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Optimal Federalism across Institutions: Theory and Applications from Environmental Policies and Health Care

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ABSTRACT: This article presents a framework to analyze federalism based on enactment, implementation, and enforcement institutions. The framework provides a mechanism to determine whether a particular public policy should be conducted at a state or federal level, by examining economies and diseconomies of scale inherent in each of these institutions. This article then applies the framework in a comparison of environmental policies for wetlands and endangered species, and in an analysis of a health care policy. These applications can then serve as guides to legislators and judges in analyzing federalism concerns.

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TABLE OF CONTENTS
I. REVIEW OF FEDERALISM, ENVIRONMENTAL, AND HEALTH LITERATURES .................... 3
II. FRAMEWORK FOR ANALYZING FEDERALISM ACROSS INSTITUTIONS ......................... 9
III. APPLICATION TO COMPARISON OF ENVIRONMENTAL POLICIES ........................... 13
IV. APPLICATION TO ANALYZE HEALTH CARE POLICY ............................................... 25
V. CONCLUSION .............................................................................................................. 31

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“Simply because you have a problem that needs addressing, it's not necessarily the case that Federal legislation is the best way to address it.”

-- United States Supreme Court Chief Justice John G. Roberts, Jr., addressing the United States Senate

The question of “federalism” then becomes, “When is federal action appropriate, and when should the problem be addressed by the states?” Over the past fifteen years, courts and legal scholars have attempted to answer this question. This article presents a framework that provides a new technique to answer this question. This framework analyzes federalism across enactment, implementation, and enforcement institutions, by examining economies and diseconomies of scale inherent in each of these institutions. This article then applies the framework in a comparison of environmental policies for wetlands and endangered species, and in an analysis of a health care policy. These applications can then serve as guides to legislators and judges, as they seek to grapple with the question of federalism.

Federalism, an American invention put forward in drafting the United States Constitution, posits that parallel government systems operate in their own spheres of authority over shared constituencies. These spheres of authority may overlap, and conflicts arise in defining these spheres, and in managing relations when the spheres overlap. During its first two hundred years, American federalism underwent a number of changes as our understanding of it altered in the face of dramatic circumstances. These developments have accelerated during the past fifteen years, through advances in jurisprudence, legal scholarship, and through new legislation and governmental programs.

In a sequence of cases including United States v. Lopez, United States v. Morrison, Solid Waste Agency of Northern Cook County v. U.S. Army Corps of Engineers (SWANCC), Gonzales v. Raich, and Rapanos v. United States, the U.S. Supreme Court has attempted to articulate limits to the federal sphere that had seemed to disappear since the NLRB v. Jones & Laughlin Steel Corporation case of 1937. This jurisprudence coincided with advances in legal scholarship in the field of “New Federalism,” which sought to re-address the theoretical underpinnings of federalism, including the “race-to-the-bottom” theory, public choice theory, the “laboratories of democracy” theory, and “economies of scale” theory. These theories

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6 Gonzales v. Raich, 545 U.S. 1 (2005).


9 The decision in this case was announced two months after the proposal of the so called “court-packing” Judiciary Reorganization Bill of 1937, in which Franklin D. Roosevelt sought the authority to appoint additional justices to the Supreme Court after the Court’s rulings in A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935), and U.S. v. Butler, 297 U.S. 1 (1936).

10 This theory refers to a quote of Louis Brandeis, dissenting in New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932): “It is one of the happy incidents of the federal system that a single courageous state may, if its citizens
were examined in particular with reference to environmental policies by a number of scholars.\footnote{11} Additionally, the takeover of Congress by a Republican majority in 1994 led to a number of legislative and administrative developments in the relations between the Federal government and the states, foremost of which was welfare reform through the Personal Responsibility and Work Opportunity Reconciliation Act of 1996.\footnote{12} At the same time, health care costs rose significantly, leading to a declaration by some of a “health care crisis.”\footnote{13} A significant amount of research followed to address the role of federalism in health policy.\footnote{14}

This article integrates these developments in federalism. Its principal contribution comes from its suggestion that analysis of federalism issues should be conducted at the level of individual institutions. Institutions consist of the set of rules and structures that govern human interaction.\footnote{15} Public policy is the product of a network of institutions, including enactment, implementation, and enforcement institutions. Analyzing federalism by analyzing the full network can become increasingly complex. This article clarifies our understanding of federalism by analyzing these institutions separately.

In its analysis of individual institutions, this article also provides a criterion that can serve as an alternative limit to federal power under the Commerce Clause, a limit that the Rehnquist Court seemed to seek in \textit{Lopez} and \textit{Morrison}. Furthermore, while most recent analyses of federalism’s role in policy making have focused on a single subject area, this article expands its analysis to examine implications for environmental and health policies.

Starting with a general model, this paper describes a framework for assessing the proper locus of different aspects of a public policy. This framework takes into consideration the multi-institutional aspects of a public policy. Within each institution, this framework uses an efficiency criterion, focusing on tradeoffs between economies of scale and diseconomies of scale.

It then applies this approach to a wide array of public policies, ranging from environmental policies to health policies. Through these applications, this article demonstrates the importance of considering federalism issues across individual institutions. It also shows the usefulness of considering economies and diseconomies of scale in assessing federalism. Legislators and judges can use these applications as guides to assess the appropriate role of federalism in solving public policy problems at the lowest cost.

The rest of this article begins with a review of recent “New Federalism” jurisprudence, followed by a review of some of the literature addressing federalism in the context of environmental policy, and health care policy. It then offers a framework for analyzing federalism across institutional dimensions. Using this framework, this article examines federalism issues in a comparison between policies for protecting endangered species and wetlands. After that, we analyze federalism issues in the healthcare policy of using managed care organizations (MCOs) to service Medicaid beneficiaries.

\footnotesize
\begin{itemize}
\item \footnote{11} See Section I.C, \textit{infra}.
\item \footnote{12} Pub.L. 104-193, 110 Stat. 2105 (1996).
\item \footnote{13} When Bill Clinton accepted the Democratic nomination in 1992, he “vow[ed] to ‘take on the health care profiteers and make health care affordable for every family.’” Others disagreed with the declaration of a health care crisis, including Senator Daniel Patrick Moynihan who stated that “there is ‘no health care crisis.’” See \url{http://www.pbs.org/newshour/forum/may96/background/health_debate_page1.html}.
\item \footnote{14} See Section I.D, \textit{infra}.
\item \footnote{15} See Douglass C. North, \textit{Institutions}, 5 J. OF ECON. PERSPECTIVES 97(1991) [defining institutions as “the humanly devised constraints that structure political, economic and social interaction,” at 97].
\end{itemize}
I. REVIEW OF FEDERALISM, ALONG WITH LITERATURES RELATING FEDERALISM TO ENVIRONMENTAL & HEALTH POLICIES

I.A A Brief History of Federalism in the United States, and the Rehnquist Court’s “New Federalism” Decisions in Lopez, Morrison, and Raich

The rise of a powerful, central Federal government was brought about by the Civil War, when the survival of the nation depending on the ability of the Federal government to marshal the full resources of the Northern states to defeat the Confederacy. Over the next seventy years, a backlash against the power of the Federal government developed, culminating in the Schechter Poultry case, in which the U.S. Supreme Court ruled that the National Industrial Recovery Act was unconstitutional because Congress had exceeded its authority under the Commerce Clause.

However, shortly thereafter, a sequence of cases including NLRB v. Jones & Laughlin Steel Corp., United States v. Darby, and Wickard v. Filburn “ushered in an era of Commerce Clause jurisprudence that greatly expanded the previously defined authority of Congress under that Clause.” These cases took place in the context of the Great Depression and World War II. As before, the all-encompassing nature of these threats to the nation led to a significant increase in the need for a strong Federal government. For the next fifty years, the Court did not strike down any federal legislation as exceeding the scope of the Commerce Clause. In this time, the Court upheld Congress’s authority to legislate over civil rights and moral wrongs. Almost no issue seemed to be out of the orbit of Congressional power.

However, in the 1995 case of United States v. Lopez, the Court held that Congress exceeded its constitutional authority when it enacted the federal Gun Free School Zones Act of 1990. The Court found that there were “three broad categories of activity that Congress may regulate under its commerce power:” “the use of the channels of interstate commerce;” “the instrumentalities of interstate commerce, or persons or things in interstate commerce;” and “those activities having a substantial relation to interstate commerce.” The court found that the possession of a gun in a school zone did not have a “substantial relation to interstate commerce.” In reaching this conclusion, it found that possession of a gun was “in no sense an economic activity.” Also, the court rejected arguments that connected the education process with later commercial activity. Extension of this argument would make it “difficult to perceive any limitation on federal power.” Consequently, Congress did not have the authority to enact this law under the Commerce Clause.

17 United States v. Darby, 312 U.S. 100 (1941).
19 Lopez, at 556.
24 Id., at 558.
25 Id., at 558-9. Note, these categories were very similar to the three matters proposed by Richard A. Epstein in The Proper Scope of the Commerce Power: “interstate transportation, navigation and sales, and the activities closely incident to them.” 73 VA. L. REV. 1387, at 1455 (1987).
26 Lopez, at 567.
27 Id., at 564.
In *United States v. Morrison*,\(^{28}\) the Court again looked at whether Congress had authority under the Commerce Clause, this time for 42 U.S.C. § 13981 of the Violence Against Women Act. The Court held that gender-based violence had an insufficient relation to interstate commerce, and held the act unconstitutional. Similar to Lopez, the court held that arguments connecting the effects of a violent crime to every possible effect on interstate commerce "would allow Congress to regulate any crime."\(^{29}\) It rejected this extension, stating, "The limitation of Congressional authority is not solely a matter of legislative grace."\(^{30}\)

In *Gonzales v. Raich*,\(^{31}\) the Court held that regulation of the production and distribution of marijuana could enable enforcement against a completely intrastate activity. It held that the activities of growing and distributing marijuana were "quintessentially economic."\(^{32}\) As a result, regulation of these activities, even though they might be wholly intrastate, was within the scope of the Commerce Power.

