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Articles

Making Sense of the Antitrust State-Action Doctrine: Balancing Political Participation and Economic Efficiency in Regulatory Federalism

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1. Introduction

Federalism, the assignment of dual responsibilities for governing to lower and higher levels of government, is a founding political principle of the U.S. Constitution and today one of our country's leading intellectual exports. In Europe, the former Soviet Union, South Africa, and elsewhere, the view that good government will involve a judicious blending of local and central governmental decisionmaking is now well accepted. What is not well accepted is exactly how that blending should be specified and achieved.1 Indeed, even in the United States, scholars, politicians, and the courts are reconsidering the allocation of policy responsibilities between local, state, and national governments as part of a national political debate concerning the role of government in economic and social affairs.

This Article seeks to contribute to this national federalism debate through a careful analysis of one matter of current policy concern: the appropriate allocation of responsibility for business regulation between the states and the national government. U.S. courts face this issue today in their efforts to resolve the inevitable tension between federal antitrust law and state business regulation through their evolving antitrust state-action doctrine. We shall examine this doctrine in detail from the perspective of a well-articulated general theory of federalism.2 The advantage of grounding our analysis in general theory is twofold. First, the principles of federalism that we articulate help us to understand current state-action case law as a reasoned doctrine of regulatory federalism to which we suggest certain perhaps fruitful extensions. Second, placing the current state-action doctrine within a general theory of federalism clarifies the role of that case law, and of the courts more generally, in determining a place for business regulation. In particular, the analysis delimits the appropriate domains of state and national legislatures in business regulation and the need for the judiciary as a principled arbiter of those responsibilities.

Part II presents a theory of federalism that respects the twin values of political participation and economic efficiency.3 Both values play


2. A carefully specified theory of federalism has many useful applications: government expenditure policy, see, e.g., WALLACE E. OATES, FISCAL FEDERALISM 3-20 (1972); tax policy, see, e.g., Robert P. Inman & Daniel L. Rubinfeld, Designing Tax Policy in Federalist Economies: An Overview, 60 J. PUB. ECON. 307 (1996); deficit policy, see, e.g., Robert P. Inman, Public Debts and Fiscal Politics: How to Decide?, AM. ECON. REV. PAPERS & PROCS., May 1990, at 81; and regulatory policy, see, e.g., Jerry L. Mashaw & Susan Rose-Ackerman, Federalism and Regulation, in THE REAGAN REGULATORY STRATEGY: AN ASSESSMENT 111 (George C. Eads & Michael Fix eds., 1984).

3. A third important value, the protection of the sovereign rights of citizens, will not be pursued further here because it has not entered substantially into the debate concerning antitrust state action. On sovereignty and the importance of small governments, see Akhil Reed Amar, Of Sovereignty and Federalism, 96 YALE L.J. 1425 (1987); James F. Blumstein, Federalism and Civil Rights: Complementary and Competing Paradigms, 47 VAND. L. REV. 1251 (1994); and Andrzej Rapacki, From Sovereignty to Process: The Jurisprudence of Federalism After Garcia, 1985 SUP. CT. REV. 341.
prominent roles in today's federalism debates, but rarely are they integrated within a common conceptual framework. Our theory provides that framework, which we then apply to deciding how best to assign responsibility for the regulation of business between state and national governments.

Part III extends our general analysis of regulatory federalism to consider explicitly current antitrust state-action doctrine. The conflict between state and federal interests has been longstanding in U.S. constitutional history. This conflict has typically been resolved by reference to the Supremacy Clause of the U.S. Constitution, which resolves conflicts in favor of federal law. In contrast, however, the "state-action" doctrine has typically resolved the tension between federal antitrust regulations and the states' sometimes anticompetitive regulation of business activities in favor of the states. As spelled out by the Supreme Court's opinion in *Parker v. Brown*, the doctrine largely exempts the actions of states from the antitrust laws. In contrast to many of the state-to-state doctrine's scholarly critics, we find the doctrine's two-pronged "participation" test requiring state regulations to be "clearly articulated" and "actively supervised" compelling, once the test has been given an intellectual foundation in a general theory of regulatory federalism. Part III offers this necessary grounding. So grounded, the current doctrine is seen to provide institutional protection for federalism's valued goal of political participation, though we shall argue the Court did err in one application of its two-pronged "participation" test in *Community Communications Co. v. City of Boulder*. Federalism's goal of economic efficiency, however, is not well protected by present state-action doctrine. Part III argues that the current doctrine allows many state regulations that adversely affect the economic well-being of nonresidents to stand, at a potentially significant cost in lost economic welfare. Indeed, *Parker v. Brown*, the cornerstone of the current state-action doctrine, is just such a case.

The analysis in Part IV seeks to correct the current doctrine's neglect of federalism's efficiency goal. We advance our own two-pronged test aimed to ensure that state regulations do not ignore the adverse economic consequences of regulatory spillovers. Our "spillover" test asks: 1) Does a state regulation generate significant monopoly spillovers onto nonresidents? and 2) Was the state regulation decided without political participation of the affected nonresidents as evidenced by the lack of interstate regulatory agreement? If the answer to both questions is yes, then the state regulation fails the spillover test for economic efficiency, and a Sherman Act review of the regulation is appropriate. The reading of the current case law suggests the courts may find the spillover test attractive in principle. To move from principle to practice, we also offer guidelines for how the test might be implemented. The guidelines are simple and, importantly, keep the courts away from a deep substantive review of business regulations when deciding state-action cases.

Part V combines the Court's newly grounded "participation" test with the "spillover" test to form an extended and, we feel, intellectually stronger state-action doctrine. We apply our extended doctrine to the current case law and find support for the courts' decisions (though not always their analyses) in all but *Parker v. Brown* and *Community Communications Co. v. City of Boulder*, two cases we would reverse. In *Parker*, the Court allowed the state regulation to stand. In our analysis of *Parker*, the state regulation passes the Court's participation test but fails our spillover test; thus we would recommend a Sherman Act review. In *Boulder*, the Court exposed the regulation at issue to antitrust review. Under our analysis, we
would allow the regulation to stand. It passes the proposed spillover test and the now newly interpreted and conceptually more firmly grounded participation test. By drawing and enforcing these lines of regulatory responsibilities, the courts can make their unique contribution to regulatory federalism.

Our extended state-action doctrine provides the courts with needed guidelines as they police the boundaries between national and state responsibilities for setting business regulations. But the extended state-action doctrine provides only incomplete guidance. The doctrine helps the courts detect when a state regulation might intrude into the national policy domain, but it provides no guidance for judging when a national regulation might overreach into the state arena. Commerce Clause jurisprudence has sought to draw this line, relying on the Tenth Amendment to block federal regulatory intrusions into the domain of state policy. Unfortunately, the case law beginning with *National League of Cities v. Usery* and ending in *Garcia v. San Antonio Metropolitan Transit Authority* has shown the Tenth Amendment to offer no substantive limits on federal regulatory reach.

An alternative approach is needed. In Part VI we provide such an alternative, one that builds upon the Supreme Court's own logic in *Garcia* and looks to the process of legislation and to the institutions of Congress to check any overreaching inclinations of the national legislators. We propose that Congress pass legislation requiring all new federal regulations to be reviewed by a seven-step Federalism Impact Statement (FIST) detailing the national economic benefits and costs of new regulations and any losses in state regulatory autonomy. FIST would serve a procedural goal only; its aim would be to ensure that important regulatory decisions were made only after Congress understood and balanced the proposed national regulation's economic gains against its likely losses in state autonomy and reductions in political participation. FIST would not dictate what that balance should be. As with other impact statements, the judiciary's role would be to ensure that FIST's seven-step process worked effectively. Experience in the United States and the European Union suggests that such impact statements, if enforced by the courts, do constrain central government regulatory powers. The recent Supreme Court decision in *United States v. Lopez*, creating its own small procedural hurdle for national regulations, suggests that this Supreme Court might welcome our alternative.

10. According to the Tenth Amendment, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X.


Part VII concludes our study by stressing the importance of the judiciary for ensuring the long-run vitality of a federalist political structure. Historical and contemporary evidence shows a steady drift of regulatory responsibility to the national level when daily politics are left unchecked. Reasoned judicial interventions can provide one check. To this end, current state-action doctrine has provided positive support for state regulatory policies; our "enhanced" state-action doctrine based upon a carefully articulated theory of federalism provides an even more confident basis for continuing this sympathetic tradition. Our FIST proposal provides the courts with a tool to actively promote state policymaking. Together, the Court's current "participation" test, our proposed "spillover" test, and FIST give the courts what they need to both promote and protect a truly federalist political process for setting regulatory policies.

II. Setting the Federalist Structure: A Framework for Evaluating Regulatory Federalism

Confederations of small governments have been praised by many—from Plato and Aristotle through Rousseau, Montesquieu, Smith, and Mills to contemporary federalist legal and economic scholars—as the political structure most likely to encourage a trio of social virtues: political participation, protection of the sovereign rights of citizens, and economic efficiency. Other scholars have been more skeptical. The *Federalist Papers*, the intellectual blueprint for the U.S. Constitution, raises serious doubts about the virtues of such loose confederations. Leading contemporary scholars from political science and economics have lent theoretical support to these concerns, arguing that a strong, democratically elected central government is more likely to promote political participation, the rights of citizens, and the efficient and equitable allocation of resources.

15. See THE FEDERALIST NO. 3, at 42-44 (John Jay) (Clinton Rossiter ed., 1961) (arguing that a strong union is required to ensure national security); No. 9, at 71 (Alexander Hamilton) (proposing that a strong union serves as a barrier against domestic factions); No. 15, at 109 (Alexander Hamilton) (criticizing a loose confederation because it "would place us in a situation to be alternate friends and enemies of each other, as our mutual jealousies and rivalships, nourished by the intrigues of foreign nations, should prescribe to us").
The currently unsettled choice between central government and state government powers in Europe, the United States, and developing economies makes very clear that the federalism debate remains open, visible, and at times contentious.

Wherever the debate is engaged, the central question is the same: Which form of government—decentralized or centralized—is best suited to make public policies, given that we want those policies to be democratically decided, respectful of personal rights, and economically efficient? A considered answer requires a careful balancing of the benefits and costs of decentralized and centralized political structures.

We begin our analysis by defining what we mean by decentralized and centralized federalist structures. In this Article, governments will be defined as "decentralized and state" or "centralized and national" according to their combination of two constitutional decisions. The first—called the partition decision—divides the single national citizenry into states. The second—called the assignment decision—allocates political responsibility for choices over a social or economic policy either to these states or to a national government. If the partition decision creates states and the assignment decision allocates ultimate responsibility for a social or economic policy to those states, then we will describe policymaking as "state" or "decentralized." If the partition decision creates only a national government or the assignment decision gives final responsibility for a social or economic policy to the central government even when there are states, then we will describe policymaking as "national" or "centralized." Together, the partition and assignment decisions define the essential federalist structure of the government.

The chosen federalist political structure in turn affects three valued outcomes: citizens' rights, political participation, and efficient resource allocations. Debates regarding the appropriate federalist structure for regulatory policies—the concern of this paper—have focused almost exclusively on the goals of political participation and economic efficiency, the approach followed here. Subpart A below reviews how the two federalist structures are likely to affect political participation and economic efficiency generally and how altering those structures may lead to varying levels of each valued goal. Subpart B applies the analysis in the specific policy area of regulatory federalism.

A. Federalism, Political Participation, and Economic Efficiency: An Overview

1. Federalism and Political Participation—Political participation is defined as "actions through which ordinary citizens of a political system influence or attempt to influence [political] outcomes." Political participation is by ordinary citizens, not by elected or appointed government officials or employees of political parties who are politically active because of direct compensation. Participatory actions include voting, debating, marching, picketing, contributing, and passive and armed resistance. The aim of these actions is to influence the direction of government policy. Active citizens may be successful in moving public policies closer to their preferred outcomes because of their participation. When this occurs, citizens are said to have influence. Alternatively, active citizens may be unsuccessful, with their political actions having no effect on policy outcomes. In this case, the citizens have attempted, but failed, to influence political outcomes.

The benefits to citizens of political participation can be divided into three categories: instrumental or utilitarian, developmental or educative, and intrinsic or consumptive. In the utilitarian view, perhaps argued most directly in the work of Bentham and James Mill, political participation is instrumental for maximizing economic efficiency. In the developmental view, political participation is valuable because it educates citizens about the policy process and helps them develop critical thinking skills. In the intrinsic view, political participation is valuable in its own right, regardless of whether it leads to political outcomes.

17. The partition and assignment choices can vary by public policy or can be set uniformly across all government decisions. For example, a fully centralized federalist structure or "uniary state centralizes all government decisions. In contrast, a fully decentralized federal system would have one state government for each type of citizen and allow negotiated agreements—or confederation—among the independent states. Federalist structures between these extremes are also possible. For example, some government functions can be assigned to the central government (e.g., defense spending) while others remain at the state level (e.g., public education). Further, both the partition and the assignment decisions might be varied within the same federalist system—for example, large regional governments might be the preferred federalist institution for environmental policies.

18. Another important dimension of the federalist constitution is the rule of citizenship for each state. The United States defines states geographically and has adopted residency as the defining principle of citizenship, but this need not be the only criterion. States might also be defined by cultural or racial groupings with citizenship belonging to those who can prove an inherited linkage to the cultural or racial group. A combination of these two approaches to states and citizenship might also be used—for example, if the United States or Australia were to give separate statehood and central legislative representation to their aboriginal peoples. In this paper we will work with the simplest and most common definition of state citizenship based upon residency in a defined state territory.

19. Justice Sandra Day O'Connor, a leading spokesperson for federalism, explicitly recognized each of these three valued outcomes in her dissent (joined by Justices Rehnquist and Burger) in PERC v. Mississippi, 456 U.S. 742 (1982). Justice O'Connor argued that independent state governments within a federalist structure may provide a "salutary check on governmental power," id. at 790, may enhance "the opportunity of all citizens to participate in representative government," id. at 789, and may ensure that elected officials remain responsive to citizen preferences when providing public services, id. at 787.

20. For other policy questions such as the regulation of criminal behavior and the protection of civil rights, the third goal of citizen rights must be given full attention. See generally Amar, supra note 3; Blumstein, supra note 3; Rapaczynski, supra note 3.


22. We follow the outline of NAGEL, supra note 21, at 11-15.
participation serves a specific function: it is to ensure that government maximizes aggregated citizen utility or welfare. In democratic societies, political participation is a necessary check on abuses of citizen welfare by ill-informed or even greedy elected officials. Political participation guarantees that abusive elected officials will be exposed and defeated at the next election. For the utilitarians, political participation’s value is fundamentally instrumental; it plays, in the words of Carole Pateman, a “protective function” for the public welfare.

For Jean-Jacques Rousseau and John Stuart Mill, political participation is instrumental to another, perhaps more important, end: it protects citizen liberties. While both Rousseau and Mill acknowledged the instrumental value of participation in protecting private economic interests and ensuring good (efficient) government, they extended the argument of the utilitarians to include participation’s protective value for personal freedom as well. Participation ensures that no one individual or group is master over any other: “[T]he rights and interests of every or any person are only secure from being disregarded, when the person interested is himself able, and habitually disposed, to stand up for them.”

For many scholars, however, participation does much more than just protect private economic interests and personal liberties. Aristotle, Rousseau, J.S. Mill, de Tocqueville, and contemporary commentators such as Dewey and Pateman view citizen political participation as serving an important educative function. By participating in the political process, the individual learns that his private interests are intimately linked to the interests of others. This knowledge leads to a willingness to compromise, to put private interests aside, and to call upon values of justice and common good when making public choices. There may be beneficial spillovers to private decisionmaking, too. Having recognized and accepted the validity of the interests of others in the public arena, we may be more accepting of those interests in our private dealings. Simply put, we may be different people—more tolerant, less selfish—after political participation.

Finally, political participation may provide direct consumptive benefits to those who participate. From those who simply like to hear the sound of their own voice or revel in controlling others to those who take genuine satisfaction in having contributed to a cause they feel is worthy, many people derive a personal consumption benefit from the act of political participation. How else might we explain widespread voting in national elections? While perhaps not the most compelling argument for increased political participation, for there are certainly other means to such consumption benefits, it should not be ignored.

If political participation is an activity to be valued, how do we know if there is more or less of it within society? Measures of each of participation’s valued outcomes are needed. First, the effects of individual participation on political outcomes can be measured by a metric of political influence. Second, the educative and consumption values of individual participation can be measured jointly by a metric of political effort—for example, by the hours, or the hourly equivalent of dollar contributions, given by the individual to a political activity. Given these metrics of

29. Aristotle, for example, argued that involvement in public decisions changes people, giving them a new appreciation of the need for compromise and accommodation in all spheres of social life. See Frug, supra note 14, at 1071.

30. See WILLIAM H. RIEDEL & PETER C. OLDBROOK, AN INTRODUCTION TO POSITIVE POLITICAL THEORY 63 (1973) (arguing that the personal satisfaction derived from voting and participating in the political process can explain the rationality of an otherwise irrational decision).

31. There is no shortage of candidates for measures of political influence. For a detailed discussion, see JAMES H. NAEGEL, THE DESCRIPTIVE ANALYSIS OF POWER 83-100 (1975). For one effort to implement one such outcome measure—the “concurrency of leaders’ priorities with those of their constituents”—see SIDNEY VERBA & NORMAN H. Nie, PARTICIPATION IN AMERICA: POLITICAL DEMOCRACY AND SOCIAL EQUALITY 299-333 (1972). Verba and Nie show that greater participation leads to greater concurrency beyond some lower threshold. Id. at 309-22, 328-33.

32. If the hourly metric is adopted—it is the one preferred by us—what “actions” should be counted as participatory? At a minimum we would include time involved in voting, listening to or reading about political debates, preparing for and speaking at public meetings, marching and picketing, and lobbying public officials. Dollars donated for political activities by others would be converted into participatory hours by dividing the individual’s contribution by the individual’s hourly wage. The hours of the paid activist would not be counted as political participation; this would be double counting. The hourly metric as a measure of effort seems closest to what most political theorists have in mind when speaking of the educative and consumptive benefits of political participation. Education and consumption benefits come from being involved. Using the dollar metric, a rich person earning $100/hour would make a $1000 political effort by contributing ten hours. A poor person earning $10/hour would make the same $1000 political effort by contributing 100 hours. Both citizens register the same political effort if measured in dollars, but the poor person clearly makes the greater effort measured in hours.
influence and effort, political participation by citizens in society can then be said to be higher when citizen influence and effort increase.33

The formal and informal institutions of politics are the most important determinants of citizen influence and effort, and thus, of a society’s overall level of political participation. In dictatorships, average citizens have little influence and, except for revolutionaries, are likely to make only small efforts. In democracies, average citizen influence and efforts are both likely to be greater. Two democratic institutions seem particularly important: open elections and a free press. Open elections ensure that citizens can replace unacceptable political leaders; a free press ensures that citizens know when the leaders are unacceptable. Open elections and a free press shift the balance of power away from professional politicians to the citizens generally. Influence rises. The increase in average citizen influence in turn makes political effort more productive. Effort rises.34 In South Africa, for example, both blacks and whites went from voter boycotts to nearly full voter participation with the fall of apartheid.35

The federalist structure of a democracy—centralized or decentralized—can also contribute to the levels of citizen influence and effort, and thus the level of political participation, in a society. Political influence is likely to be higher for each individual citizen when the democratic state has fewer participants. Each vote has more clout, access to politicians is likely to be easier, and information about politicians’ activities is likely to be more readily available. If so, then for a given set of policy choices, smaller governments are likely to give each individual citizen more political influence over outcomes than larger governments. Again, increased political influence is likely to stimulate increased individual political effort.36 Smaller governments and more decentralized democratic systems are therefore likely to foster increased political participation. Contemporary political theorists such as Pateman and Frug argue for this prediction as did Aristotle, Rousseau, and J.S. Mill before them.37

While the prediction that smaller democratic governments will involve greater political participation is a reasonable one, how the size of states actually affects political influence and political effort is ultimately an empirical question. The evidence is sparse, but what is available generally supports the prediction that both citizen influence and effort increase as the size of government declines. Comparisons of political influence and effort across small and large governments within one country seem the most appropriate testing ground of the participation hypothesis.38

First, the evidence shows that citizens surveyed in five countries (United States, Britain, West Germany, Italy, and Mexico) all reported making a greater effort to understand and having more success in understanding local rather than national political issues.39 In the surveyed

33. The final measure of societal participation by citizens must be an index of individual citizens’ influence and efforts. Constructing such an index is a subtle matter. Decisions must be made as to how to value citizen influence and citizen political efforts. Strict utilitarian such as J.S. Mill, for example, were only interested in the influence value of participation. See Mill, supra note 26, at 188-90. Frug, on the other hand, places greatest value on political effort. See Frug, supra note 14, at 1070-71, 1151. Pateman values both influence and effort. See PATEMAN, supra note 14, at 103-104 (observing that it is only through the opportunity to exert political effort that one can begin to have political influence). The central difficulty for creating such an index arises where the index must compare one participatory state in which influence and/ or effort are high for some citizens and low or efforts to another participatory state where the ordering of influence and/ or effort is reversed. Interpersonal participatory comparisons will be needed. On the difficulty of creating such indices, see generally AMARTYA SEN, CHICE Choice, Welfare, and Measurement (1982).

34. A simple model of citizen political behavior gives this prediction. When a citizen is “influential” she is said to receive a valued outcome from the government, for example, $ g (spending on education) = g^*$. When she is not influential she receives the outcome of $g < g^*$. Her political influence is measured by the probability index that she is “influential,” where $p$ is the probability that she is influential and $(1 - p)$ is the probability she is not. The citizen’s political effort ($e$) is measured in hours. The citizen values her political participation according to the expected utility ($V$) she derives from making political effort, given that effort provides direct utility (or disutility) and impacts positively on the probability that she will be influential: $V = p[u(g^*, e)] + (1 - p)[u(g, e)] = p(u(g^*, e)) - u(g^*, e) + u(g, e)$, where $u(g, e)$ measures the “utility” a citizen receives from a given load of public services ($g$) and effort ($e$). The citizen’s political effort is determined by balancing the marginal benefits of increased effort—the gain in expected utility from increasing the chance she will be influential and thus get $g^*$ rather than $g < g^*$ against the marginal costs in lost utility of making that added effort. If the marginal productivity of extra political effort on influence declines as effort increases, as seems likely, then the marginal benefits from effort decline as effort increases. Further, if the disutility of political effort increases as effort rises, as again seems likely, then the marginal costs from effort rise as effort increases. When marginal benefits from more effort due to the extra effort just equal the marginal costs from the extra effort, then our citizen is in a “participatory equilibrium.” Any political reforms that shift upward the marginal productivity of effort on influence—for example, moving from a dictatorship to democracy—will shift up the citizen’s marginal benefit curve from effort, and political effort will rise. Such a shift in government could cause a reduction in the disutility of political effort (better press coverage, freer speech, etc.); this will cause the marginal cost curve to fall, and again, political effort will rise.


36. The simple model of voter participation outlined in note 34 helps us to understand why. If with decentralization the marginal productivity of political effort increases for each level of effort, then the marginal benefits to the citizen from such efforts increase too. The higher marginal benefits from political effort stimulate greater political efforts.

37. See PATEMAN, supra note 14, at 1069 & n.41.

38. While there are cross-national comparisons between small and large countries of voter turnout, non-voter participation, and voter influence, such comparisons will be so badly contaminated by other factors unrelated to the size of the government—for example, variations in the use of laws requiring voting—that no valid conclusions regarding size on the participation hypothesis can be drawn. For a review and critique of the cross-national evidence on size and participation, see DAHL & TUFFE, supra note 16, at 44-53.

