expend a larger fraction of block-grant monies than purely unconditional funds to meet the expectations of certain groups who previously received support under the categorical programs. See Barfield, chap. 4.

here is a bit more subtle and intriguing. Consider, for example, the elimination of a broad block grant for education accompanied by a reduction of the federal taxes that support this grant. The analysis from the preceding section suggests that we can regard the block grant monies as essentially unrestricted funds. The implication is that the loss of grant funds to a state or local jurisdiction is equivalent to a reduction in its revenue sharing allocation. At the same time, however, federal taxes are being cut so that (neglecting distributional effects) the jurisdiction's tax base is being increased by the same amount. The turnback exercise effectively takes unrestricted funds away with one hand and gives them back with the other.

From this perspective, one might conclude that turnbacks would have no net effect on state-local budgets. The implicit assumption here is that a dollar of unrestricted grant funds to a local jurisdiction should have the same effect on local spending as a dollar increase in private income. This seems reasonable, since in either case the disposable income of the community has increased by the same sum. It is not hard to demonstrate this equivalence formally; the theoretical literature shows that, subject to certain conditions, a lump-sum intergovernmental grant to a community is fully equivalent in *all* its effects to a federal tax cut directly to the individuals in the community.[13] This proposition is known among public-finance specialists as the "veil hypothesis" (i.e., an unconditional intergovernmental grant is a "veil" for a federal tax cut).

Empirical work has not, however, in this instance, confirmed the theory.[14] Instead, various studies of the effects of nonmatching aid find that unrestricted intergovernmental grants have a significantly more expansionary impact on state and local spending than do equivalent increases in private disposable incomes. This finding is known in the literature as the "flypaper effect" (i.e., money sticks where it hits). Moreover, it has been of considerable interest among public-finance scholars and has led to a lively exchange involving the development of competing theories and of further empirical work. Assuming that there is something to the flypaper effect, it follows that the budgetary impact of a reduction in block (unrestricted) grants accompanied dollar-for-dollar by federal tax cuts will not net out to zero; *the contractionary effect of the reduced grants will more than offset*

[13] D. Bradford and Oates, "The Analysis of Revenue Sharing in a New Approach to Collective Fiscal Decisions," *Quarterly Journal of Economics* 85 (August 1971): 416–39.

[14] See Gramlich.

the stimulus from increased private disposable income.[15] The implication of this proposition is that state and local governments will not increase their own levels of taxes sufficiently to offset fully the loss of grant revenues.

The bottom line is that both the consolidation of categorical grants into block grants and the turnback of grant programs and tax bases to state and local governments should work in the direction of a reduced stimulus to state-local expenditure. I should expect only a small fraction of the cutbacks in existing federal grant support to be replaced by increases in state and local taxation. Finally, I want to emphasize here that I am *not* arguing that this is necessarily an undesirable outcome. Whether state and local spending is, at present, excessive or deficient involves another set of issues. My intent here is purely descriptive: to predict the effect of the New Federalism programs (for ill or good) on the size of state-local budgets.

Urban Assistance: The Enterprise Zone Program

Although not specifically a part of the New Federalism, the recent administration proposal for the creation of enterprise zones to aid recovery of "the decaying areas of America's inner cities and rural towns" is relevant to intergovernmental fiscal efforts. The concept, which originated in Great Britain and has gained considerable support in the U.S. Congress, calls for the designation of specific zones for the application of special economic incentives to encourage new business investment.

The rationale for the zone approach to urban recovery has a number of facets. First, there is an economic efficiency argument involving neighborhood externalities. The argument envisions a continuing process of urban decay in which the closing and departure of firms and the associated loss of jobs and abandonment of buildings create a progressively more unfavorable environment for existing firms and any prospective new business enterprise. There is, in short, a kind of vicious circle that leads to a process of cumulative deterioration. To reverse this process requires special measures that endow the area with particular attractions for business in the expectation that the advent of new firms will eventually change the economic environment of the area and give the recovery a self-sustaining character. Second, there is an equity argument. The economic decay of center cities has left many of the urban poor without access to nearby jobs

[15]For a useful collection of studies exploring the flypaper effect and related issues, see P. Mieszkowski and W. Oakland, *Fiscal Federalism and Grants-in-Aid* (Washington, D.C.: The Urban Institute, 1979).

at appropriate skill levels. Enterprise zones, it is argued, can bring such jobs to depressed areas (and may well be cheaper than the income transfers needed to support the poor and unemployed).