These decisions generated a rebirth of an interest in federalism. Some authors examined the theory behind federalism; others looked at the impact these decisions might have on specific subject areas; and yet others did both.

1.B **Theories on Federalism**

Theories on federalism began with the *Federalist Papers*. In Federalist Paper #51,\(^ {33}\) James Madison posited that a division of power among both state and federal governments would help prevent "factions"\(^ {34}\) from using the mechanism of government to take steps contrary to the interest of the general public. It does this by having the two governmental bodies constrain each other.\(^ {35}\)

Almost 150 years later, Louis Brandeis, in a dissent in *New State Ice Co. v. Leibmann* (1932), provided another theory to support federalism: that a state may act as a "laboratory" of democracy.\(^ {36}\) Under this theory, the federal system improves long-run welfare by permitting different states to attempt different methods for addressing a public need, comparing the results of these methods, and then having other states then adopt the more successful methods.

This laboratory might be financed through "cooperative federalism,"\(^ {37}\) under which the federal government does not directly regulate behavior, but instead financially supports states that implement policies consistent with federal goals, while at the same time permitting the

\(^{29}\) Id., at 615.
\(^{30}\) Id., at 616.
\(^{31}\) Gonzales v. Raich, 545 U.S. 1 (2005).
\(^{32}\) Id., at 25. Note: Chief Justice Rehnquist, who had written the majority opinions in *Lopez* and *Morrison*, was in the minority in *Raich*.
\(^{34}\) For more on "factions," see James Madison, FEDERALIST #10 (1787), available at http://www.constitution.org/fed/federa10.htm.
\(^{35}\) FEDERALIST #51. Madison notes, "[P]ower surrendered by the people is first divided between two distinct governments, and then the portion allotted to each subdivided among distinct and separate departments. Hence a double security arises to the rights of the people. The different governments will control each other, at the same time that each will be controlled by itself."
\(^{37}\) For more on cooperative federalism, see Richard Stewart, *Pyramids of Sacrifice? Problems of Federalism in Mandating State Implementation of National Environmental Policy*, 86 YALE L.J. 1196 (1977) [examining the problems in implementing federal policies through state and local officials, and examining the constitutionality of delegation]; and Joshua D. Sarnoff, *Cooperative Federalism, the Delegation of Federal Power, and the Constitution*, 39 ARIZ. L. REV. 205 (1997) [discussing the political reality, and constitutional history of cooperative federalism, and arguing for invalidation of insufficiently supported delegation of federal power to the states].
states to choose the means to achieve those goals. In the 1992 case, *New York v. United States*, the Supreme Court held that there are limits to “cooperative federalism,” namely that Congress cannot “commandeer the legislative processes of the States by directly compelling them to enact and enforce a federal regulatory program.” However, Congress may make the receipt of federal funds conditional, and also may “offer States the choice of regulating that activity according to federal standards or having state law pre-empted by federal regulation.”

Critiquing this decision, Joshua Sarnoff argues that, under certain circumstances, “the Supreme Court should find that the delegation or effective delegation of federal legislative power to states violates the Constitution.” To support this, Sarnoff notes that "Congress does not need to delegate legislative power to states to effectuate federal policies, because Congress may delegate broad policymaking powers to federal agencies." As a result, he concludes that "the Court should invalidate cooperative federalism statutes when Congress has not demonstrated that they will result in better, more efficient, or more accountable governance."

In the year following *New State Ice Co. v. Leibmann*, Justice Brandeis is credited with providing yet another theory about federalism in another dissent in *Liggett Co. v. Lee*: the “race to the bottom.” Under this theory, an overarching federal power is necessary to protect states from “ruinous competition.” This theory is an application of game theory’s “Prisoner’s Dilemma.”

Drawing on Charles Tiebout, public choice theory provides a response to the “race to the bottom” theory. In a sequence of articles, Richard Revesz explains that competition among states to attract residents leads to an efficient matching process between residents with different tastes for protection and states offering different levels of protection.

Another public choice theory, drawing on Mancur Olson, suggests that states are more likely to suffer from “regulatory capture.” Regulatory capture is when administrative agencies are “captured” by an industry to the point that the agency makes decisions that, while benefiting the industry, are detrimental to general welfare.

A more general theory is that of “economies of scale.” Under this theory, there are economies of scale in regulation, and so the larger scale of a federal approach would make it more efficient. In contrast, others suggest that due to the benefits of “decentralization” whereby the locus of decision-making is distributed to a number of nodes, a smaller scale such as that of a state government is more efficient.

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40 Id., at 167.
41 Sarnoff, *Cooperative Federalism*, at 212.
42 Id.
43 Id.
48 MANCUR OLSON, JR. THE LOGIC OF COLLECTIVE ACTION (1965).
I.C Review of Environmental Policy Cases and Literature

In addition to articles and books examining federalism in general, there was a particular interest in the application of Lopez and Morrison to environmental policy. Two environmental subjects were pointed to as being ripe for a Commerce Clause challenge: wetlands policy under the Clean Water Act, and protection of species under the Endangered Species Act. This was because the subject matter regulated under these policies was primarily intra-state. A number of authors examined the impact of the new federalism on both of these environmental policies, including Peter Swire, Daniel Esty, Joshua Sarnoff, Lori Warner, David Linehan, and A. Dan Tarlock.

In the midst of this scholarly debate, two cases appeared on the Supreme Court docket: Solid Waste Agency of Northern Cook County v. U.S. Army Corps of Engineers (SWANCC) and Rapanos v. United States. These cases seemed to provide opportunities for the Court to apply the jurisprudence of Lopez and Morrison to wetlands. However, the Court instead decided these cases on other grounds.

In SWANCC, the court had the opportunity to determine whether federal jurisdiction in the regulation of intrastate wetlands was appropriate under the Commerce Clause. However, the court chose to base its decision on statutory interpretation, rather than constitutional authority, holding that the Corps’s “migratory bird rule” was not authorized under §404 of the Clean Water Act.

In Rapanos, the Court, although unable to reach a majority opinion, vacated and remanded the U.S. Court of Appeals judgment that had been in favor of the Corps’ interpretation of the Clean Water Act. Rather than applying federalism principles, the plurality opinion and Justice Kennedy’s concurrence both focused on interpretation of the terms “waters of the United States” and “navigable waters.” Kennedy suggested that navigable waters “must possess a ‘significant nexus’ to waters that are or were navigable in fact.” As a result, the impact of Lopez and Morrison on the regulation of wetlands remains uncertain.

A number of other authors examined wetlands and endangered species separately. Vickie Sutton and Jonathan Adler published articles on wetlands protection prior to

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49 Peter P. Swire, SYMPOSIUM: CONSTRUCTING A NEW FEDERALISM: The Race to Laxity and the Race to Undesirability: Explaining Failures in Competition among Jurisdictions in Environmental Law, 14 YALE L. & POL’Y REV. 67 (1996) [This article presents a two-dimensional structure to the question of the “race to the bottom:” laxity versus strictness, and desirable versus undesirable. With this structure, it then challenges some of the assumptions of competitive models of the race to the bottom, and shows that, under certain conditions, there may be a race to undesirable laxness.].

50 Daniel Esty, Revitalizing Environmental Federalism, 95 MICH. L. REV. 570 (1996) [arguing that determination of the appropriate scale of environmental regulation depends on the particular characteristics of the environmental challenge that is being addressed].


54 A. Dan Tarlock, SYMPOSIUM OF THE ADVENT OF LOCAL ENVIRONMENTAL LAW ARTICLES & TRANSCRIPT: The Potential Role of Local Governments in Watershed Management, 20 PACE ENVTL. L. REV. 149 (2002), pointing out the consistencies between wetlands and endangered species policies in that they “seek to protect biologically sensitive lands such as wetlands and endangered species habitats by preventing development within the confines of the Court’s takings frameworks,” at 171.

55 Rapanos, 126 S. Ct. 2208, 2236.


SWANCC. After SWANCC failed to conclusively decide the federalism issue for wetlands, a number of other articles discussed this topic, including another by Adler and one by Edward Fitzgerald. Those examining the Endangered Species Act include Omar White, Bradford Mank, and Kevin Cassidy.

I.D  Literature on Health Policies

In the 1990s, health care reform became an important topic. In particular, the Medicaid program grew significantly during the 1980s and 1990s, representing forty percent of federal payments to states by the mid 1990s. In 1993, the Clinton administration proposed a comprehensive health care reform package. Although not enacted, this proposal spurred further debate on health care reform. After the Lopez decision and the enactment of welfare reform, a number of authors examined the implications of federalism on Medicaid policy.

