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INTERSTATE COMPETITION AND THE RACE TO THE TOP

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Federalism is an essential part of the Constitution's design. The division of sovereign power between the States and the federal government helps foster interjurisdictional competition, which, in turn, checks government power.¹ Provided a right of exit is maintained, the excessive imposition of economic burdens in one jurisdiction will cause taxpayers and businesses to flee to other jurisdictions. For this reason, federalism often is seen as a friend of the free market.² The existence of competing jurisdictions disciplines state intervention in the marketplace.³ But it would be a mistake to assume that interjurisdictional competition invariably favors market-oriented policies, at least insofar as alternative policy measures would enhance the welfare of state residents. Federalism is not just for free marketeers.

Provided states cannot externalize the costs of their own policy choices, robust interjurisdictional competition facilitates the enactment of better public policy at the state level.⁴ Rather than inducing a "race to the bottom," such competition can create a race toward the top.⁵ Although those of us who generally favor freer markets believe federalism will advance that cause, those who believe more stringent regulation is welfare-enhancing should support interjurisdictional competition too. On both theoretical

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1. For sources discussing the benefits of interjurisdictional competition, see Jonathan Rodden & Susan Rose-Ackerman, *Does Federalism Preserve Markets?*, 83 VA. L. REV. 1521, 1530 n.45 (1997).

2. See generally Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1 (1995).

3. See *id.* at 5.

4. See *id.* at 5–6.

5. See *id.*

and empirical grounds, competition among jurisdictions is a powerful means to discover and promote the policies that are most effective at providing people with what they desire.

Other participants in this Symposium have discussed whether the U.S. Constitution embodies a particular economic theory. Even if the Constitution does not implicitly endorse free enterprise, it embodies an understanding of the nature of government power in economic terms. Specifically, the Constitution embodies the theory that dividing and structuring the government will discipline and channel the exercise of sovereign power for the people's benefit. This theory of political economy recognizes that government officials are economic actors and that governmental institutions will respond to economic incentives. In response, James Madison thought it necessary to set faction against faction,⁶ and the Framers created checks and balances between and among the coordinate branches of the federal government.⁷ Many believed that a system of dual sovereignty would provide a double security to the people and their liberty.⁸

In the case of federalism, the Constitution's structure is quite instructive. The Constitution creates a federal government of limited and enumerated powers that are expressly set forth, largely in article I, section 8.⁹ All powers not granted to the federal government are reserved to the States or to the people.¹⁰ The States, on the other hand, are not so limited—at least not by the federal Constitution.¹¹ Federal constitutional limitations

6. See THE FEDERALIST NO. 10 (James Madison).

7. See THE FEDERALIST NO. 47 (James Madison).

8. See THE FEDERALIST NO. 51, at 323 (James Madison) (Clinton Rossiter ed., 1961) ("In the compound republic of America, the power surrendered by the people, is first divided between two distinct governments, and then the portion allotted to each, subdivided among distinct and separate departments. Hence a double security arises to the rights of the people. The different governments will control each other; at the same time that each will be controlled by itself.").

9. U.S. CONST. art. I, § 8.

10. U.S. CONST. amend. X ("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."). This Amendment merely restated what was implicit in the delegation of enumerated powers in Article I. See *New York v. United States*, 505 U.S. 144, 156 (1992) (noting "the Tenth Amendment 'states but a truism that all is retained which has not been surrendered'" (citation omitted)).

11. State governments may be subject to further restrictions under their respective state constitutions.

on states—like federal powers—are limited, and these limitations are imposed against a background of reserved power. For purposes of the federal Constitution, states possess a plenary police power that can extend to any matter not precluded by federal law.¹² As a result, the federal government has the power to reach only a limited set of issues and concerns, while a near infinite set of all else remains. Even under current Supreme Court doctrine, federal jurisdiction is authorized only in a defined set of areas, even if we may argue about how limited or discrete those areas are.

This structure creates a presumption that states have the power to address a given policy concern unless the Constitution has given the federal government the express power to intervene. This structural presumption makes sense not merely as a constitutional matter, but also as a policy matter. That is, we should presume that state governments should handle policy questions unless there is reason to believe that federal intervention is necessary. Just as Congress should be able to point to an enumerated power to justify any federal action, we should hope that our policymakers can identify some reason why states are incapable of addressing a particular problem before calling for federal intervention.

