Is the recent trend of expanding state regulation beneficial or harmful?

The New Role and Politics of State Regulation

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Four friends are having a drink after a think tank's annual meeting. Two are ideologically conservative scholars — she is a fan of as much deregulation as possible, he is an ardent states' rights advocate. The other two are businesspeople — she operates mainly in one state, he operates a nationwide, and increasingly international, firm. The topic of American state regulation comes up.

The deregulation scholar expresses disappointment with state regulators, arguing that, from trucking to insurance to telecommunications, they have not wanted to reduce their role. She wants more federal preemption of state regulation. Her scholarly colleague argues for more devolution — give the states time and they will be forced, via economic development competition, to find efficient policies, which include more deregulation. In any case, he adds, that is the appropriate level at which to address issues of intrastate commerce. The business leaders join in — she is happily dominating her state legislature and getting protective regulation. He is frustrated by varying regulatory policies across the states and by emerging activist attorneys general and other state policymakers.

Who is right? What do we really know about the politics and economics of state regulation, and the extent to which it supplements, substitutes, or otherwise interacts with federal regulation?

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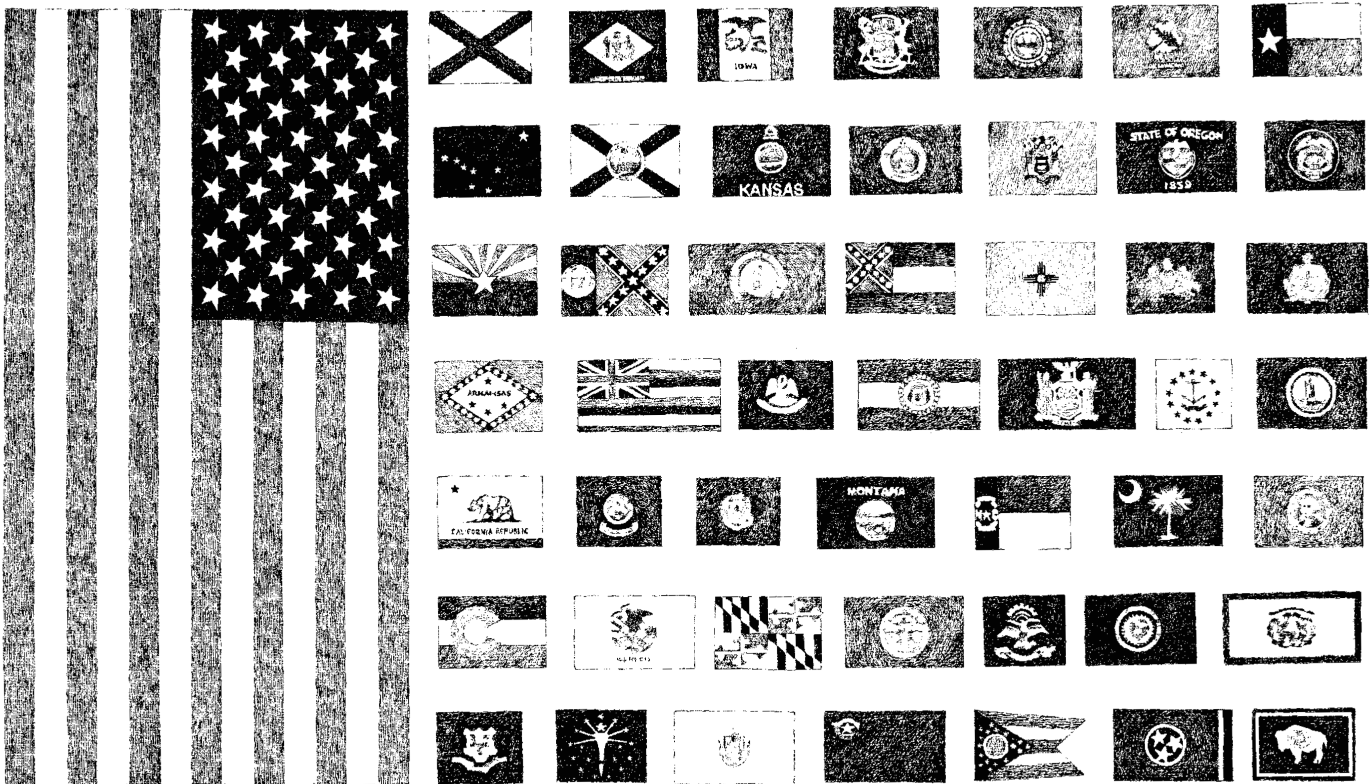
STATE REGULATION

