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Eli M. Noam

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## THE INTERACTION OF FEDERAL DEREGULATION AND STATE REGULATION

*Eli M. Noam\**

The past few years have witnessed federal deregulation in key industries. First it reached stock brokers,<sup>1</sup> railroads,<sup>2</sup> and airlines;<sup>3</sup> then communications;<sup>4</sup> and now banking,<sup>5</sup> energy,<sup>6</sup> and trucking.<sup>7</sup> While each of these deregulations is important by itself, their cumulative effect and the trend that they augur are particularly significant, suggesting a watershed in government-business relations comparable to the New Deal, even if lacking its drama. For the first time in memory, excluding post-war demobilizations, the federal government's direct role in the economy is being reduced on a broad front. This development, one would expect, must affect all actors in a federal nation, including the states. Whereas for several decades the states have played only a supporting role in the regulatory field, being eclipsed by the aspirations of federal government, they now experience new opportunities and perceive unmet needs in the wake of increasing federal withdrawal from regulation. One can thus predict that changes in state regulation are about to occur.

An analysis of this potential development leads to the conclusion that if the primary goal of deregulation is the reduction of gov-

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\* Associate Professor of Business and Lecturer in Law, Columbia University. A.B., 1970; A.M., 1972; Ph.D., J.D., 1975, Harvard University. The author wishes to acknowledge the generous research support of the R. Grace Foundation and the help extended by Richard D. Friedman, Allan B. Taylor, and, especially, Nadine Strossen.

1. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (amending various sections of 15 U.S.C.).

2. Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, Titles I & II, 90 Stat. 31 (amending various sections of 45 U.S.C. & 49 U.S.C.).

3. Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (amending various sections of 49 U.S.C.).

4. *See In re Regulation of Domestic Receive-only Satellite Earth Stations*, 74 F.C.C.2d 205 (1979) (deregulating satellite domestic communications); *In re Deregulation of Radio*, 73 F.C.C.2d 457 (1979).

5. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (amending various sections of 12 U.S.C.).

6. 10 C.F.R. §§ 210.35, 212.56-62 (1980).

7. Motor Carrier Act of 1980, Pub. L. No. 96-296, 94 Stat. 793 (amending 49 U.S.C. Subtitle IV).

ernment interference in business decisions, deregulation may in many cases be counterproductive and actually create more government regulation. It is therefore the contention of this paper that for certain federal deregulations the resulting state regulation will more than offset the reduced federal activity. If true, this finding should give pause to ardent deregulators.

#### DEREGULATION VS. DECENTRALIZATION

As a starting point, it is necessary to distinguish the concepts of deregulation and decentralization. To most observers these two appear identical: the termination of a federal regulatory activity is believed to be a reduction both of regulation and of the powers of the federal government. But while the second of these reductions may occur when the activities of a federal agency are curbed, one cannot necessarily assume a reduction of total government interference—the potential of state or local regulation remains. In the face of strong federal activity, states may have chosen to avoid duplication, or more likely were precluded by federal preemption.<sup>8</sup> Yet where federal regulation is abolished, state activity is likely to emerge.

The problem, far from hypothetical, is already upon us, having reached the courts in two recent cases. Both *Mobil Oil Corp. v. Dubno*<sup>9</sup> and *Mobil Oil Corp. v. Tully*<sup>10</sup> are challenges by major oil companies to statutes enacted in 1980 by the states of Connecticut<sup>11</sup> and New York<sup>12</sup> which allegedly impose price controls on oil products after their deregulation on the federal level. In both cases the district courts held against the states;<sup>13</sup> both were dismissed on appeal on jurisdictional grounds.<sup>14</sup> The immediate issue in these cases involves only a relatively minor aspect of a

8. For a discussion of preemption, see Freeman, *Dynamic Federalism and the Concept of Preemption*, 21 DE PAUL L. REV. 630 (1972).

9. 492 F. Supp. 1004 (D. Conn. 1980), *dismissed in relevant part*, No. 80-7677 (2d Cir. Jan. 28, 1981).

10. 80-CV-543 (N.D.N.Y. Sept. 19, 1980), *dismissed in relevant part*, No. 80-7785 (2d Cir. Jan. 28, 1981).

11. Act of April 11, 1980, No. 653, 1980 Conn. Pub. Acts 124 (to be codified in scattered sections of titles 12 & 14 CONN. GEN. STAT. ANN.).

12. Ch. 271, § 3 and ch. 272, § 2, 1980 N.Y. Laws (codified at N.Y. TAX LAW § 182 (McKinney's Supp. 1980)).

13. *Mobil Oil Corp. v. Dubno*, 492 F. Supp. at 1012; *Mobil Oil Corp. v. Tully*, 80-CV-543, slip op. at 13-17.

