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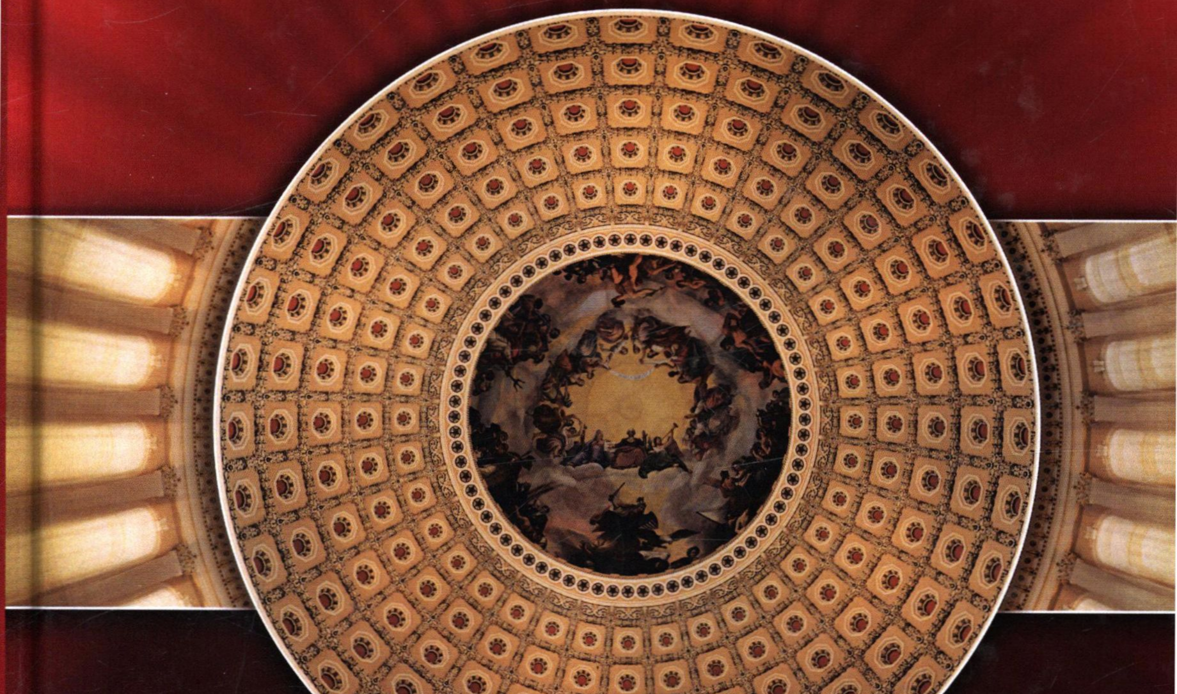
Jonathan Klick

THE LAW AND ECONOMICS OF FEDERALISM



THE LAW AND ECONOMICS OF FEDERALISM

This collection of specially commissioned chapters takes one of the oldest theoretical approaches on federalism in the law and puts it in the service of the new empirically minded law and economics. A federalist structure, at least in principle, allows for quasi-experimental examinations and evaluations of the effects of various policies that would be more difficult in unitary systems. Although legal scholars have talked about this topic for decades, rarely has the law and economics literature treated federalism empirically in such a systematic and useful way.

The Law and Economics of Federalism begins with a generalized discussion of US federalism in the environmental context and in social welfare programs. Additionally, new empirical work is provided on the effect of state regulations on entrepreneurism, consumer protection law and crime policies. Expert contributors then turn to an analysis of inter-jurisdictional arrangements on the development of Native American communities, as well as the interplay among the levels of government on budgetary issues. Lastly, the book addresses the notable dearth of empirical analysis of federalism in the EU with an illuminating analysis of the EU's institutional background that will spur comparable empirical work in the future.

This unique study offers valuable insights on federalism that will be welcomed by students and academics in law and economics. The innovative proposals on federalism as a vehicle for the empirical identification of policy effects will be of great interest to policymakers.

