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Remaking Federalism to Remake the American Economy

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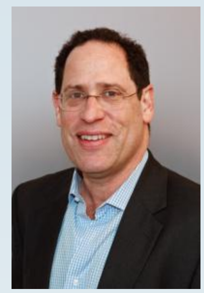

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The 2012 presidential election will be defined and dominated by the economic challenges that persist an incredible 33 months after the formal end of the Great Recession.

At the most basic level, the U.S. needs *more jobs*—12.1 million by one estimate—to recover the jobs lost during the downturn and keep pace with population growth and labor market dynamics. Beyond pure job growth, the U.S. needs *better jobs*, to grow wages and incomes for lower- and middle-class workers and reverse the troubling decades-long rise in inequality.

To achieve these twin goals, the U.S. needs to restructure the economy from one focused inward and characterized by excessive consumption and debt, to one globally engaged and driven by production and innovation. It must do so while contending with a new cadre of global competitors that aim to best the United States in the next industrial revolution and while leveraging the distinctive assets and advantages of different parts of the country, particularly the major cities and metropolitan areas that are the engines of national prosperity.

This is the tallest of economic orders and it is well beyond the scope of exclusive federal solutions, the traditional focus of presidential candidates in both political parties. Rather, the next President must look beyond Washington and enlist states and metropolitan areas as active co-partners in the restructuring of the national economy.

Remaking the economy, in essence, requires a remaking of federalism so that governments at all levels "collaborate to compete" and work closely with each other and the private and civic sectors to burnish American competitiveness in the new global economic order.

The time for remaking federalism could not be more propitious. With Washington mired in partisan gridlock, the states and metropolitan areas are once again playing their traditional roles as "laboratories of democracy" and centers of economic and policy innovation. An enormous opportunity exists for the next president to mobilize these federalist partners in a focused campaign for national economic renewal.

Given global competition, the next president should adopt a vision of collaborative federalism in which:

- the federal government *leads where it must* and sets a robust platform for productive and innovative growth via a few transformative investments and interventions;

- states and metropolitan areas *innovate where they should* to design and implement bottom-up economic strategies that fully align with their distinctive competitive assets and advantages; and

- a refreshed set of *federalist institutions* maximize results by accelerating the replication of innovations across the federal, state and metropolitan levels.

Current State: Obama Federalism and the Republican Response

Our federal republic diffuses power among different layers of government and across disparate sectors of society. States are the key constitutional partners, because they have broad powers over such market-shaping policy areas as infrastructure, innovation, energy, education and skills training. But other sub-national units, particularly major cities and metropolitan areas, are also critical, because they concentrate and agglomerate the assets that drive prosperity and share governance with economy-shaping actors in the corporate, civic, university and other spheres.

Against this backdrop, federalism has always been a living, ever-evolving practice, a dynamic rather than static arrangement.

Alice Rivlin charted three different phases of federalism in her path-breaking 1992 book *Reviving the American Dream*:

> From 1789 to about 1933, all levels of government were small by modern standards, but the states were clearly more important than the federal government, except possibly in time of war. Moreover, the two levels of government usually ran on separate tracks, each in control of its own set of activities. Scholars called the arrangement "*dual federalism*."
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> From the Great Depression through the 1970s, all levels of government expanded their activities, but power shifted to Washington. The federal government took on new responsibilities, and the distinction between federal and state roles faded. Scholars talked about "*cooperative federalism*."
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> By the beginning of the 1980s, the drive for centralization had peaked, and power began shifting back to state capitals. No new concept emerged of how responsibilities should be divided. The current era has been called a period of "*competitive federalism*," meaning the federal government and the states are competing with each other for leadership in domestic policy.

During each of these periods, federalism was at the center of national political discourse: analyzed, debated, labeled and litigated. President Roosevelt's grand battles with the Supreme Court in 1937 were essentially over federalist divisions of power. President Nixon used the term "New Federalism" to describe his ambitious mix of agency formation, program consolidation and management reforms. One of President Reagan's earliest acts was to create a Presidential Advisory Committee on Federalism that included governors, state legislators, mayors, county officials and members of the U.S. House and Senate.

As befits a former law professor, President Obama's approach to federalism is studied and multi-dimensional, defying simple categorization.