14. The Second Circuit held, as to the preemption issue, that the cases were within the exclusive jurisdiction of the Temporary Emergency Court of Appeals, because they dealt with questions arising under the Economic Stabilization Act. *Mobil Oil Corp. v. Tully*, No. 80-7785, slip op. at 4-8 (2d Cir. Jan. 28, 1981).

revenue measure—the prohibition against passing on a new tax to consumers in the form of higher prices. This restriction is economically irrelevant<sup>15</sup> and, one suspects, based more on public-relations practice than on public-finance theory. But the principle at stake in these cases, that of state entry into a regulatory field hitherto occupied by the federal government is of great importance.

Both Connecticut and New York had imposed a two-percent tax on the gross receipts of integrated oil companies from their sales within the states.<sup>16</sup> This, by itself, would not be exceptional were it not for additional provisions prohibiting the pass-through of these taxes by the oil companies. Connecticut attempts to spread the cost of its new tax to its neighboring states by forbidding any company to raise its wholesale prices in the state by an amount higher than the average amount by which it raises such prices “in all ports on the eastern coast of the United States.”<sup>17</sup> New York, more neighborly but less realistic, prohibits oil companies entirely from raising their sale prices in response to the tax and requires them to certify annually, under oath, that they have not done so.<sup>18</sup> The district courts found these provisions to be price regulations and believed it to be federal policy that most petroleum products should be free from price regulation. They concluded that state regulations in conflict with this goal are preempted under the supremacy clause.<sup>19</sup>

Federal price regulation had been authorized in the Emergency Petroleum Allocation Act of 1973<sup>20</sup> but amendments of EPAA in 1975<sup>21</sup> gave the President the power, subject to congressional approval, to exempt petroleum products from such regulation. In early 1980 this exemption was granted to several prod-

15. The irrelevance of the restriction holds because a state tax that may not be passed on to consumers will make it less profitable for an oil company to sell in such a state. Hence, supplies will become smaller in such a state while they become larger in states without a tax. Relative scarcity then drives prices higher in the tax states, just as official passing-on of the tax would have. One could not expect prices to behave other than toward equalization of marginal profits of shipments into each state.

16. Act of April 11, 1980, No. 653, 1980 Conn. Pub. Acts 124 § 1 (to be codified in scattered sections of titles 12 & 14 CONN. GEN. STAT. ANN.); Ch. 271, § 3, 1980 N.Y. Laws (codified at N.Y. TAX LAW § 182(12)(a) (McKinney's Supp. 1980)).

17. Act of April 11, 1980, No. 653, 1980 Conn. Pub. Acts 124 § 13(b) (to be codified in scattered sections of titles 12 & 14 CONN. GEN. STAT. ANN.).

18. Ch. 271, § 3, 1980 N.Y. Laws (codified at N.Y. TAX LAW § 182(12)(a) (McKinney's Supp. 1980)).

19. 492 F. Supp. at 1013-15; 80-CV-543, slip op. at 13-17.

20. 15 U.S.C. §§ 751-799.

21. 15 U.S.C. § 760(a).

ucts<sup>22</sup> that were later the focus of state statutes.<sup>23</sup> The question whether the EPAA exemptions constitute an affirmative federal policy excluding states from all action that could be interpreted as price regulation is hotly disputed at present. It is partly a question of fact: Did the federal government determine that as a matter of national policy prices of petroleum products should not be regulated? Primarily, however, it is a question of principle: Does federal nonregulation in an area that it previously regulated constitute a preemption of that area?<sup>24</sup> The latter is an important question. While there have always been conflicts between state and federal regulations before the courts,<sup>25</sup> this is the first time that federal nonregulation has been held to preempt state law.<sup>26</sup> Under the courts' holdings each area of regulation that the federal government had occupied is potentially lost forever to the states, even if the federal regulation had existed for only a short period, as in the *Mobil Oil* cases. Therefore, even when the federal government pursues a policy of deregulation, the federal system may remain centralized. As the federal powers remain intact, though temporarily quiescent, states are still powerless to act on their own.

#### THE REGULATORY MODEL

As the Connecticut and New York cases suggest, federal and state regulation are both in flux; it is therefore important to investi-

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22. The presidential authority was delegated by statute to the Federal Energy Administration and its successor agency, the Department of Energy. See 15 U.S.C. § 754(b); Executive Order 11790, 39 Fed. Reg. 23185 (1974), as amended by Executive Order 12038, 43 Fed. Reg. 4957 (1978). The exemptions were granted pursuant to 10 C.F.R. §§ 210.35, 212.56-62.