This presumption not only aligns with our constitutional structure but also creates institutional incentives that aid the development of better public policy. The benefits of decentralization in policymaking, particularly in economic policymaking, are quite large.¹³ Among other things, the possibility that taxpayers or businesses may exit the state disciplines jurisdictions and discourages the adoption of excessive tax or regulatory burdens.¹⁴ Moreover, interjurisdictional competition can also discourage states from taxing or regulating too little. Just as taxpayers and business investment may flee jurisdictions that impose excessive tax burdens, they may also flee jurisdictions that fail to provide adequate infrastructure or environmental

12. See generally Santiago Legarre, *The Historical Background of the Police Power*, 9 U. PA. J. CONST. L. 745 (2007).

13. See Weingast, *supra* note 2, at 8–9 (discussing growth in the United States as partially attributable to decentralization).

14. See, e.g., Christopher Wills, *Neighboring States Gleeeful over Illinois Tax Increase*, CNSNEWS.COM, Jan. 13, 2011, <http://www.cnsnews.com/news/article/neighboring-states-gleeful-over-illinois-tax-increase>.

protection. Thus, the pressures interjurisdictional competition creates do not all push in one direction. They generally discourage states from adopting policies that are suboptimal and fail to enhance the welfare of the residents of that jurisdiction.

Interjurisdictional competition is but one benefit that flows from federalism. Decentralizing authority over various policy matters also leaves states free to account for regional variation. Differences in geography, climate, and local demographics can influence—if not determine—what sorts of policies best fit a given part of the country. At the same time, voter preferences may vary substantially from state to state. The United States is an incredibly diverse country, and those policies that best fit one part of the country may not be the best fit everywhere else.

In the environmental context, for example, ground-level ozone pollution is a problem in many cities around the country.¹⁵ The general chemical processes that lead to ground-level ozone formation are the same from place to place. Yet, the exact nature of the ozone pollution problem—what causes it, the actual mix of activities that are contributing to it, and the sorts of controls or policies that can address and solve it—differs from New York to Los Angeles.¹⁶ Just as this mix of emission sources varies, so do local preferences about the relative desirability of, say, imposing greater limitations on automobiles as opposed to stationary sources.¹⁷ In some cases, measures that might reduce ozone levels in one part of the country might actually increase ozone levels somewhere else.¹⁸ A one-size-fits-all approach too often results in one policy that fits nobody well, particularly when we are dealing with more complex and variable problems, such as environmental protection.¹⁹

There are regional differences in knowledge about environmental problems as well. Those closest to a given environmental

15. See, e.g., NAT'L ACAD. OF SCI., *RETHINKING THE OZONE PROBLEM IN URBAN AND REGIONAL AIR POLLUTION* (1992).

16. See *id.* at 12.

17. See *id.* at 31.

18. *Id.* at 11 (“[Nitrogen oxide (NO_x)] reductions can have either a beneficial or detrimental effect on ozone concentrations, depending on the locations and emission rates of [volatile organic compound] and NO_x sources in a region.”).

19. See *id.* at 376 (“[T]he optimal set of controls . . . will vary from one place to the next.”). For a broader discussion of this point, see Jonathan H. Adler, *Jurisdictional Mismatch in Environmental Federalism*, 14 N.Y.U. ENVTL. L.J. 130, 137–39 (2005).

concern are more likely to recognize and understand it. Knowledge about the nature of a problem, what causes or contributes to it, or even its very existence tends to be local. The biggest problem that any centralized regulatory system faces is the “knowledge problem”: the difficulty of having enough knowledge in a centralized location to drive economic and regulatory decisionmaking.²⁰ For example, well-intentioned policies devised by experts in a federal regulatory agency might not translate well to a given local context, often because of the failure to account for local knowledge. Those same experts also might be unaware of what problems are, or should be, of greatest concern. In fact, in many policy areas, from workers’ compensation to environmental protection, local recognition of the problem and remedial efforts predated federal action.

In the case of wetlands regulation, local jurisdictions became aware of the need to conserve wetlands well before the federal government.²¹ Indeed, state and local governments began wetland conservation efforts at a time when the federal government still was subsidizing wetland destruction.²² Moreover, the pattern of state-level regulation was not what experts would have predicted. Those jurisdictions that some would have expected to regulate least and last in fact regulated first.²³ They did so, in all likelihood, because they were aware of the ecological and economic problems caused by wetland loss and were in a position to do something about it, even though federal regulators had yet to apply the Clean Water Act to wetland conservation.²⁴

20. See F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 519–20 (1945) (“[T]he knowledge of the circumstances of which we must make use never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.”).