One author pointed out that devolution of health policy had been “ongoing” for a number of years. Another explained that the “impact of new federalism” is that “pursu[it of] our national public health agenda” will depend on utilizing the “means” provided by our “federalist system of government,” namely the police powers of states. A number of analyses were published in Medicaid and Devolution: A View from the States, edited by Frank J. Thompson and John J. Dilulio. In one chapter, Frank J. Thompson examines whether states can accept more responsibility for Medicaid, focusing on their governing and fiscal capacities, along with their commitment to Medicaid. He concludes that devolution should follow a more incremental, calibrated approach … pay[ing] particular attention to implementation … and assign[ing] a score keeping role to the national government.

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65 Thomas J. Anton, New Federalism and Intergovernmental Fiscal Relationships: the Implications for Health Policy, 22 J. OF HEALTH POLITICS, POL’Y, & LAW 691, 691 (1997) [pointing out that significant reform of health policy already had taken place in the states, but reminding of limits to the effectiveness of devolution, due to the benefits of specialization].
68 Frank J. Thompson, Federalism and the Medicaid Challenge, in id at 260.
Many other authors analyzed federalism and health care, including Stephen Davidson, John Blum, Robert Hurley and Stephen Zuckerman, and Joan Krause. Another set of analyses were published in 2003 in Federalism & Health Policy, edited by John Holahan, Alan Weir, and Joshua M. Wiener. In addition to these analyses, the Urban Institute began a project, “Assessing the New Federalism.” This project has conducted numerous analyses of federalism and health policies.

I.E Institutional Transaction Cost Theory

Some of the articles in these literatures do address the role of economies of scale in comparing the desirability of a federal versus a state approach to these policies. Others have suggested that policies could utilize cooperative federalism to spread responsibilities for these policies across local, state, and federal governments. However, none have provided a structured approach to determining the optimal locus of policies across each of the enactment, implementation, and enforcement institutions.

This article will do so, utilizing the institutional transaction cost framework initially described in my dissertation, and published later in the Natural Resources Journal. Institutional transaction costs are the “costs of the institutions that support public policies,” and “they include the costs of enacting a policy by the legislature, implementing that policy by an administrative agency, and enforcing that policy by the agency and the courts.” This framework suggested that in comparing policies, you should choose a policy that had the least aggregate sum of compliance costs, enactment costs, implementation costs, and enforcement costs.

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69 Stephen Davidson, Politics Matters! Health Care Policy and the Federal System, 22 J. Health Politics, Policy, & L. 879 (1997) [comments on other articles in the symposium, focusing on the role of political constraints on coordination between federal and state governments to solve national health problems].

70 John Blum, Overcoming Managed Care Regulatory Chaos Through a Restructured Federalism, 11 HEALTH MATRIX 327 (2001) [arguing that dual regulatory systems by both state and federal governments leads to conflicting policies, duplication, and too-high costs, and then making recommendations to enable more standardization and coordination].

71 Robert Hurley and Stephen Zuckerman, Medicaid Managed Care: State Flexibility in Action, ASSESSING THE NEW FEDERALISM DISCUSSION PAPERS, 02-06 (2002) [examining the use of managed care for Medicaid, and the variations across states including innovations].

72 Joan Krause, Federal-State Conflicts in Health Care, 3 HOUS. J. HEALTH L. & POL’Y 151 (2003) [reviewing a symposium of articles examining the tensions between federal and state approaches to health care].


74 See Anna Kondratas, Alan Weil, and Naomi Goldstein, Assessing the New Federalism: an Introduction, 17 HEALTH AFFAIRS 17 (1998) [providing an introduction to the ANF project, emphasizing the need to understand state variations to health and social service policies, and the impact of these programs on all low-income Americans].


77 Id. at 518.

78 In my previous article, I split enforcement costs into detection costs and prosecution costs. However, in this article, I refer to only enforcement costs.
II. FRAMEWORK FOR ANALYZING FEDERALISM ACROSS INSTITUTIONS

II.A Definitions:
We begin with some definitions:

*Policy*: Composed of an Enactment Phase, an Implementation Phase, and an Enforcement Phase

*Enactment*: Determines Goals, Powers, and Constraints of a Policy

*Implementation*: Defines Mechanisms, Incentives, and Penalties for those Targeted by Policy

*Enforcement*: Monitors and Ensures Compliance of Individuals Targeted by Policy

*Diseconomies and Economies of Scale*: These arise from the transaction costs of these policies, or from the effects of transaction costs.

This framework uses a comparison of economies of scale with diseconomies of scale. In examining economies and diseconomies of scale, we consider institutional transaction costs. Those policies having rising institutional transaction costs as scale increases have diseconomies of scale, and those having relatively lower institutional transaction costs have economies of scale.

In comparing economies and diseconomies of scale, we can assess the proper scale of an institutional dimension of a policy. Depending on the relative strength of the economies and diseconomies of scale, the cost function of a policy dimension can take different shapes:

**Figure 1: Economies & Diseconomies of Scale**

In the first case, the cost of a policy is minimized by having as small a scale as possible. This would suggest that this dimension of the policy should be located at the local level. In the second case, minimization of costs suggests that policy should be located at the state level. And in the last case, minimization of costs occurs at the largest scale, and so policy should be located at the national level.
To simplify analysis, the framework presented in this article looks at only two levels: state and national. The following describes the general process of using this framework:

II.B General Technique

1. Compare single national policy with multiple state policies that have same general objective [i.e. the combination of state policies achieves the same result as the single national policy].

2. Divide into three sub-comparisons, examining policy at phases of enactment, implementation, and enforcement.

3. At each phase then, compare economies of scale with diseconomies of scale for specific policies.

4. If economies of scale are more significant than diseconomies of scale, then the optimal scale is national. If diseconomies are more significant, then the optimal scale is state.

II.C Factors Influencing Economies & Diseconomies of Scale

We now describe general factors that influence economies and diseconomies of scale for each of the policy institutions. These factors can then guide analysis of specific policies.

We begin with the enactment phase. In this phase, influenced by interest groups, legislatures decide to address a particular policy problem. The legislatures then determine the ultimate purposes of the policy, and specify available mechanisms to achieve these. In examining economies and diseconomies of scale for enactment, we focus on the legislative process and the balancing of political interests, along with the role of interest groups. We also examine financing policies through taxes, and the effects of policy errors.

<table>
<thead>
<tr>
<th>Enactment Phase</th>
<th>Economies of Scale</th>
<th>Diseconomies of Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avoidance of replication of legislative effort. [This advantage can be reduced by having a leader state or a “Uniform” approach, rather than independent legislative efforts.]</td>
<td>It will be more difficult to get political agreement, both within interest groups and among interest groups.</td>
<td></td>
</tr>
<tr>
<td>Individual states may enact policies where the costs or benefits may accrue to non-constituents. These non-constituents may attempt to influence the drafting of the</td>
<td>A larger scale implies that the interest groups themselves are larger, and this will make it more difficult to get a consensus within the group</td>
<td></td>
</tr>
</tbody>
</table>

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79 This framework could be extended to local, regional, and international levels.

80 “A political entrepreneur recognizes that a large group of voters, who might be otherwise ignored by the political process, may have substantial political power if they can be effectively mobilized. The entrepreneur then tries to mobilize this group by offering it organization and information. With the group mobilized, the entrepreneur can
legislation through lobbying, or by acting as a political entrepreneur. They may also challenge the legislation (or lack thereof) through litigation. There will also be more interest groups with the larger scale, and thus will be more difficult to achieve a political agreement.

<table>
<thead>
<tr>
<th>Possible cost advantages for lobbying when act as constituent.</th>
<th>It will be more difficult to enable flexible approaches.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avoidance of non-constituent suits.</td>
<td>More costly to anticipate what flexibility is required</td>
</tr>
<tr>
<td></td>
<td>More difficult to achieve political agreement on differential impacts.</td>
</tr>
</tbody>
</table>

Interest Groups may require an entrepreneur who will provide the public goods of organization and information. This is more likely to occur with larger scale because an entrepreneur is more likely to contribute because a larger scale policy will have a wider impact.

Costly Errors

| Errors will be more widespread |
| Easier to do experimentation with smaller scale decision-making. |

Taxes can be collected from a broader base, thereby reducing distortionary effects. Also, when economic fluctuation affects certain states harder, can spread burden of supporting that state.

Opportunity for subsidized funds to be diverted to less helpful projects, because not bearing full cost of these funds.

From these, two considerations stand out: achieving a political agreement to achieve the policy, and financing the policy. Scale provides both economies and diseconomies in achieving a political agreement, and the relative magnitudes are context dependent. Meanwhile, the transaction costs from financing a policy generally decline as scale increases, although increasing scale can lead to adoption of less efficient projects, as accountability for costs declines.

We now turn to the implementation phase. In this phase, administrative agencies determine the mechanism for achieving objectives of policy. This mechanism specifies what private and public parties must do in order to comply with the policy. In examining economies and diseconomies of scale for implementation, we focus on the process of implementing and experimentation, along with the talents and knowledge base brought by the administrative staff implementing the policy.

| Implementation Phase |
| --- | --- |
| **Economies of Scale** | **Diseconomies of Scale** |

then direct its political power to further the entrepreneur’s own purposes.” Dale B. Thompson, Political Entrepreneurs and Consumer Interest Groups: Theory and Evidence from Emissions Trading (2005), unpublished manuscript.
No need for replication of effort across states

Multiple implementations by states would lend itself naturally to experimentation. Furthermore, even if a centralized group did multiple experiments, organizational issues might create barriers to adopt successful mechanisms for future use.

