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John H. Beck
Gonzaga University, beck@gonzaga.edu

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An Economist's View of the Commerce Clause

John H. Beck
Gonzaga University

INTRODUCTION

In the course of this lecture, I will review how the courts have interpreted the commerce clause. I will also express an opinion – what might be called a "strict interpretation" – about how the commerce clause ought to be interpreted from a legal standpoint, although as an economist I have no professional expertise to do so. However, as an economist I do have expertise in analyzing what economists refer to as "market failures," situations in which free markets may fail to achieve a theoretical ideal allocation of resources and government intervention **may** lead to a better outcome. Economists have also developed a theory of "public choice," analyzing how the political process works in ways which further "special interests" at the expense of the "public interest." (There are problems with defining the "public interest," but I shall nevertheless use this phrase to describe policies that many people would consider preferable to policies favoring narrow special interests.) As I proceed through the historical review of particular cases involving the commerce clause, after discussing the legal arguments, I will ask from an economic standpoint

Has the commerce clause

(i) empowered the federal government to intervene when intervention would further the "public interest,"

(ii) allowed government intervention that does not serve the "public interest,"

(iii) prohibited undesirable government intervention, or

(iv) prohibited government intervention that would be desirable?

So what does the commerce clause say?

> *"The Congress shall have Power ... To regulate Commerce with foreign Nations, and among the several States ..." (Article I, Section 8)*

PREEMPTING DELETERIOUS STATE REGULATION

Roger Pilon (2002, 35) argues that "... Congress was given power to regulate commerce among the states as a defense against the kinds of protectionist measures that had arisen in the states under the Articles of Confederation, measures that were leading to a breakdown in interstate commerce."

Lawrence Friedman, in his History of American Law (1973, 230-231), describes the first major case before the Supreme Court involving the Commerce Clause:

> *"The Supreme Court, with other important political factions, believed that the country should be governed as a single large free-trade area. Commerce should flow smoothly across state borders; no robber barons should extract toll on the way. The issue came to the fore in the mighty case of Gibbons v. Ogden, decided by Marshall's court in 1824. New York had given to Robert R. Livingston and Robert Fulton the exclusive right to navigate 'all waters within the jurisdiction of that State, with boats moved by fire or steam.' Ogden operated a steamboat line between New York and New Jersey, under license from Livingston. Gibbons owned two steamboats, which he ran between New York and Elizabethtown, New Jersey. Ogden got an injunction against Gibbons. On appeal, the Marshall court voided the New York act and struck down the monopoly."*

Justice Johnson's concurring opinion in this case emphasizes

> *"If there was any one object riding over every other in the adoption of the constitution, it was to keep the commercial intercourse among the States free from all invidious and partial restraints." [Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 231 (1824) (Johnson, J., concurring)]*

From an economist's perspective, free trade – whether between nations or states – is good and monopoly is bad, so this decision achieved a desirable result.

A less well known decision in which the Commerce Clause preempted a deleterious state regulation was a decision of the Louisiana state Supreme Court in 1892 involving a Louisiana law requiring railroads to racially segregate passengers. Economists argue that in many cases businesses indulging discriminatory preferences do so at the expense of pecuniary profit. In this case, several railroad firms, based on their own pecuniary interests, opposed the law because providing separate accommodations would increase their costs and reduce their profits. The Pullman Company brought a suit challenging the law. The judges on the Louisiana state Supreme Court in 1892 were no advocates of racial equality, and as might be expected they condoned the requirement of racial segregation on trains providing service within the state. However, the Louisiana state Supreme Court also respected the limits that the Commerce Clause puts on state regulations of interstate commerce, and they ruled that the state of Louisiana could not require racial segregation on trains providing passenger service between Louisiana and other states. (Brands 1995, p. 222) Of course, the U.S. Supreme Court subsequently condoned state mandates of racial segregation in the infamous *Plessy vs. Ferguson*, in an 1896 decision not involving the Commerce Clause.

NEW DEAL ERA COURT DECISIONS

In the 1930s the New Deal expanded the role of the federal government and this led to several Supreme Court cases involving the Commerce Clause.