21. This history is summarized in Jonathan H. Adler, *Wetlands, Waterfowl, and the Menace of Mr. Wilson: Commerce Clause Jurisprudence and the Limits of Federal Wetland Regulation*, 29 ENVTL. L. 1, 47–54 (1999).

22. The first state wetland conservation law was adopted by Massachusetts in 1963 and was based (in part) on preexisting local measures. *Id.* at 48. Federal policies that subsidized wetland destruction, such as flood control projects, continued well into the 1970s. See David E. Gerard, *Federal Flood Policies: 150 Years of Environmental Mischief*, in GOVERNMENT VS. ENVIRONMENT 59, 64 (Donald R. Leal & Roger E. Meiners eds., 2002); see also Jonathan H. Adler, *Judicial Federalism and the Future of Federal Environmental Regulation*, 90 IOWA L. REV. 377, 457 (2005) (summarizing other federal policies that subsidized or otherwise encouraged wetland destruction).

23. See Adler, *supra* note 21, at 49.

24. *Cf. id.* at 48–50.

Even if perfect federal intervention were more effective than a patchwork of state efforts, centralization still might not be desirable. Federal regulation rarely, if ever, matches the theoretical ideal. In assessing the desirability of federal intervention, we should focus on what the federal government is likely to do, not on some abstract notion of what the government would do in a perfect world.²⁵ In the case of wetlands, although a comprehensive federal wetlands protection statute might have been preferable to variable state regulation, the federal government never enacted such a law. The federal government began regulating the filling of wetlands only after a federal court interpreted the Clean Water Act to apply to wetlands,²⁶ and, since then, the regulation has been less than ideal.²⁷ Further, there are reasons to suspect that federal intervention discouraged further state-level regulatory innovation.²⁸

For years, the federal government acknowledged that regulators should consider ecological function when evaluating permit applications from landowners seeking to fill wetlands because the significance of losing or degrading a given wetland varies depending on the ecological functions that wetland provides.²⁹ Nonetheless, the federal government did little to incorporate such considerations into the permit application process. One empirical study found that in the process of reviewing wetland permit grants or denials, the government appeared to give almost no consideration to ecological function.³⁰ Several states, on the other hand, had acted. Even though state agencies supposedly lack the resources, skills, staff, and expertise to regulate

25. See Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1, 1 (1969) (noting the pervasiveness of the “nirvana approach” in which imperfect institutional arrangements are compared against an ideal, unachievable norm); see also Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 43 (1960) (noting the tendency to compare “a state of laissez faire and some kind of ideal world”).

26. See *NRDC v. Callaway*, 392 F. Supp. 685, 686 (D.D.C. 1975).

27. See Adler, *supra* note 21, at 62–66.

28. See Jonathan H. Adler, *When Is Two a Crowd? The Impact of Federal Action on State Environmental Regulation*, 31 HARV. ENVTL. L. REV. 67, 108–14 (2007).

29. In a different context, the government has instituted some incentive programs to ensure that wetlands perform desired ecological functions. See Adler, *supra* note 21, at 57–59.

30. See Michael J. Mortimer, *Irregular Regulation Under Section 404 of the Clean Water Act: Is the Congress or the Army Corps of Engineers to Blame?*, 13 J. ENVTL. L. & LITIG. 445, 468–70 (1998).

more effectively, several had already begun to incorporate ecological function into the wetland permitting process.³¹

Not only does decentralization enable policymakers to take advantage of localized information about policy problems and their potential solutions, but decentralization and interjurisdictional competition also foster policy discovery and policy entrepreneurship. Decentralization allows for states to act, in Justice Brandeis's famous characterization, as "laboratories of democracy."³² Different states may adopt different approaches to various public policy concerns, whether because of regional differences, variable preferences, or different expectations about the viability or practicality of competing policy approaches. State-level policy initiatives often are experiments from which others may learn. States learn from each others' successes and failures, fostering an iterative process through which state-level policy can improve over time.

