

The AEI Federalism Project

This Federalist Outlook is the first in a series of writings on contemporary federalism issues. Part of AEI's newly established Federalism Project, the Outlook will appear at intervals of four to eight weeks. The purpose of the Outlook, and that of the Federalism Project, is to make the case for constitutional, competitive federalism—that is, a federalism that limits the national government's powers and, in the vast realm beyond the national government's reach, compels the states to compete for their citizens' talents, assets, and affections.

Competitive federalism disappeared from American government over six decades ago, when the nationalist ambitions of the New Deal swamped the constitutional norms that sustain limited, federalist government. It may seem that federalism's revival is to be neither expected nor wished for. Federalism is about borders, and borders are disappearing in an age of enormous economic, social, and geographic mobility. Trillions of dollars jump political boundaries at the push of a button. Children in remote Turkish villages want to “be like Mike”—living testimony to global capitalism's awesome power to mow down cultural obstacles. Millions of Americans spend half their waking hours in cyberspace, a global forum where the prerogatives of the Mississippi state government rarely become an issue. In short, federalism looks fusty—the province of latent racists, pedantic social scientists, and opportunistic political campaign consultants who understand the power behind the rebel flag.

AEI's Federalism Project rests on the proposition that the trends that—at first sight—seem to render federalism irrelevant heighten its appeal and, to a considerable extent, the prospect for its revival. Future *Outlooks* will develop and defend this proposition and apply it to salient policy issues, from Internet taxes to controversial social regulations. This first *Outlook* explains the basic intuitions that guide our thinking about those issues.¹

Michael S. Greve is a resident scholar at the American Enterprise Institute.

Choice

Real, competitive federalism is not about “states' rights” or bureaucratic “devolution” to a lower level of government where other interest groups hold sway. Real federalism does not seek to empower states; rather, it seeks to discipline governments by forcing them to compete for citizens' business. Federalism enables citizens—in their various capacities as investors, businessmen, homeowners, workers, or parents—to vote with their feet and choose among competing jurisdictions, each offering a different mix of government services. In that manner, federalism attempts to replicate in politics the advantages of choice and competition that characterize private economic markets. Benefits include innovation, product differentiation, consumer choice, and the attendant disciplining effect on the governmental service providers.

The benefits of jurisdictional choice and competition are visible at all levels of government. Overtaxed New Yorkers shop in New Jersey; in turn, they induce New York to provide tax-free shopping days (after periodic car searches for New Jersey contraband in the Holland Tunnel proved unpopular). At the international level, the free flow of capital (and to some extent labor) has rewarded America's comparatively freewheeling economy, while punishing countries whose governments insist on pursuing collectivist experiments.

Robust state competition greatly enhances government discipline and service. Environmental regulation, labor laws, education, crime prevention, corporate governance, and securities transactions—perhaps even certain aspects of intellectual property and cyber law—all benefit from a properly functioning federalist system. Fifty competing jurisdictions vying for citizen and business allegiance are far preferable to a centralized, one-size-fits-all regime.

Mobility Matters

Jurisdictional competition rarely works with the awesome efficiency of market models that economists load onto their PowerPoints. Some governments are gluttons for punishment and defy all expectations: New York City sustained its appalling tax rates and labor regulations even as Fortune 500 companies fled in droves. Some private businesses, to be sure, also fail to adjust to consumer demands. But they go out of business, and governments do not. Citizens and businesses cannot exit obnoxious jurisdictions as consumers can switch their detergent brands.

The point is not perfection but the general tendency of the effect. The effect, moreover, is inversely related to exit costs: as private exit costs drop, government competition and its salutary effects increase. Mobility has increased dramatically over the centuries, and especially of late. Technological advances from cars to computers to the Internet have dramatically expanded and democratized citizen choice.

Far from rendering federalism obsolete, enhanced mobility and border-leaping technologies render it *more* appealing. The world is in some sense becoming smaller, and borders, more porous. That does not mean, however, that borders do not matter. As often as not, “world without borders” cant comes from government bureaucrats bent on depriving citizens of their one effective means of disciplining and controlling government. Stand-pat administrators are perfectly aware of the case for federalism: *a world without borders is a world without exits*. We need the exits.

Complexity

The world, responds the bureaucrat, has not just lost its borders. It has also become *complex and interdependent*.

