

Governance in the Digital Age

The Impact of the Global Economy, Information Technology, and Economic Deregulation on State and Local Government

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The world is changing at a faster pace than ever before, with greater potential consequences for the shape and roles of states, counties, and cities than at any time in history. There are three major, accelerating trends that will affect state and local governments in the 21st century.

First, the global economy is integrating all national economies. That accelerating expansion is engulfing state and local economies, in which a rising share of the total output now is directed toward foreign markets. But the international trade agreements that have helped to accelerate this global commerce have been made almost entirely without state and municipal input, and they threaten state and local sovereignty.

Second, major industries such as pipelines, telecommunications, and banking have been deregulated, and others, such as electric utilities, now are moving down that path. These changes create opportunities, but they also threaten stable state and local revenue resources and historic and traditional local authority.

Third, technological change is now accelerating. Telecommunications and technology are rapidly shrinking the globe and increasingly obliterating political boundaries.

All of these trends will have a profound impact on the nation's states and local governments. Each will have deep-seated implications for governance in our pluralistic society in the coming decade. The focus of this report is on anticipating some of the major public policy issues confronting state and local governments in the coming five to 10 years.

Toward a Dynamic Federalism

At the cusp of the 21st century, these three trends are exerting push-pull impacts on state and local governments. The impacts are colliding, creating difficult policy choices for public sector leaders. One policy response to these major trends is to push decisions as close as possible to those with immediate responsibility to administer programs and deliver services directly to the public. The other policy response, in contrast, is to push major issues such as trade and environmental protection into the international arena. The conflict between these two trends will define the governance challenge in the coming decade.

During the 1990s, Congress has enacted several major legislative programs that have given additional flexibility and more programmatic responsibilities to state and local governments. Devolution as a governing strategy is similar to the corporate effort to decentralize as many decisions as possible, giving that responsibility to those in the front lines. It is intended to serve diverse needs, respond quickly to changing demands and circumstances, and improve organizational accountability.

In both situations, profound advances in information technologies have facilitated the decentralization of service delivery and operational responsibilities. The flood of information and the increasing access to it, eased by the digital revolution, will provide citizens with more choices. These linked phenomena also have increased the capacity of state and local governments to respond quickly and effectively to changing public demands.

Public policy in this country is enriched and complicated by the design of our federal system of government and by the strong advocacy of many articulate groups. Advocacy groups can be expected to continue to press their policy agendas in Washington, D.C. Sometimes, they will press for a national or international policy that preempts the discretion of state and local governments. Dual sovereignty should continue to be an important guide to future debates over governance structures.

Creating a dynamic federalism for the 21st century will require a constructive dialogue with Congress. In the course of this important discussion with Congress, state and local government leaders will have many success stories to share. Policy innovation and improved management capacity at these levels of government should make a compelling argument that federal preemption or national laws (one size fits all) should be the last policy option considered, not the first. Responsive government and effective governance would be advanced by the continued efforts of state and local government leaders, working with Congress, to build a cooperative and vigorous federalism for the 21st century.

The integrated global economy, the digital revolution, and the deregulation of core industries will pose many policy and management challenges for all public sector leaders in the coming decade. Each of these factors has profound implications for governance in our pluralistic society. More significantly, each represents opportunities for public sector leaders to strengthen their local economies, to improve the quality of life of their communities, and to redesign state and local government operations to adapt to the changing needs of the public.

This report addresses the issues, the trends, and the potential consequences for governance in the digital age, from a strategic perspective. Keeping states and local governments vital as the center of

the American economy and providing innovation and high-quality services will require adequate resources, flexible organizations, and managerial approaches such as privatization, market-based regulations, rapid adoption and implementation of various technologies, and other innovations. The challenge of governance in the coming century will be quite daunting at best. The federalism of the 21st century—one that reflects diversity, experimentation, innovation, responsiveness, and flexible organizational designs—is the best path to maintaining excellence. How do we get there?

During most of the 20th century, the availability of the three factors of production—labor, capital, and land (natural resources)—has been sufficient to ensure national prosperity. In the past two decades, however, the quality of these inputs and how well they are used have become more important to the creation of national wealth. The American talent for organization, the freedom to allow aggressive competition, the civil institutions that have fostered trust and social stability, and the huge national market of consumers who have demanded more choices and better quality are among the social attributes that have nurtured economic opportunity in this nation and that give us confidence about the future.