On March 23, 1982, President Reagan presented the specifics of his Enterprise Zone Tax Act to Congress. In his words, "The idea is to create a productive, free-market environment in economically-depressed areas by reducing taxes, regulations and other government burdens on economic activity." The major elements of the proposed program are:

1. Tax reductions and credits including a three- or five-percent investment tax credit for capital investments in personal property in an enterprise zone, a 10-percent tax credit for the construction or rehabilitation of commercial, industrial, or rental housing structures within a zone, tax credits for employers for new hirings in a zone (with an increased credit if the new employees are "disadvantaged individuals" when hired), elimination of capital-gains taxes, and certain other tax breaks;
2. Regulatory relief (largely unspecified but *not* including suspension of the minimum wage) at federal, state, and local levels;
3. Improved local services;
4. Involvement in the programs of neighborhood organizations.

The proposal has very little to say about the last three components of the program. This is, in part, because much of the initiative is to come from state and local levels. "Consistent with the Administration's policy of Federalism," Reagan said, "the Federal Government will not dictate to state and local governments what they must contribute to the zones. The program is designed for creative and innovative experiments by state and local governments within the zone areas." State and local authorities would nominate zones in a competitive application process; the Secretary of HUD would in turn select from the applications up to 25 zones in each of three years. The life of these zones would be determined by the nominating government, with a maximum duration of the federal incentives of 20 years plus a four-year phase-out period.

Does the Enterprise Zone program possess the potential for an economic rejuvenation of decayed inner-city areas? In addressing this question, it is important to recognize the limited character of the proposed program. The measures will apply only to certain designated zones in those cities (or "rural towns") which make application for support and whose applications are selected by the Secretary of HUD. This is not a broad-based program directing resources to all depressed urban areas. As Representatives Jack Kemp (R-N.Y.) and

Robert Garcia (D-N.Y.) said of their version of the bill: "It is no panacea. Neither is it intended as a substitute for other urban proposals. It is simply a relatively low-cost attempt to try something new, at a time when we can't turn our backs on any new approaches to unemployment and economic decay."[16] So the question must be whether or not enterprise zones can succeed in their more modest objective of stimulating economic development in selected areas.

This is not an easy question to answer in part because the program in each zone would have a distinctive character determined by the respective state and local authorities. However, there are a number of reasons for believing the potential of enterprise zones to be quite limited.

1. The basic premise of the program is that the choice of location for business investment is reasonably responsive to fiscal incentives. There is not much evidence to support this proposition. A number of economists have examined locational patterns of new investment in relation to fiscal differentials and haven't been able to find much.[17] This work is far from conclusive, but it would be fair to say, I think, that tax differentials do not seem to exert a substantial impact on business location.[18]

2. To the extent that certain firms are on the "margin," they may be induced to locate in a new enterprise zone. However, a large fraction of such businesses are likely already to be committed to the city in question; consequently, they may decide to locate in the zone instead of elsewhere in the city. In such instances, the program will simply rearrange economic activity within the city with little overall impact.

3. Some critics have emphasized that the program fails to address the crucial issue of making available new capital for investment in the zones. One survey of small urban businesses found their most pressing concern to be the shortage of available business capital

[16]"Enterprise Zone Strategy Keys on Senate," *Baltimore Sun*, April 5, 1982, p. A1.

[17]For a good survey of this body of research, see Oakland, "Local Taxes and Intraurban Industrial Location: A Survey," in G. Break, ed., *Metropolitan Financing and Growth Management Policies: Principles and Practice* (Madison: University of Wisconsin Press, 1978), pp. 13–30.