Allowing state-level experimentation also reduces the risks of policy failures. When states try different things, all of the proverbial eggs are not in a single basket. If the policy succeeds, other states retain the ability to follow suit (as does the federal government, which has often modeled federal measures on successful state initiatives).³³ If the policy fails, however, only one jurisdiction must undo it, and others can learn to avoid such mistakes. This discovery process can be slow and messy, but the federal alternative—as it exists in practice—is no better.

Even though there is a strong case for presuming that decentralization is favorable, it is rebuttable. Leaving policy questions in state hands might be desirable more often than not, but in some instances there are persuasive justifications for federal intervention. Appropriate federal intervention can even reinforce the competitive dynamic across jurisdictions.

Perhaps the most compelling case for federal intervention is the existence of interstate spillovers, such as pollution gener-

31. See William E. Taylor & Dennis Magee, *Should All Wetlands Be Subject to the Same Regulation?*, 7 NAT. RESOURCES & ENV'T 32, 34 (1992) (reporting that approximately ten states had begun considering ecological function to classify wetlands in their regulatory schemes).

32. *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

33. A recent example of such a federal program is the Affordable Care Act. See Angie Drobic Holan, *RomneyCare & ObamaCare: Can you tell the difference?*, POLITIFACT.COM (May 18, 2011, 3:07 PM), <http://www.politifact.com/truth-o-meter/article/2011/may/18/romneycare-and-obamacare-can-you-tell-difference/>.

ated in one state that crosses into another.³⁴ If, for example, pollution generated in one state causes problems in another state, there is a case for federal action. Allowing such spillovers to exist undermines interjurisdictional competition because spillovers enable states to extraterritorialize the costs of their own policy decisions onto other jurisdictions.³⁵ In a truly competitive dynamic, on the other hand, each jurisdiction would bear the costs and reap the benefits of its own decisions.

Where there is a case for federal intervention, the form such intervention takes and whether the intervention improves the status quo are critical. It is one thing to force a state to internalize the costs of the spillover problems it creates. It is quite another to use the existence of spillovers to justify far-reaching national regulations that do not directly address such concerns. In the case of air pollution, for example, some downwind jurisdictions might not believe that federal regulation through the Clean Air Act is preferable to preexisting common law nuisance claims. In one recent case, the U.S. Court of Appeals for the Fourth Circuit found the federal Clean Air Act barred North Carolina, a downwind jurisdiction, from suing upwind polluters under federal common law.³⁶ The Clean Air Act's regulatory scheme displaces such suits, and yet the Act itself does not provide North Carolina with much meaningful relief.³⁷ More broadly, relatively little federal environmental regulation targets, let alone redresses, interstate spillover concerns.³⁸

Despite the problems inherent in federal regulation, one common justification is the fear that interjurisdictional competition will produce a "race to the bottom."³⁹ This theory posits that competition will induce states to adopt ever lower levels of regulation in pursuit of capital investment and that this "race"

34. See, e.g., Thomas W. Merrill, *Golden Rules for Transboundary Pollution*, 46 DUKE L.J. 931, 932 (1997) ("Given the inherent difficulties in regulation by any single state, transboundary pollution would seem to present a clear case for shifting regulatory authority from local to more centralized levels of governance.").

35. See Richard L. Revesz, *The Race to the Bottom and Federal Environmental Regulation: A Response to Critics*, 82 MINN. L. REV. 535, 541-42 (1997).

36. See *North Carolina ex rel. Cooper v. TVA*, 615 F.3d 291, 296 (4th Cir. 2010).

37. See Adler, *supra* note 28, at 162.

38. See *id.* at 162-63.

39. See, e.g., Scott R. Saleska & Kirsten H. Engel, "Facts Are Stubborn Things": An Empirical Reality Check in the Theoretical Debate Over the Race-to-the-Bottom in State Environmental Standard-Setting, 8 CORNELL J.L. & PUB. POL'Y 55, 55-86 (1998).

will leave all states worse off than they would have been had they not engaged in economic competition at the expense of other concerns.⁴⁰ The problem, however, is that the “race to the bottom” theory lacks much theoretical or empirical support.⁴¹

States certainly compete with each other to create a more favorable climate for business investment. But they also compete with each other to provide the mix of goods and services that individual taxpayers and prospective business employees might want.⁴² A state like Virginia, for instance, might seek to attract and retain a company like Smithfield Foods by adopting less punitive environmental regulations, but it simultaneously seeks to attract and retain businesses like AOL, which depend upon a highly educated, professional workforce that is likely to demand the provision of environmental amenities. Thus, competing for business does not necessarily push a state in a single direction, as states are competing across several planes at the same time. If anything, interjurisdictional competition creates substantial incentives for states to figure out how to lessen the tradeoff between otherwise competing demands—for instance, to achieve higher levels of environmental protection at lower cost—to attract firms and taxpayers across the board.

