FEDERALISM AND COMMERCE

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The précis for this panel concerns the Supreme Court's federalism decisions. I confess, however, that I'm more interested in the Constitution's federalism rules, which may or may not be the same as the Court's.

The original plan, sketched in Madison's famous *Federalist* No. 10, was to diminish the power of interest groups (factions) by diffusing power. Some powers would be national; all residual powers would be held by the States, which would compete with one another. Groups able to dominate one state would fail elsewhere, because economic interests would differ. Some states were agricultural, others depended on manufactures or trade. The States could ensure their independence by controlling the Senate (for Senators would be elected by states, not directly by the people). And the ability of factions to control the national government would be diminished not only by states' choice of Senators but also by the different electoral bases of the House (local elections every two years) and the Executive (indirect elections every four years). Representatives with different electoral bases would compete against one another, protecting the people.

That structure of diffused powers, not any delegation to the Supreme Court, is the Constitution's formula for protecting liberty through federalism. The 1787 plan is less useful today than formerly, for several reasons. One is the Seventeenth Amendment, which provides for the direct election of Senators. Another is the Sixteenth Amendment, which gives the national government an essentially unbounded taxing power. As Chief Justice Marshall observed in *M'Culloch v. Maryland*,[1] the power

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1. 17 U.S. (4 Wheat.) 316, 391 (1819).

to tax is the power to destroy—and, we can add today, the power to regulate.

A third is the Supreme Court's conclusion in the early twentieth century that the federal commerce power can be used as a conditioning power: That is to say, Congress can provide that nothing moves across borders unless it meets certain conditions. This was used to adopt child-labor and minimum-wage laws and to regulate lotteries and other activities.[2] If a product is made by children, it can't be shipped across state lines. Congress might have regulated health care using the conditioning power. That power, plus taxation, make judicially adopted limits of little value. The Court could overrule *Wickard v. Filburn*[3] tomorrow without establishing any real limits on national power. Justice Scalia's concurring opinion in the home-grown marijuana case shows why.[4]

A fourth reason why the Constitution's original structure of federalism has faded is the change in the economy. The assumption behind giving commerce power to the national government and residual power to the States is that few goods moved in interstate or international commerce. Most economic transactions were local, just as most people died within fifty miles of their birthplace. But canals, roads, railroads, trucks, and air travel slowly decreased the cost of transportation, which increased the portion of the economy that crossed state and national borders. The telegraph, telephone, and Internet reduced the costs of communication; today information moves in a global economy, and even a call to your next door neighbor might be routed via a satellite 22,236 miles overhead, controlled by an international authority.

As the scope of interstate and international commerce grows, so does national power. This is wholly legitimate. The Constitution gives the national government authority to regulate interstate and foreign commerce as it is in the world, not as it was in the contemplation of those living in 1787.

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2. *See, e.g.*, Champion v. Ames (Lottery Case), 188 U.S. 321 (1903) (lotteries); United States v. Darby, 312 U.S. 100 (1941) (child labor laws).

3. 317 U.S. 111 (1942).

4. *See* Gonzales v. Raich, 545 U.S. 1, 33–42 (2005) (Scalia, J., concurring opinion).

It is not the function of the judiciary to turn back the clock. The goal is to implement the original public meaning, not the original anticipated consequences. Today the national government is to commerce what states were 230 years ago, and cities are to commerce what states were in the long past.[5]

I do not think that change in the cost of transportation and communication implies the wisdom of using whatever regulatory power the national government possesses. Other speakers discuss health care, but I want to look elsewhere—to the domain of corporate organization and securities.

Efficient finance is essential to economic productivity. Efficiency depends on the absence of fraud, but all fifty states, even Nevada, prohibit fraud. Efficiency also depends on competition and choice, for different organizational structures best suit different firms. And states compete for businesses—not just for corporate charters, but for LLCs, business trusts, partnerships, and so on. Federalism sets the stage for competition, which facilitates economic growth.

Some scholars used to claim that the race was to the bottom. Delaware would allow managers to exploit investors, so managers would move there. But why should investors be stupid? They can choose where to put their money. If managers can skim then investors pay less or avoid the firms altogether.

Think for a moment about what makes jurisdictional competition work. There is a powerful tendency toward optimal legislation to the extent four conditions hold: (1) people and resources are mobile; (2) the number of jurisdictions is substantial (no monopoly or oligopoly of power); (3) jurisdictions can select any set of laws they desire; and (4) all of the consequences of one jurisdiction's laws are felt by people who live in or consent to that jurisdiction (in other words, no third-party effects, often called externalities).[6]

Competition among the States concerning corporate charters and other business organizations meets these conditions. Firms are mobile, because they may change their place of incorpora-

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5. I discuss this at greater length in a law review article. *See* Frank H. Easterbrook, *The State of Madison's Vision of the State*, 107 HARV. L. REV. 1328 (1994).

6. *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 419 (1956); Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 34 (1983).

tion even if they do not relocate their plants. Investors are even more mobile; they may elect to invest in firms from any state or even other nations. There are more than fifty domestic jurisdictions[7] and many more foreign ones from which to choose, and until recently the jurisdictions were not significantly limited in the choices they could offer. Finally, the effects of chartering are largely confined to the investors, who choose their particular investment vehicles. There are few spillovers, and even those are priced.