23. E.g., Act of April 11, 1980, No. 653, 1980 Conn. Pub. Acts 124 (to be codified in scattered sections of titles 12 & 14 CONN. GEN. STAT. ANN.); Ch. 271, § 3 and ch. 272, § 2, 1980 N.Y. Laws (codified at N.Y. TAX. LAW § 182 (McKinney's Supp. 1980)).

24. The district courts in *Dubno* and *Tully* were primarily concerned with the initial question, the intent of Congress, having concluded that precedent established purposeful federal inaction as equivalent to purposeful federal action. See 492 F. Supp. at 1006-13; No. 80-CV-543, slip op. at 15-16. The reliance on precedent to answer the latter, more important question, however, does not reach the significant policy questions posed by the conflict between federal deregulation and state regulation. See pages 208-10 *infra*.

25. E.g., *White Mountain Apache Tribe v. Bracher*, 100 S.Ct. 2578 (1980); *Aronson v. Quick Point Pencil Co.*, 440 U.S. 257 (1979); *Ray v. Atlantic Richfield Co.*, 435 U.S. 151 (1978); *Jones v. Rath Packing Co.*, 430 U.S. 519 (1977); *De Canas v. Bica*, 424 U.S. 351 (1976); *Perez v. Campbell*, 402 U.S. 637 (1971); *Hines v. Davidowitz*, 312 U.S. 52 (1941).

26. See sources cited note 8 *supra*.

gate their interrelation in order to understand the future of regulatory power. To do so systematically requires a model that permits an analysis of regulation. To understand its need and introduce its methodology, the first question to be raised is why some regulating activities are lodged in the federal level of government while others are left on different levels. What, for example, is the inherent logic in corporations being regulated by the states<sup>27</sup> and agriculture by the federal government?<sup>28</sup> The traditional answer to this question is legal-historical in nature;<sup>29</sup> the federal government, in this view, has certain powers allocated to it. These powers have expanded over time as the constitutional mandate and its interpretation by the courts has broadened.<sup>30</sup> Local and regional governments, at the lower end of the hierarchy, derive their regulatory powers from the states whose creature they are. The remaining powers are left with the states.<sup>31</sup> The problem with this interpretation of regulatory responsibility is that it is purely descriptive; one learns how basic decisions on the role of governments came about, but not why they did so.

If the first explanation is associated with law, the second type is that of conventional economics; implicit in this view is the belief that the regulatory level is determined by "objective" factors such as efficiency. The economic approach attempts to show that different forms of regulation are handled with different efficiencies.<sup>32</sup> This normative suggestion is helpful, first, because there are

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27. See generally Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666-68, 701 (1974).

28. E.g., Agricultural Adjustment Act of 1980, Pub. L. No. 96-213, § 3, 94 Stat. 119 (to be codified at 7 U.S.C. § 1445(b)).

29. See E. CORWIN, *A CONSTITUTION OF POWERS IN A SECULAR STATE* (1951).

30. A prime example of this expansion is the federal commerce power, derived from the commerce clause. U.S. CONST. art. I, § 8. See, e.g., *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1 (1824) (federal licensing statute prevailed over exclusive right to engage in steamboat navigation granted by New York); *NLRB v. Jones & Laughlin Steel Corp.*, 301 U.S. 1 (1937) (upholding federal regulation of intrastate activities manifesting "a close and substantial relation to interstate commerce"); *United States v. Darby*, 312 U.S. 100 (1941) (upholding prohibition of interstate shipment of goods made in violation of federal wage and hour restrictions); *Wickard v. Filburn*, 317 U.S. 111 (1942) (small scale intrastate farming operations may be federally regulated if their impact is significant when viewed in conjunction with other small scale operations). *But cf.* *National League of Cities v. Usery*, 426 U.S. 833 (1976) (federal commerce power is qualified by the Bill of Rights).

31. U.S. Const. amend. X.

32. See Fisch, *Optimal City Size, the Economic Theory of Clubs, and Exclusionary Zoning*, 73 PUB. CHOICE 59 (1973); McGuire, *Group Segregation and Optimal Jurisdictions*, 73 J. POL. ECON. 112 (1973). For a thorough examination of

efficiencies of scale in regulation, just as in the provision of any good or service. For example, it is inefficient to have a complex issue, such as insurance regulation, governed by each small town; yet the other extreme, one large federal insurance agency, may be too cumbersome and inflexible. Somewhere between these extremes, at the low point of a U-shaped cost curve, is the optimal size, and hence the optimal level, of jurisdiction. The second normative justification for regulation suggested by the economic approach concerns the existence of externalities, or spill-over effects.<sup>33</sup> It is inefficient to let the policy of a regulating agency have significant effects outside the area of its jurisdiction because the agency will not necessarily take the spill-over costs into account. For example, local regulation of the water quality of a river may permit pollution which harms the downstream communities. The optimal level of regulation is therefore the one that captures the externalities of the regulatory activity. The problem with the economic approach is that while it adds to theoretical insight it fails to explain the mechanism that connects abstractly efficient levels of government and their actual endowment with regulatory functions. Arguably, inefficient choices of regulatory level abound, for example, in the fractionalized jurisdictions of metropolitan areas,<sup>34</sup> or in the setting of welfare rules on the state, as opposed to the federal, level.<sup>35</sup> Yet the economic view does not provide an explanation for such inefficiencies.