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The Law and Economics of Federalism

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Introduction: law and economics of federalism

Jonathan Klick

The economic theory of federalism has been well discussed through the years. Wallace Oates (1972) largely started the systematic study of economic federalism, from both normative and positive perspectives, and the subsequent fiscal federalism literature is well developed.[1] The basic theoretical framework involves the recognition that there is preference heterogeneity across jurisdictions (which can affect the optimal level of public good provision) pushing in favor of smaller decision-making units, balanced by the possibility that cross-jurisdictional externalities exist as well as the potential gains from scale economies in production. The optimal system, then, is one that sets the marginal loss from increasing the jurisdictional level at which decisions regarding a public good are made equal to the gain achieved by internalizing jurisdictional externalities and exploiting economies of scale. The so-called decentralization or subsidiarity principle embodies this trade-off.

Subsequent economic discussions of federalism have included their political economy aspects (see, for example, Inman and Rubinfeld 1997 and Weingast 2009), including analyses from a constitutional economics perspective (Mueller 1996; Buchanan 2001). Legal scholars have used the economic model of federalism, but have also critiqued it for failing to recognize important practical limitations, such as a failure to distinguish between regulatory and fiscal federalism (see, for example, Super 2005). Beyond these criticisms, legal scholars have distinguished among cooperative and competitive federalism, as well as "uncooperative federalism" (Bulman-Pozen and Gerken 2009). All of these models and perspectives help to elucidate the ways that various levels of government interact, making the normative prescriptions somewhat more complicated than the decentralization principle would otherwise suggest.

While the literatures, in economics and law, on federalism are vibrant,

1 For overviews, see Oates (1999, 2005) and Inman and Rubinfeld (forthcoming).

insightful, and challenging, they have been well covered in collections like this previously.[2] Instead, in this collection, the focus is on using federalism as a vehicle for the empirical identification of policy effects. In some sense, this collection takes one of the oldest theoretical takes on federalism in the law and puts it in the service of the new empirically minded law and economics. In 1932, in the case *New State Ice Co. v. Liebmann*, Justice Louis Brandeis famously stated "[a] state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[3]

It is through state experimentation that we have learned much of what we know regarding the effects of many policies. A federalist structure, at least in principle, allows for quasi-experimental examinations and evaluations of the effects of various policies that would be more difficult in unitary systems. Because the lower level jurisdictions share much in common with each other (since all are affected by identical federal laws) they potentially serve as decent counterfactual comparisons for each other when one engages in a policy experiment. Further, the existence of instances where the federal government steps in (e.g., through the passage of a binding national law or the preemption of the law of the lower jurisdiction) plausibly creates additional policy variation that may be conditionally random, allowing for the credible identification of causal effects.

Such an approach has been used to examine laws in the US states for at least two decades. In the chapters that follow, there is a generalized discussion of much of this work in the environmental context (Fleck and Hanssen) and social welfare programs (Gelbach; Bitler and Zavodny). Additionally, largely new empirical work is provided on the effect of state regulations on entrepreneurism (Sobel and Dove), consumer protection law (Wright), and crime policies (Owens). This volume also provides an analysis of inter-jurisdictional arrangements on the development of Native American communities (Anderson and Parker), as well as the interplay among the levels of government when it comes to budgetary issues (Galle). Lastly, because this kind of empirical work is under-developed in the European Union, this volume provides institutional background for the way the effectively federalist system works in Europe with some discussion of issues that hopefully spur comparable empirical work in that context.

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2 See, for example, Kobayashi and Ribstein (2007), Ahmad and Brosio (2006), Oates (1998), etc.

3 *New State Ice Co. v. Liebmann*, 285 U.S. 262 (1932).