Empirical studies that seek to identify or quantify a “race to the bottom” have largely come up short. In the environmental area, for example, the available empirical evidence does not demonstrate that states are systematically adopting suboptimal levels of environmental protection.⁴³ To the contrary, evidence suggests, at least in those areas not dominated by federal intervention, that states learn from each other and move toward adopting superior environmental policies because of interactions with their neighbors.⁴⁴

Even in situations in which federal intervention might be justified, it can suppress interjurisdictional competition. This sup-

40. *See id.*

41. *See* Adler, *supra* note 28, at 151–54.

42. *See* Weingast, *supra* note 2, at 5.

43. *See* Adler, *supra* note 28, at 153–54.

44. *See, e.g.,* PAUL TESKE, REGULATION IN THE STATES 180–81, 191–92 (2004); Wallace E. Oates, *A Reconsideration of Environmental Federalism*, in RECENT ADVANCES IN ENVIRONMENTAL ECONOMICS 1, 15 (John A. List & Aart de Zeeuw eds., 2002) (“States appear to be ‘pulled’ to higher levels of abatement spending by more stringent measures in neighbouring states, but relatively lax regulations nearby appear to have no effect on such expenditures.”).

pression is self-evident where federal action preempts alternative state policies, but even non-preemptive federal intervention may dampen interjurisdictional competition and state-level experimentation.⁴⁵ Setting a federal floor, even a non-preemptive federal floor, can create a de facto ceiling on state efforts, thereby dampening the discovery process that results from state-level experimentation and interjurisdictional competition.⁴⁶ Therefore, calling for federal intervention—even intervention that is theoretically justifiable—does not result in some enlightened savior enacting ideal policy. Rather, the federal government is yet another imperfect institution with imperfect tools to address real problems. Thus, it is necessary to consider the reality of federal intervention, not its possible ideal. State governments are far from perfect, but that does not mean the federal government is better.

Although decentralization and interjurisdictional competition assist in the discovery and development of better public policy, they are not without their critics. Indeed, the States themselves are less-than-consistent defenders of federalism. As Adam Smith observed, one of the biggest threats to market competition is market participants themselves, because economic competitors tend to prefer profits to competition.⁴⁷ The same phenomenon is true in the context of interjurisdictional competition. States may like to maintain a degree of autonomy, but they do not necessarily like competing with one another. Just as businesspeople collaborate and conspire to cartelize industries, divvy up markets, and suppress competition, states often accept federal intervention that reduces state autonomy so long as it suppresses interjurisdictional competition.⁴⁸ States regularly seek federal policies that enable them to externalize the costs of their decisions or act to subsidize poor, yet popular, policy choices.⁴⁹

45. For an explanation of how non-preemptive federal regulation may discourage state regulation, see Adler, *supra* note 28, at 98–106.

46. *See id.*

47. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 160 (1776) (“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”).

48. *See generally* Michael S. Greve, *Against Cooperative Federalism*, 70 MISS. L.J. 557 (2000).

49. *See id.* at 559.

That the States themselves are fair-weather friends of federalism should not be surprising. Although federalism debates often focus on the role of the States, the federalist system was not created for the States' benefit.⁵⁰ Rather, the Constitution created the system of federalism to discipline the state and federal governments for the benefit of the people.⁵¹ As a consequence, it is ultimately up to the people to ensure that the system of federalism is maintained.

50. See John O. McGinnis & Ilya Somin, *Federalism vs. States' Rights: A Defense of Judicial Review in a Federal System*, 99 NW. U. L. REV. 89, 89, 92–93 (2004).

51. See *New York v. United States*, 505 U.S. 144, 181 (1992) (“The Constitution does not protect the sovereignty of States for the benefit of the States or state governments as abstract political entities, or even for the benefit of the public officials governing the States. To the contrary, the Constitution divides authority between federal and state governments for the protection of individuals.”).