[18]In contrast, there is evidence that suggests considerable mobility of households in response to differentials in local services and taxes. One strand of this evidence is the finding of "capitalization" – the demonstrated willingness of individuals to pay more to live in jurisdictions with better services and lower taxes. See, for example, Oates, "The Effects of Property Taxes and Local Public Spending on Property Values: An Empirical Study of Tax Capitalization and the Tiebout Hypothesis," *Journal of Political Economy* 77 (November-December 1969): 957–71. A second line of work has detected

manifested in high interest rates.[19] This, of course, is largely a matter of the existing state of the national economy.

4. What is perhaps more basic are the underlying obstacles to economic growth in depressed urban areas: crime, poor work habits, and a general air of demoralization. It seems unlikely that the proposed system of zones, relying heavily on tax credits, can convince large numbers of small businesses that new ventures in deteriorated urban neighborhoods are economically viable. This is not necessarily to condemn the proposed program, for it is obviously no simple matter to eradicate these fundamental obstacles to economic revitalization. It should, however, serve to temper our expectations.

5. Finally, it is worth noting the magnitude of the proposed spending on the program: $124 to $310 million in the first year. One professed objective of enterprise zones is to offset in part some of the effects of the Accelerated Cost Recovery System (ACRS), a part of the tax bill passed last summer, that apparently will benefit primarily the Sunbelt and suburbs. But the ACRS provisions are expected to cost the Treasury some $50 to $60 billion per year. It is hard to believe that a program the size of the administration's enterprise zones can go very far in offsetting the geographical impacts of ACRS or, more generally, in making a real dent in the problems faced by the older central cities.

Conclusion

It is time for a reexamination of the U.S. federal system with particular attention to the clarification of the responsibilities of the different levels of government and a long overdue restructuring of the intergovernmental grant system. The evolution of American federalism in recent decades has exhibited a distinctly helter-skelter character with a resulting maze of overlapping intergovernmental programs and blurring of functions. The administration's concern with a return to "first principles," involving a withdrawal of the federal government from excessive involvement in many basically state-local matters, is to be commended.

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the movement over time of households away from fiscally disadvantaged communities to those providing net fiscal benefits. See J. R. Aronson and E. Schwartz, "Financing Public Goods and the Distribution of Population in a System of Local Governments," *National Tax Journal* 26 (June 1973): 137–60.

[19]"Enterprise Zones Proposal is Criticized," *Wall Street Journal*, April 12, 1982, p. 25.

At the same time, the more one probes into the specifics of the New Federalism, the more one becomes aware of the troubling absence of any vision or outline of the proper structure of our federal system. The administration has not provided any real guidelines for making the distinction among federal, state, and local responsibilities. There is, for example, no apparent principle underlying the proposed swap of welfare programs for Medicaid. Moreover, the attempt to shift the basic responsibility for income-maintenance programs to the state and local levels is, I believe, fundamentally misguided and puts in jeopardy the prospects of the nation's poor.

A further manifestation of this absence of vision is evident in the administration's approach to the consolidation of grant programs. While such consolidation is surely justified in many instances, it is not to be pursued indiscriminately. Many categorical grant programs have a sound rationale and perform an important function in terms of encouraging state and local activity on matters in which there exists a broader national interest. In such cases, a narrow program, carefully targeted on a quite specific objective and providing aid conditional on its use to promote that objective, is appropriate. To push such programs under the umbrella of block grants effectively undermines their role. What is needed is a careful assessment, program-by-program, to determine which categorical grant programs are the proper subject for consolidation (or extinction) and which have a legitimate role to play in our intergovernmental system – not a headlong rush into the consolidation of all accessible categoricals.

A return to "first principles" may well be desirable, but we do need some sense of what those principles are.