39. See id. at 55 tbl.4.8.
countries, citizen efforts to influence government were also typically two to three times higher for local than for national governments. In supporting evidence, a detailed survey of political participation across Swedish cities found average citizens in small communities were more aware of local politics than their counterparts in middle-size cities and both knew more basic local political facts than large city residents.

Second, political effectiveness or influence—at least as perceived by citizens—also seems to increase as governments get smaller in size. Again, the five-nation survey found that citizens feel much more influential at the local than at the national level; typically, half of the citizens in the surveyed countries felt they had no influence over national policies while only twenty-five to thirty percent felt powerless at the local level. A more detailed analysis of the U.S. subsample showed a significant positive correlation between an index of political powerlessness and size of government. Indirect evidence from the Swedish study also implies that citizen influence declines as governments get larger; the gap between the percentage of citizens and the percentage of elected officials who would support a tax increase increases as communities get larger. Further, this same evidence from the United States, the Netherlands, and Switzerland shows that politics in larger communities, states, and cantons is increasingly dominated by organized interest groups or political parties. While such groups make participation easier for some citizens, they may also make it more difficult for others. If so, then Rousseau’s concern that participation becomes more unequal as governments get larger is confirmed.

Finally, contemporary political science research strongly supports the claim that within any level of government—national, state, or local—the legislature is likely to be the most responsive to citizen participation. Today’s legislators view their task as servicing their constituents, working as the voters’ “agents” to the government.

The reasoned arguments by most participation theorists and the current empirical evidence lead us to the working conclusion that smaller democratic governments, and thus more decentralized federalist structures, are likely to better encourage the valued goal of greater political participation. With respect to the two constitutional decisions that define the federalist structure—the partition decision and the assignment decision—greater political participation will be achieved with a “fine” partition and with extensive local assignment—that is, many small governments with widespread policy responsibilities.

2. Federalism and Economic Efficiency.—Using the economic efficiency criterion to choose the appropriate federalist constitution for economic activities is complex because it involves a comparison of the economic benefits and costs of assigning policy responsibility to each of three levels of government: national, state, or local. There are two important dimensions to economic efficiency. First, intrajurisdictional efficiency, requiring government policies to satisfy the collective demands of citizens within a given jurisdiction at minimum costs. Second, interjurisdictional efficiency, documenting the close connection between voters and legislators, see Bruce Cain et al., The Personal Vote 213-14 (1987). Their conclusion is unequivocal: students of elections sometimes are asked why they do not concentrate their efforts on “real politics,” defined as the beliefs, calculations, and behavior of interest group leaders, high-level bureaucrats, substantive experts, and key elected officials. This query implies that public policy is determined by elites, not by voters. The citizenry at large supposedly pays little attention to political affairs, has no clear ideas about most issues, and votes largely on the basis of long-standing class, partisan, and other allegiances. To understand legislative policymaking, one must understand the electoral relationship between representatives and their constituents.

Id. at 212. Finally, recent empirical research on government spending, tax, and regulatory policy establishes the first link from constituents to policy outcomes. For research at the state level, see Sam Peltzman, Voters as Fiscal Conservatives, 107 Q.J. ECON. 358-59 (1992) (suggesting an agency relationship, however imperfect, between voters and elected officials). For a review of studies connecting constituent interests and local government policies, see Robert P. Inman, The Fiscal Performance of Local Governments: An Interpretive Review, in CURRENT ISSUES IN URBAN ECONOMICS 270 (Peter Mieszkowski & Marlos Strasheim eds., 1979).

That participation is a valued outcome and that the legislature is the most conducive institution does not imply that the legislature alone should decide regulatory policies. As we emphasize below, infra note 84, participatory legislatures often have significant adverse consequences for economic efficiency. One solution would favor less participatory legislatures, thereby allowing elected representatives to make tough decisions that improve overall efficiency but that may harm their own constituents. See, e.g., Michael A. Fitz, The Virtue of Virtue: A Political Parity Perspective on Civic Virtue Reforms of the Legislative Process, 136 U. PA. L. REV. 1567, 1605-07 (1988) (suggesting that strong political parties are a more efficient means for organizing legislative activities).
efficiency, involving the appropriate allocation of individuals and other resources, such as capital, among different political jurisdictions.48

In our complex federal system both intrajurisdictional and interjurisdictional inefficiencies can arise, the former because the political process may not generate outcomes within a jurisdiction that maximize the well-being of its residents, that is, create political inefficiencies, and the latter because the decisions and actions of individuals within one jurisdiction can have effects on individuals located in other jurisdictions, that is, generate spillovers. In a broad sense the choice of the appropriate jurisdiction to be responsible for a government activity involves a trade-off: the larger the jurisdiction the less likely that there will be spillovers from one jurisdiction to the next, but the more likely the that political process will lead to a misallocation of resources within the jurisdiction.

A decentralized system of governments is ideal from the point of view of intrajurisdictional efficiency, because assigning economic responsibility to smaller and more homogenous jurisdictions increases the likelihood that

48. We ignore a third dimension of economic efficiency—the transaction costs of making choices—because it is likely to be of small importance when compared to these two allocative costs of regulation. The transaction costs of government include the costs of selecting legislators, the decisionmaking costs of setting a policy, and the monitoring costs of ensuring that the policy is put in place. See Albert Breton & Anthony Scott, The Economic Constitution of Federal States 7, 31-33 (1978).

inefficient incumbents; competitive political entrepreneurs play a role analogous to takeover "artists" in the private market. Public sector entrepreneurs can also appear as enterprising real estate developers who build new jurisdictions—analogous to "new entrants" in a private market—to draw away dissatisfied residents from inefficient governments. Tiebout's conditions 3 and 4 promise that families and businesses will know about and can move to the efficient alternative once it has been constructed. Tiebout's condition 5 ensures that all public activities can be provided within these efficient local jurisdictions—larger government or intergovernmental cooperation is not required.

In the end, a public economy satisfying Tiebout's conditions 1 through 5 and organized as a fully decentralized network of competing jurisdictions will maximize economic efficiency. In such an economy, citizens and businesses will consume their preferred levels of public goods and regulations with a minimum sacrifice of private incomes.

Larger governments have a potential role to play when Tiebout's conditions 1 through 5 do not hold. When condition 1 is violated, the public activity becomes a "public good" with additional users of the facility having no adverse effects on the consumption benefits enjoyed by previous users. In this case, small governments are no longer the efficient producer of the service; bigger is cheaper as costs are shared over more users. Typical examples of such public goods include defense, television or radio signals, and new knowledge. Small governments will be at a significant cost disadvantage in the provision of these noncongested public services and are likely to lose the competitive struggle for new citizens to larger, more centralized governments.

Losing condition 2 means that all successful communities no longer can be easily replicated. Communities with unique advantages may become overpopulated, creating a possible inefficiency in the allocation of workers and capital. The consequence will be a less-than-efficient private economy. In contrast, a larger government shares these locationally unique advantages with all citizens, thereby avoiding these private market inefficiencies. 54


53. See DAVID E. WILDSNIS, URBAN PUBLIC FINANCE (1986); Robin Rowland & Frank Flatters, Efficiency and Equalization Payments in a Federal System of Government: A Synthesis and Extension of Recent Results, 15 CANADIAN J. ECON. 613, 615-30 (1982) (summarizing the inefficient migratory implications of models of fiscal federalism); James M. Buchanan & Charles J. Goetz, Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model, 1 J. PUB. ECON. 25, 40 (1972) ("[F]iscally-induced migration is responsible for an undue concentration of persons in the large and growing conurbations of America . . . .")

54. For central government solutions to the private sector inefficiencies created by the loss of condition 2, see WILDSNIS, supra note 53. Losing condition 2 creates another problem for economic efficiency in a Tiebout economy, but one that cannot be solved by a move to a more centralized government. This is the problem that arises when each government contains citizens with different views of what constitutes the government's best policy. If so, politics becomes important. If decisions are made by majority rule, the outcome will not necessarily be economically efficient. Local governments, of course, face the same problem.

55. See Edward M. Gramlich & Deborah S. Laren, Migration and Income Redistribution Responsibilities, 19 J. HUMAN RES. 489, 489 (1984) (pointing out, as one argument against returning welfare to the states, that state governments might hesitate to provide generous benefits for fear of attracting potential welfare recipients from elsewhere); Pierre Peauleau, The Optimality Limits of the Tiebout Model, in THE POLITICAL ECONOMY OF FISCAL FEDERALISM 173, 178 (Wallace E. Oates ed., 1977) ("There is no public service that fails to afford some benefits external to the region that provides it.").

56. This argument has been developed for regulatory policies by John H. Cumberland, Efficiency and Equity in Interregional Environmental Management, 10 REV. REGIONAL STUD., Fall 1980, at 1, 2-3 (arguing that the federal government's current practice of siting government facilities without compensating or gaining the consent of the selected communities results in detrimental externalities). See also William A. Fischel, Fiscal and Environmental Considerations in the Location of Firms in Suburban Communities, in FISCAL ZONING AND LAND USE CONTROLS 119, 143 (Edwin S. Mills & Wallace E. Oates eds., 1975) (applying the Tiebout model to nonresidential land use in suburbs).
of such agreements are large—as for example if the New England states were to bargain with Alaska and Texas for lower regulations or taxes on state oil and gas production—they will easily swap these small additional costs of bargaining.

Problems are more serious for conditions 2 to 5. If the preferences of the participants to the bargain are not common knowledge—condition 2 no longer holds—then there may be a strategic advantage to concealing costs and benefits. The concealment enables you to demand greater compensation from the agreement if you represent the "polluting" government or to offer less compensation if you represent one of the "consumer" jurisdictions. If both parties adopt the "conceal" position, however, no agreement may be forthcoming.\(^{60}\) Further, if you represent one of many consumer jurisdictions, it will be in your interest to understate your constituents' losses from the adverse policy. Such free-riding behavior is likely to undo a Coasian bargain when preferences are not common knowledge and the number of affected jurisdictions is large.\(^{61}\)

Even if the benefits and costs of agreement are common knowledge, there is no guarantee that elected government officials will choose to represent those harmed by an out-of-state policy, in which case condition 3 no longer holds. Harmed citizens may be a minority in a majority rule state.

60. In choosing their bargaining strategy, jurisdictions must assess the extent to which other parties are likely to make concessions. In game theoretic terms, the parties try to assess the threat points of the other parties—the minimum offer that they are willing to accept. In addition, they try to estimate the extent to which the other party will be willing to make concessions prior to reaching their threat point. If the parties make poor estimates of each other's threat points or miscalculate the chances that the other party will accept a compromise offer, they may take a hard line in the bargaining process. Therefore, Coasian bargainers will not be immune to possibilities for strategic behavior when they negotiate, and to the extent that they succumb, Coasian bargaining may break down. See Vincent P. Crawford, A Theory of Disagreement in Bargaining, 50 ECONOMETRICA 607, 608 (1982) (hypothetical situations in which the likelihood of disagreement will be increased; David M. Kreps & Robert Wilson, Reputation and Imperfect Information, 27 J. ECON. THEORY 253, 254 (1982) (noting that a firm may adopt hard-bargaining tactics in order to maintain a certain reputation with its rivals); Mitchell Polinsky, Resolving Nonprice Disputes: The Simple Economics of Injunctive and Damages Remedies, 32 STAN. L. REV. 1075, 1092 (1980) (observing that antagonists in the bargaining process may adopt "hold out" tactics and never reach an agreement).

61. For the first treatment of the effects of group size on voluntary agreements, see MANCUR OLSON, JR., THE LOGIC OF COLLECTIVE ACTION 66-52 (1965) (stating that in large groups, individuals face higher costs of collective action and may receive less individual benefits, both discouraging collective action). The effect of group size and information on bargaining has been studied extensively through the use of experiments. See, e.g., Elizabeth Hoffman & Matthew L. Spitzer, The Coase Theorem: Some Experimental Tests, 25 J. L. & ECON. 73, 76, 82-95 (1982); see also Mark Bagnoli & Michael McKee, Volunteer Contribution Games: Efficient Private Provision of Public Goods, 29 ECON. INQUIRY 351, 361 (1991) ("[f] ... a well-defined group of people [is offered] the opportunity to contribute to the provision of a public good when the cost of the good, the pay-offs to those in the group, and the initial wealth positions of those in the group are all common knowledge, then the Pareto-efficient outcomes will emerge.").
In contrast to private market agreements, here the affected parties are heard only if generally elected representatives choose to make their case. Condition 4 is likely to be a problem only when important contingencies that might affect the agreement cannot be foreseen in advance. Intergovernmental agreements are legally enforceable. But if a future event occurs that alters the benefits or the costs of the agreement significantly, then the agreeing states may decide to break the contract. These problems are most likely to arise in the case of new governmental activities or products whose future benefits and costs are not well known. In these cases, initial interstate agreements may be very difficult to fashion. If enforcement is lost, then governments, like private parties, have little incentive to reach an agreement in the first place.

Arguably the most important and least appreciated source of bargaining failure is condition 5. Even if conditions 1 through 4 hold, the parties may not be able to agree as to how the economic surplus generated by the bargaining process should be divided. Any Coasean bargain does two things: it establishes an efficient exchange that creates an economic surplus, and it distributes that surplus among the bargaining parties. Proponents of Coase emphasize the first outcome and have largely ignored the important difficulties of the second. Yet it is well known that the division of any economic pie is a bargaining problem that may have no solution. The often observed result in "divide-the-pie" games is that bargaining breaks down because the proposed division is viewed by one or more of the participants as not "fair." In the case of government bargaining, one jurisdiction can reject an economically beneficial offer from another jurisdiction because the proposed offer violates the first's exogenous and no doubt politically motivated sense of economic fairness.

62. Ellickson suggests that intergovernmental rights should be enforceable through arbitration compacts or statutory structures set up by higher-level governments. See Robert C. Ellickson, Public Property Rights: Vicious Intergovernmental Rights and Liabilities as a Technique for Correcting Intergovernmental Spillovers, in ESSAYS ON THE LAW AND ECONOMICS OF LOCAL GOVERNMENTS 51, 73-74 (Daniel L. Rubinfeld ed., 1979).

63. See Robert Cooter, The Cost of Coase, 11 J. LEG. STUD. 1, 17 (1982) (emphasizing that the Coase Theorem optimistically assumes that parties can solve the problem of distribution, although in reality self-interested players may not agree on how to divide the pie).

64. When redistribution games might have equilibrium outcomes is an important topic of recent economic research. See Kenneth Binmore et al., The Nash Bargaining Solution in Economic Modelling, 17 RAND J. ECON. 176 (1986); Ariel Rubinstein, Perfect Equilibrium in a Bargaining Model, 50 ECONOMETRICA 97 (1982).


Strategic interplay becomes even more complicated, and agreement even less likely, as the number of bargaining jurisdictions increases beyond two or if the bargain is one of many. The hope that voluntary interstate Coasian compacts might control interjurisdictional externalities and spillovers seems to us optimistic. The conditions required for such Coasian agreements are very demanding and unlikely to hold when governments come to the bargaining table. When any one of conditions 1 to 5 fails to hold, Coasian agreements will not arise and state-created interjurisdictional inefficiencies will remain.

What can be done? The economic theory of federalism advocates the use of the central government to internalize the spillovers and externalities created by the smaller states and local governments. The political economy theory of federalism recognizes that this solution comes with its own costs, and that centralization does not automatically promise economic efficiency.

In a typical federalist hierarchy, central government policies will be decided by majority rule in legislatures composed of elected representatives from member states. Such legislatures must overcome a fundamental structural defect of democratic choice: the propensity of the majority-rule process to cycle from one policy outcome to another. 

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65. For evidence of the difficulties states have in fashioning Coasian agreements, even when the number of states is few, see generally Bruce A. Ackerman et al., The Uncertain Search for Environmental Quality 190-207 (1974); Dennis Coates & Michael Mungur, Strategicizing in Small Group Decisionmaking: Host State Identification for Radioactive Waste Disposal Among Eight Southern States, 82 PUB. CHOICE 1 (1995); and Charles D. Kollsted & Frank A. Wolak, Jr., Competition in Intergovernmental Transfers: The Case of Western Coast, 91 J. POL. ECON. 443 (1983).

66. For evidence from the experimental literature that a subjective sense of fairness is crucial to the ability of parties to reach agreement, see Alvin E. Roth, Toward a Focal Point Theory of Bargaining, in GAMES—THEORETIC MODELS OF BARGAINING 259 (Alvin E. Roth ed., 1985).

67. For evidence that the balance of power in the legislature is not as relevant as the fundamental player in U.S. policymaking. It is, but the role of the executive is to control the legislature, which itself adjusts on the basis of the policy's political effect, in a classic study Richard E. Neustadt, PRESIDENTIAL POWER (1960), and the recent comprehensive survey by Stephen Skowronek, THE POLITICS PRESIDENTS MAKE: LEADERSHIP FROM JOHN ADAMS TO GEORGE BUSH (1993).

68. Popularity known as the paradox of voting, this fundamental observation regarding majority-rule processes has been well recognized at least since the work of de Condorcet. See Marie Jean Antoine Nicolas de Caritat, Marquis de Condorcet, Essai Sur L'Application de L'Analyse à La Probabilité des Decisions Rendus à la Pluralité des Voix (Paris, L'Imprimerie Royale 1785). Even though majority rule leads a legislature to vote for policy A over policy B, and for policy C over policy B, it is certainly possible, and often likely, that policy C will default policy A. Kenneth Arrow has proved that this paradox of voting is a symptom of a more fundamental problem with all democratic processes: there is no guarantee that such processes can find a best outcome or are immune
coalition is capable of holding its majority against small policy variations offered by a losing minority, then either no decision will be made or final policy outcomes will be random and uncertain.

If legislatures are to reach decisions, additional legislative institutions must be discovered for overcoming this inherent instability of the majority-rule process. Two institutional approaches are commonly used by legislatures. The first assigns agenda-setting powers to a small subset of members, say the speaker of the house or a key legislative committee. Other members in the legislature then simply vote—up or down—on the items in the approved agenda. Most likely, policies will be approved by a bare majority—a minimal winning coalition—in this strong agenda-setter legislature. A second strategy shares agenda-setting powers among all members, giving each legislator a right to select her most preferred policy in that policy area most germane to the legislator’s constituents. This second approach to legislative decisionmaking involves each legislator deferring to the preferred policies of all other legislators, provided the other legislators defer to the legislator’s own policy requests. The guiding principle here is a norm of deference—“You scratch my back, I’ll scratch yours”—and it typically results in legislative proposals that are approved unanimously. For this reason, such legislatures are often called “universalistic.”

See KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES 1-8 (1963). Thus, the design of political institutions will almost inevitably be a search among the second-best. For a survey of this literature in the context of the new political economy, see Robert P. Inman, Markets, Government, and the "New" Political Economy, in 2 HANDBOOK OF PUBLIC ECONOMICS, supra note 49, at ch. 1, 672-739.


70. The guiding theory can be found in Berry R. Weingast, A Rational Choice Perspective on Congressional Norms, 29 AM. J. POL. SCI. 245, 249 (1979) (defining universalism as “the tendency to seek unanimous passage of distribution programs through inclusion of a project for all legislators who want one”) and Emerson M.S. Nicou & Peter C. Ordeshook, Universalism in Congress, 29 AM. J. POL. SCI. 246, 246 (1985) (offering a “model based on constituency motivations that establishes universalism as an optimal individual choice and which accommodates inefficient legislation directly”). The theory has been developed for, and its applications are limited to, understanding how legislative bodies allocate government projects and government regulations—what has been called distributive politics. See THEODORE J. LOWI, THE END OF LIBERALISM (1969). A norm of deference is not an appropriate model for predicting how legislatures will decide redistributive policies such as welfare or progressive taxation—politics in which one group of constituents must lose to another.

Details regarding the legislative institutions needed to enforce the norm of deference can be found in Berry R. Weingast & William J. Marshall, The Industrial Organization of Congress; or, Why Legislators, Like Firms, Are Not Organized as Markets, 96 J. POL. ECON. 132, 144 (1988) (“The committee system provides substantial protection against opportunistic behavior, thereby providing durability to policy bargains.”).


A single legislator choosing between the closed rules of a bare-majority, minimal-winning-coalition legislature and the more open rules of a universalistic legislature managed by a norm of deference will typically favor the more open rules. The universalistic legislature will be preferred because under universalism and its norm of deference, projects that benefit the legislator’s constituents are nearly certain to be chosen. With closed rules, a legislator has to belong to a winning coalition to have his or her constituents’ projects approved. Without additional side-deals, the probability of being in that coalition is at best 50:50. For a member of the legislature seeking re-election the logic is simple: it is better to take home a "slice of bacon" for sure than to face a lottery with a 50:50 chance of a "pork chop" or nothing.

Unfortunately, universalistic legislatures operating under a norm of deference run a significant risk that their chosen policies will be economically inefficient. Consider, for example, the typical case of providing a public good or a regulation that benefits the residents of one jurisdiction but that is funded, because this is a central government policy, by residents of all jurisdictions. There results a cross-subsidy from taxpayers nationally to the residents of the jurisdiction receiving the public good or regulation. The incentive for the legislator selecting a project and facing such a subsidy is, of course, to ask for too much of the good or regulation. The norm of deference—"You scratch my back, I’ll scratch yours"—allows these inefficiencies to stand, not just for one jurisdiction but for all jurisdictions represented in the legislature.

71. Specifically, within the bare-majority legislature, each legislator can expect her jurisdiction to pay for a little more than half of the legislature’s average project, since all legislative districts share in the costs of each legislator’s project and one more than half of all the districts are bare-majority projects. Further, each legislator can expect her jurisdiction to be given a project, on average, a little more than half the time. Thus, expected net benefits from bare-majority rule will be a little more than .5 x [Project Benefits - Average Project Costs]. When the legislature operates under a norm of deference, however, all districts’ projects are accepted with certainty. Thus, expected net benefits will be simply [Project Benefits - Average Project Costs]. If benefits exceed average project costs in a majority of districts—a likely case—then a legislature run by a norm of deference will be the preferred legislative institution. Weingast, supra note 70, at 249-56, and Nicou & Ordeshook, supra note 70, at 256-58, prove exactly when this outcome holds. For an extension of the analysis to legislative projects of variable size, see Robert P. Inman & Michael A. Pitts, Political Institutions and Fiscal Policy: Evidence from the U.S. Historical Record, 6 J. L. & ECON. & ORG. 79, 84-92 (Special Issue 1990) and Thomas Schwartz, Representation as Agency and Pork Barrel Paradox (1989) (unpublished manuscript, on file with the UCLA library). The conclusion that legislators prefer universalism to bare-majority rule extends to this more general case.