It is no surprise that good evidence demonstrates that federalism promotes economic efficiency and growth. Roberta Romano expands on this in a wonderful short volume that the Federalist Society published about twenty years ago.[8] Daniel Fischel and I also discuss it in our monograph on corporate and securities law.[9] Banking law largely works the same way as corporate law. State-chartered banks compete nationally, and the rights of customers depend on the law of each bank's home state.[10] The benefits of competition follow from federalism.

Since Professor Romano wrote her volume, however, the domain over which states may compete has shrunk. Congress has begun to enact laws controlling how firms must be organized: how boards are elected, who may be on the board, what committees it may have, and many other details. The Sarbanes-Oxley Act, now a decade old, is full of these rules. Ironically, given its genesis as a reaction to Enron and other scandals, the terms of this statute require every corporation that engages in interstate commerce to be governed just like Enron—which had a majority independent board, an "independent" compensation committee, and met the Act's other requirements.[11] The economic effect of Sarbanes-Oxley was negative.

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7. The States, the District of Columbia, Puerto Rico, the Virgin Islands, and Guam all offer different combinations of corporate and financial law.

8. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

9. DANIEL R. FISCHEL & FRANK H. EASTERBROOK, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

10. *See, e.g.*, Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 310 (1978).

11. *See, e.g.*, ENRON CORP., ENRON ANNUAL REPORT 54–55, *available at* http://picker.uchicago.edu/Enron/EnronAnnualReport2000.pdf (listing eighteen board members, only four of whom held positions with Enron); *see also* Jennifer Schaller, *Almost Ten Years After the Enron Meltdown*, NAT'L L. REV. (July 7, 2010).

When the national government specifies details of corporate organization, the competitive model of federalism falls apart and we can get a real race to the bottom.[12] Yet Congress has continued legislating in this field. Dodd-Frank is a major recent addition to the list of federal controls that stifle jurisdictional competition.

States can't harm investors because, if states make bad laws, capital migrates elsewhere. Managers can't do much harm either; if they make mistakes (whether in selecting governance rules or in running their firms) capital migrates elsewhere. Letting bankruptcy and the criminal law take care of folly, theft, and fraud, while allowing investors freedom of contract to specify governance structures, is the formula for long-run wealth. Capital is highly mobile, as are governance structures, even when physical assets and labor are immobile. The internal-affairs doctrine, coupled with the Constitution's Commerce Clause, prevents states from discriminating against firms that move their governance elsewhere. But it is much harder to remove capital from the United States as a whole, and this country does not recognize an internal-affairs doctrine in its dealings with other nations. We insist that U.S. law govern securities traded here. If Congress makes a mistake, it is not automatically undercut by market forces. Having negated the principal means by which interest groups' rent-seeking is undercut, the United States has set itself up for the exploitation of investors at the national level.

I think that this reduction of federalism is much more significant for the long-run economy than are recent developments in health care—for federalism in health care was a lost cause long before the Affordable Care Act.

Competition among the States in health care, and healthcare payments, is possible. Insurance policies could be regulated just like corporate charters—which is to say, by the issuing state. Insurers based in Wisconsin could offer different options from those offered by insurers based in Massachusetts or Arizona. Congress set the stage for this in the McCarran-Ferguson

12. *See* Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685 (2009).

Act,[13] which provides that state law supersedes federal law on the topic of insurance, unless the federal law expressly governs. But the States themselves blocked competition. Most states insist that their domestic law govern all insurance policies—not just that Virginia law apply to policies issued to Virginia residents, even if the issuer is located in Missouri, but also that the issuer get advance permission from Virginia to sell the policy at all. So much for competition.

The States also took the bait offered via Medicaid. In exchange for a subsidy, they agreed to let the national government set the rules for medical care covering a large segment of the population. And having done that, the States not only cancelled the benefits of federalism but also gave people strong incentives not to carry insurance. Just as with disaster relief, not planning for the future is rewarded by a federal subsidy.

While the States and Medicaid jointly took federalism out of the picture, the federal government legislated extra restrictions. Think only of tax law and ERISA. Tax law gives a big advantage to health care provided as a fringe benefit of employment, because the cost is excluded from taxable income. The tax rules affect what sort of benefits can be offered and thoroughly warp incentives about what kind of insurance to buy, and whether to insure at all. ERISA regulated welfare-benefit plans, and workers' health insurance is a welfare-benefit plan. So competition was constrained long before the Affordable Care Act.

These aspects of federal control also show how insignificant the deep constitutional arguments were. The national government could have used plenty of levers had the Supreme Court ruled differently last June. The lawsuits were about politics—about the fact that the bill could not pass a second time with adjustments made to change the nature of the federal power asserted—rather than about federal versus state authority as a foundational issue.

Moral: If states want federalism, they must respect the rules of competition. When, as with insurance, the States themselves defeat competition, they must expect the national government to take over.

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13. 15 U.S.C. §§ 1011–1015.