On one level, the severity of the economic crisis required aggressive federal action to, among other things, stimulate the economy, mitigate the fiscal impact of the Great Recession on states and localities, rescue the auto sector and provide a new regulatory regime for the financial industry. The first 18 months of the administration rivaled the New Deal in the economic scope and reach of federal actions.

Beyond the urgent economic response, however, the Obama approach to federalism has been situational, bold and directional in some areas of domestic policy, permissive and supportive in others.

The Race to the Top effort in elementary and secondary education shows President Obama at his most ambitious. States were asked to compete for a comparatively tiny amount of federal education resources. In exchange for these funds, states were required to undertake a series of significant and controversial undertakings: raise the caps on charter schools; use one of four prescribed strategies to improve the performance of low-achieving schools; and develop promotion standards for teachers based on student achievement.

Race to the Top is a clear example of how the carrot of federal spending can reinvent how states carry out a critical role of government. Tennessee, New York, Florida and Ohio won competitive grants in the range of $400 million to $700 million, awards that are a mere fraction of these state's annual education budgets, which range from $5.2 billion to $19.4 billion. This provides a new twist on the conventional notion of state innovation. As Marcia Howard, executive director of Federal Funds Information for States stated, "Rather than states being the laboratories of democracy [by] themselves, some of them will become the federal government's laboratories of democracy."

In other areas of domestic policy, President Obama has used a softer, more subtle touch.

On the programmatic front, President Obama has worked to enable states and localities to tackle structural challenges in integrated ways. The administration's Sustainable Communities Initiative—a partnership among the Department of Transportation, Department of Housing and Urban Development (HUD) and Environmental Protection Agency (EPA)— has, for example, given cities and metropolitan areas resources, information and tools to make sharper connections between housing, transportation and environmental resources.

On regulatory matters, President Obama has used federal actions to set a “floor rather than a ceiling” on a range of consumer protection, clean energy and environmental matters. This has left room for the states to innovate on auto emission standards in California, for example, and to seek redress for mortgage abuses through the States Attorney Generals.

To date, President Obama’s approach to economic restructuring has tended toward the more permissive, enabling end of the federalist spectrum. The administration has, for example, set a national goal of doubling exports, but it has not sought to influence the way states organize themselves to engage globally. The American Recovery and Reinvestment Act made sizable investments in the clean economy but left states and localities alone to set their own platforms for clean economy growth. Other efforts to catalyze and leverage regional innovation clusters, using competitive grant programs, have been relatively small in size and scope.

Perhaps most tellingly, President Obama has almost exclusively populated a fairly robust group of White House advisory councils on jobs and the economy, exports, advanced manufacturing and entrepreneurs with business, civic and university leaders. The failure to engage state and local elected officials—governors, county executives, mayors, state and local legislators—in these economy-shaping efforts is shortsighted, given how much influence the states and localities have on every aspect of economic life. Other efforts to involve cities and metropolitan areas through a special White House Office have been understaffed and unfocused.

President Obama’s federalism, while varied, is nonetheless definable. The federalist views of the Republican presidential candidates, by contrast, have been a bit of a muddle.

On one hand, the Republican candidates have been predictably uniform in their condemnation of President Obama for federal over-reach in the responses taken during the height of the economic crisis in 2009-2010 and in the health care bill. Beyond that, however, their federalist philosophies cover a broader spectrum, illustrative not only of their disparate professional experiences but also the shifting federalist position and perspective of the Republican Party.

In prior decades, the federalist stances of the two political parties were easy to discern. For several decades, Democrats were the party advocating strong federal powers, Republicans the party upholding the Tenth Amendment’s reservation of unenumerated powers to the states. This clear ideological division has not held in the past

20 years. As the states (and their cities and metropolitan areas) have grown in capacity and intent, Democrats have seen the wisdom of preserving state prerogatives and respecting state and metro innovation. Republicans, for their part, appear torn between their traditional philosophy of states' rights (e.g., repeating calls to eliminate the U.S. Department of Education) and newer commitments under President George W. Bush to enhance federal power to impose social views, respond to terrorist threats and expand popular entitlements.

These internal inconsistencies are best exemplified by Mitt Romney, the Republican front runner as of this writing.