We can take some measure of comfort in the stable growth of the domestic economy in recent years, but elected state and local officials can never become complacent about the future prosperity of their communities. Several of the factors that have contributed to the longest peacetime economic expansion of this century should be understood by public sector leaders to help them think strategically about the future. Strategic investments made today will strengthen the economic viability of their communities in the 21st century.

The world is shrinking, metaphorically, as transportation and communications costs decline rapidly. The Internet has 153 million on-line users throughout

the world, and its traffic doubles every 100 days. Capital has become instantaneously mobile, flitting around the globe at the touch of a keyboard. Walter Wriston, former chair of Citibank, has noted, "Money goes where it is wanted and stays where it is well treated."

The nature of work is changing. The production of goods can be dispersed to any location throughout the world. Knowledge has become the new factor of production in high-value-added goods and services, and digital convergence (i.e., new combinations of computing, telecommunications, and the media) will alter economic patterns based on geography.

The social organization of capitalism in its latest phase is moving in two divergent directions, toward the superstructure of transnational corporations and toward venture-backed startups. The latter often grow like weeds, create new products that capture market share overnight, and cause corporate bureaucrats—trapped in organizational cages—incessant headaches and nightmares. Both forms of competitors value communities that attract a high-quality labor force, deliver superior public services, and provide a web of social relationships and an enviable quality of life.

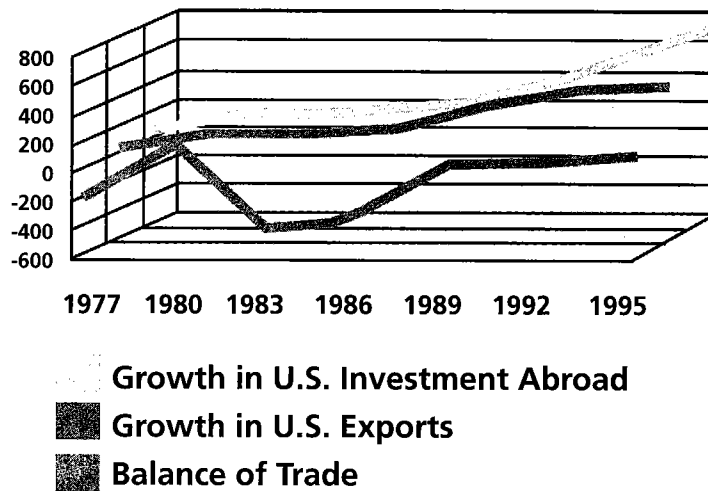
Key Issues

1. **Deregulation and its impact on state and local authority and revenues.** What aspects of deregulation are likely to have the greatest impact on state and local revenues and historic and traditional authority? What are the most effective ways for state and local leaders to affect the shape of the next waves of deregulation?

2. **How can states and local governments flourish in this new age of deregulation?** What are the most important aspects of deregulation from which states and local governments could benefit? What are the strategies or ways in which state and local leaders could influence deregulation to ensure that it would enhance the role of states and local governments and strengthen their economies?

Figure 1

U.S. Exports and Investments Abroad Percent Growth Since 1974



3. **The global economy.** What aspects of the global economy are the most critical to the future of state and local governments? Why should state and local leaders care? To what extent is state and local sovereignty threatened by this emerging global economy and by international trade agreements?

4. **Governance in the information age.** What aspects of changing technology and the Information Age are most critical to states and local governments? What are the most important and effective steps leaders could take to shape this oncoming age, to help states and local governments and their elected leaders influence these changes, and to ensure a role for state and local governance and creativity?

5. **The role of states and local governments in the digital economy.** What aspects of the digital economy and new technology constitute the greatest risks to state and local structures, revenue systems, and historic and traditional authority? What can or should state and local leaders be doing to address these risks?

Deregulation

Already, national deregulation proposals for electric utilities, securities, telecommunications, and banking have raised serious questions about the roles

of state and local governments and about their relative responsibilities. Who will set prevailing standards in a community, who will have the tax and revenue authority, who will be responsible or liable for enforcement, and how will that level of government be compensated for the costs of enforcement of standards set by someone else? What are the implications for the structure of state and local government and existing regulatory systems?

Over the past two decades, the general trend has been less economic regulation at both federal and state levels, but more social regulation (e.g., civil rights, fair housing, consumer protection, environmental protection, employees' medical leave, nondiscriminatory business practices). In general, the consumers benefit when economic regulation is replaced by competitive markets.