Can group talent to better understand problem. Here, talent can be pooled from across the country, rather than trying to collect it in all states, or in a single state acting as an implementation leader.

More people working on problem can come up with wider diversity of approaches.

A centralized implementation group will develop a knowledge base in implementing many policies.

Implementation might benefit from the use of local knowledge for problems that need locally specific mechanisms. This local knowledge will be more available for decentralized implementation groups.

A centralized implementation group will have access to a broader dataset.

Easier to provide consistency in regulations. (Even so, policies may be subject to multiple federal agencies.)

For implementation, there are two primary considerations: opportunities to innovate and experiment, and the locus of knowledge. The optimal size of a firm for enabling innovation has been the topic of a lengthy debate. Some point to the resources available to a larger firm, thereby enabling costly experimentation. Others point to the need for independence to allow innovators to come up with new ideas, which is simpler in a smaller organization.

In a similar manner, the locus of knowledge also leads to both economies and diseconomies. A project with a larger scale can support people with more specialized knowledge. On the other hand, projects with smaller scale imply that those involved have more localized knowledge, and this local knowledge can aid implementation.

The final phase is enforcement. In this phase, administrative agencies monitor compliance with the policy. Noncompliers may be induced to comply with the policy, or may be taken to court. In examining economies and diseconomies of scale for enforcement, we focus on the precedent of establishing enforcement practices, and the knowledge and abilities of enforcement agents.

<table>
<thead>
<tr>
<th>Enforcement Phase</th>
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</thead>
<tbody>
<tr>
<td><strong>Economies of Scale</strong></td>
</tr>
<tr>
<td>More even enforcement</td>
</tr>
<tr>
<td>More clear precedent if taken to court</td>
</tr>
</tbody>
</table>
Able to present a more credible punishment threat | More receptive to locally modified approach to compliance

Centralized savings in training enforcement agents

As before, knowledge is also a key consideration for enforcement, in particular knowledge of local conditions and options. Also, the relationship between the regulator and the regulated entity is important: a regulated entity may be more likely to respond positively to suggestions made by a regulator with whom a working relationship exists. On the other hand, an external enforcement agent may be able to induce a quicker response, as the regulated entity realizes they have fewer options other than complying.

Thus, for each of these policy institutions, we can use these factors to identify economies and diseconomies of scale associated with a particular policy. We can then balance the economies with the diseconomies to ascertain the appropriate scale, and thereby determine the optimal locus of policy for each institution.

While it is helpful to consider factors affecting economies and diseconomies of scale in general, in the end, the benefit from the framework comes from applying it to actual policies. To better explain how this is done, we will now provide some examples of applying the framework. Legislators and judges can then use these examples to learn the technique of applying this framework to other policies.

III. APPLICATION OF FRAMEWORK TO COMPARISON OF ENVIRONMENTAL POLICIES

We next use this federalism framework for assessing the proper scale of enactment, implementation, and enforcement institutions for policies related to the Endangered Species Act (ESA), and to wetlands. As background, we briefly describe how these policies are currently implemented by the federal government and the states. We then use the federalism framework offered here to compare these policies across their enactment, implementation, and enforcement dimensions.

III.A CURRENT FEDERAL AND STATE POLICIES TO PROTECT ENDANGERED SPECIES

In the United States, endangered species are protected at both the federal and state levels. The primary legislation protecting endangered species at the federal level is the Endangered Species Act of 1973 (ESA). In order for a species to be protected under this act, it must first be “listed” as “endangered” or “threatened” by either the U.S. Fish and Wildlife Service (FWS) or the National Marine Fisheries Service of the Commerce Department (NMFS). Once listed, it is illegal to “take” a species without a federal permit. “Take” under the ESA is defined “to harass, harm, pursue, hunt, shoot, wound, kill, trap, capture, or collect or attempt to engage in any such conduct.”

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82 Id.
83 Id.
84 Id.
In addition to protecting these species directly, the ESA also protects species by designating “critical habitat” of these species.\textsuperscript{85} Critical habitats are “areas that contain the physical or biological features essential to the conservation of the species and that may need special management or protection.”\textsuperscript{86} Once designated, federal agencies and other parties operating with federal funding or under a federal permit must avoid “adverse modification” of the critical habitat.\textsuperscript{87}

Similarly to federal protection under the ESA, many states protect endangered species under state legislation.\textsuperscript{88} These laws also prohibit taking endangered or threatened species, as designated by the state, unless permitted by the appropriate state agency.\textsuperscript{89} Habitat protection, available under federal law, is generally not available under state law.\textsuperscript{90}

Consequently, the current statutory schemes for protecting endangered species provide a parallel, overlapping structure: one at the federal level, and others at the state level. Species may be protected at only the state level, only the federal level, or at both the federal and state levels. Depending on the state, there may be significantly larger number of species protected at the state level,\textsuperscript{91} and there is the possibility that a species is protected at the federal level but not at the state level.\textsuperscript{92} An advantage of the dual listing structure is that we can ensure a certain baseline level of protection: certain species will be protected across the country, but others may be protected more or less depending upon local conditions.

The decision to list species on a state basis is different than the decision to list at a federal level. At the federal level, listing decisions frequently begin when an interest group such as the Nature Conservancy petitions to have a species protected.\textsuperscript{93} The status of the species is then assessed.\textsuperscript{94} During this assessment, it is determined whether the species is globally rare, or rare in a number of states.\textsuperscript{95} An expert scientific panel may be consulted.\textsuperscript{96} Then, a panel of managers from the FWS may make the final listing decision.\textsuperscript{97}

Significant differences at the state level occur primarily due to the more limited scope of state legislation: the state is concerned with the presence of the species within its own territory, and not necessarily across the country nor globally. The differences in scope sometimes lead to different decisions as to whether a particular species is listed at the federal level, the state level, or both.

\textsuperscript{85} Id.
\textsuperscript{86} Id.
\textsuperscript{87} Id.
\textsuperscript{88} For example, see Minnesota Department of Natural Resources, \textit{Endangered, threatened & special concern species} (2008), available at [http://www.dnr.state.mn.us/ets/index.html](http://www.dnr.state.mn.us/ets/index.html). Also, see Minnesota’s endangered species law, Minn.Stat. 84.0895.
\textsuperscript{89} Id.
\textsuperscript{90} Id. See also interview with Richard Baker, Minnesota Department of Natural Resources (August 6, 2007).
\textsuperscript{91} See for instance, Minnesota’s very lengthy list of endangered, threatened, and special concern species, and note that only one of fourteen mammals, and three out of twenty-eight birds that are listed at the state level are also listed at the federal level, available at [http://files.dnr.state.mn.us/eco/nhnrp/endlist.pdf](http://files.dnr.state.mn.us/eco/nhnrp/endlist.pdf). See also interview with Richard Baker.
\textsuperscript{92} For example, the Canada lynx, American burying beetle, and Eskimo curlew are all protected at the federal level and appear in Minnesota, but are not protected at the Minnesota state level. See [http://ecos.fws.gov/tess_public/StateListing.do?status=listed&state=MN](http://ecos.fws.gov/tess_public/StateListing.do?status=listed&state=MN) and [http://files.dnr.state.mn.us/eco/nhnrp/endlist.pdf](http://files.dnr.state.mn.us/eco/nhnrp/endlist.pdf).
\textsuperscript{93} Interview with T. J. Miller, U. S. Fish and Wildlife Service (August 9, 2007).
If a species is protected by both the federal ESA and the state act, then a project that may impact that species must obtain permits from both federal and state agencies, unless it falls into one of the exceptions.\textsuperscript{98} At the federal level, the FWS is responsible for issuing permits.\textsuperscript{99} One category of permit that is frequently sought is an “incidental take” permit, which applies to “taking that is incidental to an otherwise lawful activity.”\textsuperscript{100} If a permit is issued, a limited amount of “take” of the species may occur, as specified by the permit.\textsuperscript{101} Consequently, to protect the species, the reviewing agency must ensure that the impact to the species is avoided and minimized to the extent practical. Additionally, for impacts that cannot be avoided, permit applications must include plans for mitigation, which could include replanting of habitat, relocating affected species, or contribution of land or funds for alternative projects that address the needs of the species.\textsuperscript{102}

While listing and permitting decisions follow distinct processes at state and federal levels, there is nonetheless significant coordination between state and federal agencies. One reason for this coordination is the fact that states maintain the databases used to assess species and their habitat, in both listing and permitting decisions.\textsuperscript{103} Additionally, state “biologists often have information available that is pertinent” to the specific habitat or species.\textsuperscript{104} Coordination is also beneficial when a species is listed at both a federal and state level.\textsuperscript{105}

\textbf{III.B \ Current Federal and State Policies to Protect Wetlands}

In the United States, legislation on protecting wetlands is promulgated at both federal and state levels. At the federal level, wetlands are protected through the Clean Water Act, in particular §§ 404\textsuperscript{106} and 401;\textsuperscript{107} the Rivers and Harbors Act of 1899;\textsuperscript{108} the Emergency Wetlands Resources Act;\textsuperscript{109} and the National Environmental Policy Act. Under the Clean Water Act, the primary authority for ensuring compliance with the Act is the Environmental Protection Agency (EPA).\textsuperscript{110} However, this Act also designates the United States Army Corps


\textsuperscript{99} Id.

\textsuperscript{100} Id.

\textsuperscript{101} Id.


\textsuperscript{103} For example, Minnesota operates the “Natural Heritage Information System” with “information on Minnesota's rare plants, animals, native plant communities, and other rare features.” See http://www.dnr.state.mn.us/eco/nhnrp/nhis.html.