As Massachusetts governor, Romney embraced the role of state as innovator and, ironically, his key achievements have driven Obama's agenda. Massachusetts's health care law became the blueprint for federal action under Obama. Romney's effort on sustainable development became a model for other states and a forerunner of Obama's multi-agency Sustainable Communities Initiative. And as a candidate, Romney has expressed strong support for Obama's Race to the Top program, reflecting a view that the federal government needs to set a strong direction in areas of national significance that are co-produced with the states and localities. At the same time, he has opposed President Obama's health care reform, saying that the enactment of a similar law in Massachusetts was intended to be a "state solution" to a "state problem." Still further, he has argued that states should not have the right to enact laws to enable same-sex marriage equality, hewing to the strong federal role now embraced by social conservatives. For now, Governor Romney's approach to federalism is a shifting tableau, owing to the complicated politics of the Republican Party.

A Federalist Roadmap for the Next President

As the 2012 presidential election unfolds, and the debate over the future of the American economy comes into sharper relief, it is essential that both candidates articulate a federalist vision for economic renewal. While past federalist eras have been defined by their means—the way that different levels of government interact—the current economic imperative necessitates federalism that is defined by co-delivering particular ends, specifically a new vision for the national economy.

Over the past three years, a growing chorus of business leaders and mainstream economists has embraced a post-recession growth model, a "next economy," where the

United States exports more and wastes less, innovates in what matters, produces more of what we invent and ensures that the economy actually works for working families.

In summary terms, the next economy should be fuelled by innovation, to spur growth not only through idea generation but the virtuous interplay of invention, commercialization and manufacturing. It should increasingly be powered by low-carbon energy, to position the United States at the vanguard of the next, innovation-led industrial revolution. It should be driven by exports, to take advantage of rising global demand for quality products and services. And, it should be opportunity rich, so that working families can earn wages sufficient to attain a middleclass life.

This ambitious macro vision largely comes to ground in the nation's 100 largest metropolitan areas, which already generate more than three-quarters of the nation's gross domestic product. These communities dominate economically, since they concentrate and agglomerate the innovative firms, talented workers, risk-taking entrepreneurs and supportive ecosystems of universities, community colleges and business associations that drive modern economies.

While Washington dithers and delays, metros and their states are embracing the next-economy model and innovating in ways that build on their distinctive competitive assets and advantages:

- With federal innovation funding at risk, metros like New York and states like Ohio and Tennessee are making sizable commitments to attract innovative research institutions, commercialize research and grow innovative firms.

- With the future of federal trade policy unclear, metros like Los Angeles and Minneapolis/St. Paul and states like Colorado and New York are reorienting their economic development strategies toward exports, foreign direct investment and skilled immigration.

- With federal energy policy in shambles, metros like Seattle and Philadelphia are cementing their niches in energy-efficient technologies, and states like Connecticut are experimenting with Green Banks to help deploy clean technologies at scale.

- With federal transportation policy in limbo, metros like Jacksonville and Savannah and states like Michigan are modernizing their air, rail and sea freight hubs to position themselves for an expansion in global trade.

What unites these disparate efforts are intentionality and purpose. After decades of pursuing fanciful illusions (becoming "the next Silicon Valley") or engaging in copycat strategies, states and metros are deliberately building on their special assets, attributes and advantages, using business planning techniques honed in the private sector.

The bubbling of state and metro innovation is pervasive and viral—crossing political, regional, jurisdictional and sectoral lines. It offers an affirmative and practical counterpoint to a Washington that has increasingly become hyper-partisan and overly ideological and gives the next President an opportunity to engage states and metropolitan areas as true, working partners in the quest to restructure the economy.

Three actions are of most importance.

First, the federal government *should lead where it must* and set a strong, clear national platform for productive and innovative growth. This requires a level of focus and discipline that has been sorely missing in Washington, D.C. In other words, the federal government should *do less, better*.

What matters? It is clear that companies, states and localities crave predictable rules of the game on the fundamentals—budget, trade, taxes and immigration—so that they can invest and govern with confidence and certainty.