72. An efficient size of a government policy occurs when the social marginal benefits from the policy (MB) just equal the social marginal costs (MC) of the policy. Suppose that (1) the social marginal benefits of the policy all accrue to the residents of one legislative district, but the social marginal costs are shared equally by residents of all n legislative districts, and (2) each legislator is free to set her preferred policy by equating the marginal benefits and marginal costs that accrue to the residents of her district alone. What will happen? Social efficiency requires that MB = MC, but each legislator select a policy level so that MB = (1/n) x MC < MC. Clearly, too much of each policy is chosen by
Will this bias towards inefficient public policies undermine the usual case for centralization of economic spillovers? If the spillovers are positive, then a centralized universalistic legislature may improve resource allocations. Universalism’s cost-sharing incentive to the local jurisdiction stimulates those local citizens to provide more of the nationally beneficial public good (for example, support for the poor) or regulation (for example, air quality control) than they would on their own under decentralization.73

Unfortunately, when the spillovers are negative, centralization and the use of a universalistic legislature are likely to make matters worse; now the sharing of local costs leads the local jurisdiction to buy more of the activity producing the negative spillover. Central government regulation—but not provision—of these activities would improve resource allocation in the case of negative spillovers, but only if that regulation effectively constrains their use. From the political economy perspective, centralization is no all-purpose cure for the efficiency ills of decentralization.74

What federalist structure of government should we then recommend for the valued objective of economic efficiency? The analysis here suggests some general guidelines. Decentralized governments will be most efficient for those activities and regulations that can be efficiently provided to small populations and that have no significant positive or negative spillovers onto nonresidents. For goods with significant economies of scale in production (“public” goods) and other goods and regulations with positive economic spillovers, a single centralized government is likely to improve efficiency. The positive spillovers are “internalized” through the incentives implicit within a national legislature. Goods with negative spillovers, however, should be decentralized in provision and (ideally) regulated by central government laws constraining their use.

In contrast to political participation, which favors nearly full decentralization—a “fine” partition and full local assignment—economic efficiency favors a combined use of decentralized and centralized federalist structures. Along the partition dimension, a “fine” partition with very many decentralized governments is likely to be inefficient as spillovers across political jurisdictions become pervasive. A “coarser” partition reduces those spillover inefficiencies but creates new problems as larger legislatures inefficiently allocate nonspillover goods and regulations. A single central government—the very coarsest partition—internalizes all positive spillovers but inefficiently allocates all other government goods and regulations.

Efficient assignment will also involve a mixed federalist structure. If one can draw the fine lines between positive and negative spillovers, then our advice is clear: Assign to a central government the provision of goods and regulations with positive externalities, but assign to smaller governments those goods and regulations with negative externalities and those with no externalities at all. If they can be written, then central government regulations that constrain negative spillovers will be useful.

3. Balancing Participation and Efficiency Through Federalism.—Our analysis of how alternative federalist structures are likely to affect federalism’s valued goals of political participation and economic efficiency makes clear that no one structure—decentralized or centralized—will maximize both goals. Although political participation increases as the federalist partition moves from one government to many and assignment shifts responsibilities from the national to the state and local jurisdictions, economic efficiency is likely to first rise and then decline with such increased decentralization.75

75. We use the shorthand “decentralization” and “centralization” to reflect the federalist structure that results from the dual specification of a partition and an assignment. Decentralized structures imply finer partitions and more local assignments; centralized structures mean a coarser partition and central assignments. Strictly speaking, we should only use the complete language of partition and assignment when describing a federalist structure, since these two institutional variables are independent choices and both contribute separately to the goals of efficiency and participation. We will use the richer language when there is a possibility of confusion.
increases, \( \Delta \) first rises but then declines as many small governments assume more economic responsibilities and economic spillovers become more pervasive. The two anchor points for the "federalism frontier" are the efficiency-participation outcomes when the federalist structure is fully centralized with one national government (point \( C \)) and when the federalist structure is fully decentralized with no governments at all (point \( D \)). The important range of the frontier is the one in which hard choices must be made, the range \( FF' \), where efficiency declines as participation continues to increase. Decentralizing the federalist structure from point \( C \) to \( F \) gives society more of both valued outcomes, as does centralizing the federalist structure from point \( D \) to \( F' \). In the range \( FF' \), no single federalist structure is clearly dominant. Which structure one prefers depends upon how one chooses to weight the now competing federalist values of political participation and economic efficiency.

Having seen the inevitable tension between political participation and economic efficiency, the task of those setting a society's federalism policy becomes clear. First, select those federalist institutions—a partition and an assignment—that move us to the outer, \( FF' \) range of the federalism frontier. Then adjust those institutional choices to reflect society's preferred mix of efficiency and participation along the \( FF' \) range where the values are competing. Subpart II(B) illustrates how this general theory of federalism applies to the specific task of establishing the institutions of regulatory federalism, highlighting the potentially important role current state-action doctrine can play in moving us to the \( FF' \) range of our federalism frontier.

B. Participation, Efficiency, and the Design of the Federalist Regulatory State

Federal, state, and local government regulations play an important role in the United States economy, setting the rules that determine the flows and often the prices of capital, labor, and goods and services. One

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76. The index is a weighted average of all citizens’ values of political influence and participation efforts, denoted by \( \rho \) and \( \epsilon \), respectively. See supra note 34. If \( \rho \) and \( \epsilon \) are used to represent vectors of all citizens’ political influence and efforts, then \( \theta = \Theta(\rho, \epsilon) \). How one creates such an index is a subtle matter. See supra note 33.

77. We choose to measure economic efficiency as the sum of all consumer and producer surpluses possible under each federalist institutional structure. We should be clear that our approach to the economic consequences of federalism avoids any explicit consideration of how federalist structures affect the distribution of economic surpluses across groups in society. We feel this is the appropriate approach for matters of institutional design and judicial enforcement, our two questions here. Cf. JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT 63-84 (1962) (providing one approach to the design of the economically efficient—or contractarian—constitution); Richard A.

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Hofstra L. Rev. 487, 502-07 (1980) (using a Pareto-superior analysis to show that distributive effects are not an important factor in determining what is economically efficient).

78. From point \( C \), increasing decentralization by creating more governments and increasing local assignment improves economic efficiency and enhances participation. From point \( D \), increasing centralization by moving from no governments to small local governments and giving them responsibilities increases economic efficiency and for most participation theorists increases participation as well. Although political influence is highest when each person is her own government, it is difficult to have a meaningful political dialogue or group learning when each government is a single person.

particularly important set of regulations are those affecting the competitive practice of business, and nowhere is the potential tension between federal, state, and local rules more acute. At the federal level stand the antitrust laws designed to preserve competitive markets. From state and local governments come often quite restrictive rules aimed at controlling how businesses behave when producing and selling their goods and services. Conflict seems almost inevitable. The task of a well-articulated theory of regulatory federalism—and a reasoned state-action doctrine in particular—is to define the separate domains for federal antitrust rules on the one hand and state business regulations on the other. This subpart begins by outlining how the assignment of regulatory responsibilities to federal and state governments can enhance federalism's twin values of political participation and economic efficiency.

1. Political Participation in the Federalist Regulatory State.—In contrast to the active and visible role legislatures and elected executives play in setting and implementing government spending and taxation policy, government regulations are often specified and enforced one step removed from direct electoral controls. Although legislatures set the goals for regulation—clean air, safe workplace, fair prices—the implementation of policies to achieve those goals typically falls to regulatory agencies and appointed commissions. This is understandable; regulation of the economy is complicated and experts are needed. Further, while the direct consequences of government spending and tax policies can usually be identified, it is very difficult to learn how a government regulation affects our daily lives. For both reasons—policymaking as once removed and consequences hard to discern—citizen participation in regulatory policy may be difficult to achieve. What can be done?

The logic of participatory politics and the available evidence reviewed in section II(A)(1) above both suggest that political participation is likely to increase as policy responsibilities are decentralized to state and local governments. This conclusion is not reversed for policies regulating business. State and local governments are more likely than a large central government to foster an environment conducive to citizen political influence and policy effort over regulatory affairs. First, the important difficulty of monitoring politicians' and regulators' activities is reduced for state and local governments because citizens can look across local and state boundaries to reveal—in ways not possible with centralized regulation—the more obvious effects of regulations harmful to citizen interests. Second, when abuses are discovered, the relatively low cost of running for state and local offices permits easier entry of competitive candidates capable of bringing the case for reform to the voters' attention. Regulatory policies are complicated and removed, but assigning responsibility for those policies to state and local governments helps to lift the veil of voter ignorance and provides easier access to the channels of reform.

Once regulatory authority is decentralized, more can be done. Although expert agencies and commissions will be needed to implement regulatory policies, oversight of the agencies and commissions by elected officials can be strengthened. Enabling legislation for regulations can explicitly require periodic review by the legislature. Sunset provisions requiring regulations to be re-authorized are also useful. Strengthening the hand of elected officials through review and re-authorization in turn strengthens the hand of the average citizen. Citizen influence is potentially increased and, if so, involvement in regulatory policymaking will be encouraged. Participation rises.

There is no direct evidence on the extent of citizen participation in regulatory affairs at different levels of government. But recent empirical studies showing the influence of legislatures over regulatory agencies, when coupled with the earlier evidence showing that decentralization enhances voter control over legislators and thus encourages participation generally, lend support to the view that decentralization and enhanced legislative control will contribute to citizen participation in regulatory affairs.

We conclude that to encourage political participation in setting business regulatory policies, decisionmaking should be decentralized to the state and local levels, and institutional reforms that strengthen the control of the elected legislature and executive over regulatory agencies should be encouraged. An antitrust state-action doctrine might usefully serve these ends.

81. Sunset provisions require the legislature to vote explicitly to continue a regulation. Without that approval, the regulation is discontinued. Once a regulation has been in place for several years, new information about the effects of the regulation on consumers and producers will be available, which should make it easier to remove inefficient regulations. But not always: individuals who have invested in anticipation of an inefficient regulation's being continued—e.g., owners of taxicab medallions in New York City—have a vested interest in its approval.

82. See Matthew D. McCubbins et al., Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies, 75 VA. L. REV. 431, 433 (1989) (asserting that a legislature can exercise effective political control over agencies by restricting their decisionmaking ability through manipulation of agency structures and processes); Barry R. Weingast & Mark J. Moran, Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission, 91 J. POL. ECON. 765, 792 (1983) (arguing that Congress exerts control over regulatory agencies even without systematic oversight hearings).

80. For example, Pennsylvanians can discover the disadvantages they face in the purchase of wines and spirits because of regulated "state stores" by simply comparing Pennsylvania liquor prices and wine selection to those available in Delaware and New Jersey.
2. Economic Efficiency in the Federalist Regulatory State.—Economic efficiency of regulatory policies demands that policies be efficient both with respect to the preferences of citizens of a regulating state (intrajurisdictional efficiency) and with respect to the preferences of citizens living outside the state (interjurisdictional efficiency). Whether these two dimensions of efficiency will be achieved depends upon the performance of the legislatures and regulators selecting and implementing policies.

The pivotal institution in setting the goals and means of state regulatory policies will be the state legislature. State legislatures must overcome majority-rule’s propensity to voting cycles and policy indecision, and, since all legislatures, they tend to find a solution in logrolling across policies and the “you scratch my back, I’ll scratch yours” norm of deference. Under a norm of deference, each legislator is allowed to propose policies that her constituents favor, and favorite policies are then “bundled” (that is, logrolled) into large omnibus bills which the legislature as whole approves. Such logrolled policies are often economically inefficient, and state regulatory policies will be no exception.

As an example, consider how regulations to restrict industry output might be decided by a state legislature in which a legislator or small coalition of legislators represent districts where a majority of residents work or, on their own businesses in, a single industry. If unregulated, firms in that industry would be competitive, pricing their goods at marginal cost and earning the competitive rate of return. If regulated through price or output restrictions, however, the many firms in the industry could operate as a single, profit-maximizing cartel. Raisins in California might be one—not randomly chosen—example. What would the firms and workers prefer now, and how would their legislators vote?

**Figure 2—Industry Prices and Outputs**

![Graph showing Industry Prices and Outputs]

Figure 2 makes clear that these competitive firms will prefer the regulated cartel arrangement. When the industry is competitive, prices settle at \( P \), and output at \( Q_c \), where demand equals the long-run marginal cost (or industry supply). There are no extra profits earned when the industry is unregulated, as prices just cover costs. If state regulation can establish a cartel pricing scheme among industry firms, however, then prices will be above costs, say at the profit-maximizing price shown as \( P_{max} \). Extra “monopoly” profits equal to the shaded area are earned by the owners of the specialized inputs used in the industry—owners of existing capital, owners of land, and unionized workers. The same effect on profits could be achieved through a quantity regulation restricting total industry output to \( Q_{max} \). Given the choice between no extra profits (unregulated) or extra profits (regulated), the industry clearly prefers extra profits (regulated). The curve shown as \( MB \) in Figure 3 shows how the industry’s firms gain additional profits for each regulated reduction in industry output of \( \Delta Q \) below the competitive level of \( Q_c \). These additional profits—the
"marginal benefits" of restrictive business regulation—decline as regulation increases until total profits are maximized at a reduction in output of $\Delta Q_{\text{max}}$ ($= Q_* - Q_{\text{max}}$).

**Figure 3—The Marginal Benefits and Costs of Regulation**

Consumers of the industry's output, on the other hand, clearly prefer no regulation; no regulation means lower prices and more output. The consumers' economic losses are the costs of regulation, and curve $MC_c$ in Figure 3 shows how those costs might increase as the regulated reduction in industry output ($\Delta Q$) increases. As $\Delta Q$ rises, available output declines and market prices rise making consumers increasingly worse off. Importantly, as shown in Figure 3, the marginal costs to consumers in lost consumption ($MC_c$) lie everywhere above the gains to the industry in higher profits ($MB_b$); restrictive business regulation of a competitive industry is economically inefficient. If those consumers reside within the state, they should oppose the industry's desire for this inefficient regulation. Will they succeed?

If the proposed regulation affects only a relatively minor portion of consumers' budgets (for example, raisins), and legislators are capable of responding to only a few major concerns each year, then consumers' interest in the regulation is likely to go unrepresented. If the regulation affects a few consumers significantly (for example, vegetarians), but those consumers are spread throughout the state, then consumers' interests are again likely to be ignored. Only when the regulation is economically important and those affected are concentrated in a few legislative districts will significant opposition arise to block an anticompetitive business regulation.

**Figure 4A—Legislative Choice of Regulatory Policies:**

*No Regulatory Spillovers*

Anticompetitive business regulations will be submitted by legislators representing the benefitted industries and, except in rare instances, no other legislators will rise to oppose the legislation. The amount of regulation that will be submitted—the level of $\Delta Q$—is that which the legislator from the business district prefers. The legislator balances the district's gains in profits against the district's lost consumer benefits because some fraction

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88. The curve $MC_c$ is the marginal cost to state residents of regulating industry output. The most significant component of $MC_c$ is the loss in consumer surplus enjoyed from consuming the industry's output, measured as the area between the demand curve and the price charged for the good. See Pindyck & Rubinfeld, supra note 87, at 113-16. This loss is shown in Figure 2 as the combination of the shaded area of industry profits plus an added (or "excess") burden equal to the dashed triangle. The loss in consumer surplus increases as the output is reduced and prices rise. Importantly, the lost consumer surplus always exceeds the industry's profits at each level of $\Delta Q$ by the dashed triangle, so the curve $MC_c$ is always above the curve $MB_b$. See id. at 341 fig. 10.9. For completeness, one can also include in $MC_c$ the extra government spending needed to regulate an industry's output. These added bureaucratic costs increase $MC_c$ still further above $MB_b$. See supra note 48.

89. Figure 3 makes the well-known point in economics that competitive industries are more efficient than monopoly industries. See Pindyck & Rubinfeld, supra note 87, at 332-33.
of the state’s consumers—say, \((1/n)\)th if there are \(n\) districts—is likely to reside within the district. In Figure 4a, the politically favored level of business regulation is shown as \(\Delta Q^*\), where the district’s marginal benefits from regulation equal the district’s marginal cost: \(MB_i = (1/n) \cdot MC_i\). At \(\Delta Q^*\), statewide costs are much greater than statewide benefits. Business regulations creating significant intrajurisdictional economic inefficiencies may be approved by logrolling legislatures.\(^{90}\)

So, too, may legislatures approve regulations creating significant interjurisdictional inefficiencies. Indeed, the temptation is even greater in this case since regulations creating interjurisdictional spillovers export much of the cost of regulation outside the boundaries of the state. Again, raisins grown almost exclusively in California but consumed nationally are a good example. The benefits from the regulation of raisin output and prices accrue to producers in California, but the costs are born by consumers nationwide. Even if the California legislature considered the full costs of the regulation on California consumers—and thus the regulation was efficient for California residents alone—there still would be significant interjurisdictional inefficiencies imposed on residents outside of California. Matters are even worse, of course, if the California legislature decides policies using a localized norm of deference, for then intrajurisdictional inefficiencies remain.

**Figure 4b—Legislative Choice of Regulatory Policies: Regulatory Spillovers**

![Diagram of regulatory spillovers](image)

Reduction in Output from \(Q\)

\[\Delta Q^*\]

\[\Delta Q\]

\[\Delta Q_1^*\]

\[\Delta Q_2^*\]

\[MB_i\]

\[MC_i\]

\[MC_N\]

\[^{90}\] The analysis here is an application to business regulation of the general model of inefficient policymaking in universalistic legislatures. See supra notes 71-73 and accompanying text.

Figure 4b illustrates the case of interjurisdictional inefficiencies where the regulated industry exports a major portion of its output to residents outside the state. The benefits of regulation to state producers are significantly higher. Extra profits can be earned from out-of-state consumers, and these profits are indicated by an upward shift in \(MB_i\). In-state consumers continue to bear the same costs as before (as in Figure 4a), so their marginal costs from regulation remain at \(MC_i\). But to these costs we must now add the additional lost consumer benefits borne by out-of-state consumers to obtain the national costs, \(MC_N\), of state regulation. Even if the state legislature fully recognized the costs of regulation to its own resident consumers, it would still provide positive regulation—\(\Delta Q^*\) where \(MB_i = MC_i\)—because the profits earned for its producers from out-of-state consumers are too attractive.\(^{91}\) Of course, for reasons noted above, the state legislature may ignore its own resident consumers too. In this case, regulation of industry output will be even more restrictive, moving to \(\Delta Q_2^*\), where \(MB_i = (1/n) \cdot MC_i\). Here the legislature approves regulation that exploits both in-state and out-of-state consumers; intrajurisdictional and interjurisdictional inefficiencies are the result.\(^{92}\)

\(^{91}\) These profits are also sufficient to compensate in-state consumers for their own losses from industry regulations. This effect is illustrated in Figure 4b by the fact that the area under the state’s MC curve (i.e., its total profits from the regulation) is greater than the area under the \(MC_N\) curve (i.e., the losses to in-state consumers). A regulation of \(\Delta Q^*\) is efficient from the perspective of state residents alone, but is shown in Figure 4b to be inefficient when the costs of all national citizens are considered.

\(^{92}\) Although the central focus of this essay is on the regulation of business output, the analytical framework presented in Figures 2 to 4 can be extended easily to study other prominent forms of government regulations such as the regulation of prices to favor consumers, the regulation of pollution, and the regulation of public utilities.

For example, when market prices are regulated to favor consumers—rent control is a prominent example—consumers benefit as prices are lowered. Producers lose, however, as prices and, consequently, their profits decline. As prices fall, the quantity of the good available to consumers declines as well. Thus, consumer price controls can also be studied as regulations that restrict output. The analysis in Figures 3 and 4 therefore applies, only here \(MB_i\) represents consumer benefits from lower prices, \(MC_i\) represents lost profits to in-state producers, and \(MC_N\) represents the sum of lost profits to in-state and out-of-state producers. The political analysis is identical, except in this case the consumers are concentrated in one legislative district (e.g., renters in the urban area) while the producers (e.g., owners of housing) are assumed to live throughout the state or nation. According to the logic of Figures 4a and 4b, there will be too many consumer price controls, resulting in intrajurisdictional and interjurisdictional inefficiencies. Rent control was attacked as price fixing under the Sherman Act in *Fisher v. City of Berkeley*, 475 U.S. 260, 261 (1986).

That this single model of political decisionmaking helps us to understand the four prominent forms of regulatory policy is both a blessing and a curse. It is a blessing because it suggests we may have captured the basic forces at work when policies are decided by legislatures. It is a curse because it means we cannot simply observe the process of producers and consumers influencing legislatures and know exactly what the outcome will be. John Wiley has proposed such a "process" approach to the antitrust state-action doctrine: if producers are crucial to the passage of the regulation, then the regulation must entail producer capture, be inefficient, and fall subject to antitrust review. See Wiley, supra note 7, at 764-73. As the analysis here makes clear, no such conclusion is warranted. Producers can...
What can be done? If decentralized business regulation is inefficient, perhaps we should centralize these regulatory policies in the national government. Recent experience suggests we should think carefully before adopting this strategy.93 Congress faces the same political pressures to manage public policies for local constituent interests as do state legislatures, and, like state legislatures, it is designed as an institution to facilitate logrolls, not control them.94 Furthermore, a national regulatory policy creates additional incentives to overregulate because taxpayers and consumers in the country as a whole, not just in a given state, pay for regulations that benefit local producers. Rather than controlling regulatory inefficiencies, Congress may actually prove conducive to even more regulatory logrolls.95

An alternative approach—and the one we shall recommend in this Article—seeks to strengthen the hand of those forces in the decentralized economy that can enhance regulatory efficiency. Judge Frank Easterbrook in Antitrust and the Economics of Federalism96 explores this same approach, but focuses, we argue, on the wrong forces. He looks to find

be involved in all kinds of regulations—good and bad—as can consumers. Matthew Spitzer has developed this critique of Wiley's analysis more completely. See Spitzer, supra note 7, at 1310-15 (arguing that there is no tenable process-orientated distinction between producer- and consumer-capture, and criticizing Wiley's argument that interjurisdictional regulatory exploitation by majority rule is more democratically legitimate than intrajurisdictional interest-group regulation).

93. For surveys of national regulatory policies and their associated inefficiencies, see Greenstreet & Lave, supra note 79, at 1541-42, and Jokow & Rose, supra note 79, at 1465-86.

94. See Thomas Strumvant, The Effects of Logrolling on Congressional Voting, 82 AM. ECON. REV. 1162, 1169-74 (1992) (finding significant correlations between a support for legislation benefiting parochial constituencies and vote-trading on other issues); Weingast & Marshall, supra note 70, at 145 (explaining how the committee system encourages exchange among legislators who serve a diversity of constituencies).

95. The restriction of agricultural output and farm price support programs are good examples of how a national logroll facilitates a regulatory price subsidy that would be very difficult to achieve through interstate bargaining. See Bruce L. Gardner, Causes of U.S. Farm Commodity Prices, 95 J. POL. ECON. 290, 309 tbl.6 (1987) (finding that geographic concentration of commodity production and an optimal constituency size correlate with increased price support values).

Indeed, passage of the omnibus agriculture bill involves a curious coalition of representatives from farm states and from inner-city congressional districts. See John Ferejohn, Congress and Redistribution, in MAKING ECONOMIC POLICY IN CONGRESS 131, 144 (Allen Schick ed., 1983) (noting that "food stamp authorization bills are usually tucked onto the omnibus agriculture bill," which could account for the inner-city support). For an overview of the growth in federal regulatory expenditures and activities, see generally Melinda Warren & Barry Jones, REINVENTING THE REGULATORY SYSTEM: NO DOWNSIZING IN THE ADMINISTRATION PLAN (Center for the Study of Am. Bus. Occasional Paper No. 155, July 1995).

From 1970 to 1995, federal staffing and federal expenditures (in real dollars) both tripled. See id. at 7 figs.1-2. Many political science scholars see this period as the time when Congress shifted from an institution run by its leaders to an institution run by its members—members primarily interested in servicing their local constituents through the passage of locally helpful fiscal and regulatory policies. See, e.g., Weingast & Marshall, supra note 70, at 137 ("Electoral competition induces congressmen, at least in part, to represent the interests of their constituents.").