PUBLIC POLICY AND THE LIMITS OF ECONOMIC ANALYSIS

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In any discussion of important public policy issues, an economic analysis is useful and welcome. It is difficult to assess the desirability of a particular policy proposal without some understanding of its likely effects. This is particularly true when considering government practices of taxing and spending, where the economic effects of such practices can be widespread, complicated, and counter-intuitive. Problems arise, however, when economists wittingly or unwittingly stray from their area of expertise to make moral judgments or recommendations about the effects they have identified.

For one thing, it is unclear how an economist is any more qualified to judge the desirability of whatever economic effects may occur than any other thoughtful citizen.[1] Moral judgments in this context are likely to be mistakenly imbued with the economist's credibility as an expert in economics. This danger would be aggravated by any failure to clearly separate economic analysis from moral or political judgment since even a thoughtful reader may have difficulty discerning the boundary between the two types of claims.

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[1]The enterprise of recommending certain legal rules on the basis of an economic analysis has been subject in recent years to a similar critique. See generally the "Symposium on Efficiency as a Legal Concern," *Hofstra Law Review* 8 (1980):485–770; and especially Mario J. Rizzo, "The Mirage of Efficiency," pp. 641–669. See also Ronald Dworkin, "Is Wealth a Value," *Journal of Legal Studies* 9 (1980):227; Richard S. Markovits, "Legal Analysis and the Economic Analysis of Allocational Efficiency," *Hofstra Law Review* 8 (1980):811; and Lawrence G. Sager, "Pareto Superiority, Consent, and Justice," p. 939.

The problem of the economist as public policy analyst is nowhere better illustrated than by Wallace Oates' paper, "The New Federalism: An Economist's View." Professor Oates' analysis of the "New Federalism" is dominated by two arguments. The first is that a transfer of responsibility for welfare programs from the federal government to the states will result in a net reduction of spending (and taxing) in this area. The second is that converting federal matching grants to block or unconditional grants will result in a net reduction of spending (and taxing) in the areas of the grants. This comment will concern the first of these observations.

Some Costs of the Status Quo

Professor Oates makes the argument that local governments are limited in their ability to provide relief to the poor by the perception, if not the reality, that those net taxpayers who must pay for these measures will move if taxes rise above a certain level. In other words, taxes are obtained from individuals by a threat of force to be spent in a way that they assumedly would not freely choose if their money was not expropriated—else why tax in the first place? Yet if at the same time individuals' rights to freely spend their income are denied, their right of free migration, that is, the right to move their legal residence from place to place, is recognized, individuals may effectively resist coercive taxation by leaving the relevant jurisdiction. And the knowledge that they might leave is itself enough to inhibit local taxing authorities.

Professor Oates also mentions the flip side of free migration: that poor people will migrate to where welfare payments are relatively high, thereby raising the levels of taxes needed to support the programs and exacerbating the flight of the net taxpayers. "In short, mobility within a federal system imposes real constraints on the scope for decentralized redistributive policies."[2] Federal taxation avoids this result to a considerable extent by extending the coercion uniformly to all net taxpayers in this country. Only by the sometimes difficult steps of renouncing one's citizenship and expatriating for at least a decade can one avoid this imposition. Such an analysis, however, which is as far as Professor Oates goes in his paper, does not go far enough.

First, a purely economic analysis of this "problem" created by free migration does not lead only to a "solution" of federal taxation. One might with equal logic oppose the right to freely migrate. If net

[2]Wallace E. Oates, "The New Federalism: An Economist's View," *Cato Journal* 2 (Fall 1982):475.

taxpayers want to avoid paying their "fair share" by moving, the government might simply not let them move or might permit local jurisdictions to continue to tax those that do move. This option is and should be rejected because it is morally reprehensible to deny individuals their right to choose where they will live. And yet denying these same persons the right to choose how their earnings are spent finds a much more receptive audience. I suggest that any preference for one solution over the other reflects more than an economic judgment.