A third approach, and the one used in this paper, is the public choice methodology. Public choice theory is, loosely speaking, the application of economic techniques to political questions such as governmental decision processes.<sup>36</sup> Applied to the question of regulation, a public choice model would enable examination of the preferences for regulation by affected interest groups, of gov-

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the value in applying efficiency-related concerns to legal problems, see *Symposium on Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485 (1980).

33. For a discussion of externalities in various legal situations, see Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV L. REV. 1089 (1972).

34. In many metropolitan areas, the city government and various county governments have conflicting jurisdiction regarding local services and many governmental functions are fragmented among numerous small jurisdictions.

35. See, e.g., N.Y. Soc. Serv. Law, ch. 55 (McKinney's 1976 & Supp. 1980).

36. For a survey, see D. MUELLER, *PUBLIC CHOICE* (1979). The applicability of public choice theory to various legal problems is examined in the *Symposium on the Implications of Social Choice Theory for Legal Decisionmaking*, 9 HOFSTRA L. REV. (forthcoming, 1981).

ernmental action, and of the interaction between different jurisdictions.

Let us assume a country composed of two states, *NY* and *CT*. In each state we have two interest groups, *B* and *S*; one could think, for example, of buyers and sellers of petroleum products as the interest groups. We also have a type of regulation which can be set by the regulatory agency of each state at different levels of strictness, *R*. It is the characteristic of the two interest groups that *B* receives positive benefits from increasing regulation *R*, while the opposite is the case for *S*. Not surprisingly, the former group favors regulation while the latter opposes it. Both interest groups are also affected by the regulation in force in the other state. For example, a price regulation in state *CT* affects both the energy price to buyers in state *NY* as well as the profits of *NY*'s sellers. These assumptions can be summarized by equations that express the aggregate benefits for *NY*'s two interest groups, *B* and *S*. Total group benefits *U* are the product of individual benefits  $b_i$  times group size  $N_i$ :

$$(1) \quad U_B = b_B \cdot N_B = \alpha R_{NY}^\beta R_{CT}^\phi \cdot N_B$$

$$(2) \quad U_S = b_S \cdot N_S = \gamma R_{NY}^\delta R_{CT}^\psi \cdot N_S$$

$\beta$  and  $\delta$  are the elasticities of benefits<sup>37</sup> to group members with respect to the state's own strictness of regulation, and  $\phi$  and  $\psi$  are those with respect to the other state's regulation.  $\alpha$  and  $\gamma$  represent the effects of many other factors which, however, are assumed in this model to be given and not variable.

The other actor in the model is the regulating agency itself. It is assumed that its decisions are determined by the desire to maximize the political support given to it; this assumption conforms to those made in the literature by, among others, Niskanen<sup>38</sup> and Stigler.<sup>39</sup> Support is granted to the regulating agency by each interest group according to its stake in regulation, *i.e.*, the total benefits that it receives from the regulatory policy. When the group's benefits from regulation are high, the support that is given is strong. In order to take account of political influence, this support, moreover, is weighted by the relative importance of each group,

37. The elasticity of benefits referred to here represents the extent to which, for example, buyers will profit from controlled prices or business practices resulting from greater regulation. For a general introduction to the concept of elasticity, see E. MANSFIELD, *PRINCIPLES OF MICROECONOMICS* 159-66, 170 (2d ed. 1977).

38. *E.g.*, Niskanen, *Bureaucrats and Politicians*, 18 *J.L. & ECON.* 617 (1975).

39. *E.g.*, Stigler, *Free Riders and Collective Action: An Appendix to Theories of Economic Regulation*, 5 *BELL J. ECON. & MGT. SCI.* 359 (1974).

the measure of which is expressed by the rate of the sizes of each group,  $\frac{N_B}{N_S}$ . The support function,  $F$ , for the regulating agency is hence:

$$(3) \quad F = F_B + F_S = U_B \frac{N_B}{N_S} + U_S \frac{N_B}{N_S}$$

Into this equation the expressions for the benefits  $U_B$  and  $U_S$  can be substituted from equations (1) and (2), making agency support a function of the regulation,  $R_{NY}$ , that is chosen by the agency. The regulating agency can vary the support that is given to it by choosing different regulatory strictnesses. For the agency, the optimal strictness is where support is maximized. The optimal regulatory strictness,  $R_{NY}^*$  can be found, after taking the derivative of (3)<sup>40</sup> and solving for  $R_{NY}$ , as:

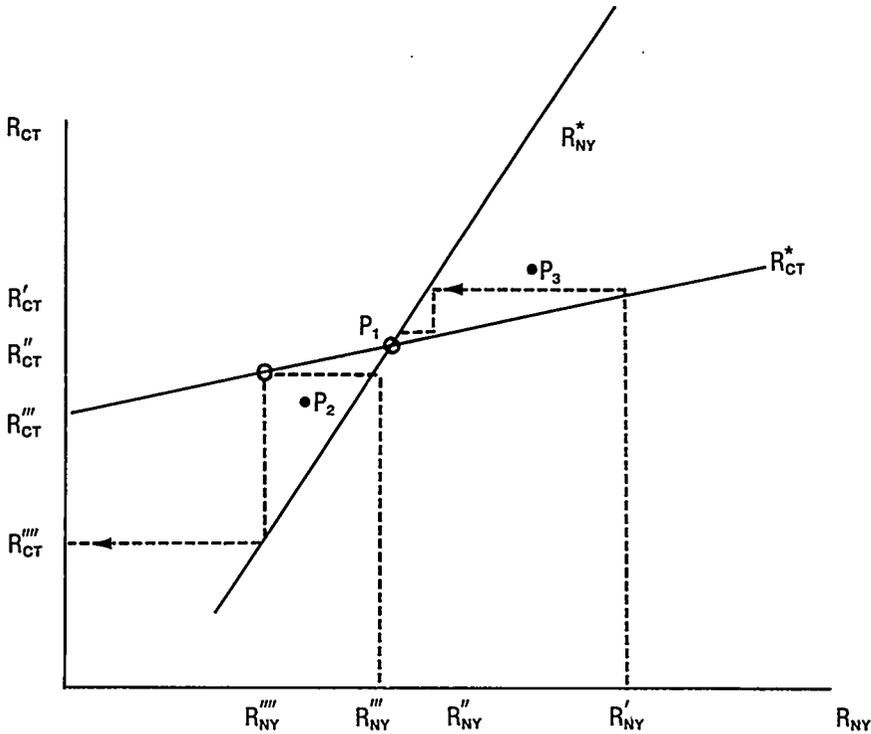
$$(4) \quad R_{NY}^* = \left( \frac{\gamma\delta}{\alpha\beta} \frac{N_S^3}{N_B^3} \right)^{\frac{1}{\beta-\delta}} R_{CT}^{\frac{\psi-\phi}{\beta-\delta}}$$

This expression shows the optimizing regulation for the agency as dependent on the sensitivities of the interest group within state  $NY$  to its own regulations ( $\beta$  and  $\delta$ ), on the relative size of the groups  $\left(\frac{N_S}{N_B}\right)$  and on the sensitivities to the other state's regulation,  $R_{CT}$  ( $\phi$  and  $\psi$ ). For the second state  $CT$  we assume similar relations to hold; the same two interest groups  $B$  and  $S$  exist, with the same individual benefit functions but with different group sizes  $M_B$  and  $M_S$ . State  $CT$ 's optimizing regulation will be analogous to equation (4), thus,  $R_{CT}^* = \alpha\gamma \left(\frac{M_S}{M_B}, R_{NY}\right)$ .

Thus each state's optimal regulation is, in part, dependent on the other state's regulation. One can illustrate this in Graph 1 with functions of the optimal regulation for the two states. For example, state  $CT$ , reacting to  $NY$ 's initial regulation  $R'_{NY}$ , chooses to have  $R'_{CT}$ . State  $NY$  thereupon chooses  $R''_{NY}$ , which prompts  $R''_{CT}$ , and so on. This mutual adjustment process leads either to an equilibrium

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40. In taking the derivative of equation (3), one would arrive at the regulating agency's increment in support, given the utility functions of both the buyers' interest group and the sellers' interest group.



GRAPH 1

in point  $P_1$  or to extreme points without equilibrium. The latter situation prevails if CT's reaction function is steeper than NY's (which occurs when the absolute difference between the own-regulation elasticities,  $\beta - \delta$ , is smaller than that of the cross-elasticities,  $\phi - \psi$ ).<sup>41</sup> This can be observed if we interchange the two curves in Graph 1. An initial regulation of  $R_{NY}'''$  is now reacted to by CT's choosing of  $R_{CT}'''$ , which in turn causes  $R_{NY}''$ , etc. These increasing cuts in regulation can occur because states compete with each other and relinquish regulatory strictness. This process, in the case of corporation law, has been aptly termed by Cary as a "race to the bottom."<sup>42</sup> The opposite extreme, a "race to the top," may also

41. That is, because one interest group would gain substantially greater relative benefit from the other state's regulation, the home state would be forced to choose an alternative strictness of regulation which is sufficiently different to require the other state to modify its regulation significantly in order to maximize support.