96. Easterbrook, supra note 7.


the pressures for efficiency in intergovernmental economic competition.97 We shall look instead to intragovernmental political competition, hoping to find ways to strengthen that competition and thereby improve regulatory performance.

In setting regulatory policy, Judge Easterbrook argues that the world of decentralized, economically competitive governments will create a national regulatory marketplace in which individuals and businesses move among local jurisdictions or states to select that regulatory combination they most desire. Just as a private marketplace forces suppliers to produce their goods at the lowest cost, and to provide the goods most desired by consumers, so too—argues Easterbrook—will the pressure of citizens and businesses shopping, through exit and relocation, force governments to be efficient in their provision of public regulations.98 Relying on Charles Tiebout's famous economic model of government competition, Easterbrook concludes "that the goal[ ] of competition to avoid exit leads jurisdictions to enact that set of laws most beneficial to the population. . . . [E]xit causes a powerful tendency toward optimal legislation."99 Easterbrook recommends that the courts show a strong presumption in favor of state and local economic regulations, shaped as they are from the pressures of efficient economic competition.100

Although we support Judge Easterbrook's recommendation, we feel it follows from the wrong analysis. Economic competition will not ensure efficient regulations. Consider the plausibility of Charles Tiebout's five conditions for efficiency for regulatory competition between states.101 If Tiebout's conditions do not hold, then Easterbrook's conclusion that economic competition alone will produce regulatory efficiency cannot be accepted. We will need to look elsewhere to justify regulatory decentralization. Tiebout's condition 1—regulations provided at minimum average cost—is likely to hold; Tiebout's conditions 2 through 5 are more problematic.

97. See id. at 33-35.

98. See id.

99. Id. at 34 (emphasis in original).

100. See id. at 45-46 (suggesting that courts step in when monopoly overcharges are paid by consumers outside of the jurisdiction and ignore arguments that commerce into the jurisdiction is burdened).

101. See supra note 50. Intergovernmental regulatory competition is our central concern because most business regulation, and the primary focus of the antitrust state-action doctrine, is state regulation. The Tiebout-Easterbrook analysis has a better chance at the metropolitan level with competition between local governments. Certainly this seems to be the case for local fiscal policies. See Edward M. Gramlich & Daniel L. Rubinfeld, Micro Estimates of Public Spending Demand Functions and Tests of the Tiebout and Median Voter Hypotheses, 901 POL. ECON. 536, 534-55 (1982) (describing empirical results that were "reasonably consistent with a Tiebout interpretation: In large metropolitan areas, there is quite extensive grouping; in smaller areas, there is some grouping."). Whether we can generalize from fiscal performance to regulatory performance is an important question, however. See infra note 103.
involved in the choice of regulatory packages over multiple jurisdictions, that collecting and acting upon the information is expensive, and that it is strategically advantageous to wait for others to (literally) move first, then it seems to us unlikely that families or firms acting on their own will be motivated to satisfy the Tiebout-Easterbrook full-information requirement for efficient regulatory policy.

Condition 4—mobility of households and businesses—represents another high hurdle for Judge Easterbrook's application of the Tiebout argument. But relocation costs can be significant, both for families and for firms. Both bear search costs, moving costs, and the costs of replacing valuable but locationally tied assets (for example, gardens and friends; plants and customers). If these relocation costs are large, then households and businesses can be "explicated" by inefficient public policies, including inefficient regulations, up to the cost of relocation.105 Matters are more

on their knowledge, reveal the same to uninformed traders and thus lose their competitive advantage. See also Robert Cooter & Thomas Ulen, Law and Economics 101-02, 117-19 (2d ed. 1997); Sanford J. Grossman & Joseph E. Stiglitz, Information and Competitive Price Systems, 60 AM. ECON. REV. 246 (1976) (arguing that informed investors can only earn compensation for the cost of gathering information when the market does not reflect true value, i.e., when information has not been "fully conveyed" to the uninformed investors).

105. A simple example shows how large these relocation costs can be. If a family earns $40,000 a year and lives in a $100,000 house, then moving from one location to another and buying an identical house will cost approximately $6000 in realty fees (3% when selling and 3% when buying) and approximately $2500 in moving expenses. Amortizing these one-time costs of $8500 at 5% per year implies an annual cost of relocation of about $425/year. That leaves a lot of room for inefficiency regulations before the family will relocate. Further, this $425 annual ceiling is conservative; it ignores all the psychic costs of finding new friends and inking in touch with old ones that any move entails.

These psychic costs are likely to be large for interstate relocations. The costs of home purchase and moving expenses are present even with metropolitan relocations, and these costs create barriers to efficient competition. Although differences in fiscal policies—taxes and school quality in particular—are often large enough to warrant a relocation, see Glamlich & Rubinfield, supra note 101, at 551-55, it is not clear that differences in local regulatory policies (e.g., cable TV, rent control, liquor store pricing, legal services) will loom so large. If not, condition 4 is violated and there is reason to doubt the usefulness of the Tiebout-Easterbrook model as the basis for efficient regulatory policy at the local level as well. Easterbrook's potential rebuttal to this argument is that: (1) it is the "marginal mover" (i.e., the one who makes the winning bid) who determines site prices for homes and businesses; (2) this crucial marginal mover is a family or business from outside the jurisdiction—or more generally, has choices outside the jurisdiction—and so makes a low bid that reflects the relative inefficiencies of the jurisdictions in public policies; and (3) the fall in land prices is a stimulus to regulatory reform. See Easterbrook, supra note 7, at 44. While step 1 is obviously true, see R. Preston McAfee & John McMillan, Auctions and Bidding, 25 J. ECON. LITERATURE 699, 707 (1987), the validity of steps 2 and 3 is not so clear, particularly for state jurisdictions. It is important to realize that the land market is not one market for identical parcels whose price is determined by one marginal buyer, but rather thousands of markets, one for each type of home or business in each location, whose prices will be determined by thousands of marginal buyers. For Easterbrook's argument to hold, there must be a marginal buyer with out-of-state options in each of these markets. Most residential relocations, however, involve in-state moves; nationally, only three percent of individual moves are across state lines within a given year. See U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 32-33 (1995). It is not clear that there are sufficient "marginal movers" to significantly affect overall state land prices. Furthermore, as Tiebout originally conceived the efficiency role for


104. For the public-good aspects of private information, see Sanford J. Grossman & Joseph E. Stiglitz, On the Possibility of Informationally Efficient Markets, 70 AM. ECON. REV. 333, 400-05 (1980) (arguing that prices cannot fully reflect costly information because informed traders, by acting
complicated, but even worse for Easterbrook’s argument, when relocation costs are asymmetric—high for families but low for business. As states compete for mobile businesses, there will be pressure to offer those businesses favorable regulations. One pro-business regulation that might be offered is cartel control over output and prices.106 If consumers cannot exit the state easily, if they are geographically spread throughout the state, and if the good is a small fraction of consumers’ budgets, then such inefficient regulations may be approved.107 Rather than fostering economic regulatory efficiency in this case, economic competition contributes to inefficiency.108

Condition 5—no interjurisdictional externalities or spillovers—is also essential for Tiebout-Easterbrook regulatory efficiency. When spillovers are present, state and local governments underprovide regulations with valuable, positive spillovers (for example, air quality control) and overprovide regulations with harmful, negative spillovers (for example, anti-competitive business regulations). Economic inefficiency results. Judge Easterbrook recognizes that condition 5 is likely to be violated by real-world regulations, and we agree. Indeed, economic competition often makes matters worse when there are spillovers. Consider, for example, the case of anti-competitive business regulations with negative spillovers.109 Here states might use the promise of “pro-cartel” regulations to attract firms, or groups of firms, that sell their products in national markets. As long as these firms remain the industry’s leaders, excess profits can be earned.110 Interstate regulatory competition can lead to a proliferation of oligopolistic markets, dominant firms, or price leaders, which maximize their own profits by taking into account how the output of smaller firms varies depending on the act price.

111. For an example from environmental policy, see Charles E. David & James P. Lester, Federalism and Environmental Policy, in ENVIRONMENTAL POLICIES AND POLICY: THEORIES AND EVIDENCE 57, 59 (James P. Lester ed., 1989) (discussing the negative externalities and inefficiencies related to the decentralization of federal environmental programs). For other examples of the race to the bottom, see Cumberland, supra note 56, at 3 (arguing that federal siting of toxic storage facilities results in resource misallocation because “the activity generating the toxic waste transfers, in effect, a subsidy with the result that its output tends to be underpriced and over-produced”); Gramlich & Laren, supra note 55, at 506 (finding that “AFDC families should happen to make an interstate move, they are much more likely to go to a state with higher AFDC benefits”); Iman & Rubinfeld, supra note 2, at 314-15 (noting the potentially negative effects of competitive tax policies in a decentralized economy); and Oates & Schwab, supra note 56, at 334-35 (presenting a model in which interjurisdictional competition can lead to suboptimal tax rates and environmental standards).

112. This conceptual distinction between economic processes based on “exit” and political processes based on “voice” as alternative mechanisms for the allocation of resources was first formalized in Albert O. Hirschman, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN Firms, ORGANIZATIONS, AND STATES 15-20 (1970). Although Judge Easterbrook makes the argument for “exit” as the means to regulatory efficiency, we will be making the argument for “voice.” Easterbrook did recognize that political competition is an alternative to economic competition, but he doubted that one could collect the information necessary to make a reasoned choice between the two approaches. See Easterbrook, supra note 7, at 33. Pleading ignorance about “voice,” he opted for “exit.” We feel that the needed analysis and evidence is now available, and it favors “voice” as the relatively more effective mechanism for controlling regulatory inefficiencies at the state level.
If these three political conditions hold, then policies that make a majority of citizens better off will be on the agenda, known and understood by the voters, and chosen either directly by referendum or through their elected representatives. We argue below that these three political conditions are more likely to hold than their economic (Tiebout) counterparts, and that it is consequently more productive to look to the process of political, rather than economic, competition as a source for regulatory efficiency.

Politics with open access permits citizens and their representatives to select from a range of policy choices and to do so without moving their residence. Open access to reform is most likely to occur when key policy choices and policy implementation are decided by elected officials chosen through competitive elections. Candidates are free to choose their policy positions from a wide range of alternatives. In contrast to economic competition, in which there are at most fifty policy options offered by separate states, competitive state and local politics can mimic the successful policies of neighboring states and localities—in effect, bringing the options available through Tiebout-Easterbrook competition into play—but promising that new policies may be introduced as well. To ensure a wide range of possible reform options for consideration, competitive state and local politics seem the more promising venue.

But opening the political system to new ideas does not ensure economic efficiency; both efficient and inefficient policies can be admitted. For example, universalistic legislatures in which each legislator can offer her favorite policy is a source of regulatory inefficiencies. A political incentive to choose efficient over inefficient policies must exist for individual legislators, and the political means to implement the efficient reform choice must be created. It is here that the political conditions ensuring full information and the ability to mobilize collective action play their role.

Full information about the consequences of regulatory policies—current and proposed—allows voters to reward the elected officials who deliver the economically beneficial policies. But as argued above in our critique of Tiebout's condition 3, individual citizens will find the collection of such information costly and probably not worth their personal efforts. Political candidates, on the other hand, will find such information valuable if it helps them pass efficient policies and win elections, and the candidates can often share the costs of collecting this valuable information via political parties and legislative committees. For both reasons—higher benefits and lower costs—political candidates will find the collection and dissemination of information valuable in ways that private parties will not. Full information is more likely the outcome of political competition than of economic competition.

Finally, if more efficient regulatory policies can be placed on the legislative agenda and their benefits are known, will they pass? More pointedly, how can a political coalition in favor of economic efficiency be mobilized in an open, universalistic legislature? States with strong parties or strong governors can mobilize broad-based citizen support and thereby control regulatory inefficiencies. By definition, strong parties form a stable legislative majority. Members who might be tempted to deviate from the party's platform can be disciplined so that deviations will not occur. Regulatory policy will therefore be the policy that is in the interests of the stable, majority party; minority-party districts will receive no regulatory benefits. Further, because party leaders are likely to internalize regulatory inefficiencies generated by their members on their members, majority-party districts will seek fewer regulatory favors. In the end, strong political parties are likely to produce fewer regulations, and those that do emerge are likely to be more efficient.

116. More precisely, if the extra value to the candidate(s) of being in office multiplied by the increase in the chance of re-election made possible by the information exceeds the cost of collecting the information, then the candidate(s) will invest in information. On the use of political parties as a source of shared policy information for candidates, see JOHN H. ALDRICH, WHY PARTIES? THE ORIGION AND TRANSFORMATION OF PARTY POLITICS IN AMERICA 273 (1995). On the use of legislative committees as a source of useful policy information, see generally KAHN, supra note 69, at 61-191.

117. Fewer regulations follow from the fact that the strong, majority party no longer has to give any economic benefits to the minority party to ensure a stable policy outcome. Thus, only regulatory policies that favor majority districts will be approved. Inefficient regulations in minority districts will be defeated.

But even in the majority districts, strong political parties improve regulatory performance. Assume there are m districts (a majority) represented in the party. From the perspective of party leaders, industry regulations for any one district provides MB benefits to party constituents—those in the district that benefit from the regulation—but imposes (m/n) * MC costs on party members, calculated as the m party districts each paying (1/n) * MC in regulatory costs. The preferred level of regulation in each majority district will be set where party marginal benefits equal party marginal costs: MB = (m/n) * MC. Because (m/n) * MC > (1/n) * MC for all levels of regulation, then for the same MB curve, the party-preferred level of regulation must be less than the level of regulation preferred by the universalistic legislature. Less regulatory restriction of output follows, and improved economic efficiency is the result.

Political parties may even promote full economic efficiency, setting ΔQ = 0 in Figure 4a. This limiting case occurs if the political party controls all representatives in the legislature so that m = n. Then by the argument above, if the party seeks to set (m/n) * MC = MB, each district asking for regulation, the party must equate (m/n) * MC = MB. This pushes ΔQ to 0, which is the efficient outcome. See Donald Wittman, Why Democracies Produce Efficient Results, 97 J. POL. ECON. 1395, 1411 (1989). In this situation, each district has an incentive to elect a representative to the stable majority party because his is its only way to join the controlling coalition and to receive constituent.
Likewise, governors who have access to extra-legislative political resources—appointment powers, control over appropriated budgets, and an executive veto—can achieve efficient economic reforms. Using appointment powers and discretionary executive authority over policies and the budget, the governor can fashion a regulatory reform coalition in which each member district agrees to sacrifice its inefficient regulatory policy for a compensating executive-controlled substitute policy. On balance, regulatory reform makes all residents in the state better off, thereby increasing the governor’s chances for re-election. But only strong governors, those with sufficient executive-controlled resources to pay compensation to the district hurt by deregulation, can hope to achieve regulatory reform.118

Finally, successful political competition leading to the adoption of efficient economic reforms can be contagious. States serve as laboratories for public policies, and successful policies will be copied. Governor Christine Todd Whitman’s reduction in New Jersey income tax rates now sets the standard against which other state governors are to be compared. Studying state tax policies over the period 1960-1988, Professors Besley and Case show that the Whitman example holds as a general proposition: Good tax policies are mimicked, and if they are not, the governor loses.119 Both anecdotal and empirical evidence show that open, informed, and mobilized political processes can and often do lead to the adoption of efficient economic policies. Institutions and rules that promote

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118. See generally Fitts & Inman, supra note 74.
119. See generally Fitts & Inman, supra note 74. Although Fitts and Inman’s analysis focuses on the ability of the president to control Congress, the argument can be analogized directly to the ability of a governor to control a state legislature.

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3. Participation and Efficiency in the Federalist Regulatory State.—The analysis of participation and efficiency in the regulatory state leads us to the following conclusions. First, to enhance political participation in the management of business regulatory policies, such policies should be decentralized to the state and local levels of government, and efforts should be made to ensure the active and constant role of elected executives and legislators. A fully centralized regulatory process or one that delegates primary authority for the design and supervision of policies to government agencies will fall short of a fully participatory state—that is, the level of political participation will be inside the “federalism frontier,” say at point $\delta_{50}$ of Figure 1.

Second, to enhance economic efficiency in the management of business regulatory politics, such policies should again be decentralized to competitively elected, informed, and politically mobilized state and local legislators and executives, except when such policies entail significant interjurisdictional spillovers. Regulatory policies with spillovers should be managed by the central government; in the case of business regulations with “monopoly spillovers,” the application of federal antitrust laws is a potentially effective federal policy response. To the extent that business regulation policy is assigned to the central government, is decided in

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119. See Besley & Case, Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition, 85 Am. Econ. Rev. 25 (1995) (building an economic model suggesting that voters determine whether to re-elect incumbents in part by comparing their jurisdiction’s tax policy with those of neighboring jurisdictions).
isolated and unsupervised government agencies, or entails significant inter-jurisdictional monopoly spillovers unmitigated by federal antitrust supervision, the level of economic efficiency achieved by the federal regulatory state will be inside its full potential, say at point $A_{29}$ in Figure 1.

Adherence to a pre-\textit{Parker} standard of regulatory policymaking is probably well approximated by a point such as $S_Q$ in Figure 1. Many current federal business regulations reduce economic efficiency and political participation.\textsuperscript{122} At the same time, present state regulations may encourage inefficient interstate monopoly spillovers.\textsuperscript{123} To move from $S_Q$ to a regulatory state whose performance places our political economy on, and not inside, the federalism frontier of Figure 1 requires institutional reforms. Parts III to V below show how an expanded state-action doctrine can enhance our current regulatory performance. Part III argues that the Court’s current antitrust state-action doctrine requiring “clear articulation” and “active supervision” contributes importantly to improved political participation and, as the doctrine strengthens intrastate political competition, makes a contribution to intrajurisdictional economic efficiency as well. Part IV expands the present doctrine to include a “monopoly spillover” test; the expanded doctrine contributes to interjursisdictional efficiency and, as the expanded doctrine protects out-of-state consumers, gives those consumers an indirect but still effective voice in regulatory policies. Part V applies the expanded state-action doctrine to the present case law and argues that the new doctrine offers significant gains for our twin federalism goals of political participation and economic efficiency.

III. Current State-Action Doctrine: Increasing Political Participation

It is inherent in our federal system that there will be conflicts between the federal antitrust laws and the regulatory activities of state and local governments. The antitrust laws are directed toward encouraging competition through the prohibition of activities that restrain trade or monopolize markets.\textsuperscript{126} State and local regulations, however, frequently limit market competition. Because such regulations may have conflicting and not easily discerned motivations—some to control monopoly power or reduce adverse externalities, others to promote state cartels for politically favored producers—it is necessary to ask under what conditions the federal antitrust laws should apply to state and local regulatory activities.

122. On the inefficiency of regulation, see, for example, Rose-Ackerman & Mashaw, supra note 2. For participation concerns, see Cass R. Sunstein, \textit{Paradoxes of the Regulatory State}, 57 U. CHI. L. REV. 407, 422 (1990) (explaining that groups likely to be harmed by redistributive regulation are also likely to be poorly organized and incapable of expressing themselves politically).

123. See our discussion of California’s raisin cartel, infra Part IV.


Whereas in the \textit{Lochner} era the U.S. Supreme Court tried to undertake a full substantive review of state economic regulations that balanced state and federal interests, in recent years the Court has moved toward a more limited approach to regulatory federalism, developing a process-oriented test aimed, we shall argue here, at enhancing political participation in the regulatory process.\textsuperscript{125} As a consequence of this change, the validity of a particular state regulation now depends heavily on whether that regulation has been clearly authorized by the state legislature and, if so, whether that legislature actively supervises the regulatory activity.\textsuperscript{126}

A. The Evolving State-Action Doctrine: From Parker to Midcal

1. The Path Is Set: Parker v. Brown.—In 1890, when Congress passed the Sherman Antitrust Act, Congress would not have thought that it had authority to apply federal antitrust laws to the activities of states and to the political units within the state.\textsuperscript{127} The applicability of the antitrust laws to the states was first raised in the 1943 case of Parker v. Brown, in

\begin{itemize}
  \item[125.] Two other commentators on the state-action doctrine cases have also interpreted recent cases as supporting the goal of political participation. See Thomas M. Jorde, \textit{Antitrust and the New State Action Doctrine: A Return to Deferential Economic Federalism}, 75 CAL. L. REV. 227, 249 (1987); McGowan & Lemley, supra note 7, at 307.
  \item[126.] Although the main focus of the Court’s clear articulation test has been on requiring state legislatures to approve regulatory policy, in \textit{Hoover} v. Brown, 466 U.S. 558 (1984), the Court suggested that a state’s supreme court could also be viewed as a legitimate approving body. In \textit{Hoover}, the plaintiff challenged the manner in which the Arizona Supreme Court’s Committee on Examinations and Admissions graded the bar examinations. According to the plaintiff, the committee chose pass-fail rates based on its determination of how many new lawyers it wanted instead of whether the examinee was competent. Id. at 564. Importantly, the committee was appointed by the state supreme court itself. By determining that grading should be considered an action of the Arizona Supreme Court, not of the appointed committee, the Court determined that Parker v. Brown governed the case and that the grading was immune from federal antitrust laws. Id. at 571. What proved decisive for the Court was not the possible adverse economic outcome of the admission regulations, but rather the Court’s confidence that the state’s supreme court participated enough to ensure that all affected parties had an opportunity to influence the final regulations. In fact, the participation test is passed in \textit{Hoover} because “the Arizona Supreme Court established the Committee to examine and recommend applicants for admission to the Arizona Bar” and “[t]he Arizona Supreme Court Rules . . . delegated certain responsibilities to the Committee.” Id. at 561. Evidently, the Arizona court was functioning in a legislative capacity by setting and supervising policies. It may also have been relevant that the judges had been elected by the public and the court had been granted the authority to admit or deny admissions.
  \item[127.] Although Hoover did “not present the issue whether the Governor of a State stands in the same position as the state legislature and supreme court for purposes of the state-action doctrine,” id. at 568 n.17, the Court’s reasoning suggests that regulatory actions by a state governor would also be exempt from antitrust review. Cf. Parker v. Brown, 317 U.S. 341, 352 (1943); Olsen v. Smith, 195 U.S. 332, 340, 344-45 (1904) (both finding the action of a commission whose members were appointed by the governor to fall under the state-action doctrine). See Herbert Hovenkamp & John A. Mackerron III, \textit{Municipal Regulation and Federal Antitrust Policy}, 32 UCLA L. REV. 719, 725-28 (1985) (asserting that the prevailing views on constitutional law at the time the Sherman Act was passed would have obviated any need for the Parker state-action doctrine).
\end{itemize}
which the Court was asked whether California's Agricultural Prorate Act violated the Sherman Act. California had established a program to maintain the prices of and competition for a number of agricultural products. Under the program, ten producers of any crop within a production zone could petition the Prorate Advisory Commission to implement a restrictive marketing program. If the Commission agreed, a proposed program would then be drawn up and submitted for ratification by at least sixty-five percent of the growers. The Agricultural Prorate Act was challenged by a producer of raisins on the grounds that it violated the Sherman Act and the negative Commerce Clause.128

The Court began its analysis by noting that the marketing program would violate the Sherman Act if it had been devised solely upon the initiative of the producers. However, the Court asserted that while Congress had the power under the Commerce Clause to prohibit anti-competitive state programs, Congress did not intend to prohibit states from undertaking regulatory activities approved and directed by state legislatures.129 Underlying the Court's decision in *Parker* was a concern to protect state legislative sovereignty in a federalist system; the Court was not unusually troubled by the fact that the Prorate Act was anticompetitive in that it cartelized California's raisin producers by restricting output and raising the price of raisins.