Of course Professor Oates does not contend that local tax-based financing of welfare programs would cause their elimination. He recognizes that the exercise of a right to freely migrate is not cost-free. Indeed, in the case of a large business it is quite costly. Even individuals, with their emotional as well as financial ties to their homes and regions, are willing to withstand major impositions before they will vote with their feet.

Professor Oates' only claim is that local taxation will net a marginally lower amount of tax revenues and goes on to assert that this "may well undermine efforts to provide adequately for the poor."[3] He does not provide any definition of the term "adequate" nor evidence that, however defined, local spending will not in fact be adequate. He nevertheless concludes that "the attempt to shift the basic responsibility for income-maintenance programs [from the federal] to the state and local levels is, I believe, fundamentally misguided and puts in jeopardy the prospects of the nation's poor."[4]

Since he gives no indication of the degree to which spending in this area will be reduced if the proposed shift of responsibility takes place, his conclusion can only mean that *any* net reduction of spending in this area will not provide the level of aid to the poor that Oates thinks is appropriate and therefore desirable. It is not obvious, however, what the needs of the poor really are and what level of support they require. And, however "need" is defined, it is likely to vary, just as wages vary, according to regional differences in economic conditions, types of employment opportunities, and costs of living. Without some such analysis I fail to see how any decreased level of net expenditures can be labeled "inadequate" per se.

Such a conclusion must be supported by establishing on noneconomic grounds some goal or standard against which efforts at aiding the poor can be evaluated. For example, if the level of assistance that is thought to be desirable is some minimum amount in emergency

[3]Ibid., p. 479.
[4]Ibid., p. 488.

circumstances, and current levels of taxing and spending exceed this standard, then, by the economic reasoning presented here, local taxation with its constraint of free migration might be perfectly adequate to this task. Indeed, if this is the desired level of assistance, the negative implication of Oates' analysis is that it would be much harder to keep a federal scheme at this level.

It may be simply impossible to prevent a growth in welfare-type taxing and spending because of the ineluctable interest group pressures favoring increases and the relatively diffused interests of the net taxpayers who are the targets of the increased level of taxation. As with any person or group that receives most of its income from taxes, the interest of each welfare recipient is clearly defined. With respect to any given program, the interest of the taxpayer is relatively much less, since only a small fraction of a taxpayer's income contributes to any one program. Each welfare recipient or group, therefore, has a lot at stake in preserving and expanding "benefits," while each taxpayer has considerably less at stake in opposing these increases. A plausible argument can be made that where power is relatively centralized and therefore vulnerable to a concentrated lobbying effort, as it is on the federal level, this pressure becomes all the more irresistible. It is difficult to refute or confirm this effect, however, by assessing the rise or fall of benefits adjusted for inflation, as Oates suggests in a footnote,[5] since any such analysis must be counterfactual in nature.

Even without interest group pressures politicians have a multitude of incentives to consistently advocate increased spending in these areas that Oates might have considered. When all these factors are taken into account and a different set of funding goals is assumed, Oates' economic analysis could be seen as favorable to this aspect of the New Federalism proposals. State and local funding with the constraints Oates identifies would be preferable to federal programs which know only the most limited of constraints.

Oates' economic analysis only concerns differential expenditures among local taxing jurisdictions; consequently, his analysis says little about what aggregate spending levels would exist at the state and local level. His non-controversial contention is that significant disparities among jurisdictions will impose costs on those offering higher benefits, and this will provide a disincentive to increasing expenditures at a faster *rate* than other jurisdictions.

There is nothing in the argument that precludes a gradual or not so gradual rise in local spending nationwide provided no significant

[5]Ibid., p. 479, n.7.

relative disparities appear in the rates of increase across jurisdictions. If all increases in local taxes and spending are in rough proportion to existing taxing and spending levels, migration of either net taxpayers or net tax recipients will not occur as a result and will therefore provide little constraint on a general nationwide increase in such taxing and spending programs. While there may be reasons why such aggregate increases in spending are likely to be less extreme on the local level than at the federal, it would be wrong to question on the basis of Oates' analysis the possibility of continued increases of aggregate spending on local income-maintenance programs.