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Contents

1. Congressional control of state taxation: evidence and lessons for federalism theory

Brian Galle*

INTRODUCTION

Theories of the "political safeguards" of U.S. federalism have frequently been aired but seldom tested. The basic claim, beginning with Wechsler (1954), is that state influence is sufficient to preserve state autonomy from federal encroachments. For example, Kramer (2000) argues that the dependence of federal officials on state party support gives state officials bargaining leverage to fend off incursions (see also Choper 1980, La Pierre 1985, Rubin & Feeley 1994, Dana 1995). Critics counter that state autonomy as a whole is a public good, such that officials may have little incentive to exercise whatever influence they hold, and so only courts can adequately ensure that states in the long run will retain independence from federal control (Derthick 1986, Baker & Young 2002, McGinnis & Somin 2004).[1] Others accept Wechsler's and Kramer's claims only partially, arguing that one or more of the branches of federal government are more or less apt to respect state autonomy (Mendelson 2004, Nzelibe 2006, Metzger 2008, Sharkey 2008, Pursley 2010).

In a parallel debate, commentators also disagree over which federal institution should be responsible for ensuring a free flow of trade among the states. In the current U.S. arrangement, courts and Congress share power, with Congress holding final say. Courts fill in interstitially, striking

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[1] For extended discussion of this argument and exploration of the instances in which autonomy would not represent a public good, see Galle & Seidenfeld (2008) and Galle (2008).

down sub-national taxes and regulations that discriminate against interstate commerce. Since at least the 1950s, however, the Court has urged Congress to assume more responsibility for reviewing state taxation. In recent decades the Court has seemed to take steps to force Congress to do so. And prominent scholars have suggested retreat from or wholesale abandonment of federal judicial oversight of state taxes (Redish & Nugent 1987, Zelinsky 2002).

This chapter breaks from the existing literature by offering quantitative evidence of how Congress has actually used its authority to regulate state taxing power.[2] Utilizing a hand-collected dataset of every federal statute affecting state power to tax since the beginning of the republic—though only a handful predate the 20th century—I analyze what features, conditional on enactment, characterize congressional behavior in this area. I find that when Congress acts, it tends to reduce rather than expand

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[2] Several earlier authors examine the evidence on the safeguards hypothesis, but their efforts are purely qualitative, generally consisting of the historical background of one or two statutes (Lee 1988, Dinan 1997, Hamilton 2001, Pickerill 2004, Jones 2004, Resnik 2008, Dinan 2009). Bowman & Krause (2003:302) lament this state of affairs. Frymer & Yoon (2002) also present qualitative descriptions of the sources of funding for modern political parties, which they argue bears on the Kramer hypothesis. Jenkins & Roscoe (2014) find evidence that local party activity affects national party success, a key assumption of the political safeguards theory, but they do not connect these findings to congressional behavior. Kam and Mikos (2007) present a quantitative study of voter attitudes towards federalism, but similarly do not observe legislative outcomes. There is a somewhat more extensive literature examining the determinants of *judicial* federalism decisions (e.g., Cross & Tiller 2000, Joondeph 2003, Solberg & Lindquist 2006, Collins 2007); this chapter can be thought of as a congressional complement to those studies.

Perhaps the closest to an antecedent quantitative study is Nicholson-Crotty (2008), who reports that Congress proposes and enacts fewer pieces of state-autonomy-affecting legislation during election years. However, Nicholson-Crotty does not examine whether legislation is simply shifted from one year to another, so that his findings appear to speak only to the timing, rather than the volume, of congressional action. His results can be equally well explained by two competing hypotheses. On the one hand, legislation may decrease because of heightened state influence during crucial periods. Alternatively, federalism-type legislation may decrease because of opportunity costs: federalism legislation is less important, and creates fewer rents, than others, and so is shifted aside when stakes are higher. Only the first of these would support the political-safeguards hypothesis.

I do not mean to suggest that quantitative analysis is necessarily superior to qualitative efforts. Indeed, the quantitative analysis here necessarily must omit important details that may be critical to the outcome of any particular piece of attempted legislation. The point is only that this contribution differs from the existing literature in its wider focus on the commonalities across statutes.

state autonomy, except in the case of state power to tax Indian tribes and tribal resources. I also find that public-choice factors appear to play a significant role in congressional decisions: narrow, concentrated interests are considerably more likely to win relief from state taxes. Surprisingly, this tendency holds true even when there are potentially competing concentrated interests, although competition somewhat blunts the efficacy of special interests.