Yet pragmatic leaders are also demanding that the federal government invest, at scale, in economy-driving assets over a sustained period. The list of target areas for recommended investments, and even the institutional vehicles for investments, is remarkably similar and consistent across a broad cross-section of corporate, political, civic and university leaders. Last year, the American Energy Innovation Council, an organization founded by seven major corporate leaders (including Bill Gates, Jeff Immelt and John Doerr) recommended scaling clean-energy R&D investments from $5 billion to $16 billion annually. The investments would be "focused on technologies that can achieve significant scale, and be freed from political interference and earmarking."

Felix Rohaytn, a respected investment banker and former chairman of the New York City Municipal Assistance Corporation, has been a long-time champion of a National Infrastructure Bank. Rohatyn's design, backed by a diverse set of political and corporate leaders, would initially capitalize a bank at $60 billion to leverage $250 billion of new capital in the private sector during its first few years and as much as $1 trillion over the next decade.

Finally, a plethora of business, university and philanthropic leaders have argued for aggressive steps to upgrade the education and skills of the American workforce. Andrew Liveris, the CEO of Dow Chemical Co, has, for instance, called for significant investment in STEM (science, technology, engineering and mathematics) education and improved skills training programs at community colleges so that workers can learn the skills necessary for high-paying advanced manufacturing jobs in the United States.

In many respects, the question is not what to invest in, but how? In a fiscally constrained environment, where will the resources come from?

The answer: "cut and invest."

The Simpson-Bowles Commission recommended creating a bipartisan Cut-and-Invest Committee to be charged each year with identifying two percent of the discretionary budget that should be cut and identifying how to redirect half of that savings, or one percent, into high-value investment—exactly the same priority areas identified for investment above.

The Commission's recommendation is technically feasible, because the federal tax code is replete with provisions that subsidize excessive consumption, rather than production, and wasteful, rather than sustainable, growth. The worst offender, the federal mortgage interest deduction, is scheduled to grow steadily over the next five fiscal years. The single act of capping this deduction at current levels would save $177 billion during this period, more than enough to contribute to deficit reduction and finance every market-shaping solution mentioned above.

Second, states and metropolitan areas *must innovate where they should* to drive and enable bottom-up economic strategies that fully align with the distinctive competitive assets and advantages of disparate places. That will require a radical restructuring of the federal government.

As Mark Muro wrote in his seminal MetroPolicy treatise in 2008:

> New technologies, globalization, and deregulation, ha[ve] brought a new era of speed, entrepreneurship, innovation, flux and complexity—as well as new challenges—for organizations. . . . Compelled by the new conditions, firms,

> governments and organizations of all types have embarked upon an urgent search for new, more flexible and effective forms of organization out of which the outlines of a distinctive 21st century style of governance have begun to emerge. *Top-down planning and control structures are giving way to decentralized, "federated" systems —because pre-set central plans cannot encompass the complexity and variation of contemporary reality—to build in space for decisive front-line responsiveness, problem-solving, experimentation, and learning* (emphasis added).

Against this backdrop, the federal government largely remains a legacy government rooted in a different era.

The current federal agencies are siloed and stove-piped, highly compartmentalized and specialized, allergic to risk in the face of challenges that are multi-dimensional and multi-layered. Most federal structures, policies, programs and rules are prescriptive and technocratic, narrowly defined, poorly coordinated and, in general, ill-suited to support creative state and metropolitan problem-solving. The proliferation of federal programs is alarming. The Simpson-Bowles Commission, for example, found that there are over 44 job training programs across nine different federal agencies, and 105 programs meant to encourage STEM education.

Throughout the federal government, an inspector-general culture prevails, stifling innovation and limiting latitude for invention and experimentation. Despite the diversity of the country, a "one size fits all" categorical approach drives national investment, enticing different regions to compete for discrete federal funds whether they need them or not.

One can imagine multiple ways—for example, consolidating trade agencies with similar missions, consolidating workforce programs under a performance block grant—to modernize the federal government to leverage the possibilities of a differentiated economy. The most direct way might be to apply a variant of the Race to the Top education competition to the economic restructuring arena.