\textsuperscript{106} Under Section 404, permits are required before discharging dredge or fill material into a wetland.

\textsuperscript{107} Section 401 sets water quality standards, and policies affecting wetlands must consider the effects on water quality of the particular affected water body.

\textsuperscript{108} This act regulates construction affecting national waterways.

\textsuperscript{109} This act requires the maintenance of a National Wetlands Inventory, the responsibility for which is given to the U.S. FWS.

of Engineers (Corps) as being responsible for issuing wetlands permits. The U.S. Fish and Wildlife Service maintains the National Wetlands Inventory.

Many states also have legislation protecting wetlands. For instance, Minnesota has enacted the “Minnesota Wetlands Conservation Act.” This act establishes a policy of “no net loss in the quantity, quality, and biological diversity of Minnesota’s existing wetlands.” It also states that activities that adversely impact wetlands should be minimized where possible, and, when it is not feasible, to “replace wetland values.” In Minnesota, this legislation spreads responsibility for protecting wetlands among the Minnesota Department of Natural Resources (DNR) and the Minnesota Pollution Control Agency (PCA), and wetland permits are issued by the Minnesota Board of Water and Soil Resources (BWSR).

Implementation of the federal legislation involves a complex network of guidelines and rules. The EPA establishes general guidelines for permitting in wetlands. Part of the Corps’ task is to develop guidelines for wetlands delineation, i.e. establish what areas are considered wetlands versus “uplands.” The Corps has also developed a “hydrogeomorphic classification system—a state-of-the-art method for evaluating ecological functions of wetlands.” This system allows the Corps to develop regionally specific guidelines for assessing wetlands. This system is consistent with the significant degree of independence of one district office of the Corps from another. Additionally, the Corps has established a “Nationwide Permit” (NWP) program, whereby certain categories of activities in certain designated areas may qualify for a permit without undertaking a full permit application and review process.

Furthermore, the Corps also frequently coordinates with state agencies responsible for protecting wetlands. Under Section 404, Part F, of the CWA, when someone applies for and receives a state wetlands permit, they may be entitled to an exemption from a requirement to receive a federal permit. Accordingly, it is essential for the Corps and relevant state agencies to coordinate with state agencies in establishing permit guidelines that are consistent. As a result, another set of guidelines established by the Corps in coordination with state agencies are guidelines for mitigation, including mitigation banks.

111 33 USCS § 1344
114 Id.
115 Id.
118 See 33 CFR 320-336, in particular 33 CFR 320.4.
121 See for instance, the numerous publications of regional guidebooks using this system, available at http://el.erdc.usace.army.mil/wetlands/wlpubs.html.
122 See 33 CFR § 320.1: “The Corps is a highly decentralized organization;” and telephone interview with Susan Elston, U.S. Environmental Protection Agency, Region V (September 18, 2007).
123 33 CFR § 330.1.
124 Water bodies noted as “critical resource waters” are not included in certain parts of this program. Ibid.
125 Interview with David Weirens, Minnesota Board of Water & Soil Resources (August 1, 2007).
In addition to these rules, both the EPA and the Corps have centers for conducting experiments related to wetlands. The Corps facility is known as the “Waterways Experiment Station (WES)” and is located in Vicksburg, Mississippi.

At the same time, state agencies also develop locally appropriate guidelines for managing wetlands. Minnesota’s Wetland Conservation Plan states, “Local water plans, wetlands plans, and land use plans remain the best way to account for specific local needs and conditions.” In Minnesota, management strategy begins by identifying and describing differences across hydrogeologic zones in the state. For each of the zones, appropriate management techniques are specified. State agencies use these management strategies to develop “general and specific standards that apply to the evaluation of permits for each type of activity.”

Additionally, as noted above, mitigation guidelines are developed, in coordination with federal agencies. However, while the federal government maintains experimental labs for wetlands, it is less likely that states will do so.

In the enforcement phase of wetlands policy, local, state, and federal agencies make decisions about granting permits, and these decisions may be appealed. Permits satisfying the requirements of the federal Clean Water Act are generally issued by the Corps, although a state agency may also be granted authority under certain circumstances. In general, permitting decisions by the Corps are made by District Engineers. Substantive appeals of these decisions may be submitted to a Division Engineer, while further appeals are handled under the Administrative Procedures Act.

At the state level, initial permitting decisions may be made by local governmental units, such as the County Board of Commissioners, or by state agency staff. Appeals made by agency staff may be made to the heads of commissions, or beyond that, to courts under state administrative law procedures. Meanwhile, appeals of local government units can generally be made to the state agency that oversees the process under which the local government unit manages wetlands.

III.C  Policy Comparison

Memorandum of Understanding on Wetland Mitigation], available at http://www.bwsr.state.mn.us/wetlands/BWSR-COEmemo.pdf.
128 Interview with Susan Elston.
129 This facility houses a wide array of experiments. The wetlands center is known as the Wetlands Research and Technology Center. See http://www.wes.army.mil/Welcome.html and http://el.erdc.usace.army.mil/wetlands/
131 See id.
133 Interview with David Weirens.
134 One state that does this is Michigan. Interviews with Doug Norris, Minnesota Department of Natural Resources (August 7, 2007), and Susan Elston, U.S. Environmental Protection Agency, Region V (September 18, 2007).
135 See 33 CFR §§ 320 and 331.
136 Id.
137 See Wetlands Regulation in Minnesota, supra note 132.
138 Id.
139 Id. See also interview with Doug Norris.
Under the federalism framework offered in this article, we select a particular goal to achieve, and then consider economies and diseconomies of scale associated with that goal, across different institutions. The goal of the first policy will be to protect the habitat of species listed as endangered or threatened. This goal will provide its principal benefits to citizens across the country, through gains from maintaining biodiversity and existence values. The goal of the second policy will be to preserve wetlands located near major water bodies. This goal will provide its principal benefits to local and regional citizens who are affected by these water bodies. Wetland protection will improve the water quality of these water bodies, and also serve as buffers in case of overflow and flooding. Some of these water bodies are intra-state, while others cross many states. We now compare these policies across their enactment, implementation, and enforcement dimensions.

**Enactment**

In analyzing economies and diseconomies of scale during enactment, we examine the transaction costs of legislatures, interest groups, and political entrepreneurs. Some of the key aspects are the scope of the benefits and costs. As noted, an endangered species policy provides benefits to citizens across the country. These benefits are very diffuse, and not well-understood by many citizens. As a result, a political entrepreneur may be needed to champion the cause of protecting endangered species. There are significant economies of scale to the activities of these entrepreneurs, because their provision of information and organization can be done at a national level, rather than over multiple, separate state levels.

However, in order to preserve the habitat of the endangered species, development opportunities in the area in which the habitat is located will need to be curtailed. This will impose more concentrated costs on the locality in which the species’ habitat is located. Consequently, there might be a need to compensate affected owners of properties on which the habitat lies. A broader tax base should lower distortionary effects of this tax, and so there is an economy of scale here.

In contrast, the benefits from a wetlands policy will accrue to those citizens located near affected hydrogeological systems. As a result, for systems contained completely within one state, it is more likely that those beneficiaries can be more effectively represented at a state level, and so the economies of scale are less here than for the endangered species policy. Additionally, in the end, the interest groups supporting a wetlands policy will be a coalition of groups impacted by water quality and flood-control effects located in different areas. Because this will be a coalition, it may be more difficult to coordinate these groups if they are impacted differently by wetlands policies. This effect is one of diseconomies of scale.

However, to a great extent, most hydrogeological systems are interconnected. As a result, in the case of multi-state hydrogeological systems, beneficiaries exist at a more regional-level. In these instances, in order to enact policies at the state level, regional compacts between the states sharing the water body would be necessary. We have seen such compacts for water policies addressing the Great Lakes and the Colorado River.

Other economies of scale remain, as duplicative legislative efforts could make state enactment of a wetlands policy costly. These duplicative efforts could be avoided by a

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140 Existence value is “the value someone derives from knowing that a resource exists.” Dale B. Thompson, *Valuing the Environment: Courts’ Struggles with Natural Resource Damages*, 32 ENVTL. L. 57, 58 (2002).
141 See note 80, supra.
142 See note 182, supra.
143 Interview with Doug Norris.
“Uniform” approach, however. The following table summarizes economies and diseconomies of scale in enactment:

<table>
<thead>
<tr>
<th>Endangered Species</th>
<th>Wetlands</th>
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</thead>
<tbody>
<tr>
<td><strong>Economies of Scale</strong></td>
<td><strong>Diseconomies of Scale</strong></td>
</tr>
<tr>
<td>Avoid duplicative legislative efforts</td>
<td>Can have one state lead, or have consortium of states as leader.</td>
</tr>
<tr>
<td>May be easier to organize at national level because benefits of policy are more esoteric: the welfare of different endangered species in an area provide benefits through biodiversity, the balance of an ecosystem, and as a proxy for the health of the local ecosystem (economies of scale of a political entrepreneur)</td>
<td></td>
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</tbody>
</table>

Endangered species interest groups are more willing to support national policies because impact of policies rises at an increasing rate as scale increases. (survival rate of species increases exponentially as additional habitats are protected, and hence are less subject to having entire species exposed to individual threats). To properly address effects of wetlands that service multi-state hydrogeologic systems, it is much easier to legislate at the national level: simplification of coordination (if done at state level, the legislature must direct that effects on other states are considered, and this must be done through reciprocity negotiations of neighboring legislatures). Also may have localized benefits: benefits of policy for an entirely local hydrogeologic system flow to local residents. If so, local legislatures may be better in-tune with true value of wetland protection for that waterbody.