These findings arguably weigh against wholesale judicial retreat in both of the areas I have mentioned. On the state autonomy front, I cannot observe the statutes that failed to pass, so I cannot draw strong conclusions about whether "political safeguards" may suffice to defeat legislation in some or even most instances. I can, though, confirm empirically the theoretical prediction that safeguards are unlikely to be fully effective in the face of strongly opposed congressional self-interest. Prior qualitative observations of federal lawmaking have noted many instances where federal authority has appeared to expand but has not generally inquired whether these expansions might serve to enhance state autonomy in the long run. My quantitative approach allows me to control, to some extent, for that possibility, and so I argue that my evidence represents a useful advance over the current state of the literature.

In this respect I may provide support for current judicial practices, which allow many forms of congressional regulation of states but prohibit certain so-called "unfunded mandates." Likewise, it is a familiar point in the theoretical literature that political economy factors may lead to excessive federal legislation if the federal government is not obliged to incur significant costs for its decisions. (La Pierre 1985). In that situation, enacting or threatening legislation allows the federal actor to extract rents, but the costs of the legislation are largely externalized. My results help to confirm this pattern: when Congress regulates state taxation, it tends to enact statutes that pass costs on to others (i.e., reduce state taxing authority) while generating rewards for itself (taking credit for enacting a tax cut).

On the free-trade front, my evidence again casts some doubt on the wisdom of placing full authority in the hands of an unrestrained Congress. Here my own hypotheses were that Congress is a dubious caretaker of state taxing power, for two reasons. For one, as I have just explained—although the literature has not fully recognized it—congressional regulation of state taxes has exactly the political-economy structure of an unfunded mandate. For another, Congress and the States arguably compete over the same tax base, meaning that any reduction in state authority potentially results in less political resistance to congressional revenue-raising.

These hypotheses are not mutually exclusive, and indeed I find support for both. Again, I find that opportunities to extract rents from concentrated interest groups correlate highly with enactment of federal legislation reducing state taxing power. As for the second hypothesis, I note that Indian tribes and Indian tribal lands are, as the Constitution states, "not taxed" by the federal government. Congress therefore does not compete with the States for the opportunity to tax them. I find, accordingly, that Congress is considerably more permissive in its treatment of state efforts to tax the tribes, although I cannot entirely rule out the possibility that tribes are simply much worse than anyone else at lobbying Congress.

Part I of the chapter provides a brief overview of the legal context for my investigation. Part II reviews the prior literature, and offers several hypotheses about the expected dynamic between states and the Congress that regulates them. Part III explains my methodology, and Part IV reports the results. Part V offers interpretation and caveats.

I. LEGAL FRAMEWORK FOR FEDERAL CONTROL OF STATE TAXES AND TRADE

The U.S. Constitution grants overlapping taxing authority to states and the federal government. On the face of the Constitution the states' power is plenary, aside from bars on tariffs on imports and exports, and "dut[ies] of tonnage." The text also suggests that the federal government's taxing power is virtually unlimited, although until the enactment of the 16th Amendment in 1913 it imposed the burdensome procedural hurdle that all "direct" taxes had to be apportioned; "income" taxes now are exempt from that requirement. One other notable federal restriction is that the Constitution suggests that "Indians [are] not taxed" by the national government (U.S. Const. Art. I § 2).

At the same time, both courts and Congress have used federal authority to protect free trade among the states to modify state taxing power. Congress, of course, can "regulate Commerce ... among the several states, and with the Indian Tribes" (U.S. Const. Art. I § 8 cl.3). It has often used this power to alter the scope of state authority. For example, in ERISA, the Employee Retirement and Income Security Act of 1974, Congress invoked national uniformity to sweep aside all subnational regulation of employee benefit plans, including any efforts to tax such plans or their assets.

Even when Congress has stood still, the Supreme Court has defended free trade against perceived state threats. Beginning with Chief Justice Marshall's opinion striking down New York regulation of steam boats, in *Gibbons v. Ogden*, the Court has interpreted the constitutional grant of the power to regulate "Commerce" as also impliedly requiring a common