Surprisingly, what is overlooked in this economic analysis is the economic effects of massive federal welfare programs of the sort that now exist. If a cost-benefit calculus is possible in such matters (which is doubtful), the costs of the present approach must be weighed against its purported benefits. Oates, however, neither considers nor acknowledges the existence of these costs.

The costs of such programs might include: the effects of high taxes on the productivity of net taxpayers; the incentive effects of welfare payments on their recipients and how this affects the aggregate amount and relative distribution of wealth in society; and the effects on private charitable giving from the public's perception that its tax payments are "adequately" caring for the poor. (One would anticipate marginally lower private contributions, though this effect will be distorted by the tax-deductible nature of the charitable contributions.) It is also likely that the incentives created by targeting a particular group for increased support (e.g., single parents with children) will increase the number of persons in that group relative to the number that would exist without the subsidy.

Other harmful, noneconomic consequences of such programs might include: the subservient position recipients must necessarily assume vis-à-vis the bureaucrats distributing the funds, creating political as well as economic dependence; the adverse effect this has on individual self-image; and the effects on family structure and cohesiveness created by politically mandated restrictions on recipients such as restricting some forms of aid only to households where no adult male is present. Further, the social consequences of creating a class conflict between those that are net taxpayers and those that are net tax recipients cannot be ignored. Such a conflict breeds resentment, bigotry, and violence that threaten to unravel the fabric of a civilized and humane society, upon which altruistic instincts depend.

In evaluating the efficacy of government assistance programs, one could discuss what percentage of total expenditures actually reach the poor and whether any marginal differences exist between federal and local programs. One could then ask whether the primary beneficiaries of extensive tax-funded welfare programs are not the poor, but the white-collar bureaucrats paid handsomely for their "public service" and the farm sector paid handsomely for their surplus production.[6]

A cynic might argue that massive welfare programs are a way of mollifying those classes of citizens who are denied access to the traditional modes of economic advancement by protectionist government interventions in the labor market (such as minimum wages and compulsory unionism). If, to benefit some, the upward mobility of millions of other people at the lowest rungs of the economic ladder is impeded, a program of subsistence support may be required to prevent some of these persons from turning to violence. On this view, the real beneficiaries of such programs (in addition to the bureaucrats) are those who benefit from government protectionist intervention in the marketplace. This provides another potent constituency for income maintenance programs. While the beneficiaries of this protection might pay taxes, they obviously profit by the assistance programs at the expense of fellow taxpayers whose jobs and wage levels are responding to genuine market demand and who therefore need no such protection. This would also explain why a coalition that effectively supports the existence of such programs might break down when considering the level of funding that is desired, since members of the coalition may have different objectives to satisfy.

While Professor Oates mentions the effects of welfare disparities on local-level on intranational migration, he does not show how the higher amounts of federal welfare expenditures he favors affect *international* migration. It is quite clear that higher welfare payments would marginally increase the incentives for poor persons to enter the United States, just as higher taxes would be a disincentive for wealthier individuals who might otherwise have immigrated. To the extent that this would cause a greater burden to fall on net taxpayers, all the effects mentioned thus far would be seriously aggravated. We may today be witnessing the fruits of this sort of welfare policy.

But the situation is worse still. When relief was largely voluntary and therefore more strictly controlled and primarily for emergency use, there was no excuse for excluding those who were poor from

[6]This food is "surplus" in the sense that without the subsidized demand provided by food stamp programs, for example, overall prices would grow at a lower rate, encouraging capital to flow to other sectors of the economy. Or if supply is maintained, overall prices would decline, benefiting all, but benefiting most those that spend a higher proportion of their income on food – the poor.

immigrating, other than racism or the economically and morally invalid claim that immigrants would deprive current residents of their jobs. Today, while these motives are still with us, the most common reason advanced for closing the borders to the poor is the much more respectable and plausible claim that these immigrants will exploit welfare benefits (and, indeed, all public programs, such as public education). Such an argument is strengthened by a belief that once on welfare it is difficult for a recipient to be weaned from it.