State regulation has been around a long time, predating federal regulation (indeed, predating the federal government). Insurance and corporate charters were the first forms. In 1752, Pennsylvania granted a charter to Ben Franklin's Philadelphia Contributorship for the Insurance of Houses from Loss by Fire. Pennsylvania chartered the first stock insurance company in 1794. Even though the Civil War marked a major shift toward a greater federal role in the economy relative to the states, the states helped develop ideas about how to regulate the railroad industry, which provided the critical infrastructure for the development of national commerce. The 1890 Sherman Act is generally cited as the start of antitrust regulation, but 20 states had passed antitrust legislation before 1890. In the 20th century, states developed trucking regulation before the federal government. Prior to the Great Depression, most financial regulation took place at the state level. Texas initially won innovation awards for its 1962 decision to relax regulations on the investment choices of its savings and loans, an idea the federal government later adopted. California legislation on automobile emissions pushed forward national environmental regulations. Florida deregulated economic regulation of its intrastate trucking industry in 1980, the same year in which the federal government deregulated interstate trucking — both to great successes.

Thus, perhaps under many analysts' radar, state regulation is not a harmless anachronism from the 19th century. As much

as 20 percent of the American economy is regulated by the states, including elements of such critical industries as telecommunications, energy, insurance, and professions. Despite predictions to the contrary, it does not seem likely to fade away, either from state-vs.-state economic development competition or in the face of growing international trade.

Consider five 21st century state actions. In the area of monopoly and competition, determined state attorneys general from nine states resisted a proposed U.S. Department of Justice settlement of the Microsoft antitrust case. In occupational regulation, New Mexico became the first state to allow psychologists to prescribe medication, formerly permitted only to M.D. psychiatrists. Addressing asymmetric information problems in the wake of many Internet firm collapses and corporate accounting scandals, New York Attorney General Eliot Spitzer successfully sued Merrill Lynch, prompting much wider investigation of financial firms. Also dealing with information, seven state legislatures passed "do not call" laws against telemarketers, the popularity of which prompted the Bush administration's Federal Trade Commission chair Timothy Muris to develop a national rule limiting telemarketing that he admitted would not have been developed otherwise. Addressing the regulation of externalities, the California legislature passed an automobile emissions law aimed at reducing greenhouse gasses — an approach Congress rejected — that will likely force automobile manufacturers to alter the cars they sell across the United States because California is by far their largest market. Clearly, the states are actively applying regulatory solutions to an important range of perceived market failures.



MORGAN BALLARD

REASONS FOR AND AGAINST There are several strong theoretical reasons to continue to regulate at the state level. (See "Federalism and Regulation," Winter 2003.) States are closer to the businesses they regulate and can shape policies that better match the preferences of their citizens and businesses. State regulation provides a form of natural experimentation, which operated in railroad regulation in the 1860s, trucking regulation in the 1920s, airline regulation in the 1960s, telecommunications regulation in the 1980s, electricity deregulation in the 1990s, and perhaps in environmental regulation in this new century. Because states are, to some degree, in competition with one another for mobile, productive economic resources, they have incentives to regulate in efficient ways.

Scholars have also developed theoretical arguments against state regulation and in favor of a single federal regulatory regime. A single national regulatory policy, rather than 50 different state policies, promotes consistency and stability for firms competing in national (and international) markets. Regulation of some activities has impacts beyond a single state, which suggests a role for national regulation. For example, some scholars oppose state regulation of national corporate advertising campaigns because of extra-jurisdictional impacts. National regulators may also be better able than individual states, especially small states, to marshal the necessary analytic and oversight resources for complicated regulatory decisions and enforcement, as with scientific issues. Finally, many still perceive national regulation to be less susceptible to extreme interest group capture than state regulation, as a wider range of interest groups are active in Washington, D.C., than in most state capitals.