Yet governments lose stable revenue sources from the regulated industries and inherit new social responsibilities. The end of economic regulation squeezes out the implicit cross-subsidies that support social objectives (universal service for telephones, for example).

Almost two decades after airline deregulation, medium-size cities in the

plains states subsidize small airlines, as part of their economic development strategies, to provide daily service to major, regional cities.

Will governments inherit more social responsibilities resulting from continued economic deregulation? Will partial deregulation and the rapid consolidation of the financial services industry result, paradoxically, in more government regulation, at least at the federal level?

Preserving the State Role In Economic Deregulation: Telecommunications, Electric Utilities, and Financial Services

The economic deregulation of core industries poses different policy choices for state and local governments in the coming decade. Consumers generally benefit from lower prices, and the national economy is improved by the resulting ef-

iciencies and productivity. Nevertheless, state and local governments face substantial revenue losses from this transition toward competitive entry and may inherit new social responsibilities.

Allowing competitive entry in local telephony and the electric utility industry will pose tough policy choices relating to achieving tax equity, universal service objectives (providing access to essential services at affordable rates), and consumer protection. The old regime of publicly regulating monopoly providers enabled the public sector to impose discriminatory taxes on these companies, to protect the companies from competition in exchange for their providing affordable services to all consumers within defined service areas, and to develop strong consumer protection practices. Competitive entry in these industries will force a major change in the role of public regulation.

Consolidation in banking and other

financial services could also pose new challenges to public sector leaders. Advocates want every community to have reasonable access to capital to promote local economic development. They fear that mergers and acquisitions would diminish the traditional role—credit allocation based on character, for example—served by local bankers, if lending decisions are shifted to regional bank officers. The advance of electronic banking will provide more choices to most consumers but will prompt additional questions about who has access to capital and at what price, as bank branches close and are replaced by ATMs.

To varying degrees, many of the dominant firms in the regulated industries of telecommunications, electric utilities, and financial services have sought a federal role that would diminish the traditional authority of the states. Paradoxically, the states have frequently been more innovative in regulating these

industries than the federal agencies and have developed a strong record of consumer protection.

The global economy and the movement toward both national and international deregulation will increase pressure to preempt traditional state and local government authority in land use, zoning, health care, labor, insurance, and environmental regulations. Each of these powerful trends has important tax and revenue implications and consequences. There will be a greater pressure to insist upon national and international uniformity in regulations and in revenue authority.

New international trade treaties and negotiations, from NAFTA and the WTO to the proposed Multilateral Agreement on Investment (MAI), could rewrite existing federal, state, and local laws and regulations affecting ownership, real estate regulation, and securities, in effect creating a supranational body to prohibit "discrimination" against out-of-state investors based upon environmental or political practice.

International trade contributes \$1 trillion to the United States economy and has accounted for one-third of all growth since 1992. Continued growth will depend on agreements to ensure access for American goods and services in foreign markets, requiring new international treaties on agricultural products, intellectual property rights, insurance, telecommunications, and electronic or digital commerce.

A key element in any of these treaties will be the business community's desire for uniformity (national laws superseding state and local laws and international trade agreements superseding national laws) and for the elimination of obstacles.

Currently, the electric and telecommunications industries pay more in state and local taxes and fees than any other industries, far more than localities are likely ever to see again from the federal government. But deregulation will change that. It will change both local franchise authority and zoning

and land use authority. Deregulation, after all, is about eliminating or reducing government authority to regulate how citizens gain access to goods and services.

The stakes are huge. It could end with Congress terminating local authority to provide electric and gas energy services, and that could be a prelude to the next deregulation wave: water, a political issue as deeply inbred into states and cities as almost any in history.

Finally, the extraordinary impact of digital commerce is almost certain to reshape the nation's states and local governments. It is likely to lead to wholesale changes in landscapes, with the elimination of many businesses that simply cannot compete against electronic commerce. It also may force major restructuring of the tax system of every state in America. But at the same time, the digital economy has already led to one of the most important urban revivals of the nation's history.

Today, the nation's largest localities have become the epicenters of the Information Age: "tightly integrated combines that generate information, the conversations, and the spontaneous innovations that are the lifeblood of a knowledge-based economy." Or, as Michael Porter of the Harvard Business School says, "Cities are aligned with the nature of modern competition, with its emphasis on fluidity, information flow, and innovation." What could be more exciting or important?