In its dormant Commerce Clause analysis, the *Parker* Court did concern itself with the substantive economic effects of the California regulation on residents within and outside the state, but it chose to evaluate those effects in political rather than economic terms. The Court seemed persuaded by the fact that the raisin production was confined largely to California. However, the fact that almost all of the raisins consumed in the U.S. were grown in California was interpreted by the Court not as a source of harmful economic spillovers, but rather as a fortunate configuration of the economic interests of raisin producers.130 Interestingly, in its analysis of the Sherman Act, the *Parker* Court rested its judicial restraint on a view of federalism emphasizing state legislative sovereignty: "In a dual system of government in which, under the Constitution, the states are sovereign, save only as Congress may constitutionally subtract from their authority, an unexpressed purpose to nullify a state's control over its officers and agents is not lightly to be attributed to Congress."131

Furthermore, the Court in *Parker* saw the sovereignty of the state legislature as a means of protecting the participation of the citizens of California in a public decision of close interest to them. The Court noted:

Examination of . . . available data of the raisin industry in California, of which we may take judicial notice, leaves no doubt that the evils attending the production and marketing of raisins in that state present a problem local in character and urgently demanding state action for the economic protection of those engaged in one of its important industries.132

To the Court, only the legislature of the state of California, and no other governmental unit, had the proper incentive to worry about the plight of the raisin growers of California. It is also noteworthy that the Court's willingness to grant California antitrust immunity coincided with a substantive area—the regulation of agricultural production—in which Congress itself had also resorted to market intervention. One might assume that having taken up agricultural marketing regulation, Congress could have relied on the Commerce Clause to explicitly limit raisin and other agricultural cartels. Having chosen not to do so, Congress left the door open to the states. Against this background it is not surprising that the *Parker* Court concluded:

This history shows clearly enough that the adoption of legislative measures to prevent the demoralization of the industry by stabilizing the marketing of the raisin crop is a matter of state as well as national concern and, in the absence of inconsistent Congressional action, is a problem whose solution is peculiarly within the province of the state.133

It seems clear that the *Parker* Court understood that there were economic consequences outside of California but believed that, absent any explicit action by Congress to remedy such consequences, the action by the state legislature was sufficient to warrant the state-action exemption. Looking favorably upon decentralized political decisionmaking, the *Parker* Court set the path along which all subsequent state-action doctrine would evolve: the economic consequences of state regulations would be largely ignored, provided those regulations were decided by an open, participatory political process, as evidenced by state legislative involvement.

128. *Parker v. Brown*, 317 U.S. 341, 344-49 (1943). The negative Commerce Clause is largely a court-developed doctrine that restricts states from discriminating against out-of-state residents. As such, it stands as a possible constraint on the ability of states to approve regulations that generate out-of-state spillovers. Because of its narrow focus on discrimination against out-of-state residents, however, the negative Commerce Clause does not act to limit regulations affecting only in-state residents. The negative Commerce Clause does have a potential role to play when a state business regulation creates significant interstate monopoly spillovers. See infra Part IV.


130. *Id. at* 359-61.

131. *Id. at* 351.

132. *Id. at* 363.

133. *Id. at* 367 (emphasis added).
2. *The Evolving Participation Test.*—In a series of cases beginning in 1975 with *Goldfarb v. Virginia State Bar*,134 the Court sought to clarify the applicability of the federal antitrust laws to the regulatory activities of the states. In *Goldfarb*, the Court denied state-action immunity to a local bar association that set a minimum fee schedule for attorneys. This ruling was made despite the fact that the state bar association, a state agency authorized by the legislature, had issued opinions and reports that condoned the use of fee schedules.135 In the Court’s view, there was no evidence that the anticompetitive fee schedules were required by the state bar.136 Rather, the Court argued that the state bar’s enforcement of violations of local fee schedules made the state bar a private participant in a restraint of trade.137

Apparently, then, the state regulation of the bar was not upheld in *Goldfarb* because there was no evidence the state legislature actually wanted the minimum fee schedules that the Virginia bar had promulgated—that is, the Court saw no evidence of sufficiently open political participation in setting the regulation.

In contrast, when the state legislative interest was clear and there was reason to believe that all affected groups were given the opportunity to participate politically, the Court has granted a state-action exemption from the Sherman Act. In *Bates v. State Bar of Arizona*,138 the Court saw evidence of clear and active supervision by the state and acknowledged that “the regulation of the activities of the bar is at the core of the State’s power to protect the public.”139 The Court explained, “[O]ur concern that federal policy is being unnecessarily and inappropriately subordinated to state policy is reduced in [a situation like this]; we deem it significant that the state policy is so clearly and affirmatively expressed and that the State’s supervision is so active.”140

In *Cantor v. Detroit Edison Co.*141 the Court denied immunity from federal antitrust laws to an electric utility’s free light bulb exchange program despite the fact that the utility’s rate structure had been approved by the legislatively appointed Michigan Public Service Commission. The Court’s primary concern in *Cantor* was that the light bulb program itself had not been explicitly approved by the Public Service Commission.142

Those individuals and interest groups involved in the determination of Public Service Commission regulations did not have the opportunity to express their views explicitly through a legislatively approved political process.143

Seen from the perspective of promoting federalism’s valued goal of political participation, exemptions from the federal antitrust laws should, in principle, be given to municipal as well as to state governments. The previous analysis suggests that local governments are in many ways the most participatory of all governments.144 Yet the Court has been more reluctant to grant immunity to lower levels of governments than to states. Whether and to what extent state exemptions should apply to local governments was the focal point of the Court’s opinion in *City of Lafayette v. Louisiana Power & Light Co.*145 In *Lafayette*, a municipally owned utility was accused of unfair tying arrangements by a suburban investor-owned utility. The municipal utility offered gas and water on a tie-in contract requiring that suburban users switch their electricity consumption to the municipal utility.146 Seeing a problem with political participation in this case, the Court opted not to grant an antitrust exemption.147 The Court stressed the various ways in which a municipal utility, though akin to a regulated business in some respects, was less likely to act in the broad public interest.148 However, the Court did say that the political participation hurdle could be overcome if proper state legislative direction and authorization were present.149 Finally, the *Lafayette* Court also noted the presence of economic spillovers, remarking that a municipal utility’s predatory practices outside its city boundaries are not subject to the same political checks as are a state’s regulatory activities:

> [When local governments] act as owners and providers of services, they are fully capable of aggrandizing other economic units with

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135. Id. at 777.
136. Id. at 790. According to the Court, “[t]he fact that the State bar is a state agency for some limited purposes does not creates an antitrust shield that allows it to foster anticompetitive practices for the benefit of its members.” Id. at 791.
137. Id. at 792.
139. Id. at 361.
140. Id. at 362.
142. The Court stated that although the integration of the lamp exchange program into the utility rate structure involved a “mixture of private and public decisionmaking[,] . . . there can be no doubt

143. The Court made clear that “[t]he Commission’s approval of [the utility’s] decision to maintain such a program does not, therefore, implement any statewide policy relating to light bulbs.” Id. at 585.
144. See supra section III(A)(1).
146. Id. at 403-04.
147. Id. at 406-08.
148. “[T]he municipal utility’s goal is likely to be, broadly speaking, the benefit of its citizens. But the economic choices made by public corporations . . . are not inherently more likely to comport with the broader interests of national economic well-being than are those of private corporations . . . .” Id. at 403.
149. The Court acknowledged the argument that “because government is subject to political control, the welfare of its citizens is assured through the political process and that federal antitrust regulation is therefore unnecessary.” Id. at 406. But the Court made it clear that “when the State itself has not directed or authorized an anticompetitive practice, the State’s subdivisions in exercising their delegated power must obey the antitrust laws.” Id. at 416.
which they interrelate, with the potential of serious distortion of the rational and efficient allocation of resources, and the efficiency of free markets[,] . . . [and thus cities should not be] free to make economic choices counselled solely by their own parochial interests and without regard to their anticompetitive effects . . . . 150

But, as in Parker, the Court resolved its concern not through an efficiency analysis, but rather by using its emerging political participation doctrine. It was the city’s political process, in which the disenfranchised power company and customers had no representation, that most troubled the Court. 151

3. The Court Defines its Participation Test: Midcal.—The Court’s decision in California Retail Liquor Dealers Ass’n v. Midcal Aluminum, Inc. 152 was the defining step in the development of the current political participation test for state-action immunity. In Midcal, the Court faced the

150. Id. at 408 (emphasis added).

151. Id. Lafayette revealed for the first time a fundamental disagreement as to how the line should be drawn to distinguish exempt government activities from nonexempt ones. In Lafayette, an alternative to the emerging participation test was offered by Chief Justice Burger, but the Burger approach was rejected by the plurality. Believing that the immutable nature of an economic activity—public or private—would logically determine how that activity would be provided—using politics or markets—Burger sought to distinguish traditional governmental activities (exempt) from proprietary activities (not exempt). Id. at 418, 422-25 (Burger, C.J., concurring). If an activity could be classified as private or proprietary, it must be provided through a market process. Thus, public utilities providing proprietary goods and services must act similarly to private firms. Justice Burger argued that there should be no exemption when “cities are engaging in what is clearly a business activity . . . with the inherent capacity for economically disruptive anticompetitive effects.” Id. at 418 (Burger, C.J., concurring). He added, “It certainly is the case that the Cities are attempting to provide a public service, but it is likewise undeniable that they seek to do so in the most profitable way.” Id. at 418 n.1. (Burger, C.J., concurring).

A majority of the Lafayette Court declined to accept Chief Justice Burger’s alternative approach for identifying immune public activities, preferring instead the participation test that evolved from Parker and Cemer. Id. at 415-19. In his dissenting opinion, Justice Stewart remarked that “the socalled immunity of governmental activities as such is not in dispute.” Id. at 441 (Burger, C.J., dissenting). The difference between “proprietary” and “governmental” activities has aptly been described as a “quagmire.” Id. at 433 (Stewart, J., dissenting) (citation omitted). Justice Stewart’s comments foreshadowed an important later result in Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528 (1985), which rejected the “traditional government function” test because it is “unworkable” and inconsistent with federalism. Id. at 531. It also drew upon National League of Cities v. Usery, 426 U.S. 833 (1976), in which the Court demonstrated for the states’ right to “structure delivery of those governmental services which their citizens require.” Lafayette, 435 U.S. at 439 (quoting National League of Cities, 426 U.S. at 847). We strongly concur in the wisdom of Stewart’s insight. The traditional versus proprietary distinction can be drawn only after a full balancing of the production and transaction costs of using governments or markets. See Inman, supra note 68, at 753-65. There is no obvious “mapping,” as Chief Justice Burger’s test requires, from the technological attributes of a commodity to the use of governments (police) or markets (exchange) for its provision. That steel is produced efficiently by private firms in the United States and by the government in Korea illustrates the point.


question of whether the involvement of a state agency in a per se violation of the antitrust laws—supporting a resale price maintenance scheme for wine distributors—would render the scheme immune from the federal antitrust laws. The state legislature had clearly authorized price setting and provided an enforcement mechanism, but the state did not establish prices, review the reasonableness of price schedules, regulate the terms of fair trade contracts, monitor market conditions, or engage in any “pointed reexamination” of the program. 153

After reviewing the facts, the Court put forth a two-part participation test to determine whether a state regulatory system should be immune from antitrust liability: (1) “the challenged restraint must be ‘one clearly articulated and affirmatively expressed as state policy’”; and (2) “the policy must be ‘actively supervised’ by the State itself.” 154 The state interests identified by the state court were “to promote temperance” and to protect “small licensees from predatory pricing policies of larger retailers.” 155 Although there was a clearly articulated state resale price maintenance policy approved by the state legislature, the liquor pricing program was deemed to violate the second prong of the Court’s test. The Court found there was no indication that the program was actually supervised, because there was no supervision or review of the prices set by the producers and wholesalers. 156

As an approach for protecting political participation of the citizens of the state in regulatory policymaking, Midcal’s two-part test has proven to be an important step forward. Requiring the clear articulation of the regulatory policy by the state legislature—Midcal’s first prong—helps to ensure that all interested parties know of and have the opportunity to be involved in the original political agreement. Demanding that the legislature actively supervise the approved regulation—Midcal’s second prong—assures the original participants that their initial bargain will be enforced. The second prong gives meaning to the first, for without supervision, interested individuals cannot be assured that their initial participation in the political process will be meaningful.

Subsequent cases have reinforced the importance, and clarified the reach, of each part of Midcal’s two-part participation test. The “clear articulation” prong of the Midcal test was the focus of the Court’s decision in Community Communications Co. v. City of Boulder. In Boulder, the plaintiff, a cable television licensee, attacked the anticompetitive regulation

153. Id. at 105, 105-06.

154. Id. at 105 (quoting City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389, 410 (1978) (Brennan, J., concurring)).

155. Id. at 112 (quoting Rice v. Alcoholic Beverage Control Appeals Bd., 579 P.2d 476, 490, 493 (Cal. 1978)).

156. Id. at 105.
of local cable television by the city, which had been granted "home rule" authority by the state. The Court made it clear that to satisfy the first prong of the Midcal test, the state must clearly articulate and affirmatively express its decision to allow the city to regulate a market.157 "Home rule" authorization is not enough. In the Court's mind, home rule is only a "neutral" mandate and does not show a clear articulation by the legislature to allow the city to set regulatory policy.158

The dissent in Boulder expressed concern that the application of the Midcal test was casting too wide a net and that the courts would be overwhelmed—that is, drawn into detailed economic analyses—if all local ordinances were to be evaluated on the basis of a cost-benefit analysis.159

Subsequent cases reaffirmed a commitment to Midcal but clarified its reach. Although clear articulation of a regulatory policy will be required, a substantive evaluation of the final consequences of the regulation will not. In Town of Hallie v. City of Eau Claire,160 a number of small towns near and around the City of Eau Claire charged that the city was seeking to acquire a monopoly in sewage treatment services, in part by tying treatment facility access to the purchase of collection and transportation services. The city responded that as a city and not a state, it was immune from Sherman Act prosecution under the state-action doctrine of Parker. In ruling in favor of Eau Claire, thereby granting it antitrust immunity, the Court held that a state statute need not explicitly spell out legislative intent to regulate competitive activity, stating, "It is not necessary . . . for the state legislature to have stated explicitly that it expected the City to engage in conduct that would have anticompetitive effects."161 Furthermore, the argument that a state must expressly anticipate a locally anticompetitive effect in its authorizing statute was labeled by the Court as "an unrealistic view of how legislatures work and of how statutes are written. No legislature can be expected to catalog all of the anticipated effects of a statute of this kind."162 In Hallie, the Court also retreated from the pursuit of legislative intent, viewing such an exercise as burdensome for the courts and tending to undermine the principle of political participation that state immunity was supposed to serve.163

In Southern Motor Carriers Rate Conference, Inc. v. United States,164 the Court again gave a relaxed interpretation of its clear articulation test, at least with respect to a need to fully detail all—or even any—anticompetitive effects of local regulations. In Southern Motor Carriers, the federal government had challenged as price fixing the joint rate proposals submitted to the Public Service Commissions in four southern states. The Court accepted the Commissions' claim that "without collective ratemaking they would be unable to function effectively as rate-setting bodies."165 The Court further held that there need not be a "specific, detailed legislative authorization" for the conduct.166 If the state clearly intends to create a regulatory program, its failure to spell out unforeseen details of how the program should operate will not cause the program to fail the Midcal test as long as there was a clear intent by the legislature to delegate the determination of the details to the agency.

Although immunity is not always granted to local governments, recent case law has suggested that fears that courts would be overwhelmed by dealing with local ordinances under a "Rule of Reason"167 standard have been greatly exaggerated. For example, in City of Columbia v. Omni Outdoor Advertising, Inc.,168 the state granted a municipality zoning authority over billboards. The Court held that the state grant of power was sufficient to give the city immunity from antitrust liability.169 In clarifying its view about the ability of a state to extend its immunity to local governments, the Court stated that, if the city's "restriction of competition [is] . . . an authorized implementation of state policy,” antitrust immunity should apply to the city's actions as well.170

158. "[P]lainly the requirement of "clear articulation and affirmative expression" is not satisfied when the State's position is one of mere neutrality respecting the municipal actions challenged as anticompetitive. A State that allows its municipalities to do as they please can hardly be said to have 'contemplated' the specific anticompetitive actions for which municipal liability is sought." Id. at 55 (emphasis in original).
159. The dissent in Boulder expressed fear that a "[l]ocal ordinance could not be defended on the basis that its benefits to the community, in terms of traditional health, safety, and public welfare concerns, outweigh its anticompetitive effects." Id. at 66 (Ruhrgquist, J., dissenting). The result, the dissent predicted, would be antitrust liability for "enacting restrictive zoning ordinances, by requiring business and occupational licenses, and by granting exclusive franchises to utility services." Id. (Ruhrgquist, J., dissenting).
161. Id. at 42.
162. Id. at 43.
163. Id. at 44 n.7.
165. Id. at 51.
166. Id. at 64 (citing City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389, 415 (1978)).
167. The Rule of Reason, a common-law doctrine, has been applied to limit the Sherman Act by requiring that the Sherman Act focus directly on the challenged restraint's impact on competitive conditions. The Rule of Reason forecloses inquiry into the reasonableness of the prices set by private agreement. See National Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 691 (1978) ("[T]he inquiry mandated by the Rule of Reason is whether the challenged agreement is one that promotes competition or one that suppresses competition.").
169. Id. at 379.
170. Id. at 370. In dissent, Justice Stevens, joined by Justices White and Marshall, stressed that federalism requires municipal immunity only to the extent that the municipality is acting for the state. Id. at 389-90 (Stevens, J., dissenting). The dissenters argued further that the decision whether to replace competition with regulation must be that of the state. In this case, however, they found that
Although Boulder required explicit state authorization for municipal government regulations, Hallie, Southern Motor Carriers, and Omni made clear that such authorization need not be intrusive. Municipal governments cannot do all that they please; under Boulder the state legislature must sanction municipal regulations through an enabling statute. But under Hallie, Southern Motor Carriers, and Omni, the enabling statute can be quite open-ended, even to the point of allowing municipalities to pursue clearly anticompetitive policies with possibly adverse effects for residents outside the regulating community. Together, these cases promote the Court’s intention to foster political participation when setting regulatory policy. The most participatory of all governments—municipalities—are allowed to regulate their own economies, but citizens outside the regulating community must have had a chance to consider, and possibly constrain, those regulations through an enabling state statute.

Similarly, the Court has encouraged political participation through the second prong of the Midcal test—the requirement that authorized state regulations be “actively supervised.” For municipal governments, the Court sees active supervision as less essential because the affected citizens have the direct ability to remove city officials if they abuse their role as regulators. But when private parties have been authorized to regulate, there is no such participatory check; the Court has found in these cases a strong need for active supervision by the enabling state legislature. In Hallie, for example, the Court effectively dropped the active supervision requirement for municipalities. The rationale for this lenient treatment was the Court’s observation that local participatory politics provide the needed supervision. At the same time, the Court has tightened the constraint

171. See Town of Hallie v. City of Eau Claire, 471 U.S. 34, 45 n.9 (1985) (“Among other things, municipal conduct is invariably more likely to be exposed to public scrutiny than is private conduct. Municipalities in some States are subject to ‘sunshine’ laws or other mandatory disclosure regulations, and municipal officers, unlike corporate heads, are checked to some degree through the electoral process.”).

Professors Hovenkamp and Mackerron have offered an expanded, tougher version of a municipal exemption test, one which directly considers the effects of a local regulation on nonresidents:

1. Is the municipality an “optimal” regulator, where “optimal” is defined to mean no significant regulatory spillovers to residents outside the community? If yes, the regulation should be exempt from federal antitrust scrutiny.

2. If no, then the two-prong test of Midcal should apply. That is, did the state clearly articulate and does the state actively supervise the regulation? If yes, the regulation should be exempt from federal antitrust scrutiny.

3. Does the local regulation conflict with any existing federal regulatory requirement on states and their subdivisions? If yes, the inconsistent local regulation must yield to the federal regulation.

Hovenkamp & Mackerron, supra note 127, at 775-76. The attractiveness of the Hovenkamp-Mackerron test for political participation is that it assures nonresidents a voice—through the state legislature—when their interests are affected by a municipal regulation. Political participation is thereby enhanced. By checking municipal spillovers, economic efficiency can be improved as well. Our own expanded version of the state-action doctrine to control inter-state monopoly spillovers is similar in spirit to the Hovenkamp-Mackerron test to control municipal spillovers. See infra Part IV. Like the Hovenkamp-Mackerron test, our expanded state-action doctrine also improves participation and efficiency.
"[w]here a private party is engaging in the anticompetitive activity, there is a real danger that he is acting to further his own interests, rather than the governmental interests of the State" and therefore that "private party . . . may be presumed to be acting primarily on his or its own behalf."  

The importance of legislative oversight in the second prong of the Midcal test was stated clearly once again in Ticer Title. In Ticer Title, the Federal Trade Commission sued six title insurance companies for unfair competition, alleging that they had fixed prices for title searches and examinations. The insurance companies belonged to rating bureaus which were licensed—but not appointed—by the state legislature, and which submitted rates to the state that went into effect if the state did not act within thirty days. Despite the fact that the insurers had participated in the ratemaking process, the Court denied state-action immunity, holding that the State had not actively supervised the rate making process. According to the Court, the active supervision prong of the participation test would only be satisfied when the State has exercised sufficient independent judgment and control so that the details of the rates or prices have been established as a product of deliberate state intervention, not simply by agreement among private parties. Much as in causation inquiries, the analysis asks whether the State has played a substantial role in determining the specifics of the economic policy. Implicitly, the Court may have been concerned that a ratemaking policy generated by the political process without active supervision by the state could be "captured" by the industry being regulated, a result contrary to the original regulatory goals.  

As in its specification of Midcal's clear articulation test, the Court has defined the domain of Midcal's active supervision requirement with the apparent goal of maximizing political participation. In Hallie, the Court exempted municipal regulations from the active supervision requirement while still requiring those regulations to meet a clear articulation test. This makes sense if political participation is the goal. Hallie's clear-articulation/no-supervision version of the Midcal test for municipalities allows residents living outside a municipality an initial (state) legislative say in setting local regulations when their interests are affected, but it does not allow those outsiders to intervene—that is, actively supervise—after the local regulations have passed state legislative muster and are in place. Local political participation is thereby encouraged as local residents are allowed to set local regulations, subject to the limits of the enabling state statutes, and to see those regulations enforced as they wish.  

In contrast, when a private party has been given rights to set regulations, Southern Motor Carriers, 324 Liquor, Patrick, and Ticer Title do require active supervision. This seems a sensible safeguard if political participation is the goal. When private parties rather than municipalities are involved, active supervision ensures that all parties to the original regulatory agreement will continue to have oversight of each chosen regulation, even though that regulation itself has been proposed by only one of the interested parties to the original legislative agreement. By requiring active supervision, the Court ensures all affected parties still have their say. 

The current state-action doctrine's two-pronged clear articulation and active supervision test provides important safeguards for federalism's valued goal of political participation. The most participatory of all political bodies—state and local government legislatures—are assigned a central responsibility for the design and enforcement of business regulations. Only when those branches of government have been pushed aside or ignored may federal antitrust law come to bear. By showing a clear but moderated deference to state and local legislatures—arguably the branches of government "closest to the people"—the Court significantly advances the goal of political participation in regulatory policymaking.