Although the Constitution only explicitly authorizes federal regulation with regard to interstate commerce, in today's complex financial environment, that characterizes most major industries. It is quite difficult to distinguish truly intrastate commerce. Still, as much for historical and politi-

cal reasons as jurisdictional justification, in 2004 states retain their role as the only regulators of such business activities as corporate chartering, insurance, workers compensation, and occupational licensing. States share some regulation with the federal government, usually along the intrastate/interstate geographic division, for such industries as telecommunications, electricity, and a few areas of transportation. States implement specific federal regulations and standards in areas like occupational safety and environmental regulation. Sometimes, they even have authority to go beyond federal standards, try different implementation approaches to meet those standards, or address problems not handled by federal legislation. States have some overlapping jurisdictions with the federal government in broad and discretionary enforcement areas like consumer regulation, regulation of advertising, and some aspects of financial regulation.

POLITICS AND PATTERNS

Struggles over power and likely outcomes, as well as historical path dependence, shape the actual division between federal and state regulation. Affected groups try to influence legislative, executive, bureaucratic, and judicial decisions about federal preemption or state actions.

Regulatory capture would seem to be even more applicable to the states than the federal government because a smaller number of powerful, and sometimes mobile, interests are presumed to hold sway in state capitals and because the competition for business location and economic development can fuel a "race to the bottom." Examples are not too hard to find. By the late 1980s, nearly 50 percent of the national costs of the S&L crisis accrued in Texas, much of it the result of risky and poor investments by state-chartered savings and loans. California, one of the first states to deregulate its electricity markets in 1996, faced a severe crisis of spiraling rates and rolling blackouts in 2000. By 1994, 14 years after the clearly demonstrated success of trucking deregulation, several states still regulated trucking heavily. (Texas continued to allow only six intrastate carriers to provide services, at a cost of over $1 billion to its state economy.) Still, capture is not the only possibility at the state level.

The pattern of political interaction between federal and state regulation is markedly different depending on whether one examines the *ex ante* regulation of establishing prices, market structure, and firm entry, or the *ex post* regulation that focuses more on market enforcement issues and often addresses information, risk, and externality market failures. (Those categories are often distinguished as "economic" and "social" regulation, respectively, but that terminology does not capture the differences quite as clearly.) The *ex ante* regulation of market structure and pricing has been characterized by a combination of federal deregulation and explicit preemption of further state regulation, based partly on the concern that state regulation was captured and counterproductive. Most prominently, the federal government preempted state efforts to regulate transportation industry prices and entry, specifically and statutorily preempting state airline regulation in 1978, state railroad regulation in 1980, state intercity busing regulation in 1982, and later, state trucking regulation in 1994. While preempting the states, the federal government largely stopped its own economic regulation of those industries, even eliminating the Civil Aeronautics Board and the venerable Interstate Commerce Commission.

The federal government also preempted much of the states' ability to regulate prices and entry in financial industries. After the S&L crisis of the late 1980s, the federal government put the states out of the business of chartering savings and loans. Then, in 1994, Congress preempted state restrictions on interstate branch banking and later preempted state oversight of mutual funds. Finally, Congress relaxed the separations between different kinds of financial firms in the 1999 Financial Services Act and set up a greater possible role for federal regulation over the insurance industry, the oldest and perhaps most important industry only regulated by the states. For example, if 29 states do not successfully coordinate their regulation of insurance agents in 2004, the federal government will preempt state licensure of insurance agents. With fewer regulatory walls between the activities of commercial banking, investment banking, and insurance, it may only be a matter of time until the federal government preempts a greater portion of state insurance regulation, as several insurance groups have requested.

Although federal officials have not preempted state telecommunications and electricity regulation as much, the 1992 Energy Act and the 1996 Telecommunications Act paved the way for further state deregulation and, in some cases, have preempted state authority. In 2002, the Federal Communications Commission redefined statutory terms from the 1996 Telecommunications Act in a manner that preempts some state and local regulation. Federal preemption has not gone even further in those two industries in part because local providers continue to hold considerable monopoly power and face only limited competition.

Thus, during the past quarter-century, Congress decreased the power of states to regulate prices and entry, and federal lawmakers have decreased the federal role as much, or even more. Supporters of reduced regulation were cheered by both outcomes.