Levy and Mellor (2009) list the case of *Wickard v. Filburn* (1942) among their "Dirty Dozen" Supreme Court decisions that "radically expanded government and eroded freedom." The Agricultural Adjustment Act of 1938 had directed the Secretary of Agriculture to establish annual acreage allotments for wheat limiting how much individual farmers could grow in order to reduce the supply and raise the price. Roscoe Filburn grew wheat on his Ohio farm for his own family's consumption, to feed his chickens, and to sell a small portion within the state. He planted more than his allotment and was fined for doing so, but challenged this government action on the grounds that no part of his crop was

sold in interstate commerce, and therefore the federal government had no constitutional authority to limit the acreage he planted. However, in a unanimous decision the Supreme Court held that the government's actions were constitutional.

> *"[E]ven if [Filburn's] activity be local and though it may not be regarded as commerce, it may still ... be reached by Congress if it exerts a substantial economic effect on interstate commerce." [Wickard v. Filburn (1942)*

According to the Court's reasoning, if Filburn hadn't grown the wheat to feed his own livestock, he might have purchased it from other farmers and this might have raised the price of wheat by an infinitesimal amount. But the aggregate effect of similar actions by other farmers might have had a significant effect on the price of wheat in the national market.

One rationale for restricting output in order to raise prices of agricultural products is to increase the incomes of farmers. This might obviously be thought to benefit the special interest group of farmers, but a "public interest" rationale might be based on an argument that this furthers a desirable redistribution of income. Other policies regulating prices, such as rent controls and minimum wage laws, have been justified as redistributing income in favor of the poor. Henry Simons was a strong advocate of progressive taxation of income to reduce inequality, but he was very critical of government interference with the determination of prices in competitive markets as a means of altering the distribution of income:

> *"It is urgently necessary for us to quit confusing measures for regulating relative prices and wages with devices for diminishing inequality. One difference between competent economists and charlatans is that, at this point the former sometimes discipline their sentimentality with a little reflection on the mechanics of an exchange economy." (Simons 1948, pp. 83-84)*

In a market economy prices serve as signals to producers and consumers, guiding them in allocating resources efficiently. An increase in the demand for corn, will raise the price of corn, inducing farmers to plant more corn instead of soybeans. Or a bad harvest will reduce the supply and raise the price, inducing consumers to reduce their consumption of corn and substitute other food products. Government regulation of prices in competitive markets interferes with this process.

Although Simons' statement quoted above is a particularly harsh condemnation of price regulation to achieve distributional objectives, many economists share Simons' preference for government transfer payments and progressive taxation as tools to affect the distribution of income rather than regulation of prices and wages. For example, in response to President Obama's proposal to increase the federal minimum wage, Christina Romer, who chaired the Council of Economic Advisors during Obama's first term, wrote an article in *The New York Times* arguing that an expansion of the earned income tax credit is a better policy to aid low-income workers than an increase in the minimum wage (Romer 2013).

The Agricultural Adjustment Act of 1938 was not the first New Deal legislation to attempt to restrict output and raise prices. Indeed, Title I of the National Industrial Recovery Act of 1933 allowed industry associations to apply to the President for approval of "codes of fair competition" to prevent "overproduction" and "cut-throat underselling." The President might approve the codes as proposed by industry association, approve a code with additional conditions determined by the President, or impose a code on his own initiative where "abuses inimical to the public interest" occurred in the absence of a code of fair competition. (Letwin 1961, 362-371)

These provisions of the National Industrial Recovery Act were struck down by a unanimous Supreme Court in *Schechter Poultry Corp. vs. United States* (1935). The Schechter Poultry Company had been convicted of violating a "Live Poultry Code" adopted under the N.I.R.A. In this particular case the Court found that "the attempted regulation of intrastate transactions which affect interstate commerce only indirectly" was unconstitutional. But the more sweeping implications of this decision rested on Article I Section 1 of the Constitution: "All legislative Powers herein granted shall be vested in a Congress of the United States ..." The Court found that the broad discretionary powers granted to the President to approve and modify industry codes constituted an unconstitutional delegation of legislative power to the executive branch of government. (Letwin 1961, 385-394)

From an economist's perspective the N.I.R.A. was not just an attempt to regulate prices in order to raise the income of a particular group, as the Agricultural Adjustment Act attempted to raise the

incomes of farmers. It was an attempt to deal with the macroeconomic problem of **deflation**.