B. Evaluating the Critics

Not all legal scholars of federalism and business regulation agree, however, that the Court's current doctrine draws a valid, or a sufficiently bright, line between federal and state regulatory responsibilities. Critics of the Court's current state-action doctrine have rejected the doctrine for three reasons. First, the doctrine does not succeed in its objective of enhancing political participation in the formulation of regulatory policies. Second, even if participation is encouraged, the doctrine has significant, and more than offsetting, negative consequences for federalism's other valued goal of economic efficiency. Third, even if the participation is

180. Id. at 100 (quoting Town of Hallie v. City of Eau Claire, 471 U.S. 34, 47 (1985)) (alteration in original).
181. Id. (quoting Hallie, 471 U.S. at 45).
183. Id. at 629.
184. Id. at 634-35 (emphasis added).

186. For an stronger "active supervision" test for municipalities, one which is likely to enhance both goals of participation and efficiency, see supra note 171.
187. There is one exception. The Eleventh Amendment protects the state and its officers from suits for damages associated with antitrust liability. See, for example, Seminole Tribe v. Florida, 116 S. Ct. 1114 (1996), in which the Court held that the Eleventh Amendment precludes Congress from authorizing suits against states pursuant to federal statutes enacted under the commerce power. Id. at 1131-32. However, suits against individuals acting under the authorization of the state are not affected by the Eleventh Amendment. As a result, Seminole is likely to have at best a minor, indirect effect on both current state-action jurisprudence and our expanded state-action test.
encouraged and efficiency not adversely affected, the Court is ill-equipped
to do the review it has set for itself in the two-pronged Midcal test.
Although the critics do raise a number of valid issues, we remain generally
sympathetic with the direction taken by current doctrine.

1. The Current State-Action Doctrine Will Enhance Participation.—Of
the recent commentators, Einer Elhauge and William Page are perhaps the
most skeptical that present doctrine can deliver on its promised goal of
enhanced political participation.188 Elhauge doubts that greater political
participation will follow from Midcal’s two-pronged test. Page argues that
the clear articulation test is conducive to citizen control of regulatory
policy, but that the active supervision test undermines those gains. Neither
critique strikes us as decisive.

Professor Elhauge, as part of a larger effort to rationalize current
antitrust law, sees the present state-action doctrine not as a concern for
valued outcomes—for example, political participation or economic
efficiency—but as part of a larger doctrine that seeks to subject both private
and public restraints on competition to antitrust review whenever the pro-
cess setting those restraints allows those controlling the restraints to profit
financially from the restraints they impose.189 Elhauge sees current politi-
cal institutions as poorly designed to ensure citizen participation in
policymaking. Further, he doubts that citizens pay much attention to pol-
icy decisions. Thus, only minimal citizen participation is likely to result
under Midcal.190 Elhauge is certainly correct in his prediction: Midcal
has not stimulated a groundswell of popular participation in regulatory
policy. But that is not the important point. What Midcal’s two-pronged
test does is protect the most open channels for political activity now
available—legislatures at the state and local levels—for those moments
when citizens do decide to participate. By protecting a central role for
state legislatures and municipalities in regulatory policymaking, Midcal
keeps the costs of participation as low as possible. This is an important
contribution towards enhancing federalism’s goal of political participation.
We believe this Article’s focus on political participation to be at least as
compelling an explanation for the current case law as Elhauge’s process
approach. Our political-participation approach also provides a stronger

188. See Elhauge, supra note 7, at 672-82; Page, supra note 7, at 768-69. Two other commen-
tators who have argued that the current state-action doctrine will enhance the objective of political parti-
cipation are Jorde, supra note 125, at 249-50, and Merrick B. Garland, Antitrust and State Action: Eco-
nomic Efficiency and the Political Process, 96 YALE L.J. 486, 507, 499-508 (1987) (explaining that state and municipal action decisions result from the Court’s attempt to reconcile state and federal
interests while respecting “the results of the political process at both levels”).

189. See Elhauge, supra note 7, at 671.

190. See id. at 678-79.

foundation upon which to build a sharpened, and perhaps expanded, state-
action doctrine. Professor Elhauge’s own theory requires the Court to
distinguish between financially disinterested and financially interested
parties setting a state regulatory restraint of trade.191 Although this
distinction might be possible in the private sector, where individuals can
reasonably be assigned a “profit motive,” how will this distinction be made
in the public sector, where citizens and public officials operate from a
variety of motives and regulatory policies follow from group actions?
Assigning a “financially disinterested” or “financially interested” motive
for public policies will take the courts into some of the darkest and least
understood territories of contemporary political analysis.192

Professor Page reads the intention of the current state-action doctrine
much as we do: to promote the valued goal of political participation in the
formulation and execution of regulatory policies.193 He finds that the
current doctrine’s clear articulation test puts matters squarely in the hands
of the state legislature, where it belongs for citizen participation.194
However, Page would abandon the active supervision test.195 First,
active supervision, Page argues, adds nothing to what clear articulation has
already contributed toward the goal of ensuring legislative involvement in
regulatory policy.196 This argument misses an obvious point: passing a
law does not mean the law will be implemented. Effective implementation
requires supervision. Without implementation, there is no incentive to pass
legislation. Active supervision serves, therefore, as an essential incentive
to engage in clear articulation, particularly when there is a risk that the
initial intentions of the law might be subverted by private parties as the law
is implemented. Second, Page worries that the Court may focus its attention
on the active supervision test, ignoring the more important (to Page)
clear articulation standard.197 This has not happened. As implemented,
the Midcal doctrine clearly requires both clear articulation and active
supervision to be satisfied. Clear articulation has remained a significant
hurdle to be cleared by any state regulation.

191. See id. at 685.

Politics, 74 AM. ECON. REV. 279, 281-85 (1984) (arguing that the “economic theory” of legislator
voting patterns has been adopted too quickly, and examining “publicly-interested” voting objectives
as an alternative); Steven D. Levitt, How Do Senators Vote? Disentangling the Role of Voter Preferences,
Party Affiliation, and Senator Ideology, 86 AM. ECON. REV. 425, 427 (1996) (finding personal ideol-
ogy and core “support” constituency more determinative of voting habits than party or general
counties preference); Sam Peltzman, Constituent Interest and Congressional Voting, 27 J.L. &
ECON. 181, 206-10 (1984) (considering the impact of party ideology on legislators’ votes and finding
it generally less determinative than constituency and political contributions).

193. See Page, supra note 7, at 747.

194. See id. at 749.

195. See id. at 754-59.

196. See id. at 748-49.

197. See id. at 754.
More compelling is the concern for political participation expressed by Justice Rehnquist in his dissenting opinion in Boulder. Justice Rehnquist worried that requiring municipal regulations to meet a clear state articulation requirement would chill local government action and thus local citizen participation in regulatory policymaking.200 Justice Rehnquist's solution was to use a state approved "home rule" charter as a compromise standard between no state supervision and the more intrusive clear articulation standard of Midcal.201 This approach has appeal, subject to one important exception. If there are significant monopoly spillovers from the municipal regulation, then nonresidents must be protected. Professors Hovenkamp and Mackerron suggest joining Justice Rehnquist's "home rule" standard with a state-level spillover test as the preferred approach—that is, municipal regulations would be allowed if there is a home rule charter and no intercommunity monopoly spillovers.202 Absent a home rule charter or finding significant intercommunity spillovers, however, Midcal's clear articulation standard would apply. This home-rule/no-spillover standard for municipal regulations should be preferred to the strict application of Midcal's clear articulation test if enhancing political participation is the goal. Local regulations that affect only local residents need only be approved locally, without having to use the less participatory political process of state government as is now true under Midcal. The likely outcome would be an increase in overall participation in regulatory policy.

2. The Current State-Action Doctrine Increases Economic Efficiency.—Whatever the Midcal doctrine might mean for political participation, Judge Easterbrook and Professors Wiley and Page each criticize the current doctrine for its potential adverse effects on economic efficiency, in particular, administrative efficiency. First, writing in 1983, Judge Easterbrook was particularly concerned that the application of the clear articulation prong of the Midcal test as applied in the (then recent) Boulder decision would become overly intrusive and as a consequence stifle potentially efficient municipal regulations.203 Judge Easterbrook essentially advocates a "hands-off" approach to state regulations, relying upon Tiebout "exit" competition to ensure that states adopt intrajurisdictionally efficient regulatory policies.204 We reject this approach because we doubt that Tiebout competition will be sufficient to discipline state governments.205 We favor political competition instead and have argued that, rather than inefficiently intervening when no intervention is required (Easterbrook's critique), the current state-action doctrine may actually help intrajurisdictional regulatory efficiency.206 Decisions subsequent to Boulder—that is, Hallie (1985), Southern Motor Carriers (1985), and Omni (1991) may ease his concerns on this point.207 Judge Easterbrook's one exception to his "hands-off" approach is when a state regulation generates significant interjurisdictional inefficiencies through monopoly spillovers. He suggests imposing antitrust review in these cases.208 We agree; in Part IV of this Article, we propose how one might implement Judge Easterbrook's recommendation.

Easterbrook, Wiley, and Page also object to the active supervision prong of Midcal on the related ground that it limits the state's ability to delegate regulatory authority and thus hampers administrative efficiency.209 But again, subsequent decisions have significantly loosened this requirement, dropping active supervision for municipal210 and agency-promulgated regulations,211 but keeping it for regulations suggested by private parties.212 Even in the case of private-party regulations, the state legislature can be an "active" supervisor dictating the economic behavior of the private parties or a "re-active" supervisor approving proposed private party actions.213 Both modes of regulation

200. See supra note 61-111.
201. See supra note 112-19.
202. Judge Easterbrook writes that the Court had followed the Rehnquist reasoning in Boulder effectively favoring "home rule" for business regulations. See Easterbrook, supra note 7, at 37-38. Wiley, writing in 1986, also expressed concern for the loss of local autonomy. See Wiley, supra note 7, at 755. He is pleased with the reasoning in the Hallie-Southern Motor Carrier- Omni case law but, like Easterbrook, favors dropping the clear articulation test in favor of home rule. See id. at 737-39.
203. See Easterbrook, supra note 7, at 49-50.
204. See id. at 38 (criticizing Midcal and other decisions for eliminating delegation as a regulatory option that states may choose); Page, supra note 7, at 758, 755-58 (criticizing the current definition of active supervision in part because it prohibited New York from using "market-based, permissive regulations" instead of "a cumbersome system of command-and-control regulation"); Wiley, supra note 7, at 733, 733-34 (criticizing Midcal's clear statement requirement for making "the process of state and local government less efficient by discouraging delegation"). Elbsage is less critical of an active supervision test in principle, see Elbsage, supra note 7, at 708 (arguing that supervision of "financially interested" parties makes" perfect sense"), though he finds the current implementation of the test in Midcal to be ambiguous, see id. at 674.
208. The new theory of public administration catalyzed all regulatory styles as either active monitoring—often called "command and control" or, more vividly, "police patrols"—or re-active monitoring—called "fire alum." These two basic approaches to regulatory supervision are discussed in Mathew D. McCubbins & Thomas Schwartz, Congressional Oversight Overlooked: Police Patrols Versus Fire Alarms, 28 AM. J. POL. SCI. 165 (1984).
will meet the Midcal test. Rather than constraining the administrative structure for regulatory policy, current Court doctrine allows the state to adopt either of these two common forms of regulatory supervision; we doubt there will be any significant efficiency losses here.

Finally, Professor Wiley expresses concern that the Midcal test pushes regulatory policymaking and supervision onto state and local legislatures, institutions which he sees as open to regulatory "capture." Starkly put, with the Midcal doctrine the Court is assigning regulatory responsibility to what may be an inherently inefficient branch of government. But such a criticism misses the point; what is relevant is the relative performance of regulatory alternatives. Although elected state and local legislatures may choose economically inefficient regulations, will non-legislative institutions do a better job? Recent theoretical arguments and empirical evidence on state government economic performance strongly suggest that periodic election review can be an important stimulus for intra-jurisdictional economic efficiency. In particular, while elected legislatures will surely generate some inefficient regulations, there are important institutional features (political parties and strong governors, for example) that can constrain this inefficiency. Furthermore, there are strong electoral incentives that encourage the adoption of efficient policies. The efficiency-enhancing benefits of political competition may not apply, or at least not with equal force, to bureaucratic and agency regulatory policymaking, however. We conclude that moving regulatory policies from politically isolated commissions and agencies to an elected responsible legislature is likely to contribute to, or at least not discourage, intra-jurisdictionally efficient regulatory performance.

3. The Current State-Action Doctrine Has Begun to Clarify the Line Between Valid and Invalid State Regulation.—Professor Elhauge raises concerns that the current state-action doctrine pushes courts into making difficult, complicated substantive determinations in an unstructured way: to establish the source of regulation, courts must determine what constitutes state action; to establish clear articulation, courts must determine what constitutes state intent; and to guarantee active supervision, courts must determine what constitutes state supervision. Because courts have had difficulty making these determinations, a confused and uncertain doctrine has emerged that fails to provide a bright line between those state and local regulations that are, and those that are not, exempt from federal antitrust oversight.

The Supreme Court has been sensitive to these worries and, we feel, has been responsive. The Court has consistently defined a state regulatory action as a rule promulgated by an elected public body, whether that body is the state legislature (Parker and Goldfarb), the elected state supreme court (Hoover), or, presumably, the state’s elected governor. Likewise, the Court has consistently sought to remove substantive analyses of decisionmaking toward efficient economic policies, see Gary S. Becker, A Theory of Competition Among Pressure Groups for Political Influence, 98 Q.J. Econ. 371, 396 (1983), and Wittman, supra note 117, at 1416-18. For empirical evidence that such competition moves state governments towards more efficient policies, see the recent studies by Timothy Besley & Anne Case, Does Electoral Accountability Affect Economic Policy Choices? Evidence from Gubernatorial Term Limits, 110 Q.J. Econ. 769, 775-93 (1995) (finding that gubernatorial term limits have positive efficiency effects on policy), and Pettinato, supra note 46, at 529 (asserting that “the voting market punishes growth” in government spending through votes against politicians who support or allow it).

121. In Southern Motor Carriers, the rating bureaus made joint rate proposals to the Public Service Commission, which had the authority to accept or reject them. Southern Motor Carriers, 471 U.S. at 50. The Public Service Commission clearly operates as a “reactive” supervisor, and such an administrative structure was sufficient to meet the Midcal active supervision test. Id. at 62.

122. Wiley, supra note 7, at 731-33.

123. Professor Wiley proposed replacing the current doctrine with his own four-step test: Does the state regulation (1) restrain competition, (2) have no exemption from antitrust laws, (3) have no possible efficiency rationale, and (4) result from the direct political action of producers? If the answer to all four question is yes, then immunity should be denied. See id. at 743. Regulations that emerge from such “producer capture” will typically be inefficient. See, e.g., supra note 85-92 and accompanying text. For Wiley, such direct state challenges to the goal of economic efficiency should be met by a new term, and federal antitrust review. See Wiley, supra note 7, at 788-89. Wiley’s test has been criticized in detail by Professor Jorde as a serious misreading of the current state-action doctrine, see Jorde, supra note 125, at 239; by Professor Spitzer as analytically incomplete, see Spitzer, supra note 7, at 1302-03; and by Professor Elhauge as intrusive and leading to the risk of “substantial judicial decisionmaking,” see Elhauge, supra note 7, at 725, 717-29. We share these concerns. See infra notes 215-18.

124. In fairness to Professor Wiley, he does not miss this point, and indeed makes his arguments about legislative inefficiencies to balance those of other commentators who see bureaucratic regulatory agencies as the sole source of regulatory inefficiencies. Compare Wiley, supra note 7, at 732-33, with William H. PAGE, ANTITRUST, FEDERALISM, AND THE REGULATORY PROCESS: A Reconstruction and Critique of the State Action Exception After Midcal Aluminum, 61 B.U.L. REV. 1099, 1118 (1981). Professor Wiley is rightly concerned about regulatory inefficiencies from all sources within government. He offers his efficiency arguments against Midcal as a starting point for his own decision rule of how to draw the line between federal and state regulatory responsibilities. See Wiley, supra note 7, at 733. For detailed comments on Wiley’s decision rule, see Spitzer, supra note 7, and Elhauge, supra note 7, at 717-29.

125. See supra notes 118-19.

126. For theoretical arguments that political competition through elections pushes political
legislative motives and to clarify its requirements under its clear articulation test: Regulations (Cantor) or a clear responsibility for regulatory policies (Hallie, Southern Motor Carriers, and Omni) must be explicitly (Boulder) allowed by the state legislature (Parker) or other elected agents (Hoover). Further, intent has no bearing on the legality of the regulation; legislatively allowed regulation or legislatively assigned regulatory responsibility can be approved for anticompetitive reasons or have anticompetitive consequences (Hallie and Omni) and still satisfy the clear articulation test.\textsuperscript{221} The Court has sought to be equally precise in the specification of its active supervision test: Supervision must be by an elected legislative body (Hallie, Patrick, and Ticor Title) or an agency appointed by the legislature (Southern Motor Carriers). Acceptable legislative supervision can involve either direct legislative management of the policies (Ticor Title) or explicit approval of regulations suggested to it and enforced by private parties (Southern Motor Carriers).

While some confusion and uncertainty remains, the present state-action doctrine seems to have begun to clarify the line between allowable state regulations and those regulations that must be reviewed further for federal antitrust liability. Simply put, business regulations that are explicitly approved by an elected state body and then supervised by that body, or its appointed agent, are likely to be acceptable state regulations under current state-action doctrine; they are immune to review under federal antitrust laws. Not only is the line becoming brighter, it also has some bite, as the Court's most recent ruling in Ticor Title shows. To the extent that doctrinal uncertainty remains, the Court appears committed to using its state-action doctrine to enhance federalism's goal of political participation in setting regulatory policies. Our review of participation theory may provide the Court with the guidance it needs to address any unsettled questions.\textsuperscript{222}

C. Summary

Current state-action doctrine seeks to resolve the fundamental tension between the national interest in economic competition now embodied in our antitrust laws and the interests of the states in regulating business activities within their borders. Travelling down the path first chosen by the Court in Parker v. Brown, present doctrine shows strong deference to the regulatory decisions of the states and their agencies. But two hurdles must be cleared for antitrust immunity: A state's business regulation must have been clearly articulated by a politically elected body within the state government (legislature, supreme court, governor) and the regulation must be actively monitored by the elected body or its directly appointed agent. Having met these tests, the state regulation is protected from review under federal antitrust laws. As currently articulated, the state-action doctrine serves well federalism's twin goals of political participation and economic efficiency and does so in a principled and reasoned way. First, requiring state regulations to clear the twin hurdles of clear articulation and active supervision from an elected legislature channels regulatory policymaking into the arena most conducive to citizen participation. Second, once within the legislative arena, re-election pressures for intrajurisdictional economic efficiency come to bear on those setting regulatory policy. Although current state-action doctrine does not guarantee more participation and improved efficiency, it confines regulatory policy to an institutional setting where those valued outcomes are most likely to occur. This is an important step forward.

Yet more can be done. As Judge Easterbrook has stressed in his own commentary on the current doctrine, what is not now well handled is states regulation of business that creates inefficient "monopoly spillovers" on residents of neighboring states. Part IV argues for an extended state-action doctrine to promote interjurisdictional economic efficiency.

IV. Beyond Midcal: Increasing Economic Efficiency

Although the state-action doctrine under Midcal offers citizens a clear political voice in determining regulatory policies within their state, the present doctrine offers no such protection for regulatory policies decided in neighboring states. Such protections are neither needed nor desired when state policies have no cross-border economic effects. But if one state's economic regulations create significant interjurisdictional economic spillovers, then affected residents in neighboring states may be harmed.\textsuperscript{223} The resulting economic inefficiencies go unameliorated under Midcal and its progeny. This gap in the Midcal doctrine is viewed by Judge Easterbrook and Professors Hovenkamp and Mackerson, Jorde, and Spitzer as its major weakness.\textsuperscript{224} We agree. Subpart IV(A) argues that there is substantial recognition of the problems created by interjurisdictional spillovers in the current antitrust exemptions cases although to

\textsuperscript{221}. Omni is quite explicit in stating the Court's desire to avoid a deep substantive review of legislative intent and stands as the Court's response to the defects faced in Gold Cross Ambulance & Transfer v. City of Kansas City, 705 F.2d 1005, 1008-10, 1013 (8th Cir. 1983), and Ailiated Capital Corp. v. City of Houston, 700 F.2d 226, 227-30 (5th Cir. 1983), rev'd en banc, 735 F.2d 1555 (5th Cir. 1984). See Hovenkamp & Mackerson, supra note 127, at 762-64, 767. In Omni, the briefing for the plaintiffs and their amicus curiae suggested that the Court craft a rule that would deny antitrust immunity when the regulation came from "corrupt or bad faith decisions" or was "not in the public interest." City of Columbia v. Omni Outdoor Adver., Inc., 499 U.S. 365, 376 (1991) (quoting Brief for Respondent at 44 and Brief for Associated Builders and Contractors, Inc., as amicus curiae at 5, respectively). The Court rejected this suggestion for substantive review as an approach "we have consistently sought to avoid." Id. at 377.

\textsuperscript{222}. See supra sections II(A)(1), II(B)(1), & subpart III(B).

\textsuperscript{223}. See supra Figure 4b and accompanying text.

\textsuperscript{224}. See Easterbrook, supra note 7, at 45-50; Hovenkamp & Mackerson, supra note 127, at 768-71, 775; Jorde, supra note 125, at 253-56; Spitzer, supra note 7, at 1319-21.
date the Court has not yet embraced a test to correct the problem. Subpart IV(B) specifies a two-step "spillover test" that courts can use to identify those instances in which interjurisdictional economic harm may have been imposed on out-of-state residents without their prior political approval. If a state regulation fails the two-step test, then it should be subject to Sherman Act review. The proposed spillover test enhances overall economic efficiency in the regulatory economy and contributes to the goal of political participation as well.

A. The Legal Underpinnings

In its state-action antitrust jurisprudence, the Court has regularly confronted the nexus between state regulatory action and interstate commerce. In *Parker v. Brown*, for example, the Court was clearly aware of the presence of significant monopoly spillovers associated with the raisin cartel. In *Parker*, state law created a Prorate Advisory Commission to control the production of raisins, subject to the approval of sixty-five percent of the raisin growers. The effect of the state law was to facilitate a California cartel for the sale of raisins. At the time, however, more than ninety percent of raisin consumption occurred outside the state of California. Monopoly prices would be paid by consumers, most of whom lived outside of California, and monopoly profits would be earned by producers, most of whom lived inside California. Ruling in favor of the state law and the Prorate Advisory Commission, the Court focused solely on the regulatory benefits to the California raisin industry and on the political process that created and maintained the cartel. It recognized, but failed to weigh in the balance, the monopoly spillovers created by the state's regulatory policy. 225

Taken to its extreme, the approach to monopoly spillovers seen in *Parker* would allow states to actively pursue self-aggrandizing policies that impose substantial costs on other states. The obvious limits to such policies would be the unfettered threats of regulatory reprisals by other states, running the risk of a regulatory race to the bottom, or alternatively, the constraint of federal law. 226 The latter approach seems clearly preferable, in which case two legal alternatives are available: application of the current negative Commerce Clause doctrine or developing an expanded state-action doctrine. 227

Consideration of interstate monopoly spillovers from state regulations will not be a new worry for the Court in state-action doctrine cases. In *Goldfarb v. Virginia State Bar*, for example, the Court explicitly dealt with the link between state action and interstate commerce. In *Goldfarb*, the Court stated that "there is an obvious distinction to be drawn between a course of conduct wholly within a state and conduct which is an inseparable element of a larger program dependent for its success upon activity which affects commerce between the states." 228 This language tracks closely the constitutional language in the negative Commerce Clause cases and could have led the Court to conclude that an activity must not substantially affect interstate commerce if an exemption is to be granted.