STATE REEMERGENCE The pattern for regulatory enforcement has been more complex, with the development of an increasingly common political interaction pattern. Often, federal regulatory enforcement is relaxed in the name of deregulation, or regulatory action is not taken in the face of a newly emerging concern. Many states explicitly or implicitly accommodate that relaxation. Some do not, however; particularly states where aggressive attorneys general or pro-regulatory interest groups are influential — often, though not always, states like California, New York, and Massachusetts. They develop a tougher new set of regulations, which either creates different regulatory landscapes across the states or forces national firms to change their policies across the country to accommodate new regulations promulgated only in a few states. The affected business interests then lobby heavily at the federal level for the establishment or re-establishment of a single regulatory standard to

preempt the states — hopefully a more favorable regulatory standard than in the most extreme states. Often, then, Congress or a federal agency pursues this secondary, or reactive, federal regulation, which never would have occurred in the absence of state activism. That gives the states a balancing or "re-enforcing" regulatory role.

Observers first noticed this trend during the Reagan administration. Despite the greater voter popularity of social regulation over economic, President Ronald Reagan, the 1994 Republican Congress's "Contract with America," and President George W. Bush lumped social regulation together with "big government," trying to reduce its enforcement by cutting staff and budgets and centralizing their authority over agency promulgation of new rulemaking decisions. In response, many organized labor, environmental, and consumer groups resisted those attempts, and they often used the states as a form of venue shopping to achieve their goals. This pattern accelerated after 2000, when President Bush appointed regulators like FTC Chairman Muris and Office of Information and Regulatory Affairs head John Graham, who have written widely about the need to reduce various forms of social regulation.

MONKEYS ON STEROIDS State regulatory activists have relied on two main institutions to develop pro-regulatory policies: legislatures and state attorneys general. For example, in the late 1980s, several state legislatures considered numerous bills to regulate nutrition labeling, prompting fears among food manufacturers that they would soon face 50 different standards. Congress preempted that possibility with the passage of the 1990 federal Food Labeling Act. The most dramatic example may have been the California legislature's 2002 passage of a bill requiring steep reductions in greenhouse gases from automobiles after Congress had earlier rejected that same policy. Automobile manufacturers, in an effort to avoid the cost of building different lines of cars for different state environmental laws, might just produce cars that comply with California standards.

Of course, not all state legislatures have become wellsprings of social regulatory activism, nor are they likely to do so. Though more than half the states, led by California and New Hampshire, have voluntarily set carbon dioxide emissions above federal standards, another 16 state legislatures went on record opposing the Clinton administration's Kyoto Treaty on climate change that called for rapid reductions in such emissions. Still, it would be a mistake to assume that only a small number of extreme states are driving this pattern.

In the growing world of "regulation by litigation" state attorneys general are now the most prominent regulatory activists. Active attorneys general were derisively labeled "Chowhounds" in the 1980s for their efforts in food nutrition labeling, but they are garnering more positive attention now, perhaps highlighted by New York's Spitzer for his efforts to oversee financial firm behavior. Spitzer has appeared on numerous magazine covers as the activist regulator for the new century. His successful $100 million 2002 suit against Merrill Lynch, brought under New York's 1922 Martin Act, prompted wider investigations by the Securities and Exchange Commission, New York Stock Exchange, and NASDAQ into the role of analysts in the investment banking industry. Subsequent Wall Street lobbying efforts to get Congress to preempt the states' ability to regulate securities failed in the U.S. Senate.

Other recent examples include six northeastern state attorneys general (including Spitzer) challenging in court the Bush administration's proposal to relax environmental standards for new plants or upgrades of industrial facilities, 29 attorneys general suing Bristol-Myers over the issuance of a generic drug alternative to BuSpar, and eight attorneys general suing the U.S. Department of Energy over revisions to regulations on appliance energy efficiency.

State attorneys general have moved into the forefront of social regulatory activism, ahead of state legislatures, because they are piggybacking on the popular product liability movement in law and their stunning financial success in the tobacco cases. They reinforce that linkage by taking on cases against big national corporations perceived to have deep pockets. Before the 2002 elections, 34 state attorneys general were Democrats (though an aggressive business-funded campaign yielded 10 Republicans in 15 November 2002 contests). Many activist attorneys general seek to build name recognition to run for higher office, especially for governor.

Business lobbying groups have not taken this state activism lightly. They usually challenge it in legislatures, agency hearings, business-sponsored initiatives, and court. If business groups fail to stop aggressive state social regulatory actions, large national and international firms face the possibility of balkanized regulations, different across 50 different states, or the possibility that a large and pro-regulatory state like California will effectively dictate national standards based on the size of its market and the difficulty of adapting a single product to many different markets.