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144 See *ESA Basics*.

145 See interviews with Richard Baker and T. J. Miller.
<table>
<thead>
<tr>
<th>Easier to manage national environmental groups, than fifty individual state environmental groups, because of the wide range of organizational strength of environmental groups across different states.(^{146})</th>
<th>Similar economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Can reduce the impact of anti-endangered-species-protection interest groups that are more influential in a small number of specific states.</td>
<td>Similar economy</td>
</tr>
</tbody>
</table>

Thus, under this framework, we search for the lowest cost way to enact a particular policy. As seen in the table above, for a given endangered species policy, groups wishing to politically support this policy would encounter economies of scale, while groups opposing this policy would have greater strength at state levels. Although of a different nature, there are also significant economies of scale for policies that protect multi-state hydrogeologic wetland systems. It is simpler to coordinate efforts through a single piece of legislation rather than multiple pieces of legislation in different legislatures. In marked contrast, there are considerably less economies of scale for a local wetlands policy. Much of the benefits of local wetlands is captured locally, and hence can be properly assimilated in a political “who-bears-costs versus who-benefits” battle within a state.

In the end, the framework therefore suggests that policies protecting endangered species and multi-state hydrogeologic wetland systems are relatively less costly to enact at the federal level, while policies protecting local wetlands are better candidates for enactment by individual states.

**Implementation**

In the enactment phase, policy goals are defined. During implementation, an administrative agency develops rules to achieve these policy goals. During enforcement, these rules are applied in particular cases, and then are monitored to ensure compliance.

Both endangered species and wetlands policies are fundamentally about land use and development decisions. Consequently, the implementation phase of these policies can be understood as an agency’s attempt to develop rules protecting endangered species and wetlands while balancing land use and development interests. Rules that need to be developed for endangered species include determination of what species are “listed,” and development of mitigation guidelines. For wetlands, rule development includes scientific

\(^{146}\) See interview with Richard Baker.
assessment and designation of critical waters, development of scientific approaches to categorizing wetlands, development of mitigation guidelines, and determination of appropriate management strategies.

In comparing economies and diseconomies of scale for implementation, we focus on the process of writing rules and guidelines; baseline protection; database management; and both local and centrally developed knowledge. We find the following economies and diseconomies:

<table>
<thead>
<tr>
<th>Endangered Species</th>
<th>Wetlands</th>
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<tbody>
<tr>
<td><strong>Economies of Scale</strong></td>
<td><strong>Diseconomies of Scale</strong></td>
</tr>
<tr>
<td>Avoid costs of duplication for developing lists of protected species (although not necessary to address species that are not present in a state, and hence there may be less overlap), and rules for mitigation guidelines</td>
<td>Could approach this on a state level using a “Uniform” method, thereby also avoiding duplication costs</td>
</tr>
<tr>
<td>We can more easily assure that there are baseline protections for particular species. Also, we can coordinate rule development for multi-state species.</td>
<td>Knowledge of local conditions may be needed in particular cases for making listing decisions and in developing mitigation guidelines. More likely that this information is possessed by local staff.</td>
</tr>
<tr>
<td>Development of listing decisions requires databases of information on species and their habitats. Significant economies in coordinating databases of species</td>
<td>Record structure of database may need to be inconsistent from one jurisdiction to another jurisdiction, because local</td>
</tr>
</tbody>
</table>

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147 Id.
148 Interview with T. J. Miller.
149 Id.
150 Interviews with Doug Norris and Susan Elston.
residing in multiple state jurisdictions. circumstances may lead to need to collect different information in different places. Diseconomies of centralized data collection from managing data of different record structures. Also diseconomy from managing large amount of information about all critical species across the nation.  

Can support research through centralized grant system. Conduct wetlands research through national laboratories. Establish general scientific approach to modeling wetlands that enables adjustment for regionally specific guidelines for assessing wetlands. Much easier to adapt these models to local conditions with local information.

In this case, we see significant economies and diseconomies of scale for implementing policies protecting both endangered species and wetlands. There is a critical need for baseline protection, an economy of scale; while at the same time, determination of the appropriate level of additional protection depends on knowledge of local conditions, a diseconomy of scale. There are economies of scale in coordinating protection of multi-state species and wetland systems, but diseconomies in collecting and managing data needed to make implementation decisions. In comparison, wetland protection offers a strong economy of scale in the opportunity to conduct research on wetlands through a national laboratory.

In the end, the existence of both economies and diseconomies of scale suggests that implementation of these policies should be performed at both the state and federal levels. Federal implementation should focus on establishing baseline protection, coordinating rule development for multi-state species and wetlands, and, in the case of wetlands, conducting primary research at a national laboratory. At the same time, states should be responsible for determining rules for protection beyond baselines, and for collecting and managing data for protecting species and wetlands.

151 See interview with Richard Baker.
**Enforcement**

As mentioned above, enforcement involves applying rules to particular cases, and monitoring to ensure compliance. For endangered species, implementing agencies develop rules about which species and which habitats are protected. In enforcement, these rules are applied to individual permits. In this process, agencies must determine whether any taking of a protected species is justified, and if so, whether the taking is minimized. The agencies also assess the need for mitigation. Additionally, agencies must monitor projects to ensure that they are complying with the terms of their permits.

Meanwhile, enforcement of the protection of wetlands likewise involves applying rules to individual permit applications. This process may involve assessment of the wetland itself, as well as the effect on the wetland, and may also include mitigation actions. Permit decisions may be appealed.

To examine economies and diseconomies in enforcement, we again must consider baseline protection and the role of information. We also need to look at the number of staff needed to enforce policies; coordination of mitigation projects; and the advantages and disadvantages of external enforcement agents. In comparing these policies, we see the following economies and diseconomies of scale:

<table>
<thead>
<tr>
<th>Endangered Species</th>
<th>Wetlands</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economies of Scale</strong></td>
<td><strong>Diseconomies of Scale</strong></td>
</tr>
<tr>
<td>Oversight may be needed to ensure baseline protections of species. This can be achieved through “memoranda of understanding,” coordinating initial permitting decisions by state agents, followed by routine approval by federal agents.</td>
<td>Issuing permits and monitoring compliance requires large numbers of people, and there are diseconomies of managing larger numbers of people. Meanwhile, state agencies can utilize large numbers of staff who have a number of other responsibilities in addition to species protection.</td>
</tr>
<tr>
<td>Similar economy.</td>
<td>Local information is important in assessing the effects on the species, the value of the project proposed, and the usefulness or</td>
</tr>
</tbody>
</table>

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152 See BWSR / USACE Interagency Memorandum of Understanding on Wetland Mitigation.
153 See interviews with Richard Baker and T. J. Miller.
154 Interviews with Doug Norris and Susan Elston
155 Interview with T. J. Miller.
proposed mitigation. State agents are more likely to have local information.\textsuperscript{156} politicians,\textsuperscript{157} and as a result, it is less likely that additional appeals (and hence transaction costs) would be necessary for a given wetlands project that could be considered detrimental, but nonetheless could win approval.\textsuperscript{159}

| Large advantages in coordinating mitigation projects across state lines.\textsuperscript{160} | It may be easier to negotiate reciprocity in mitigation projects for species that cross borders, because border crossing by endangered species normally takes place in both directions. | In multi-state system situations, it will be easier to centrally coordinate mitigation projects, rather than negotiating for reciprocity between states. This is due to the direction of flow limiting the opportunities for reciprocity. |

In comparing enforcement of these policies, we see a significant number of similarities, with some differences. For both policies, there are substantial diseconomies of scale in initially processing permit applications and later in monitoring. This is true for both in managing the people performing these tasks, and in the availability of local information. This diseconomy is more significant for wetlands due to the higher magnitude of wetland permits. Another similarity is the usefulness of the “gorilla in the closet,” which is an economy of scale. There are also economies of scale in coordinating multi-state mitigation projects. The current overlapping permitting system coordinated through memoranda of understanding between federal and state agencies is a method to capture both economies and diseconomies of scale in enforcement.

In the end, the significant diseconomies of scale for enforcement of both endangered species policies and wetland protection policies suggest that both of these policies should be enforced primarily at the state level. Federal enforcement should have a supporting role,

\textsuperscript{156} See interviews with Richard Baker and T. J. Miller.
\textsuperscript{157} Id.
\textsuperscript{158} Interview with Susan Elston.
\textsuperscript{159} Interview with Mark Gernes, Minnesota Pollution Control Agency (July 31, 2007).
\textsuperscript{160} Interview with T. J. Miller.
addressing the needs to coordinate multi-state mitigation projects, and to provide oversight in order to ensure baseline protections.

IV. APPLICATION OF FRAMEWORK TO ANALYZE HEALTH CARE POLICY

In this section, we begin with a description of the Medicaid program. We then explain the policy goals for Medicaid, and after that, compare the economies and diseconomies of scale across each policy institution.