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226. See supra text accompanying notes 128-33.

227. In principle, the Commerce Clause of the U.S. Constitution could be used affirmatively as a source of regulatory jurisprudence because it authorizes congressional regulation of commerce, subject to the Tenth Amendment's reservation of certain rights to the states. See U.S. CONST. art. I, § 8, cl. 3; id. amend. X. In fact, the line of Commerce Clause cases beginning with *National League of Cities v. Usery*, 426 U.S. 833 (1976), and ending with *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), back away from defining standards whereby a public regulatory activity could be classified as federal, state, or local. The cases simply suggest that the Tenth Amendment imposes an external check on Commerce Clause regulation. See infra notes 268-78 and accompanying text.

228. To the extent that any check could be inferred from the Tenth Amendment, it would seem to involve notions of sovereignty. See Rapaport supra note 3, at 345, rather than the efficient provision of regulatory activities or political participation, which are our concerns here. Susan Rose-Ackerman's recent commentary on the links among the Commerce Clause, the Tenth Amendment, and regulatory federalism in the area of environmental regulation provides a useful perspective. See Susan Rose-Ackerman, *Environmental Policy and Federal Structure: A Comparison of the United States and Germany*, 47 VAND. L. REV. 1587 (1994). According to Rose-Ackerman, the Commerce Clause has not provided the basis for a normative evaluation of the level of government to which regulatory assignments should be made. Id.

229. In the negative Commerce Clause framework, a court starts by asking whether a state regulation discriminates against interstate commerce (that is, its effects are not merely incidental). If there is no discrimination, deference is given to the state. If there is discrimination, the state must justify it. The court is then required to balance the federal interest in free interstate commerce against the competing state regulatory interest. A state regulation that places too much of a burden on interstate commerce without good reason is disallowed under the negative Commerce Clause doctrine. For a useful summary of current negative Commerce Clause doctrine, see generally Julian N. Eule, *Laying the Dormant Commerce Clause to Rest*, 91 YALE L.J. 425 (1982).

The application of the negative Commerce Clause's balancing approach has proven problematic in practice. After more than 100 years of application, no clear standard has yet emerged to guide the courts as they seek to balance the burdens on interstate commerce of a state regulation against the benefits to state residents of the regulation. According to Justice Rehnquist:

The true problem with today's decision is that it gives no guidance whatsoever to [the] states as to whether their laws are valid or how to defend them. . . . We know only that Iowa's law is invalid and that the jurisprudence of the "negative side" of the Commerce Clause remains hopelessly confused.

Instead, however, the Court declined to take the balancing approach of the negative Commerce Clause, stating that "once an effect is shown, no specific magnitude need be proved."230

The Court also raised a spillover concern in City of Lafayette v. Louisiana Power & Light Co. In Lafayette, the Court noted that a municipal utility's predatory practices outside its city boundaries were not subject to the same political checks as were a state's regulatory activities.231 In fact, the Lafayette Court discusses spillovers at a number of points in its analysis, stating, for example:

"[T]he economic choices made by public corporations in the conduct of their business affairs, designed as they are to assure maximum benefits for the community constituency, are not inherently more likely to comport with the broader interests of national economic well-being than are those of private corporations acting in furtherance of the interests of the organization and its shareholders."232

Further, the Court stated that "those consumers living outside the municipality who are forced to take municipal service have no political recourse at the municipal level . . . ."233 Had the Court wished, the participation approach used in state-action cases could have been amended to include a substantive spillover test.234

The Court dabbled with and eventually dismissed a spillover test in Community Communications Co. v. City of Boulder as well. In the district court's opinion, as described by the Supreme Court, home-rule "status gave autonomy to the city only in matters of local concern, and . . . the operations of cable television embrace 'wider concerns, including interstate commerce . . . [and] the First Amendment rights of communicators.'"235 This language suggests that the Court might be open to a test that took spillovers into account. The city claimed that "the regulation of cable television is a local matter."236 Ultimately the Court, by failing to find adequate state authorization for the regulation's enactment, reached the same result as the district court but did not adopt a spillover test.

230. Id. at 785.
232. Id. at 403.
233. Id. at 406.
234. The inclusion of a spillover test would not have altered our view as to the correct outcome in Lafayette. Our full theory will suggest that intrastate spillovers need not invalidate an exemption if a statewide political participation test is satisfied. The record in Lafayette suggests that there were substantial spillovers from the city to the suburbs. However, it also provides no evidence that such spillovers extended beyond the boundaries of the state. The regulation fails because a political participation goal was not met, not because of the presence of city-suburb spillovers. See infra Part V.
236. Id. at 53 n.16.


The Court again confronted the spillover question in Town of Hallie v. City of Eau Claire. Recall that in Hallie a number of small towns near and around the City of Eau Claire filed suit against the city, charging it with seeking to acquire a monopoly in sewage treatment services, in part by tying access to sewage treatment services to the purchase of collection and transportation services.237 The Court avoided a complete substantive analysis of the regulation. It did, however, make clear that if the state authorizes a regulatory activity by a local government, that regulation is immune from the antitrust laws even if it generates substantial spillovers across the jurisdiction's boundaries.238 The only requirements are that the authority from the state must be somewhat specific as to the area in which the city is operating, and that the state must contemplate the city's acts.239

The decision in Hallie to ignore interjurisdictional spillovers is consistent with the current state-action doctrine's singular focus on political participation. If the tying arrangement between sewage treatment and transportation were known to generate substantial spillovers outside the jurisdiction, but the connection had been accounted for in the state's authorization of the program, an antitrust exemption would be appropriate under a participation test. According to the Court in Hallie, "The only real danger is that [a city] will seek to further purely parochial public interests at the expense of more overriding state goals. This danger is minimal, however, because of the requirement that the municipality act pursuant to a clearly articulated state policy."240 To the Hallie Court, ensuring political participation at the state level was sufficient to protect all state residents from the adverse economic effects of monopoly spillovers from a local regulation. In the Court's mind, to subject state-monitored local regulations to federal antitrust review would sacrifice the valued goal of participation and offer little improved economic efficiency in return.241

Although there are good reasons to be confident that the current state-action doctrine promotes local political participation and encourages intrastate economic efficiency, those reasons do not apply when state regulations create interstate monopoly spillovers.242 Although Parker does hint at a congressional check on state regulations,243 the two-

238. Id. at 40.
239. Id. at 41, 44.
240. Id. at 47.
241. Id. at 45. But see Heckenkamp & Mackernon, supra note 127, at 782-83 (characterizing the state-action exemption as economically inefficient and unjustified in light of the Sherman Act's legislative history).
242. See supra Figure 4b and accompanying text.
pronged Midcal participation test for clear articulation and active supervision has never been extended to Congress as a justification for allowing a state regulation. Put simply, there appears to be no protection for political participation at the national level in Midcal. As a consequence, nonresidents affected adversely by a state’s regulation at present have no direct say in its passage and remain exposed to any resulting monopoly spillovers. Although Congress might provide protection to affected out-of-state residents without judicial prodding, current analyses of congressional policymaking suggest this is unlikely. The incentives in Congress are to favor local constituencies. One effective way to favor them is to grant a regulation with monopoly spillovers to particular industries that are economically important to a state or congressional district. Agricultural price support programs and tariff protections are examples. There is, however, an alternative to direct congressional control of state regulatory spillovers. It is to extend the current state-action doctrine to require antitrust review of any state regulation with significant monopoly spillovers where the affected out-of-state consumers did not have a direct say in the approval of the regulation. Subpart IV(B) shows how this alternative might be specified and implemented.

B. Specifying and Implementing a Spillover Test

Our proposed approach to the problem of interstate regulatory spillovers is to use a state-action review to evaluate, first, the economic significance of the monopoly spillovers and, second, the participatory history of the offending regulation. Then, if the regulation generates significant monopoly spillovers and ignores out-of-state interests, courts should subject that regulation to an antitrust review against the standards of the Sherman Act. To implement this strategy the courts would ask two questions:

1. Does the state regulation create an interjurisdictional monopoly spillover with the potential to significantly harm customers outside the state?
2. If so, was the state regulation decided without the effective political participation of the affected customers residing outside the regulating state?

If the answer to both questions is yes, then the state regulation will fail the monopoly spillover test and a Sherman Act review of the regulation is appropriate. 245

1. Does the state regulation create an interjurisdictional economic spillover with the potential to significantly harm customers outside the state? Implementation of step one of the two-step spillover test requires a clear definition of an interjurisdictional economic spillover and a standard of potential economic harm borne by out-of-state customers. An interjurisdictional economic spillover occurs when a state’s regulatory policy raises the price charged for an exported good or service purchased by residents outside of the regulating state. The good or service may be consumed directly by out-of-state residents or be used by those residents as an input into the production of other goods and services. In either case, the state’s regulation will have imposed an economic burden on residents outside the state in the form of higher consumption or production costs.

To limit the bringing of frivolous state-action cases under our spillover test—almost all state regulations can be argued to have some final equilibrium effects on prices paid by out-of-state residents—our test is limited to those state regulations that impose a significant potential economic burden on nonresidents through higher prices. Here the U.S. Department of Justice’s and the Federal Trade Commission’s Horizontal Merger Guidelines are suggestive. In those guidelines, mergers thought to lead to price increases of five percent or more are to be given close scrutiny under the Clayton and Sherman Acts. 247 A similar standard for economic harm seems reasonable for our spillover test review of a state regulation.

Attributing a given price increase to the challenged state regulation requires an analysis of underlying market conditions, but a simple pricing rule used by profit-maximizing monopolies and cartels should provide sufficient information to trigger Sherman Act review. The rule sets the percentage mark-up of price \( P \) above marginal cost \( MC \) in proportion to the inverse of the market’s (absolute value) elasticity of demand \( \left| e_P \right| \) for the monopolized good or service: \( (P-MC)/P = 1/\left| e_P \right| \). 248 If a five percent monopoly mark-up is a guideline of sufficient economic harm, then

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244. See supra subpart II(A) (discussing the inefficiencies of universalistic legislatures).
245. Note that this approach will fall substantially short of the Lochian dilemma of whether to undertake a complex review that seeks to balance state and federal interests; by requiring the plaintiff to show that significant spillovers are present, we ensure that most litigation will not proceed to a full-rigorous examination of the relevant market characteristics.
247. See id. at 7.
248. See PINCZUCK & RUBINFIELD, supra note 87, at 326-27 (articulating a rule of thumb for determining correct pricing in which the mark-up over the marginal cost, as a percentage of price, should equal the negative inverse of the elasticity of demand). The price elasticity of demand in the above formula is understood to be measured in its absolute (always positive) value. Strictly speaking, the rule can be applied only in those ranges of demand where the marginal revenue from the sale of additional goods or services is positive. This will be the case for most state-exported goods and services. Goods with a price elasticity of demand of 20 (in absolute value) will, if cartelized, see their prices rise by 5% or more: \( P/MC = 1/(1 - \left| e_P \right|) \geq 1.05 \) for values of \( \left| e_P \right| \leq 20. \),

a state regulation restricting the sale of goods or services for which the elasticity of demand by out-of-state residents is twenty or lower exhibits sufficient potential economic harm to warrant Sherman Act review.

Assuming that transportation costs are minimal, goods and services supplied by state residents to competitive national markets—markets where there are ready substitutes—will face very high price elasticities. In perfectly competitive markets, the elasticities will be infinite. State regulation of such goods will be immune from Sherman Act review under our spillover test, although they must still pass the Court's M telephone test for in-state political participation.

In contrast, state regulations restricting out-of-state supply of goods and services that have unique demand features are potential candidates for Sherman Act review under our spillover test. Goods such as California avocados, Utah uranium, and Wyoming coal do compete in national markets, but their unique features give producers in those states potential monopoly power—that is, the price elasticities of demand by out-of-state residents for those goods are less than twenty. If a state regulation were passed that restricted the supply of those goods to nonresidents, that regulation would fail step one of the two-step spillover test.

We then ask: 2. Was the state regulation decided without the effective political participation of the affected customers residing outside the regulating state? This second step seeks to protect interstate (that is, Coasian) agreements on regulatory policies. Such agreements may restrict the sale of products from one state to another in violation of step one above, but the residents of each affected state may have balanced those potential economic losses against other, presumably greater, economic gains made possible by the agreement. For example, regional paper production in North Carolina might be regulated to the detriment of regional paper consumers in Tennessee and Georgia, but the residents of those states gain cleaner "downstream" rivers in return. Step two will allow such regulations to stand provided that residents in all affected states were given valid opportunities to participate in setting the interstate agreement.

Much as the Court's current M telephone doctrine protects state regulations decided by participatory state politics, step two of the spillover test protects regulations with interstate effects and decided by participatory interstate politics. We propose as a measure of participatory interstate politics the application of the M telephone doctrine to each state whose residents are affected by the regulations of the interstate agreement. Are the regulation's affected customers citizens of an agreeing state and does that state's interstate agreement demonstrate "clear articulation" and "active supervision" as now interpreted by M telephone and its progeny? If the answer to both of these questions is yes, then the regulation passes step two of the spillover test and stands immune from Sherman Act review.

Finally, implementation of the two-step spillover test should not be difficult. The Court has reviewed the economic benefits and costs of a state regulation in deciding state-action cases, but in its debate has raised concerns about the appropriateness of undertaking a deep substantive review. We agree with this view. Step one—the market elasticity test for sufficient economic harm—only requires the courts to decide the relevant market for the regulated good; this task is familiar terrain. Step two—whether the regulation is covered by an actual interstate agreement encompassing all affected customers—seems conceptually straightforward.

250. In the application of our spillover test, the Court will have to decide what is sufficient evidence of an interstate agreement sufficient to satisfy step two. Certainly sufficient is the presence of an actual agreement involving all states whose consumers are substantially affected by the monopoly spillover. More difficult is the case in which two states cannot reach an agreement after serious negotiations or the case in which a few states reach an agreement but other affected states do not join. To keep the courts off the slippery slope of having to infer "best intentions," we would require an actual interstate agreement of all affected states for satisfaction of step two.

251. See, e.g., Custer v. Detroit Edison Co., 428 U.S. 579 (1976). In Custer, several members of the Court considered the merits of a substantive review of the benefits and costs of regulation.

Justice Blackmun, concurring, offered an attempt to balance federal antitrust interests with state regulatory interests. In Justice Blackmun's view, the extent of an exemption should be determined by applying a "rule of reason analysis" as in other antitrust cases, but allowing "the fact of state action to figure powerfully in the calculus of harm and benefit," and thus, usually, to yield a state action exemption. Id. at 610-11 (Blackmun, J., concurring). In effect, Justice Blackmun's notion was that the Court should distinguish beneficial from harmful regulation and in the latter case search for more desirable alternatives; spillovers would apparently be included in that calculus. However, Justice Blackmun supplied no procedures for making such a benefit/harm distinction.

A strong opinion to the contrary was expressed by Justice Stewart, who worried about a chilling effect of such a substantive review on state policymaking: "If a state legislature can ensure antitrust exemption only by exchanging such broad delegation of regulatory authority and incorporating regulatory details into statutory law, then there is a very great risk that the State will be prevented from regulating effectively." Id. at 638 n.26 (Stewart, J., dissenting). Justice Stewart also expressed concern about the increased power of the federal judiciary: "[T]he Court is adopting an interpretation of the Sherman Act which will allow the federal judiciary to substitute its judgment for that of state legislatures and administrative agencies with respect to . . . anticompetitive regulatory provisions . . . ." Id. at 630 (Stewart, J., dissenting).

252. The determination of the relevant antitrust market is typically the first step in an analysis of monopoly power under Section II of the Sherman Act as well as in analyses of mergers and acquisitions under § 7 of the Clayton Act. See PHILLIP AREEDA & Louis KAPLOW, ANTI TRUST ANALYSIS: PROBLEMS, TRENDS, CASES 567 (4th ed. 1988). What the elasticity test does not consider is the extent of the market "damage" that the state regulation might impose once it has been determined that the $|\epsilon| \leq 20$. That is, is there one out-of-state consumer harmed or are there millions? This inquiry into the extent of economic damage from the state regulation is best left to the antitrust portion of the case, where such considerations are commonplace.
State regulations failing both steps one and two above—those with significant adverse spillovers not politically approved by affected residents outside the state—will be subject to scrutiny under the Sherman Act. *Parker v. Brown* involved one state regulation that would fail the spillover test and (likely) a subsequent Sherman Act review as well. In *Parker*, the California legislature passed, at the request of producers, an Agricultural Prorate Act creating a Prorate Advisory Commission to implement restrictive marketing programs for California produce. Approval of the Commission and of sixty-five percent of the crop's producers was required to establish a marketing regulation. Because California is an important national producer of agricultural products, restrictive marketing regulations in that state are likely to have adverse effects on the prices of the regulated produce. Nonetheless, the resulting regulations would pass the participation tests of the current *Midcal* doctrine; they were allowed by the state legislature ("clear articulation") and supervised by a legislatively appointed Commission ("active supervision").

Under the extended spillover test, however, *Parker* would not be exempt from the antitrust laws. The spillover consequences of California's Agricultural Prorate Act are potentially significant. The Act was challenged by a producer of raisins on the ground that the state's approved regulation of raisin production restricted competition in violation of the Sherman Act. At the time of the regulation, California produced "almost all the raisins consumed in the United States," and ninety-five percent of that output was shipped out of the state. Further, the demand for raisins by out-of-state residents was relatively price inelastic. The Agricultural Prorate Act, at least as applied to the regulation of raisin production, clearly creates interjurisdictional monopoly spillover with the potential to significantly harm customers outside the state and therefore violates step one of our spillover test.

The Act also violates step two, the requirement that the regulation be decided with effective political participation by the affected out-of-state residents. There is no evidence that the Act was part of any participatory interstate agreement to limit raisin production. Indeed, because raisins are consumed throughout the nation, Congress would be the appropriate participatory arena in which to reach such an agreement. But Congress, despite having approved the regulation of other agriculture production, did not choose to limit raisin production. Because it fails our spillover test, California's Agricultural Prorate Act should undergo Sherman Act review. Most state-action doctrine commentators agree that the Act would not now survive such scrutiny.

C. The Spillover Test and the Goals of Federalism

The two-step spillover test seeks to ensure that state regulations that adversely affect the economic interests of citizens living outside the regulating state will be curtailed. To the extent that such monopoly spillovers now exist but are checked by the two-step test—for example, the overturning of California's Agricultural Prorate Act—then regulatory efficiency will be increased. This is a gain for economic efficiency, one important goal of federalism.

But will the application of our spillover test discourage political participation, federalism's other goal? Professor Elhaug has expressed concern that suppressing regulations with associated spillovers will chill local and state regulatory policymaking. Most all regulations, he correctly notes, will have some consequences on residents living outside the regulating jurisdiction. Our test, however, is not a blanket condemnation of all spillovers and all regulations. First, only those regulations that restrict the supply of goods and services to markets across state lines will be affected. Health regulations, environmental regulations, and labor market regulations are unlikely to have such effects. Second, because most markets are now national, or even international, in scope, most goods and services produced within a state will have many competitors outside the state. Substitutes are readily available. Thus, few states that regulate their interstate goods or services violate the elasticity requirement (|e_x| ≤ 20) in step one of the spillover test. Finally, step two of the spillover test

254. Id. at 347.
255. Id. at 344.
256. Id. at 345, 359.
258. See, e.g., Easterbrook, supra note 7, at 47 ("Under an approach forbidding the export of a monopoly overcharge, the raisin prorate program would have been preempted by the Sherman Act."). At the time of the original decision, however, it might well have passed muster. See id., supra note 125, at 254 n.153.
259. See Elhaug, supra note 7, at 703-31 ("Antitrust review that preempts such spillovers (and thus forces regulatory decisions into a higher level of government) may impair rather than improve the overall quality of decisionmaking and make meaningful local autonomy impossible.").
260. See id. at 729-30.
261. Though, of course, they may. Environmental, labor, and health regulations can all raise firm costs that will lead to less industry output by the regulating state. This reduction in output can in turn have an adverse effect on market prices and consumption by out-of-state residents. Although such regulations could conceivably fail our spillover test, they should not fail the antitrust review that follows (in contrast to the raisin cartel in *Parker*).
262. For an explanation of the elasticity requirement, see supra note 248 and accompanying text.
should encourage political participation as it rewards with an exemption from federal antitrust laws those regulations set by participatory interstate agreement. Currently, nonresidents are excluded from the political deliberations that set the offending regulations. Step two will encourage the states setting those regulations to hear and then, as part of an agreement, to compensate the out-of-state consumers hurt by the regulations. Political participation in regulatory policy should be enhanced by such interstate agreements.

We conclude that adding the spillover test to *Midcal* is likely to strengthen the federalist performance of our current state-action doctrine. *Midcal* and its progeny promise significant improvement in *intrastate* political participation with possible gains in *intrastate* regulatory efficiency. The spillover test promises significant improvements in *interstate* economic efficiency with possible gains in *interstate* political participation. Together, an extended state-action doctrine using *Midcal* plus a spillover test allows our federalist regulatory institutions to achieve their full potential.

V. An Overview: Assessing the Performance of an Extended State-Action Doctrine

Using the logic of Part II's theory of federalism articulating the twin goals of economic efficiency and political participation, Parts III and IV have argued for two tests to be met before any state regulation is to be exempted from federal antitrust review. The first test (in Part III) has been developed by the Court in its *Midcal* doctrine. Our theory of federalism allows us to see the potential of the *Midcal* test: encouraging political participation by state residents in the setting of their state's regulatory policies. Furthermore, to the extent the test centers regulatory policymaking in the politically responsive state legislature, there is the chance that economic efficiency will be improved as well. The second test (in Part IV), first suggested by Judge Easterbrook, allows the Court to address in a principled fashion those state regulations that generate significant interstate monopoly spillovers. Our version of the spillover test is likely to promote economic efficiency in national regulatory policymaking and may also encourage interstate political participation. Perhaps one of the central benefits of using a more encompassing theory of federalism—a theory that recognizes both participation and efficiency as valued outcomes—is recognition that the Court's current *Midcal* doctrine and a more efficiency-oriented doctrine can stand side-by-side, not as competitors but as complements. The extended state-action doctrine joining *Midcal* to the spillover test is one attempt to productively exploit these complementarities.

### Table 1—The Antitrust State-Action Cases

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**Note:** Cases in which the Court has granted an exemption are in italics.

* Boulder fails the Court’s current interpretation of the *Midcal* participation test. Boulder would pass a “relaxed” *Midcal* test allowing a home rule exemption for municipal regulation without spillovers.

How will our extended doctrine work? Table 1 summarizes the application of the extended state-action doctrine to the leading cases previously considered by the Court. Cases that pass both the *Midcal* and spillover tests are placed in Quadrant I of Table 1. Cases that fail the *Midcal* test but pass the spillover test appear in Quadrant II, and cases that pass *Midcal*
but fail the spillover test appear in Quadrant III. (None of the cases discussed will appear in Quadrant IV, where both tests are failed.) Table 1 shows that, of the cases in which the Court gave exemptions (those in italics), the Court acted in accordance with the extended state-action doctrine in all but one instance: *Parker v. Brown*. As Table 1 indicates, the extended state-action doctrine would have decided *Parker* differently. Table 1 also shows a desire to reverse *Boulder*, moving the case from Quadrant II (failing the *Midcal* test) to Quadrant I (passing a “relaxed” *Midcal* test for municipal regulations).