The Global Economy

States and local governments have had great success in attracting foreign investment, as well as hosting investors who own significant investments overseas. Consequently, international trade is an issue that presents critical opportunities yet carries significant risks. The proposed Multilateral Agreement on Investment (MAI) being negotiated by the world's most developed countries, for example, is intended to foster additional investment activity while at the

same time providing stability to and leveling the playing field for U.S.-based investors.

Along with these potential benefits, however, the MAI also may have the effect of impinging on the sovereignty of state and local governments. What are the implications of trade proposals for state and local sovereignty, and what actions can state and local leaders take to enhance and protect their interests?

What are the implications for state and local sovereignty—not just against federal preemption but international preemption? Ought there to be a fundamental reevaluation of the federal/state/local relationship as it applies to the international economy? What will become of the ability of states and local governments to use investment incentives and performance requirements to achieve legitimate public purposes?

The Digital Revolution And Governance Challenges

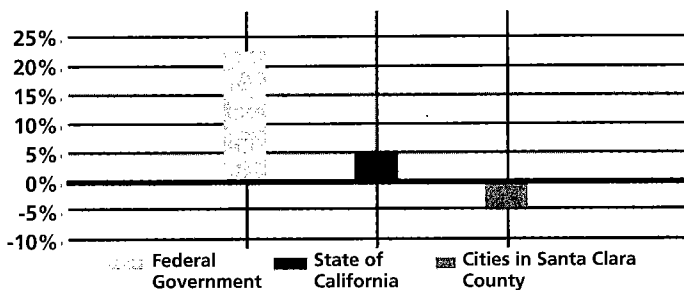
The ability to convert text, data, images, voice, and video into a string of 1s and 0s and to transmit bits of digital information instantaneously to anywhere in the world is rapidly approaching. This digital revolution will transform the business world and will have tremendous implications for public sector leaders in the coming decade.

On April 15, 1998, the U.S. Commerce Department released its report on the emerging digital economy. The report stated that information technology, led by the booming business on the Internet, is driving the U.S. economy. According to the report, the high-tech industries of computers and telecommunications accounted for 25 percent of the economy's growth over the last five years. This translates into hundreds of thousands of jobs, major drops in inflation, and surges in federal revenues that have balanced the federal budget for the first time in a generation.

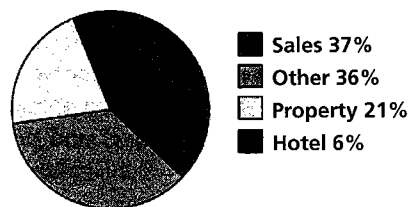
For states and local governments, the report offers both good news and bad

Figure 2

Change in Tax Revenue Per Capita, 1985–1995, Constant Dollars



Major Sources of Tax Revenue, 1995, All Cities in Santa Clara County



Sources: State Controller, California Department of Finance, Tax Foundation.

news. It demonstrates that this emerging digital economy is driving the United States to world economic preeminence at a time when states and localities are ever more reliant upon the economy. It demonstrates that getting onto the leading edge of this technology offers extraordinary opportunities. And it shows that mastery offers extraordinary efficiencies and advantages for governing. The report, for instance, notes that General Electric will save over \$500 million over the next two years by making \$5 billion in purchases of goods and services over the Internet.

The report also demonstrates the risks. As the federal government has talked less and less about turning over responsibilities to states and local governments and more and more about freeing the Internet from state and local (but not federal) taxes and regulation, federal revenues have surged far faster than state and local revenues. (See Figure 2, comparing per capita changes in revenue to the federal, state, and local governments from cities in the Silicon

Valley between 1985 and 1995.)

If one-quarter of the growth in the national economy comes from information technology, with the federal government now proposing to bar state and local taxes, there may be enormous potential adverse consequences. Not only are there serious revenue implications but also state and local investment questions: what kinds of investments will be required at the state and local levels to sustain the environment to guarantee continued U.S. dominance?

The leadership challenge in this digital age includes assessing the potential benefits of new technologies to improve the quality of public services and to gain efficiencies, implementing the best ones in the public agencies and anticipating how information technologies can improve governance. State and local governments may lag in some ways behind the corporate sector in implementing some of the latest information technologies.

Yet, as laboratories of democracy, they have been the leaders in innovating

with other technologies such as distance learning, information kiosks, electronic commerce, state-of-the-art Web pages, geographic information systems (GIS), electronic bracelets to monitor parolees, intelligent transportation systems (ITS) that improve highway and transit operations, electronic tolls to reduce traffic congestion, and a host of others.