National problems demand national solutions. International problems demand a United Nations with teeth; global warming demands a Kyoto Protocol with claws. Like the mobility-and-borders argument, however, the complexity-and-interdependence argument cuts not against but for federalism, choice, and competition.³

Congressmen, one may presume, can generally manage their tool sheds—provided they do so one at a time, each his own shed. If they seem less competent at legislating, that is largely so because the central, collective optimization of social outputs over a vast array of complex, interdependent, uncontrollable activities is impossible. As complexities and interdependencies mount, so do the learning costs and the rigidities attendant to centralized schemes. The law of unintended consequences hits hard.

We do not know what we should do when we do not know what we are doing. Not doing it all at once and in every place seems a good first approximation. National problems do not automatically demand national solutions; instead, they demand a variety of responses that will depend on local tastes, preferences, and circumstances. (Potholes are a “national problem,” but why should we prefer a national solution to remedies by local jurisdictions with directly affected citizens?) Even in instances in which a uniform solution seems sensible, it is often best to allow that solution to emerge gradually, under conditions of competition. Process can be quite instructive.

Look at the country—or for that matter the world—as one vast commons, and *nothing* can be solved or managed. The sensible response to a complex and interdependent world is to carve it into smaller, more manageable, *competing* jurisdictions.

Competition Rules

Competition comes in several forms—some good, some bad. Tariffs are a form of jurisdictional competition, but not one that is particularly attractive. (That is the reason the Constitution prohibits state tariffs, imposts, and duties and permits Congress, under the Commerce Clause, to regulate interstate commerce.) Ensuring proper competition depends on getting the rules of the game right. That can be tricky business.

Let credit card transactions be governed by the laws of the customers’ various home states, for example, and banks will have to comply with fifty regulatory regimes that “protect” some consumers and, in the process, freeze

many others out of credit markets. That is a poorly operating system. Let the same transactions, instead, be governed by the card issuer's home state: states will compete for the banks' business, and banks will migrate to states that provide favorable business conditions. Each bank's interstate transactions will be governed by one set of rules, and credit will become available to millions of previously ineligible consumers.⁴

Make states bear the full costs of their regulatory experiments, and they will have to consider whether the benefits are worth the cost (including the cost of losing productive citizens and businesses to their neighbors). Let states export the costs of those experiments by imposing them on outsiders, and each state will race to beggar its neighbors before getting beggared by them. Modern product liability law is a splendid example: since the rules of the game permit plaintiffs to choose jurisdiction, manufacturers can be hauled into every state court in the country (regardless of where the company itself resides), and each in-state judge and jury will loot out-of-state firms. Change the rules—say, by allowing an *ex ante* choice of jurisdiction by contract between buyers and sellers—and firms and customers would sort themselves into civilized jurisdictions.

Those, arguably, are *easy* cases. Some of the hard ones spring readily to mind. What if a local police regulation—say, a meat inspection law—effectively excludes outside firms from competing? What if jurisdictions start to export undesired activities or individuals? (Antivagrancy laws generate a flourishing “trade” in hobos.) When states or cities compete by doling out subsidies to billionaire sports team owners, is that healthy competition or a destructive “race to the bottom”? Which issues are matters of legitimate consumer preferences (that can be safely left to citizen choice and state competition), and which ones are so fundamental that we should not permit choice and competition? (Slavery, yes. But what, say, of abortion?)

Many of the hard cases are important and intellectually interesting. But fascination (or frustration) here should not drive one's general perspective. First, even hard cases have answers. There once was a debate on whether corporate chartering should be left to states or should instead be committed to the tender mercies of Congress. Academic research on the huge efficiencies of corporate law as a competitive legal product—much of it conducted under AEI's auspices—settled that debate.⁵

Second, and more fundamentally, the true test of legal and institutional rules is not whether some of the hard cases go wrong; that will be the case under any set of rules. The true test is whether the easy cases are settled satisfactorily. Figure out the rules for straightforward applications of competitive federalism, and leave the hard cases to one side. First steps are an important achievement.