The problem in *Parker* is not the *Midcal* test but the failure of the state regulation to survive the interstate spillover test. Recall that at issue in *Parker* was the validity of the California Agricultural Prorate Act, which protected raisin growers by allowing them to form a cartel that reduced raisin output and raised raisin prices. In our view, *Parker* satisfies the participation test. Because almost all U.S. raisins were grown in California and ninety percent of those were consumed outside of the state, the act of cartelization was obviously in the interest of most residents in the state, which supported the cartel with its enforcement authority. *Parker* clearly fails the spillover test, however. The state-sanctioned raisin cartel generated monopoly spillovers that flowed across the country. Further, the price elasticity of demand for raisins is below the spillover test guideline. Finally, there was no evidence of an interstate Coasian agreement approving the cartel; indeed, the expansiveness of the spillover alone made such a bargain between states difficult to achieve. As a consequence, the regulation in *Parker* fails the spillover test.

The problem with *Boulder* is the application of *Midcal*’s “clear articulation” standard to a municipal regulation, in effect requiring state legislative approval of local regulatory policies. This makes sense only if the municipal regulation creates intercommunity monopoly spillovers. To foster federalism’s twin goals of participation and efficiency, local regulations should be decided locally unless there are spillovers. If there are spillovers, then requiring the state to clearly articulate its approval is appropriate. For municipal regulations, the “home rule” standard from Justice Rehnquist’s *Boulder* dissent supplemented by the spillover test is preferred. Under this version of our extended state-action doctrine—using a “relaxed” *Midcal* plus the spillover test for municipal regulations—the regulation in *Boulder* would survive scrutiny and the case would move to Quadrant I.

![Figure 5 - State-Action Doctrine and the Federalism Frontier](image)

What are the ultimate benefits to federalism of implementing the extended state-action doctrine outlined here? Figure 5 shows the potential gains in political participation and economic efficiency. As argued in Part III, the *Midcal* doctrine—or a “relaxed” *Midcal* doctrine allowing a “home rule” standard for municipal regulations—is likely to contribute to both of federalism’s goals. The *Midcal* doctrine’s twin hurdles of “clear articulation” and “active supervision” ensure that state regulations will be decided within, and enforced by, the elected branches of state government, most prominently the state legislature. Without the *Midcal* constraint, regulatory policies might well be decided in the nonelected branches of governments, most prominently the state regulatory bureaucracy. This centering of regulatory policymaking in elected politics has two beneficial effects.

First, the *Midcal* doctrine is likely to increase political participation because it confines decisionmaking to those arenas of government in which citizens have the most direct influence. As a consequence, political participation should rise from a pre-*Midcal* level at SQ to a post-*Midcal* performance at SD in Figure 5. By encouraging local policymaking, a “relaxed” *Midcal* might stimulate even more political participation, an effect denoted as a further improvement in SD to SD' in Figure 5.

Second, *Midcal* may also have a beneficial effect for federalism’s goal of economic efficiency. By limiting regulatory policymaking to the elected branches of government, *Midcal* brings the discipline of political competition to bear on the policymaking process. Although elected
They protect legitimate national interests from the intrusions of municipal and state regulations, but they provide no safeguards in reverse. What is to protect legitimate state and municipal interests from overreaching national regulations? The Commerce Clause of the U.S. Constitution opens wide the door for Congress to regulate business within state boundaries. Standing in the way has been the Tenth Amendment's reservation to the states of those "powers not delegated to the United States by the Constitution." Beginning with National League of Cities v. Usery, the Supreme Court has sought to provide Tenth Amendment guidelines for when a national regulation has overreached its bounds.

The Court's efforts in this direction have not yet proved successful. In National League of Cities, the Court held that Congress could not apply a minimum wage and national hour standard to state and local employees working in areas of "traditional governmental functions." Efforts to apply the National League of Cities guidelines in later cases, however, showed that the Court was unable to agree on a definition of what would constitute a traditional government function. Although over three hundred cases raising Tenth Amendment claims were brought following National League of Cities, most were rejected by the courts. The Supreme Court itself never relied on National League of Cities to invalidate another federal law. Finally, after nine years of frustration, the Court overruled National League of Cities in Garcia v. San Antonio Metropolitan Transit Authority. In evaluating the application of the federal Fair Labor Standards Act to the states, the Court stated in Garcia: "We therefore now reject, as unsound in principle and unworkable in practice, a rule of state immunity from federal regulation that turns on a judicial appraisal of whether a particular governmental function is 'integral' or 'traditional.'"

VI. Protecting the States: Enforcing Guidelines for National Regulatory Restraint

The extended state-action doctrine linking Midcal (or a "relaxed" Midcal) with a spillover test seeks to assist the Court as it polices the boundaries between state and national responsibilities for the regulation of business. But the extended state-action doctrine guidelines are one-sided.

268. See U.S. CONST. art. I, § 8 (giving Congress the power to "regulate Commerce . . . among the several States").
269. Id. amend. X.
270. In National League of Cities, the Court held that Congress could not impose wage restrictions on state employees because "Congress may not . . . force upon the States its choices as to how essential decisions regarding the conduct of integral government functions are to be made." National League of Cities v. Usery, 426 U.S. 833, 855 (1976). The decision in National League of Cities was a sharp break with the Court's past interpretation of Tenth Amendment protections for states. Since United States v. Darby, 312 U.S. 100 (1941), the Court had refused to read the Tenth Amendment as a cap on Congressional powers, calling the Amendment nothing more than "a truism." Id. at 124.
274. See Merritt, supra note 272, at 12.
In the place of defining explicit Tenth Amendment guidelines for what constitutes a protected arena of state policymaking, the Garcia Court turned to the process of congressional decisionmaking as the best guarantor for state policy discretion.276 The Court saw the U.S. Senate in particular—giving each state two members elected statewide—as that branch of government most in tune with state government interests.277 Because every federal regulation requires Senate approval, the Senate serves to protect state interests.278

The Court's recent decision in United States v. Lopez can be read as reaffirming Garcia's focus on process. At issue in Lopez was the constitutionality of the Gun-Free School Zones Act, which outlawed the possession of a gun within one thousand feet of a school. The Court ruled that absent a "substantial effect" of gun possession on interstate commerce, the law is simply not within Congress's power to enact.279 Congress had failed to provide, either in the statute itself or in the accompanying committee reports, a rationale linking the regulation of guns near school yards to a substantial effect on interstate commerce. As things stood, "no such substantial effect was visible to the naked eye."280 Presumably, if Congress had made the link to interstate commerce either in the statute or elsewhere—that is, if the process of approving the national regulation had illuminated the substantial effect—then the statute would have been upheld.281

Given the Court's current approach, if protections for state regulatory policymaking are to be fashioned, then they must be built into the process of national policymaking. The question then becomes how to strengthen the hand of state and local regulatory interests in the process of setting national regulatory policies. We offer one answer: Congress should consider the adoption of a self-disciplinary check as it decides on those policies. We call this check a Federalism Impact Statement, or FIST.282 FIST is a seven-step guide to national regulatory policymaking that explicitly incorporates federalism's interests in protecting states and localities as independent policymaking bodies. A FIST would be required before any federal regulatory scheme were put into place. The application of FIST becomes a procedural hurdle that each national regulation must clear.283

277. Id. at 1632. However, the Court agreed with the government that "Congress normally is not required to make formal findings as to the substantial burdens that an activity has on interstate commerce." Id. at 1631.
278. The question remains as to whether the Court might be tempted to do more in future cases— that is, to pass on the substantive merits of constitutionally stated links between regulative and interstate commerce. See Richard Cordy, Judicial and Legislative Enforcement of Federalism: A Summary of Recent Efforts by the Supreme Court and Proposals Introduced in Congress to Enforce Principles of Federalism Through the Courts, in COUNCIL OF STATE GOVT'S, THE BOOK OF THE STATES 485, 488, 488-89 (1996) (arguing that it remains to be seen whether or not Lopez "will come to stand for rigorous judicial second-guessing of congressional determinations about where and why it derives authority to legislate in a particular area"). Three recent commentators seem to think this is unlikely. See Nelson & Ezekir, supra note 1, at 1848 (arguing that "Lopez is no declaration that the Court is prepared to stop a wide range of congressional initiatives" and "does not and should not augur a new period of aggressive judicial enforcement of jurisdictional limitations on congressional power"); Gregalia, supra note 278, at 767 ("It is most unlikely, however, that the Court will be able to muster five votes to invalidate a commerce power measure when Congress does not commit the oversight that explains Lopez."); supra note 278. See infra Figure 6.
280. Id. at 1632. However, the Court agreed with the government that "Congress normally is not required to make formal findings as to the substantial burdens that an activity has on interstate commerce." Id. at 1631.
281. See infra Figure 6.
282. We see the requirement for a FIST arising from congressional legislation, much as the requirement for Environmental Impact Statements was part of the National Environmental Policy Act. A recent article by Professor Gardebaum argues that a FIST requirement might also originate in the Court from its enforcement of the Necessary and Proper Clause on matters of national regulation. See U.S. CONST. art. I, § 8, cl. 18 ("The Congress shall have Power ... To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested..."
The judiciary’s responsibility is to ensure that a FIST is in fact performed for each national regulation. Ample experience suggests that a FIST proposal can be made operational. Currently in the United States, regulatory impacts are evaluated with respect to state and local budgets, takings, the environment, inflation, justice, and arms control. Moreover, the European Union now uses a process hurdle much like FIST with some success.295

How will FIST work? Each proposed national regulation will be required to show that it has answered successfully (that is, YES) either Question 1, 2, 3, or 6 and then Questions 4 and 7. Questions 1 and 2 ask, respectively, whether the proposed regulation deals directly with a national spillover or with a regional spillover that has not been adequately addressed through interstate agreements. If the answer to Questions 1 and 2 is NO, then direct national regulation is not appropriate. Question 3 allows for another policy approach and asks whether the proposed national policy might be redesigned to foster interstate Coasian agreements rather than to regulate directly. If the answer to Question 3 is NO, then there is no compelling economic case for the proposed national regulation. FIST therefore recommends state regulation only.

However, if the answer to Question 1, 2, or 3 is YES, then the FIST analysis moves to Question 4: Is the proposed national regulation or policy efficiently provided at the national level of government, or might it be better to provide the regulation at the state or local level? There is, of course, no guarantee that Washington knows best when it comes to regulatory policies.296 If national policymaking is likely to be inefficient relative to state or local policymaking (Question 4: NO), then Question 5 asks whether there might be an institutional or procedural reform that could improve national performance. For example, greater executive or political-party control over legislation and administration might improve national regulatory performance.297 If so (Question 5: YES), then Question 6 asks if those national institutional reforms can be implemented. If so (Question 6: YES), then the national regulation deserves another chance and FIST returns to Question 4 for a re-evaluation. If Questions 5 and 6 are answered NO, however, then FIST recommends state regulation only.

Finally, if Question 4 is decided on efficiency grounds in favor of the national regulation (Question 4: YES), then the regulation moves to

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295 See supra notes 200-201 and accompanying text.
296 See, e.g., supra notes 95, 122 (citing studies that reveal the inefficiency of federal regulation).
297 See supra notes 117-118 (discussing studies that reveal that strong political parties and executives improve the efficiency of regulatory policies).
Question 7 and the final FIST hurdle. Because most national regulations are less participatory than corresponding state regulations, Question 7 asks whether the national efficiency gains justify the possible decline in state and local political participation. If Congress answers NO, then FIST recommends *state regulation only*. If Congress decides that the answer is YES, then the proposed *national regulation* is approved.

For this study of business regulation, one particularly relevant national regulatory policy is embodied in the Sherman Antitrust Act, which seeks to foster economic competition and to control privately and publicly created monopoly spillovers. Will the Sherman Act pass a FIST review? The answer to Question 1 is YES; the Sherman Act is a logical response to the need to monitor national monopoly spillovers from firm collusion or from state and local government regulations. The answer to Question 4 is YES as well; it is hard to imagine an equally effective state or local government alternative for controlling national monopoly powers. Finally, the answer to Question 7 involves Congress’s own balancing of improved economic efficiency from the national regulations versus a possible decline in state and local political participation. A Sherman Act review might actually improve political participation by forcing states to consider their neighbors when passing regulations with monopoly spillovers—that is, there may be no efficiency/participation trade-off at all. In any case, Congress ultimately decides Question 7. All FIST requires is that there be evidence in the legislative record that the legislature recognized the possible trade-off between efficiency and participation when making its decision. If such evidence exists, the Sherman Act passes a FIST review and will be allowed to stand as a national regulatory policy.

The adoption by Congress of a FIST requirement for national regulatory policy would not push congressional or executive decision making into uncharted waters. Congress and the executive branch have approved and worked under impact-statement guidelines in a variety of policy areas in the past. For example, the requirement that new policies include an Environmental Impact Statement (EIS), introduced in the National Environmental Policy Act (NEPA), has been in effect since 1969. Under NEPA, each government agency is required to file an EIS with each new regulation or policy proposal. 290

289. The original framers of the Sherman Antitrust Act appreciated the Act’s national scope and viewed its purpose as the control of business combinations that restrain trade among the several states. See 1 EARL W. KINTNER, THE LEGISLATIVE HISTORY OF THE FEDERAL ANTITRUST LAWS AND RELATED STATUTES 32 (1978) (“As a study of the debates makes clear, and subsequent Supreme Court decisions have recognized, Congress chose, in enacting the Sherman Act, to exercise the full extent of its constitutional power to regulate interstate commerce.”).
290. See supra subpart IV(C).
Budget (OMB) before issuing new regulations. 297 Under these Orders, each agency must put together an annual agenda of anticipated significant regulatory actions, and submit the agenda to OMB. OMB checks for consistency with the goals of the agency and the administration and then compiles a regulatory program for the administration as a whole. 298 Finally, there are other, though less prominent, examples of the legislative and executive branches requiring impact statements as guides to policy choices, including land use policy, inflation policy, judicial policy, and arms-control policy. 299

298. Executive Order 12,291 says that the agencies must submit a Regulatory Impact Analysis to OMB before issuing a new rule. See 3 C.F.R. 127, § 3(a). If OMB objects to the Regulatory Impact Analysis, it can prevent the agency from publishing the rule until the agency responds to the OMB criticisms. See 3 C.F.R. 129, § 310(1) (1982). Executive Order 12,498 also requires a cost-benefit analysis earlier in the process. See 3 C.F.R. 323. For a good overview of how the two orders work, see generally W. Andrew Jack, Note, Executive Orders 12,291 and 12,498: Unification of Legislative Power or Blueprint for Legislative Reform?, 54 GEO. WASH. L. REV. 512 (1986).


If FIST can be implemented, will it succeed in limiting inefficient congressional regulations, particularly those intrusive to state and local policymaking? Past U.S. experience and recent successes with a form of FIST in the European Union suggest reasons to be optimistic. The two major applications of impact statements in the U.S. have been in environmental and regulatory policymaking. In both cases, the effects on policy appear to have been significant. Studies of the effects of Environmental Impact Statements (EIS) show the impact statements to have affected both the process and outcomes of federal agency policymaking. Agencies already familiar with environmental policy issues—for example, the Corps of Engineers and the Forest Service—were the most receptive; new and environmentally more responsive decisions were the result. 300 Agencies not familiar with environmental issues found the EIS more of a burden and their compliance was more spotty. 301 Yet even in these agencies, the EIS gave environmental groups a formal means to make their case to agency officials, thereby raising decisionmakers' awareness of a policy's environmental consequences. 302 Evaluations of executive orders requiring agencies to do a cost-benefit impact analysis of new regulations also find a significant effect on policy. The required impact statements appear to have checked the flow of proposed regulations, and to have done so at a moderate cost and with reasonably short delays. 303 We conclude from

300. See Stark Ackerman, Observations on the Transformation of the Forest Service: The Effects of the National Environmental Policy Act on U.S. Forest Service Decision Making, 20 ENVTL. L. 703, 708-10 (1990) (noting that the Forest Service has integrated NEPA into its basic decisionmaking process, resulting in an environmentally responsive approach, expanded public information and involvement, better-staffed and documented decisions, and increased centralization); see also SIEGEL TAYLOR, MAKING BUREAUCRACIES THINK: THE ENVIRONMENTAL IMPACT STATEMENT STRATEGY OF ADMINISTRATIVE REFORM 150-62 (1984) (arguing that NEPA's EIS requirement has caused the Forest Service and the Corps of Engineers to change their behavior positively, for example, in considering low cost environmental mitigation strategies, and occasionally blocking environmentally harmful actions).


302. See H. Paul Frizeansa & Paul J. Culhane, Social Impacts, Politics, and the Environmental Impact Statement Process, 16 NAT. RESOURCES J. 339, 349-51 (1976) (finding that the EIS process has been positive because it has increased access to agencies; see also Paul J. Culhane, NEPA's Impacts on Federal Agencies: Anticipated and Unanticipated, 20 ENVTL. L. 681, 690-93 (1990) (arguing that agencies at least now consider environmental impacts, and EISs have increased the number of environmentalists on staffs and public participation in agency decisionmaking).
this brief survey of the U.S. experience that impact statements can have significant effects on the process and outcomes of policymaking, largely by raising the salience of valued outcomes previously neglected when policies were chosen. This is exactly what we hope FIST might do for federalism when the national government sets regulations.

A procedure very similar to FIST is now at work in the European Union. The 1992 Maastricht Treaty on European Union has made a principle for protecting decentralized policymaking—known as “subsidiarity”—a central tenet for the new Union. According to subsidiarity, the European Community (the “central” government of the Union) should refrain from acting on policy, even if the Treaty allows such actions, if the objectives of the policy could be effectively served by one of the member states. In November 1993, the European Commission (the “executive” branch of the Union) produced a report entitled “Adaptation of Community Legislation to the Subsidiarity Principle,” outlining how the subsidiarity principle might be implemented within Community decisionmaking. In effect, the report recommended a version of FIST. Initial analysis by the Commission shows that meeting the subsidiarity guidelines of the Adaptation Report has led the Commission to curtail several legislative initiatives previously favored by the Commission.

The Court’s role in FIST is to ensure that the FIST process works effectively. As a process check the Court should ask: Does each national regulation approved by Congress have an accompanying FIST, and does that FIST answer the seven questions posed in Figure 6? We do not see the Court reviewing the substantive merits of the proposed national regulation. Rather, we prefer the role the Court has assigned to itself in environmental policymaking. In this arena, the Court has avoided any substantive interpretation of the National Environmental Policy Act and the accompanying Environmental Impact Statements, choosing instead to focus on ensuring that agencies follow NEPA-approved procedures. In this role, the Court has been successful; agencies have generally complied with NEPA’s requirements. We would hope for a similar success in the enforcement of FIST reviews.

If approved, implemented, and successfully enforced, FIST has the potential to move our regulatory economy closer still to its “Federalism Frontier.” FIST should do so by protecting the valid contribution of state policymaking to political participation while still allowing the national government to adopt business regulations that improve economic efficiency. FIST’s contribution is shown in Figure 5 by the dashed arrows radiating from point ESD (or ESD’). FIST’s central contribution is to expose potentially inefficient regulatory regulations to public debate. Hopefully, the debate will lead to the abandonment of policies that threaten to lower efficiency (Δ) below the levels made possible through our extended state-action doctrine alone. Hence, no FIST “arrows” point down from ESD (or ESD’). FIST will allow political participation in regulatory policymaking to decline, but only if there are potential efficiency gains. Increasing efficiency (Δ) but declining participation (Θ) may be a common outcome of a FIST review as Congressally approved and FIST-sanctioned national policies pre-empt state policies. In those cases, the FIST “arrow” points upward but back to the left (northwest) in Figure 5. In certain special cases, FIST might improve both efficiency and participation—for example, if the FIST-sanctioned national policy encourages interstate barter to resolve interstate regulatory spillovers. In this case, the FIST “arrow” points outward (northeast) from ESD (or ESD’).

We are cautiously optimistic about the successful implementation of the FIST outlined in Figure 6. Previous government experience with impact statements in the U.S. and Europe suggests that FIST can provide Congress with better information about the effects of proposed regulations. Better information will not guarantee better regulatory outcomes, but it may help us to avoid highly inefficient regulations, and it could substantially improve the quality of the decisionmaking process.

VII. Conclusion

The conflict between state and federal interests in the design and implementation of the regulation of business has a longstanding U.S. constitutional history. The conflict has typically been resolved, through application of the Supremacy Clause, in favor of federal regulation. However, with the Court’s landmark 1943 decision in Parker v. Brown,
which exempted certain state regulatory actions from the Sherman Act, the tide turned. Unfortunately, the Court's evolving antitrust state-action doctrine in *Parker* and its progeny appears to many legal commentators to be at best confused, and at worst, seriously misguided.

The problems with the present doctrine can be traced to the lack of a clearly articulated conceptual framework for the Court's thinking on matters of regulatory federalism. Part II of this Article has sought to provide that framework by spelling out a theory of federalism that draws the clear connection between the structure of government decisionmaking and the valued federalist goals of political participation and economic welfare. In contrast to alternative theories of federalism grounded solely in economics, our theory is explicitly political, showing how the number of governments and their legislative and executive institutions enhance, or diminish, participation and efficiency.

Parts III and IV applied our conceptual framework to show the strengths and weaknesses of the Court's present state-action doctrine. Part III has shown the present doctrine to be an important first step toward achieving regulatory federalism's full participatory and economic potential. In the light of our federalism theory, the Court's present two-pronged *Midcal* test—granting exemptions from federal antitrust laws to "clearly articulated" and "actively supervised" state regulations—was seen to make a potentially significant contribution towards maximizing the valued federalist goal of political participation. Part IV argued that more can be done, however. Moving beyond *Midcal*'s focus on political participation, we offered our own two-pronged economic spillover test—denying exemptions to state regulations with "significant state spillovers" unsupported by a "negotiated interstate agreement"—to encourage the second federalist goal of economic efficiency.

Adding our spillover test to the Court's current *Midcal* test creates our extended state-action doctrine, which (as Part V argued) moves the federalist regulatory economy a significant way towards its full potential. Importantly, the extended state-action doctrine will not require the courts to choose explicit regulatory outcomes or regulatory institutions. The extended doctrine seeks to improve local and state regulatory policymaking and, in the case of monopoly spillovers, to prevent state regulations from circumventing the central government's efforts toward economic efficiency.

But the extended doctrine provides no protections for state policymaking. Part VI sought to restore the federalist balance. Consistent with the Court's Commerce Clause/Tenth Amendment jurisprudence in *Garcia* and *Lopez*, Part VI offered a seven-step guide to congressional decision—making—called a Federalism Impact Statement, or FIST—to improve national regulatory policymaking and, in the case of national regulatory inefficiencies, to prevent such regulations from overriding more participatory local and state policies. The courts would enforce the application of FIST.

By monitoring but also protecting the municipal, state, and national political institutions that set business regulations, courts can play an essential role in the design of good regulatory policies. The judiciary should set and enforce the rules for the process of policymaking—ideally our extended state-action doctrine plus FIST—but it should leave to the elected branches of government in our federalist democracy the task of actually choosing the policies that regulate the business economy.