As a consequence, in the name of helping "our" poor, pressure is generated to spend large sums of the taxpayer's money (with inconsistent effectiveness and with occasional brutality) to exclude "foreign" poor from the freedom and opportunities this country has to offer. A black market for illegal immigrants has therefore arisen where coercive immigration laws can be employed by black marketeers to genuinely exploit these people. Those immigrants and potential immigrants who may suffer the most from a fixed focus on the supposed "beneficiaries" of the current system are unknown, unknowable, and largely disenfranchised, but nonetheless very real. Who speaks (or lobbys) for them?

Professor Oates cannot be faulted for failing to analyze every factor I have mentioned. To do so would have required a much longer treatment than I am sure was possible. The criticism here, however, is that his economic conclusions have far outpaced his analysis. At most, he has identified one possible effect of the New Federalism proposals. A much more thorough economic inquiry is required before any other economic conclusions can be made.

The Need for a Moral Framework

More than an economic analysis must be offered, however, before one is justified in concluding that these proposals are "fundamentally misguided." What is required is a defensible moral framework. This Oates attempts to provide largely by assumption and by a novel application of the otherwise familiar "public goods" argument.

According to Oates, any significant decrease in tax-funded spending in this area would not sufficiently amend "the market-determined distribution of income and wealth to one which better satisfies our objectives of social equity (particularly of providing adequate assistance to the poor)."[7] He asserts that

> on purely equity grounds, one can contend that a "fair" resolution of the poverty problem requires central-government participation . . . . [I]t seems unfair to allow certain higher-income individuals to

[7]Oates, p. 474.

> avoid their share of the burden of financing income-maintenance by [re]locating in states or localities with a relatively low incidence of poverty. A fair system . . . requires central funding of assistance to the poor that spreads the burden evenly over the non-poor residents of the nation.[8]

Of course the moral justification for income redistribution, the concepts of "social equity" and "fairness," and even what constitutes "adequate" assistance to the poor are not within the domain of economics. As an economist, Professor Oates can only assume certain goals and analyze whether they are likely to be achieved by a given proposal. It is important that moral assumptions not be confused with economic analysis. Any extended discussion of these assumptions in an article that purports to be "an economist's view" runs this risk. After all, what other purpose does this discussion serve, once the effect of lower net spending is identified, except to reinforce his view, as an *economist,* that the New Federalism proposals are "fundamentally midguided?" The moral issues raised by this discussion are too important for this type of treatment.

A serious analysis of this question would have to explain how the supposed legal obligation of those who are better off to provide for those with less only applies within the arbitrary borders of this country. How does a net taxpayer of Nogales, Arizona, come to owe a legally enforceable debt to a lower-income resident of the South Bronx, but not to a possibly even poorer resident of Nogales, Mexico who will be imprisoned if he tries either to collect his "fair share" by force from his Arizona neighbors or, more likely, if he tries to enter this country without permission and sign up for this support? And on what basis do we resist the demands of Third-World governments to collect their "fair share" of the American taxpayers' earnings to distribute to their citizens, the majority of whom may be worse off than our poor?

One might believe, as I do, that those who help the less fortunate are doing good. But more than this is required to show that the less fortunate or well-intentioned third parties have a right to confiscate the property of others for this redistributive purpose. And, the issue of individual rights aside, the "morality" of aid to the poor that is not freely chosen but is coerced, or of those who advocate this coercion may also be questioned. By raising these issues I do not intend to argue the merits of the moral case for or against coerced assistance to the poor. I do so to illustrate the extent to which the discussion of

[8]Ibid., p. 476.

these sorts of moral assumptions cannot be avoided in any article that attempts to engage in this kind of public policy analysis.