Hope Springs

Even the intellectually easy federalism cases often prove politically difficult. Democratic government, as Alexis de Tocqueville and Max Weber knew, tends toward political centralization. Centralization has been attributed to a number of powerful forces. Democratic peoples are naturally predisposed to centralization, observed Tocqueville, since they are impatient with imperfections and always eager to impose their own ambitions. The complexities of a modern society demand more rational government, observed Weber, and result in centralized control. Wars and emergencies induce massive and effectively irreversible government mobilization. Ideologues press for central schemes. Interest groups seek, through and from government, special benefits that are paid by a great mass of largely indifferent citizens and taxpayers. That too, pushes toward centralization, both because the costs of interest group schemes can be spread over a larger population of losers and because centralization prevents the losers from voting with their feet. A plausible theory of—and any plausible project on—competitive federalism must chart a way around those obstacles.

The forces of centralization are undeniable. Centralizing interests and energies, however, do not have the unalterable force of gravity. If centralizing forces operated *always*, under all conditions, we could not explain incidents of decentralization. But such incidents happen. Great Britain dismantled the national institutions it had created to fight World War I. Here at home, the United States partially denationalized welfare with results that were dared not dreamed of by reform advocates.

Three large factors provide reasonable hope for competitive federalism. One of them is the U.S. Supreme Court. Another is the rapidly changing economic landscape. A third is the mobilization of civic discontent with rigid central schemes.

Judicial Federalism

The U.S. Supreme Court has reasserted certain constitutional principles. Federalism has been the Rehnquist Court's principal theme from the 1995 *United States v. Lopez* to the May 2000 *United States v. Morrison*, where the justices ruled that nothing in the Constitution authorizes Congress to enact a federal remedy for "gender-based" violence. During the current term, the Court determined that residential arson, despite government arguments to the contrary, is *not* a federal crime; further, nude dancing, once thought to be a nationally protected right, is the proper stuff of local regulation. That trend shows no signs of abating: the justices have agreed to rule, next term, on the limits of congressional power in the area of environmental regulation.

The Supreme Court's enthusiasm for federalism matters for one central reason: without constitutional, judicially enforced limits on national power, Congress will assume omnipotence and (in a famous phrase of the *Federalist Papers*) draw all power into its "impetuous vortex." We know this because we have observed it. The fate of the New Deal Court is an object lesson in what happens when judicial checks are thwarted. The Court abandoned constitutional rules after 1937 that it is only now beginning to rediscover.

The thought that the Supreme Court should play a central role in the federalist scheme of things is unsettling—to liberals, for instance, who need a nationalist jurisprudence to accompany their nationalist ambitions. It is no less disturbing to conservatives who only yesterday wished to let 1,000 Court-curbing measures bloom. Court leadership in this area is itself paradoxical, for it entrusts federalism's protection to the institution that is, by design, the most nationalist of the branches of government. (The states have no role in the Supreme Court's composition. Why should the Court take account of their concerns?) It is also fair to say that the modern Supreme Court's federalism has, so far at least, had little practical effect. It may also prove unsustainable, should it endanger federal laws that enjoy broad support among the public and among powerful political interests.

Court activity is not a cure-all for the government problems that ail us. The Court has, however, reintroduced federalism as a subject of serious debate among scholars, journalists, activists, and politicians. The jus-

tics have helped create an intellectual and political environment in which competitive federalism proposals receive serious consideration.

The New Economy

Rapid and pervasive changes in technology and economic organization tend to shake up existing political coalitions and institutions and thus provide opportunities to institutionalize competitive political arrangements. Unlike well-established industries that have learned to live with—and have acquired a stake in—centralized regulatory regimes, new industries (or old industries trying to reinvent themselves) will often find it in their interest to defend legal and regulatory regimes that protect exit rights.

By way of example, Christopher C. DeMuth, AEI's president, suggested in his Francis Boyer lecture earlier this year, in the midst of a heated debate over Internet taxes, that interstate "sales taxes should apply to sellers rather than customers. . . . Washington State would be free to tax all of the sales of Amazon.com as well as those of local bookstores—but Amazon would be free to locate in another state with a lower tax."⁶ The DeMuth proposal would substitute state and local tax competition for the existing, depression-era sales tax regime, under which every state and local jurisdiction imposes tax collection obligations on outside businesses that have a presence within its borders. Among the irrationalities of that sales tax cartel is the fact that only ordinary retailers with a physical presence can be subjected to the obligation to collect tax, whereas e-commerce sellers cannot. The rapid growth of e-commerce has led to a rising chorus of complaints from brick-and-mortar sellers, and that has, in turn, created a political opening for the DeMuth suggestion to reform the taxation of all interstate sales.