42. Cary, *supra* note 27, at 666.

be reached as the states drive each other into ever-increasing strictness. This can happen when states strive to keep undesirable activities, for example the disposal of radioactive waste, out of their jurisdiction, and issue increasingly stringent regulations.

In those cases where a stable equilibrium is reached, it is at the point of intersection  $P_1$  of the two reaction functions. Some tedious algebra reveals this point to lie, for state  $NY$ , at:

$$(5) \quad R_{NY}^{**} = \left[ \left( \frac{\gamma\delta}{\alpha\beta} \right)^{\beta-\delta+\psi-\phi} \left( \frac{N_S}{N_B} \right)^{\frac{1}{\beta-\delta}} \left( \frac{M_S}{M_B} \right)^{\psi-\phi} \right]^{\frac{1}{(\beta-\delta)^2 - (\psi-\phi)^2}}$$

An analogous result is found for state  $CT$ . This, then, is the equilibrium for regulation in a situation where both states are free to set their standards of regulatory strictness.

Suppose, however, that the reactions of both states are such that no equilibrium is reached, but rather a "race to the bottom" takes place to the detriment of both states. As mentioned, the condition for an equilibrium is  $\beta-\delta < \phi-\psi$ . Quite frequently this stability condition will not be met. In this situation two remedies are possible: first, a "cartel" or horizontal agreement among states, for example in the form of uniform laws, adopted by all or most of the states. However, just as in the case of private cartel agreements, uniform laws are cumbersome to agree upon since each state holds some veto power if substantial uniformity is sought; and even when uniform laws are agreed upon, the temptation to reap benefits by breaching them is irresistible. This indeed has happened to most uniform acts at their adoption by state legislation or in subsequent interpretation by courts.<sup>43</sup> The second alternative in a situation of disequilibrium is the creation of an entity entrusted to set rules for all, similar in its function to a business trust or a holding company. This authority is the federal government. Such a limited view of federalism prevailed during the early years of the American Constitution.<sup>44</sup> The drafting of this view was, in part, prompted by the

43. See Hintz, *Disparate Judicial Construction of the UCC—The Need for Federal Legislation*, 22 UTAH L. REV. 722 (1969); Robertson, *Federal Regulation of Banking: A Plea for Unification*, 31 L. & CONTEMP. PROB. 673 (1966); Schnader, *Why the Commercial Code Should be 'Uniform,'* 19 WASH. & LEE L. REV. 237 (1963).

44. See E. BAUER, COMMENTARIES ON THE CONSTITUTION 1798-1860, at 223-30 (1965).

competition between states under the Articles of Confederation. (Southern states held the holding-company view when they seceded; as far as they were concerned they sold their shares in the American enterprise when they disliked management).

In terms of Graph 1, a federal government could prevent the complete deterioration of regulation by its setting and enforcement of a rule at some level of strictness, for example at  $P_2$ . Where  $P_2$  will lie depends on the interplay of interest groups on the federal level. An unstable situation such as a "race to the bottom" makes for a convincing case in support of federal regulation. Yet it should be noted that in most areas of federal regulation one would not intuitively expect a disequilibrium to develop if, instead, states were to assume regulation. Why then federal regulation? An alternative explanation for the federal presence must be sought. To discuss this the model is consequently expanded. Let us assume that regulation is now lodged at the federal level. We have again two interest groups with a national regulatory agency that seeks to maximize support. The two interest groups,  $B$  and  $S$ , exist nationwide; their national size is the sum of their state sizes (*i.e.*, of  $N_B+M_B$  and  $N_S+M_S$ ). Because nationwide regulation is in force there are no separate state standards,  $R_{NY}$  and  $R_{CT}$ , but instead a common standard,  $R_{US}$ . Therefore, for an interest group such as  $B$  the benefits from regulation are expressed as:

$$(6) \quad U_B = b_B \cdot (N_B + M_B) = \alpha R_{US}^{\beta+\phi} (N_B + M_B)$$

An analogous relation holds for group  $S$ . The point of maximum support for the federal regulatory agency can then be found, after some calculus and algebra, at:

$$R_{US}^* = \left[ \frac{\gamma(\delta+\psi)}{\alpha(\beta+\phi)} \left( \frac{N_S+M_S}{N_B+M_B} \right) \right]^{\frac{1}{(\beta+\phi)-(\delta+\psi)}}$$

This is the expected strictness of regulation on the federal level.