Professor Oates offers another argument, which he labels "economic," to justify

> a basic central role [for the Federal government] in the funding of income-maintenance programs. This argument is based on the presumed concern of individuals with the alleviation of poverty in all parts of the nation. In economist's jargon, assistance to the poor possesses some of the properties of a "public good" in that such assistance in one state confers not only benefits directly to the recipients themselves, but also contributes to the well-being of the non-poor across all states. From this perspective, support from the central government becomes the instrument through which the national concern with poverty expresses itself in the income-maintenance programs in the individual states.[9]

Together with a footnote, this is the entire discussion of the matter, so it is difficult to know what to make of it. Taken at face value, such an argument proves too much or nothing at all. If individuals are concerned with the alleviation of poverty in all parts of the world, then by the same reasoning assistance to the poor worldwide is a "public good." Would this justify a central world government through which international concern with poverty (or any other worthy moral cause) can express itself? If so, one would expect that more than this would be required to establish the point.

Such an argument is tantamount to asserting that any and all charitable concerns are public goods. And it is doubtful that this kind of argument is at root an economic one. Further, the public-goods argument is primarily concerned with justifying coercion to collect payments from so-called free riders who enjoy benefits they have not paid for, and who thereby discourage others from assuming the costs of these "external benefits." Of course the fact that coercion may be required for the funding of a particular benefit does not morally justify the use of that coecion. To identify a "public good" is not to justify its forcible provision.

This is not the appropriate forum, however, to weigh the merits of this type of argument. Indeed, whatever the merits of this argument in general, it certainly is misapplied here. The public-goods analysis says only that coercion may be necessary, not that nationwide or worldwide coercion is preferable to state and local coercion. To support the assertion made here, Oates must do more than suggest that a "central" government must provide this "good;" he must demonstrate *which* central government must supply it. Ultimately the

[9]Ibid., p. 476.

principal deficiency of such an argument may be that determining who is a free rider enjoying what benefits at the expense of which others is a rather arbitrary and possibly impossible task with no relevant purpose.

Oates' analysis must then rest on his prior point: "A community may wish collectively to establish what it sees as adequate support for its low-income residents, but be unable to do so because of the prospective movement of economic units that such a program would encourage. In this way, mobility may effectively prevent a community from doing what its members want to do."[10] By this reasoning Oates appears to base his case for coercion on the consent of the "community," and suggests that an adequate level of support for the poor is what the community "collectively . . . sees as adequate."

Without the assumptions of a "public goods" analysis, however, such reasoning begs the issue since force would not be needed unless some members of the community did not want to spend their money in this way. To speak of the community as if it was a person with a will of its own that "wishes" things and makes judgments of "adequacy" is to imbue society with properties it does not possess and thereby to reduce the individual to nothing more than an "economic unit," which is precisely the term Oates employs without apology or embarassment.

Professor Oates would have done well to observe the same restraint here that he showed in his analysis of the effects of substituting block grants for categorical grants and the proposed turnback, in other areas, of grant programs and tax bases to state and local governments. There he took pains to emphasize that he was "*not* arguing that [any predicted reduction in net expenditures that may result] . . . is necessarily an undesirable outcome. Whether state and local spending is, at present, excessive or deficient involves another set of issues. My intent here is purely descriptive: to predict the effect of the New Federalism programs (for ill or good) on the size of state-local budgets."[11]

Conclusion

In this paper Professor Oates combines some limited economic conclusions with some ambitious and controversial moral assumptions to produce "an economist's view" of the New Federalism proposals. Even if this paper were confined to economic analysis or its

[10]Ibid., p. 475.
[11]Ibid., p. 484.

misleading title was changed, there would remain serious substantive difficulties of the sort I have described.

The only conclusions, if any, warranted by the economic analysis presented here are quite modest indeed, particularly if they are tempered by the multitude of economic effects that are left unmentioned and unanalyzed. It might turn out that if all the economic effects of federal welfare programs were identified, *no* economist would be capable of weighing whatever benefits are yielded by those programs against the costs imposed by them. The appropriate economist's view of the New Federalism, in the sense of approval or disapproval, might just be a shrug of the shoulders.