The approach of shifting their focus to lobbying at the federal level for a single, ideally less strict, federal standard is not entirely new, as strict California environmental regulations prodded businesses to be more supportive of federal standards in 1969. But it does appear to be more common in recent years in response to attorney general activism. As Brookings analyst Pietro Nivola has written, for businesses it is "better to have one 500-pound gorilla in charge of regulating the industry, its lobbyists reckoned, than to deal with 50 monkeys on steroids."

Thus, the politics and interaction patterns of federal and state officials have differed for regulation of market structure and for regulatory enforcement efforts. Less clear is what specific areas of regulation have been handled effectively by the states and what areas might be ripe for further preemption.

ASSESSING MAJOR AREAS OF STATE REGULATION

In previous work, I reviewed the findings from more than 40 earlier studies of state regulatory politics. That research demonstrated that state-level interest groups, state legislatures, or state bureaucrats wield the most influence over policy decisions. Sometimes the policies they develop address

market failures appropriately to enhance economic welfare, other times they do not, and such inefficient capture by industry groups is more likely for less salient regulatory issues.

Although I have not done a comprehensive economic assessment of policy outcomes, my analyses do yield some general conclusions. In what domains have states regulated (or deregulated) relatively well, especially compared to how the federal government has regulated, or likely would regulate, in those areas? While their performance has not been excellent across the board, compared to the top-down federal regulation we have seen since the 1980s the states have done a credible job in regulating two very complex and important infrastructural industries — landline telecommunications and electricity. Here, states are guided by a wide range of interest group input, general decisions from legislatures, and detailed decisions by public utility commissions — the oldest form of regulatory body in the nation. Although Congress, the Federal Communications Commission, and the Federal Energy Regulatory Commission have made important (albeit slow) decisions about those industries, it is not clear that the states have done any worse in moving toward a more competitive environment while protecting captive consumers. Because the best timing of deregulation is not yet clear in those industries where monopoly power continues, a "one size fits all" regulatory approach may not succeed and continued state experimentation seems appropriate. And, while some states have done so, perhaps surprisingly, many states have not bent over too far backward to protect their incumbent monopoly providers. After all, 24 states authorized electricity competition and many states have developed policies favorable to telecommunications competitors. On the other hand, the continuing economic regulation of trucking by some states, after the 1980 federal deregulation of trucking, was clearly counterproductive. Federal preemption of that regulation in 1994 increased economic efficiency and there have been no serious calls for the return of state regulation.

Also surprisingly, the states have varied substantially in their approach to environmental regulation, again with good experimental results. While some negative externalities cross state borders, others do not, and thus are clearly appropriate for state actions. State policies generally have not fueled a race to the bottom, but instead several states have acted innovatively in addressing their own problems and also in contributing to solutions for more national and international environmental issues. States have also developed valuable bargaining or "regulatory negotiation" approaches rather than relying solely on command-and-control regulation.

THE BAD NEWS On the other extreme, there are areas of regulation where states have performed less well. Occupational regulation remains the poster child for captured, welfare-reducing regulation. My own studies of lawyer and doctor regulation support this perspective, though the entry barriers states create are not overwhelming. Legislatures require some continuing education regulation despite the opposition of professional groups, but it is generally minimal and there are no studies assessing the benefits.

Apart from occupational regulation, insurance may be the other biggest state problem. While there is some variation, too many states have constraining price regulation and slow approval process for new services. Still, state solvency regulation has been solid even in the face of economic upheavals, and should be retained. Given the 1999 Gramm-Leach-Bliley Financial Services Act, federal preemption of much state financial regulation, and convergence of bank and insurance activities, it is not surprising that Congress is now listening to large insurance firms calling for federal regulation to preempt the states, or at least for greater federal oversight and required state coordination.

There is a middle ground of regulatory arenas in which state regulation seems annoying and not clearly beneficial, but it is not fatal either. That is, key actors seem to find ways around it without great difficulty. The federal government has preempted most state financial regulation, which seems efficiency enhancing for large banks in international markets. Although two-thirds of the states still require health care certificates-of-need for new facilities and equipment (even after the federal government stopped funding those programs), economic studies of certificates-of-need requirements show minor and mixed effects. Thus, while there may be little justification for those areas of state regulation, neither is there substantial harm.