The important question now is which of the two levels of government, federal or state, is stricter in its regulation? The underlying assumption of federal deregulation is, after all, that it reduces regulation. There is no general answer to this question, since the solution depends on the size and direction of the parameters. But

certainly federal regulation is not *necessarily* stricter; one can demonstrate that in the model, under quite reasonable conditions, state regulation is the stricter of the two. To show this, let us assume that the proregulation group *B* is stronger than the antiregulation group *S* in both state *NY* and in state *CT*, *i.e.*,  $\frac{N_S}{N_B}, \frac{M_S}{M_B} < 1$ . Let us further assume that the sensitivity of group *S* to its own state's regulation is stronger than that of group *B*, and that state regulation would result in an equilibrium point of the type  $P_1$  in the graph rather than at the unstable extreme points. This, as mentioned, means that the difference of cross-elasticities is larger than that of their own-elasticities, *i.e.*, that  $\phi - \psi > \beta - \delta$ .<sup>45</sup> This stability condition exists, for example, if both interest groups in a state receive positive externalities,  $\phi$  and  $\psi$ , that are not too low. In fact, all it takes is for one state group to be substantially and positively affected by the other's regulation, while the other's cross-elasticities are of moderate value; their sign then becomes immaterial. Alternatively, the stability condition is met when the antiregulation group is strongly affected by changes in its own state's regulation, while the other group's sensitivity is of moderate size.

When these conditions,<sup>46</sup> none of which is very exceptional, are met, the state regulation for the state *NY* that will emerge from the interaction of the two states is higher than federal regulation has been, *i.e.*:

$$R_{NY}^* > R_{US}^* \text{ and } R_{CT}^* > R_{US}^*$$

The conclusion therefore is that, generally speaking, state regulation will be more strict than federal regulation if (1) one interest group experiences substantial positive spill-over effects from the regulation in another state, or (2) all interest groups experience at least some positive spill-overs, or (3) the antiregulation group is particularly sensitive to changes in its own state's regulation.

It is helpful to refer again to Graph 1. Contrasted with state

45. See note 41 *supra*.

46. An additional algebraic equation provides that:

$$\frac{N_S + M_S}{N_B + M_B} > \frac{\alpha\beta}{\gamma\delta}$$

This will usually be the case if group *S* is more sensitive to regulation than is group *B*, since  $\gamma$  is negative and the other quantities are positive.

regulation, federal rules are stricter when federal regulation is at a point like  $P_3$  on the graph and  $P_1$  is the state regulatory equilibrium. On the other hand, if the federal regulation had been at  $P_2$ , state regulation will actually be higher. Or, where federal regulation is at  $P_3$  and its removal triggers a "race to the top" in state regulation, a federal ceiling is lower than the decentralized outcome. The common assumption of federal deregulation is the  $P_3$  situation. As we have seen, however, this is only one of several possibilities. It may be objected that federal regulation would not be abolished in the first place if it is likely to result in stricter state regulation since to do so would be counterproductive. Yet for this objection to be true one must presuppose a political-decision process of considerable foresight. When the abolition of federal regulation is sought there may be no state regulations in existence. Yet once federal regulation is abolished the interest group pressures generate regulation in some states and the other states then adjust their regulation to it.

It is interesting to speculate what sets this process in motion. One explanation is that a previously existing point of equilibrium that determined federal regulation has been disturbed by a shift in the relative influence of the interest groups. But it is also possible that no shift in interest-group powers has occurred; instead a slow and cyclical process of oscillation between federal and state regulation may exist even in the absence of such regulation. These cycles are based on quite stable preference within the body politic for the regulatory strictness. The level of government that will be vested with regulatory authority is the one whose regulatory strictness most resembles the preferences of the body politic. This choice would be different at different times because the states' regulation, and hence attractiveness, changes. For example, state regulation may be, at an initial point  $P_1$ , too high relative to expected national regulation  $P_2$ , given the prevailing influence of interest groups  $B$  and  $S$ . The result is a decision for national regulation which eliminates most state regulation by federal preemption. At that point national regulation may become unfavorably high in comparison to the state alternative; hence federal deregulation occurs. But now the states' regulation increases and their strictness moves toward equilibrium in  $P_1$ . From there the cycle can start anew.<sup>47</sup>

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47. For a discussion of the cycle in the regulation of banking, see Redford,