The application of new technologies toward improving the efficient delivery of public services is clearly the greatest management challenge facing local and state government leaders today. Many of the core functions of government involve providing information and making transactions, most of which could be conducted electronically. In this regard, three immediate challenges await public sector leaders: the Y2K problem, the loss of skilled computer professionals to the private sector, and the potential revenue losses from electronic commerce.

The Year 2000 problem (Y2K) refers, of course, to fixing the old computer code to accommodate the transition to the year 2000. Fixing that problem is not a technological challenge but a management challenge that looms large because the private sector is luring skilled computer professionals away from the public sector with higher salaries.

The development of the Internet has given the average citizen (anyone with a personal computer, modem, local telephone service, and an on-line provider) the opportunity to transact business electronically. Estimations of the growth in electronic commerce by consumers range from "spectacular" to "unprecedented." Due to past Supreme Court rulings, states may not require vendors to impose sales taxes on distance sales unless the vendor has a physical presence within that state. Many state and local elected officials are concerned that the explosion of electronic commerce could undermine the public sector revenue stream in the future.

In the fall of 1998, Congress enacted the Internet Tax Freedom Act, which established a three-year moratorium on state and local taxation of Internet ac-

cess and electronic commerce. That legislation also established an Advisory Commission on Electronic Commerce to issue recommendations concerning tax policy within 18 months. The Communications and Electronic Commerce Tax Project, sponsored by the National Tax Association, also has accomplished important work on this complex tax problem. The work of both groups may be instrumental in educating Congress about the potential public sector revenue losses that could result if electronic commerce continues to grow at its exponential rate.

Telecommunications overcomes distance. Information technologies flatten organizational hierarchies. Governments, however, are still bound to geography, structured as labor-intensive organizations, and anchored to "legacy" (mainframe) systems, and they cannot pay enough to recruit and retain the best information systems professionals. Fur-

thermore, to ensure accountability, government procurement is slow and deliberate at best. Given these formidable obstacles, the degree of innovation and progress by state and local governments in implementing advanced technologies is most impressive.

The public sector is far behind the leading corporations in terms of integrating information technologies and redesigning business processes. Additional progress will be aided by learning from the private sector, especially by matching various technologies with particular services and by carefully reviewing the core functions of government. A focus on the potential benefits of advanced technologies often stimulates an evaluation of current business processes and a consideration of alternatives.

Building permits can be submitted by facsimile on a standard form by contractors as long as the government agency

can redesign its processes to record a filing, to review it for accuracy, to verify that the applicant is licensed (and/or bonded), and, in short, to ensure that the public is adequately protected. The management challenge is not just to find the best mousetrap but to redesign business processes to use a variety of improved methods to catch mice.

These prominent trends suggest three bold themes:

1. The domestic economy is becoming integrated into the world economy. This integration builds upon our national comparative advantages. Liberalized trade and investment policies have contributed to the growth of the domestic economy. State and local government leaders have become adept at harvesting the fruit from this integration by promoting exports, recruiting foreign investment, and establishing rela-

Reasons to Enhance the Value of Place

Local and regional economies are becoming more integrated into the global economy. Both international trade and direct foreign investment are growing at a faster rate than world output.

Capital and other factors of production have become, and will continue to be, increasingly mobile. As Walter Wriston, former chair of Citibank, has noted, "Money goes where it is wanted and stays where it is well treated."

The digital revolution will enable a growing share of knowledge work to be performed anywhere in the world. Peter Drucker notes, "Knowledge knows no boundaries."

The trend of decreasing place-based investments by the federal government will continue to increase the burden on state and local governments to ensure the economic viability of their communities.

- tionships with leaders throughout the world. The challenge in the future will be to pursue these activities strategically.
2. The prospect of further integration in the future should encourage public sector leaders to think about enhancing the "value of place" in the global economy (see box on this page). If capital is mobile, then what should public sector leaders do to enhance the value of place to attract future investment? Similarly, if knowledge-based work becomes increasingly mobile in the future, then what must public officials do now to secure the value of place in the digital future?
 3. The outlook of greater integration of the local economies into the world economy also poses governance challenges. The tension between liberalized trade policy and federalism

must be minimized. State and local government leaders want to maximize the benefits from increased trade and foreign investment flowing into their jurisdictions and yet retain state sovereignty and local independence on important policy choices. Maximizing the economic benefits and minimizing the loss of policy

discretion will be among the most significant governance challenges for public sector leaders in the coming decade, as Congress considers future international trade and investment agreements. **DAI**

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