The good news from empirical studies is that states make real policy decisions — they are not simply captured by the most powerful interest groups and they do not appear to engage in a collective race to the bottom. Those decisions are sometimes good and sometimes bad. Economic outcomes from the complex politics of state regulation vary by state and by issue area.

STATE INSTITUTIONAL REFORMS

As state actors recognize the growing importance of their regulatory choices, they have developed some new, cross-cutting institutions to try to influence policies. In the past decade, such governors as Michigan's John Engler, California's Pete Wilson, Virginia's George Allen, and New York's George Pataki have issued executive orders to establish gubernatorial offices that require rigorous cost-benefit analyses of state regulations and a centralized oversight process, parallel to federal OMB policies. Those offices combine more control over regulatory rulemaking and centralized permitting processes for new businesses, but they also seek to eliminate regulations where possible. Though analysts have not yet prepared careful, independent assessments, those offices claim to have cut and prevented many unnecessary regulations.

Since the Republican Congress's "Contract with America," legislatures in a few states, like Virginia, Arizona, and Massachusetts, have undertaken one-time or continuous regulatory reviews in the reform spirit of "sunset" legislation. Those reviews, plus an executive-ordered one in California, analyzed thousands of state regulations and, on average, repealed 20–30 percent of existing regulations, modified another 40 percent,

and left about 30–40 percent unchanged.

Just as many federal regulatory decisions are appealed in court, state courts influence regulatory decisions as well. While scholars have not yet prepared comprehensive studies of the regulatory role of state courts, I find that they uphold challenges against state regulatory agency decisions about two-thirds of the time, a rate quite similar to federal court decisions. Still, this means that state courts are overturning a state regulatory agency decision in one out of three cases. And, as discussed above, state attorneys general are playing increasing roles in regulation by litigation.

Thus, all branches of government are substantially involved in state regulation today. Rather than disappearing and becoming inert, many areas of state regulation are characterized by increased contestation by interest groups and policy activism by elected officials. That has surprised observers who expected state regulatory authority to be vulnerable to federal preemption and to the growth of global commerce and supranational bodies with regulatory powers.

FUTURE OF STATE REGULATION

From this evidence, a good argument can be made that state regulation has become relatively more important compared to federal regulation in recent years, as the federal government has deregulated more and "de-enforced" in a number of areas. States have gained ground in relative terms, even as the larger arena of regulation has been reduced somewhat. In the future, will states continue to add "balance" to the national regulatory system or will they provide additional "checks" on regulatory growth in a nation where voters seem almost evenly divided on the desirability of government intervention in market choices?

The answer probably depends upon both federal regulatory choices and general perceptions about the advantages and disadvantages of regulating emerging technologies and continuing economic problems. While state regulation has increased in prominence, those who expect a massive resurgence of state regulatory authority that reshapes the contours of domestic policy are likely to be disappointed. The federal government is not going to devolve most of its regulatory power to the states.

Still, state regulatory activism, which businesses react to at the federal level, is likely to keep federal regulation from falling below a certain threshold level even as prominent federal elected officials themselves might favor greatly reduced regulations. Ironically, while states collectively lose some authority by pressuring the federal government to, in effect, preempt them, the states are the innovative government player in this type of interaction. Such successful leverage makes it more likely over time that states will continue to be aggressive on other regulatory issues as activists see the opportunity for national leverage.

What are future regulatory issues likely to be? New technologies, in particular, historically have generated new regulatory questions. What role, if any, will the states play in regulating biotechnology, genetically altered foods, cloning activities, Internet privacy, and identity theft? In some of those areas, the greater scientific expertise of the federal government might prove decisive, while in others, state experiments will test the efficacy and impacts of new regulatory policies. For example, states are already playing a leading role in the protection of Internet privacy.

Unsolved social and economic problems also tend to generate pressure for new regulations in major industries. It seems unlikely that the thorny problems of maximizing health care quality and access, while containing costs, will be solved, especially as the United States watches its aging baby boom population demand greater and more expensive health care interventions. Will those interventions be viewed as national issues or will the states take a lead in regulation?

States probably will continue to take up the role as experimental laboratories. Policy experiments like Illinois's lack of insurance price regulation, North Carolina's pre-OSHA ergonomic repetitive-stress regulations, or even New Jersey's flawed and failed plan for buying and selling pollution rights will inform other states and national policy. When it is not clear that state regulation is impeding economic efficiency, states should be allowed and encouraged to continue with this role. **R**

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