## APPLYING THE MODEL

We can now apply the model to the *Dubno* and *Tully* cases. Federal regulation of the prices of petroleum products had been abolished, largely because the influence of the antiregulation group, *S*, was very strong on the national level. On the state level, however, the power balance between *S* and *B* did not result in  $R=0$ . Both New York and Connecticut thus impose some regulation,  $R_{NY}$  and  $R_{CT}$ , conforming to equation (4). These regulations have externalities on the neighboring state, and judging from the proximity in the adoption of the statutes, the regulators are aware of these effects. In the case of Connecticut the externality is actually written into the law; as Judge Blumenfeld found, the cost of Connecticut's tax "may be recouped only on a pro-rata basis from all customers in the states (including Connecticut) to which petroleum products are distributed from east coast ports."<sup>48</sup> Hence, in terms of the model, the cross-elasticity  $\phi$  is negative.  $\psi$ , the cross-elasticity for group *S*, is assumed to be negative with respect to the other state's regulation; this can be expected because as *CT* becomes a less profitable place for oil companies, they will move some of their operations and efforts into the more promising state *NY*, thereby increasing competition in that state and reducing profit margins. Because the benefit function is negative, a negative cross-elasticity means that  $\psi$  is positive. The quantity  $\phi-\psi$  is therefore a negative minus a positive, which is positive when the cross-elasticity of the interest group *S* is higher than that of *B*. Since the sellers of oil products can be expected to be more sensitive to price changes than will consumers, it is reasonable to conclude that this is indeed the case. Turning to the elasticities  $\beta$  and  $\delta$ , we can assume that the elasticity of buyers to regulation is positive but moderate in size, while that of oil companies is negative and large, again because they are strongly affected. Given the negative form of the benefit function for *S*, its elasticity  $\delta$  is then positive and large. The quantity  $\beta-\delta$  therefore has a negative sign.

The comparison of  $\beta-\delta$  with  $\phi-\psi$  is, it will be recalled, the equilibrium test for state regulation. It is met if the latter quantity is larger than the former. We have found that  $\beta-\delta$  is negative, while  $\phi-\psi$  is positive. Hence the condition for a stable equilib-

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*Dual Banking: A Case Study in Federalism*, 31 L. & CONTEMP. PROB. 749 (1966); Scott, *Economic Theory of Competition in Regulation*, 30 STAN. L. REV. 1 (1977).

48. 492 F. Supp. at 1010.

rium is fulfilled. The conclusion is therefore that one need not be alarmed about the challenged state regulation in the belief that the two states will escalate their taxes indefinitely as they shift its consequences to their neighbors. There will be some stable equilibrium; but where will it lie? The first condition for state equilibrium to be greater than federal regulation is, from before,  $\frac{N_S}{N_B}, \frac{M_S}{M_B} < 1$ , *i.e.*, that proregulators are in the majority in both states. Judging from the fact that anti-oil-company laws were passed in New York and Connecticut, this may be inferred. The second condition is that of stability, *i.e.*,  $\phi - \psi > \beta - \delta$ , which was shown already<sup>49</sup> to hold. The third condition requires a greater sensitivity of sellers to regulate,  $|\delta| > |\beta|$ , which was also assumed above<sup>50</sup> to be true. The final algebraic condition is that  $\frac{N_S + M_S}{N_B + M_B} > \frac{\alpha\beta}{\gamma\delta}$ . We know from before that  $\delta > \beta$ , and we can also presume that the size of *S*'s benefit function is larger than *B*'s, *i.e.*,  $\gamma > \alpha$ . Hence,  $\frac{\alpha\beta}{\gamma\delta}$  is  $< 1$ . When the benefits of *S* (parameters  $\gamma$  and  $\delta$ ) are sufficiently more sensitive than those of *B* (parameters  $\alpha$  and  $\beta$ ), the last condition is also fulfilled. Hence, the model predicts that at the end of the adjustment process both states will have regulation that is stricter than the previous federal rules.

The exclusion of states from regulation is indeed crucial if one wishes to avoid this result. The attempt at expansion of the preemption doctrine, as sought in *Dubno* and *Tully*, is thus a predictable defensive response by the federal government and its allies in energy policy. It is, however, a losing battle. Even in these cases, the courts would probably have let the statutes stand had they been drafted differently.<sup>51</sup> The authority of states to pass their own revenue measures was reaffirmed rather than disputed. If the prevention of a pass-through was the states' goal, a similar result could have been obtained by a levelling of the tax on petroleum products that are particularly price-elastic and therefore more immune to a pass-through.

Other methods to circumvent preemption will, no doubt, be proposed by enterprising legislators. The federal government,

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49. See p. 204 *supra*.

50. See p. 206 *supra*.

51. See 492 F. Supp. at 1010-12; 80-CV-543, slip op. at 34-37.

equally predictably, will press for ever-wider interpretation of its power to preempt states in order to plug the ever-new loopholes. If these attempts are successful, the end result will be more centralized federal power against state activity. If they are not, the outcome, in some areas, will be state rules more strict than the previous federal regulations. Such choice between regulation and centralization is not necessarily a pleasant one, and one whose tradeoffs ought to be considered by advocates of deregulation.