IV.A THE MEDICAID PROGRAM

Through Medicaid, states receive federal assistance to finance health insurance plans designed to serve low-income pregnant women, families with children, the elderly, and the disabled.\(^{161}\) Medicaid was initially created by federal legislation in 1965.\(^{162}\) Under traditional Medicaid, a state can apply for federal matching dollars (ranging from 50% to a maximum of 83%, depending upon the state)\(^{163}\) to support its expenditures on medical assistance for certain low-income groups. To qualify for these matching dollars, state plans have to meet certain requirements. Certain services must be included in these plans. These “benefits extend well into the realm of long-term care and include such interventions as personal care services, respite care, home care adaptation and case management.”\(^{164}\) These plans must reflect “freedom of choice,” whereby an individual beneficiary of the plan could choose to receive care from any provider.\(^{165}\) Another requirement is uniformity of benefits across a state, also known as “statewideness.”\(^{166}\) Also, the state has to limit beneficiaries to certain protected low-income groups: pregnant women, families with children, the elderly, and the disabled.\(^{167}\) Federal legislation also mandates coverage for certain income levels of some of these groups: for instance, “pregnant women, infants, and children up to age 6 with family incomes up to 133 percent of the [federal poverty level (FPL)].”\(^{168}\) States could sometimes extend coverage to higher income levels for these groups. However, once these income levels are determined, anyone who falls within these protected groups and meets income requirements is entitled to receive benefits.\(^{169}\)

In 1981, states were given the opportunity to seek waivers from some of these requirements. The most flexible waiver came under §1115,\(^{170}\) and it allowed states to seek waivers to continue to receive matching funds to support a “research and demonstration” plan. Under these plans, freedom of choice could be limited, uniformity was not required, and managed care could be applied.\(^{171}\) Additionally, “Managed Care/Freedom of Choice Waivers”

\(^{161}\) 42 CFR 430: “low-income persons who are age 65 or over, blind, disabled, or members of families with dependent children or qualified pregnant women or children.”

\(^{162}\) Title XIX of the Social Security Act (1965). 42 USCS § 1396.

\(^{163}\) This share is called the “federal medical assistance percentage (FMAP).” Elicia J. Herz, CRS Report for Congress, Medicaid: A Primer (2005), at CRS-6, available at https://www.policyarchive.org/bitstream/handle/10207/2676/RL33202_20051222.pdf.


\(^{165}\) See id. at CRS-3.

\(^{166}\) See id. at CRS-2-3.

\(^{167}\) See FEDERALISM & HEALTH POLICY, at 181.

\(^{168}\) See 42 USCS § 1396a.

\(^{169}\) 42 USCS § 1315.

\(^{170}\) See 42 USCS § 1396n. Under this waiver, a state can require beneficiaries to enroll in a managed care plan. Both of these waivers were created under the Omnibus Budget Reconciliation Act of 1981, 97 P.L. 35, § 2175, 95 Stat. 809 (1981).
IV.B GOALS

The Medicaid policy considered in this article will achieve the following goals. One is that eligibility for medical benefits for a particular group, for example children, should be extended to include higher income levels. Another goal is for total state expenditures to remain the same. Consequently, expansion of coverage would have to be balanced by savings in expenditures elsewhere. To achieve these savings, existing beneficiaries would be moved into a managed care plan (or MCO, and which we will assume would entail lower costs per beneficiary for the same level of services).

IV.C ENACTMENT

As it currently stands, the enactment process of Medicaid is performed by legislatures at both the federal and the state level. The initial Medicaid legislation was enacted by the federal Congress, and it provided federal financial support to state plans that were submitted and met statutory requirements. Subsequent amendments of this legislation have provided additional flexibility in receiving federal financial support.

Meanwhile, authorization of state plans requires legislation enacted by the state legislature. The following is a brief description of the different steps that would be necessary to achieve the goals specified above. The legislature would make certain decisions: Would these plans be “mandatory or voluntary?” What services would be included? Would the coverage area be state-wide, or just a specific area? Would a state agency “promulgate rates” for the managed care plan, or “invite competitive bids?” Exactly what income levels for each protected group would be eligible for coverage? These changes would then be embodied in state legislation authorizing development of a new (or amended) plan.

In drafting this legislation, state agencies would work closely with the federal Centers for Medicare and Medicaid Services [CMS, formerly the Health Care Financing Administration

174 See 42 USCS § 1396u-2.
175 See note 162 supra.
176 See section III.A supra.
178 Federal requirements include a number of services as mandatory, while others are optional. For examples of mandatory and optional benefits, see Medicaid: A Primer at CRS-3-4.
179 Actuaries Report at 11.
(HCFA) to ascertain which federal Medicaid statutes would enable the state to recover matching federal dollars to help finance these plans. Eventually, the plan must be submitted to CMS for approval, which will determine whether the state plan or state plan amendment conforms to statutory requirements, to receive federal matching support.

From this process, we can identify certain economies and diseconomies of scale, as noted in the following table. In examining these, we focus on financing these programs and consequent incentives, benefit provision, and opportunities for experimentation.

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<th>Economies of Scale</th>
<th>Diseconomies of Scale</th>
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<td>These programs can be funded through taxation at the national level, and with less distortion under a larger tax base. Also, coverage for low income groups may be difficult to finance in states with high proportions of these groups.</td>
<td>There may be less incentive to use this funding appropriately, if the localities spending these monies do not utilize their own funds for these programs. [<em>Medicaid Maximization</em>]</td>
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<td>Consistency of benefits: ensure that baseline services are provided.</td>
<td>Some states may have less need for certain services as benefits. Local legislators can better assess when this is the case.</td>
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Examining these, there are two principal effects relating to enactment: the economies of a larger tax base, versus the diseconomies of specifying exactly which services, regions, and populations would be covered under a policy. The current process of enactment at both the federal and state levels enables Medicaid policy to benefit from both the tax economy of scale by allowing some funding of the programs at the federal level, and also from the flexibility diseconomy by allowing states to tailor their programs to their needs. Enactment by individual

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180 More specifically the Center for Medicaid and State Operations within the CMS.
181 Telephone interview with staff at the Centers for Medicare and Medicaid Services, Baltimore, MD: Peggy Clark, Bruce R. Johnson, Gerald Zelinger, and Donna Schmidt, director of the Division of Benefits, Eligibility and Managed Care from the Family & Children’s Health Programs Group (August 31, 2007).
183 This is because, with large proportions of low income groups, these states will have a smaller tax base on which to draw to fund this program.
185 “The current federal-state system of health insurance provides a base of … coverage to the neediest populations. The federal mandates regarding populations and services covered ensure that this base will remain in place.” Alan Weil, John Holahan, and Joshua M. Wiener, *Improving the Federal System of Health Care Coverage*, in *FEDERALISM & HEALTH POLICY*, at 401.
186 See interview with staff at the Centers for Medicare and Medicaid Services, note 181 supra.
187 *Actuaries Report* at 12.
states also permits state plans to serve as “laboratories of democracy.” However, this comparison also suggests that the federal financial support of state Medicaid programs should be designed in a manner to reduce the incidence of “Medicaid Maximization” behavior, and also to ensure the delivery of baseline services.

IV.D IMPLEMENTATION

After this legislation has been enacted, the principal task will then turn to the agencies for implementation. Implementing a Medicaid policy begins when the agency seeks a health plan to provide coverage for beneficiaries in particular areas. As noted above, this can be done either by seeking competitive bids, or by setting rates for provided services followed by selecting a plan or plans at those rates. When utilizing a managed care plan, these rates are known as “capitation” rates. Capitation rates are a per-person (“per head”) fee that the health plan receives to provide services for the covered population. It is out of this payment that the plan itself must pay its own providers. This is in contrast to a “fee for services” approach, whereby a plan is paid for each service actually delivered.

The capitation rate approach shifts the risk of the cost of delivering health services to the health plan, if participants demand health services of greater costs than covered by the capitation payments, then the health plan will lose money. This possibility provides an incentive for health plans to proactively manage the provision of health care for their participants, so that earlier, less-costly preventive care is encouraged to reduce the costs of later treatment.

After a health plan has been selected, additional negotiation is necessary to draft the contractual agreement between the state and the health plan. This contract will specify exactly what services must be provided. It will also use terminology appropriate to the locality being served.

One aspect of this negotiation will be to determine which services should be “carved out” of the capitation payment. As noted above, the risk for providing services for patients will be transferred to managed care plans. Sometimes these risks are extremely high, depending on what service is provided, such as mental health care or substance abuse programs. To reduce these risks for the plan, these services may be “carved out”, whereby the payment the plan receives for their provision is not through the capitation payment, but instead is done on a fee-for-service basis.

Other aspects during these contract negotiations include developing standards to assure the quality of care provided; determining methods for monitoring the plans to ensure that these standards are met; and developing database structures for services provided for participants. Focusing on the knowledge embedded in implementation staff, the following are economies and diseconomies of scale from implementing this health care policy:

189 See Yellow Book at 139.
191 See interview with staff at the Centers for Medicare and Medicaid Services.
193 See 2008 Minnesota Families and Children (Medical Assistance under age 65, General Assistance and MinnesotaCare Medical Care) Model Contract, note 191 supra.
### Economies of Scale

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<td>Less knowledge of plans to serve as contracting partners. This is significant in first finding plans, and then in working out details of the contract.</td>
<td>Difference in local knowledge of providers, and their rates (essential for doing bids, setting contract rates)</td>
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<td>Can have model contract, applicable to all states.</td>
<td>Difference in language of provided services, by locality.(^{195}) Hence, model contract may not be appropriate depending on differential language.</td>
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<td>Determining what services will need to be “carved out” depends on knowledge of local beneficiary base, and operation of local health care provision.</td>
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Exhausting these, it is clear that there are significant diseconomies of scale for implementing a Medicaid plan. Local knowledge about plans and providers is essential in setting rates and negotiating the contract. It is also essential to ascertain when it is appropriate to carve out certain services. As a result, implementation of a Medicaid program at a state level seems clearly preferable.