To recognize the liberating potential of new technologies is not to subscribe to a kind of reverse techno-Marxism. Political cartels do not crumble because some pony-tailed nineteen-year-old invents a new cyber gadget. The pathways from technological and economic changes to political competition are more complicated, and innovations often create new, hard-to-resist demands for increased centralization. It remains true, nonetheless, that the New Economy makes competitive federalism more plausible and ben-

eficial. It also, in the long run, will enhance the prospects for the revival of competitive federalism.

Civic Discontent

Democratic sentiments, Tocqueville observed, produce centralized government. Tocqueville also noted, however, that centralization produces a public sentiment that cuts in the opposite direction—namely, public unease. At present, there is an undercurrent of impatience with governmental regimentation. Over the past three decades, public disaffection has accompanied the growth of national power. Government secures public support by promising the impossible. (“Totally clean air everywhere—tomorrow!”) It then fails to deliver, promises more, and fails again. As the national government becomes progressively unwieldy and meddlesome, citizens become progressively disenchanted.

Disaffection does not automatically translate into support for decentralized, competitive institutions. Over the past two decades, however, public discontent has become organized, and it has found institutional venues alongside and competing with the drab fare offered up by government monopolies.

Education is the most obvious example. More than a million children are now being schooled at home, and their parents expect little from government except that it stay out of the way. Many more children are enrolled in private and parochial schools. Parents are not looking to transform the U.S. Department of Education into Voucher Central. What they and their allies desire instead is the freedom to run experiments from Milwaukee to Cleveland to Florida. Having gained that ground, they will be loath to surrender it. Competitive federalism has found a real political constituency through education reform, and its attraction will ultimately be seen in other areas. Exit rights *do* matter, and competition in a wide range of areas produces economic and social solutions.

The Federalism Project

To many, it may seem unrealistic to expect resistance to, never mind a reversal of, pervasive centralization. Real federalism will not come easily. But procompetitive changes in the legal, technological, economic, and social landscape are real. Moreover, they overlap in complicated

and potentially useful ways. While traditionalist parents are concerned about Internet pornography, the Net is *also* the medium of choice for a burgeoning home school culture. This means that on some regulatory issues, evangelicals will fight alongside the nose-ring brigades against central controls. Corporations and their lawyers and lobbyists have ignored, and occasionally opposed, the Supreme Court’s federalism. But let some corporation win the first environmental case on constitutional grounds, and corporate indifference or hostility to legal “ideologues” will give way to a more nuanced appreciation. Once corporate America rediscovers the virtues of competitive federalism in a legal case, it may translate that discovery into a legislative context.

American political history abounds with hopeful predictions of a federalist revival. None of them has been realized. But many things have changed. Those changes provide reason for hope and opportunities to make the case, once more, for competitive federalism.

Notes

1. Conventional wisdom is that federalism is somehow archaic and irrelevant. As a first cut, it is worth trying to counter that sense at a general and intuitive level. For a fuller and referenced version of the argument for competitive federalism, see Michael S. Greve, *Real Federalism: Why It Matters, How It Could Happen* (AEI Press, 1999) (available for sale at www.aei.org/shop1/shops/1/p-r.htm and 800.937.5557).

2. These dynamics often induce nation-states to seek refuge in multilateral arrangements that, while sailing under the banner of “liberalization” and “harmonization,” amount to political cartels—as when Germany works to fortify the European Community in an effort to export its bureaucracy along with its beer. Similar efforts among the American states will be the subject of an upcoming *Outlook*.

3. For a useful discussion of this argument, see Richard A. Epstein, *Simple Rules for a Complex World* (Harvard University Press, 1995).

4. That actually happened. See Christopher C. DeMuth, “The Case against Credit Card Interest Regulation,” *Yale Journal on Regulation*, vol. 3 (1986), p. 201.

5. See Roberta Romano, *The Genius of American Corporate Law* (AEI Press, 1993).

6. Christopher C. DeMuth, “After the Ascent: Politics and Government in the Super-Affluent Society.” The address is available on AEI’s website: www.aei.org/boyer/demuth.htm.