The federal government could challenge states and metropolitan regions to articulate how they would attain a critical economic goal (say, doubling exports) over a set period of time. A consolidated competition could then be held to group together federal programs across a broad and diverse range of activities and policy areas. An export competition could group together programs that fund advanced manufacturing, workforce, freight infrastructure, brownfield remediation and export promotion and financing. The competition could challenge a broad cross-section of leaders in states and metropolitan areas to: (a) articulate a bold economic vision that builds from their special assets and advantages; (b) design strategies that carry out that vision through tangible projects and investments; (c) reform state and local policies and governance in support of these strategies; and (d) hold themselves accountable on a regular basis through transparent performance measures. Finally, a nonpartisan group of business, state and regional leaders could be tasked to recommend the goals and parameters of the competition and could even be designated to assess disparate applications.

This proposal would differ from Race to the Top in one critical dimension. The focus would be on catalyzing innovation, rather than using competitive resources to drive adoption of a series of predetermined and preferred reforms. Race to the Top followed 20 years of school reform at the state and local levels. Yet no state "has it right" on maximizing the elements of the next economy and pursuing an integrated approach between, say, advanced research and development, advanced manufacturing, clean technology, foreign direct investment, skilled workers, infrastructure and exports.

With the national and global economy in a period of disruptive change, now is a good time to challenge states and metropolitan areas to invent the next growth model. Several states and metros might, for example, pioneer a new way of supporting advanced manufacturing. Others might do the same with exports and foreign direct investment or with upgrading the skills of key advanced industry workers. With federal direction, this could be a golden period of state and metropolitan innovation in shaping a more productive, sustainable and inclusive economy.

On technique, the federal government can learn from states like New York, Colorado, Tennessee and Nevada, as they work to incentivize bottom-up economy shaping. New York state, for example, challenged 10 regional councils—public-private partnerships of corporate, civic, university, labor, environmental and local governmental leaders—to craft economic development plans for their regions. The New York competition flipped traditional economic development on its head, rewarding strategies rather than transactions and local investment priorities rather than state solutions dictated by inflexible bureaucracies and fragmented programs.

Finally, the federal government needs a new array of permanent institutions and time-limited commissions and task forces to advance and steward the new federalist order.

Such institutions once existed. The Advisory Commission on Intergovernmental Relations ("ACIR"), for example, was an independent agency established in 1959 but disbanded in September 1996 during an early round of federal budget cutting. ACIR's mission was "to strengthen the American federal system and improve the ability of federal, state and local governments to work together cooperatively, efficiently and effectively." In its prime, ACIR provided timely data on government finance as well as an independent forum for information exchange among federal, state and local officials.

Several options are worth pursuing.

As described above, existing White House task forces on economic policy could be expanded to include governors, mayors and other state and local officials. President Obama recently made a start by announcing that membership on the President's Export Council, currently co-chaired by the CEOs of Boeing and Xerox, would be increased to include designees from the National Governors Association and U.S. Conference of Mayors.

The next president could also appoint a separate Task Force on Federalism and the Economy, comprised of government, corporate, university and civic leaders, to examine ways in which the federal government, states and localities could collaborate on creating jobs in the near term and retooling the economy for the long haul, perhaps even designing a Race to the Top-style competition, as described above. Special focus would be given to collaborative efforts that further the growth of advanced industries that are central to U.S. competitiveness.

Finally, the federal government, in conjunction with the states and localities, could create a National Laboratory on Federalism and Competitiveness. The laboratory would have three separate missions: (a) capture and disseminate the best economy-shaping innovations under way in states and metropolitan areas, to speed replication and improvement; (b) capture and disseminate the best innovations under way in other nations, particularly countries where key powers are shared among different levels of government; and (c) report periodically to the federal, state and local governments on ways in which policies at all levels could be refined to enable or scale up the most promising innovations. A biennial Federalist Forum could be held to debate the recommendations, bringing together, for the first time in decades, key representatives of each level of government and key corporate, civic and academic institutions.

A Concluding Federalist Thought

Federalism is not a gift that Washington bestows on state houses and city halls. Rather, it is a special, often dormant, vehicle for galvanizing and unleashing the talents and energies of an entrepreneurial nation. The president has an historic opportunity to usher in a new era of pragmatic, collaborative federalism that capitalizes on the economic power of metros and the policy creativity of state and local leaders. Remaking federalism is the path toward an economy that is productive, sustainable and inclusive. More broadly, it can be a vehicle for economic prosperity, fiscal solvency and political comity—if the next president is willing to take it.