#### IV.E ENFORCEMENT

After contracting with the managed care plan, the state agency will then need to enroll beneficiaries in the plan. To better enroll beneficiaries, the agency will need to educate them about the opportunities.\(^{196}\) Once beneficiaries are in plans, there are additional steps of investigating the quality of care provided, and handling appeals.\(^{197}\)

The plans will report data on service utilization by their enrollees.\(^{198}\) This data is known as “encounter data.” The states then must process this data, and submit additional data to the federal government. This data will be used to assess conformity of the state’s plan with federal requirements.\(^{199}\) The federal government will also conduct audits of both the state and their health plan partners, to ensure compliance with Title XIX.\(^{200}\) Additionally, payments will be processed based on this data.\(^{201}\) These payments will be made to providers, plans, and the states themselves, through the federal matching grant. One concern that may arise is with respect to “Medicaid Maximization.”\(^{202}\)

\(^{195}\) Interview with staff at the Centers for Medicare and Medicaid Services, note 181 supra.
\(^{196}\) See Actuaries Report at 13.
\(^{198}\) See Yellow Book at 133.
\(^{199}\) Interview with staff at the Centers for Medicare and Medicaid Services, note 181 supra.
\(^{200}\) See Yellow Book at 134-137.
\(^{201}\) See Yellow Book at 135 and 142.
\(^{202}\) See Yellow Book at 134, describing the “guaranteed tension” between states and the federal government.
Furthermore, this encounter data will be used to determine the sufficiency of the capitation payments to the plans. The capitation rates were based on a predicted level of service utilization by enrollees. However, the plans may end up serving populations requiring higher levels of services. Federal legislation requires payments to plans to be “actuarially sound,” and so adjustments to capitation rates must be made based on actual use. However, there is a cap to these adjustments: capitation payments cannot exceed the “upper payment limit” applied to a fee-for-service delivery of the same services.

In this case, economies and diseconomies relate to economies of scope, data management, and knowledge:

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<tr>
<td>Economies of scope in enrollment, and appeals: services already provided by other state agencies. Also, more experience in working with particular groups.</td>
<td>Encounter data suffers from similar problem as differences in contract language: records of data will have a different structure from state to state, as each locality adapts database to local conditions.</td>
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<td>There are some areas where data should be consistent across states. Oversight of data is also needed to protect against Medicaid Maximization.</td>
<td>Recognition of “red flags” indicating a need to investigate further to protect against possible fraud may depend on local knowledge.</td>
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As with implementation, there are again significant diseconomies of scale in enforcing a Medicaid policy. Enforcement here involves working with individual beneficiaries to sign up for these plans, and economies of scope apply to give a state agency an advantage over a federal one. Meanwhile, localized knowledge also helps in properly analyzing encounter data, and recognizing whether additional audits are necessary.

IV.F SUMMARY

In the end, this federalism framework suggests that the current division of Medicaid policy takes advantage of existing economies and diseconomies of scale. The Federal Government’s role in Medicaid is one of providing financing and oversight to ensure states limit “Medicaid-Maximization” behavior. While additional constraints should be applied to further

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203 Interview with staff of State of Minnesota Department of Human Services: George Hoffman and Shawn Welch (August 14, 2007).
204 Id. See also Yellow Book at 142.
205 See John Holahan, Suresh Rangarajan, and Matthew Schirmer, Medicaid Managed Care Payment Methods and Capitation Rates (1999), available at http://www.urban.org/publications/309064.html. See also Yellow Book at 141-142.
206 Interview with Hoffman and Welch, note 203 supra.
207 State Medicaid management information systems (MMIS) are required to meet certain federal requirements relating to compatibility with Medicare information, and giving information on “beneficiaries and paid claims.” Yellow Book at 144.
208 Interview with staff at the Centers for Medicare and Medicaid Services, note 181 supra. See also Yellow Book at 131-132 (pointing out that although there are some consistencies, there remains a “lack of accurate, timely, and reliable Medicaid policy and program data at the national level”).
209 Interview with Hoffman and Welch, note 203 supra. See also Yellow Book at 143.
reduce Medicaid-Maximization behavior, it is appropriate that the locus of these constraints is at the federal level. Meanwhile, there are diseconomies of scale in specifying which populations are served and what services are provided; in negotiating with plans to provide these services; in enrolling individual beneficiaries; and in collecting encounter data. These all suggest that the primary responsibility for implementing and enforcing Medicaid policy is properly placed with state governments. This example illustrates how this federalism framework can be used to allocate responsibility for enactment, implementation, and enforcement of a policy between the Federal Government and the states.

V. CONCLUSION

When it comes to federalism, many people agree with Lee Hamilton, former Congressman from Indiana and vice chairman of the 9/11 Commission,\textsuperscript{210} who writes, “Early in my congressional career, I discovered a simple truth about our [federalist] governmental system: it’s confusing.”\textsuperscript{211} This article attempts to make the daunting task of understanding federalism more manageable by separating our analysis into the individual institutions behind policy. It presents a framework that divides federalism analysis into components of enactment, implementation, and enforcement. This framework then provides the opportunity to consider how responsibility for different phases of an individual policy should be divided between federal and state levels. In making this assessment, economies of scale for these individual phases are compared with diseconomies of scale. The technique for performing this analysis is demonstrated with a comparison between environmental policies for endangered species and wetlands, and with an analysis of a health care policy.

Our comparison of environmental policies suggests that economies of scale in enactment mean that there is a clearer need for enacting protection of endangered species at a federal level. The interplay of both economies and diseconomies for implementation suggests that the principal federal role should be to establish baseline protections, while states should be responsible for establishing additional levels of protection and for data collection relevant to protecting species and wetlands. Finally, the presence of significant diseconomies of scale in enforcement suggests that primary responsibility for issuing both species and wetlands permits should lie with the states.

Furthermore, our analysis of the health care policy, Medicaid, suggests that the existing division of responsibility between federal and state government is consistent with the relative importance of economies and diseconomies of scale. The primary federal roles of providing financial support and oversight for Medicaid correspond to the principal economies of scale in enactment. Meanwhile, the significant diseconomies of scale in implementation and enforcement lead to state control of contracting with health plans to serve Medicaid populations, enrolling beneficiaries, and collecting encounter data to properly set capitation payments.

These analyses of environmental and health care policies demonstrate that there are certain key considerations in analyzing economies and diseconomies of scale across institutions. For enactment, we must determine the economies and diseconomies related to the political effects of the distributions of benefits and costs, along with the ability to reduce social losses through increases in the tax base. For implementation, we should consider the benefits of establishing broad baselines, the collection of information and storage in

\textsuperscript{210} For more on the 9/11 Commission, also known as the National Commission on Terrorist Attacks Upon the United States, see http://www.9-11commission.gov/.

databases, and the role of local knowledge in determining rules. And for enforcement, we again need to recognize the significance of local information in applying rules, along with economies of scope that arise in staffing.

The analyses also provide guidance for legislatures and courts as they address issues of federalism. While some claim that delegation of federal power could be considered unconstitutional, this article provides a positive political economic theory that can serve as a foundation for the constitutionality of federalist delegation. A legislature considering a new policy needs to determine the appropriate locus for the policy, across each of the enactment, implementation, and enforcement institutions. The legislature could start with a single policy analysis, as was done with health care, identifying economies and diseconomies of scale. If an existing policy has similar characteristics to the proposed policy, the legislature could leverage its understanding of the economies and diseconomies of the existing policy through a comparison of the proposed policy with the existing policy.

Where economies of scale are dominant, the appropriate locus would be at the federal level; while where diseconomies of scale are dominant, the appropriate locus would be at the state or local level. In instances where there are both significant economies and diseconomies, a structure involving both federal and state levels may be appropriate. Performing this analysis at each level would thereby permit the legislature to properly structure responsibility for enactment, implementation, and enforcement. In doing so, a federal legislature should recognize the need for federal oversight when it devolves responsibility for implementation or enforcement to state and local governments. It should also recall the requirements for properly structuring federal oversight to conform to the holding in New York v. United States.

Courts can also utilize this framework to provide some limit to federal power. As seen in the analyses performed above, the framework does not always provide a bright-line classification for the appropriate locus of policies. Nonetheless, a limit to federal power may be drawn when the policy considered involves relatively minimal economies of scale. For wetlands, while there were significant economies of scale for wetlands that are part of a multi-state hydrogeological system, there were only minimal economies of scale for wetlands affecting systems completely contained in one state. As a result, a case like Rapanos could be decided on federalism grounds using this framework, where the court could distinguish constitutional federal action to protect wetlands that are part of multistate systems, from unconstitutional federal action to protect wetlands that are part of only local systems. Thus, the federalism framework presented here provides a comprehensive and yet comprehensible mechanism for legislatures and courts to structure the responsibility for enacting, implementing, and enforcing policies to take advantage of economies and diseconomies of scale, thereby enabling the achievement of these policies at the lowest cost.

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212 See Joshua D. Sarnoff, Cooperative Federalism, note 37 supra.
213 See section I.B supra.
214 Recall, however, that the interconnectedness of most hydrogeological systems means that there would be relatively few wetlands that would fit in the latter category.