It may seem paradoxical, but economists think that price flexibility is a good thing at the microeconomic level dealing with prices of particular products and resources while thinking that stability in the price level at the macroeconomic level is desirable. The resolution of this apparent paradox is that in microeconomics changes in the **relative prices** of particular goods are essential signals to reallocate resources in response to changes in supply and demand. E.g. an increase in the price of corn relative to the price of soybeans signals farmers to plant more corn. But a general inflation in which all prices rise by the same proportion would not change relative prices and would not serve any useful purpose in allocating resources. However, an unanticipated inflation would redistribute wealth from lenders to borrowers, and hyperinflation – very high rates of inflation – would disrupt an economy by drastically reducing the value of money and making people unwilling to hold money. On the other hand, deflation redistributes wealth from borrowers to lenders by increasing the real burden of debts fixed in nominal terms. Severe deflation would reduce real GDP and employment, by raising real wages if nominal wages are "sticky" and by disrupting the flow of credit to worthy investment projects through "debt-deflation" as first argued by Irving Fisher during the 1930s and more recently by Ben Bernanke (2000).

The desirable economic policy to deal with deflation or inflation is a policy that allows price flexibility at the microeconomic level while stabilizing the general price level at the macro level. The flaw in policies like the N.I.R.A. to fight deflation or Richard Nixon's wage and price controls to fight inflation is that such policies interfere with the determination of market prices at the micro level. Monetary policy offers a better alternative to prevent deflation (or inflation).

Another piece of legislation during the 1930s was the Civil Aeronautics Act passed in 1938, creating the Civil Aeronautics Board (originally the Civil Aeronautics Authority), with broad powers to set fares, allocate air routes, and control other aspects of airline operations. This legislation did not lead to any court challenges because it unquestionably was within the constitutional powers of the federal government under the Commerce Clause. Like other industry regulators, the CAB set fares with the

intention of allowing airlines a “reasonable rate of return.” However, fares on individual routes were independent of the costs of those routes. Fares on longer routes were set well above costs in order to cross-subsidize shorter routes serving smaller communities.

There were 16 “trunk” airlines in 1938. Although the CAB did allow entry of some local-service carriers, between 1938 and 1978 it did not allow entry of any new trunk carriers, denying 79 applications between 1950 and 1974. Existing airlines were allowed to offer new service on some routes, although from 1965 to 1974 only 10 percent of applications to enter an existing route were approved. (Breyer 1982, 205)

John Panzar (1980) describes the airline industry in the 1930s as a “joint-product natural monopoly.” It was a “joint-product” industry because for airlines at that time transporting mail was a major source of revenue along with passenger transportation. It was a “natural monopoly” because the demand and cost conditions made it economic for only one airline to serve most routes. Most economists would recognize natural monopolies as a case of “market failure” where government regulation might serve the public interest.

Whether the early actions of the CAB actually served the public interest is beyond the scope of this discussion, but by the 1970s conditions in the airline industry had changed. It was no longer a “natural monopoly.” If not “perfectly competitive,” the airline industry exhibited competitive aspects so that air travel markets might be described as “monopolistic competition” or “contestable markets.” Most economists viewed CAB regulation as limiting competition and harming consumers.

Because the Civil Aeronautics Act was passed in 1938, after the *Schechter* decision and before the *Wickard* decision, it respected a distinction between interstate and intrastate commerce. Therefore, the CAB did not regulate **intra**state airline flights. As a result, when the movement to deregulate airlines arose in the 1970s, economists had not just theoretical arguments but also empirical evidence that competition in deregulated airline markets would benefit consumers.

Supreme Court Justice Stephen Breyer was the staff director of the Senate Subcommittee on

Administrative Practice and Procedure chaired by Senator Edward Kennedy in the 1970s that initiated reform of airline regulation. Breyer (1982) recounts some of the evidence from the performance of intrastate airlines demonstrating that CAB regulation of interstate air routes was harming consumers:

> *"... a comparison of fares in California and Texas, where economic regulation existed to only a limited extent (none in California before 1967), suggested that fares could be lowered substantially ... Thus, in 1975, for example, the 456-mile, one-hour-five-minute flight from San Diego to San Francisco cost $26.21, while the 399-mile, one-hour-seven-minute flight from Boston to Washington cost $41.67." (Breyer 1982, 201)*

> *"[In 1971] Southwest Airlines, an intrastate carrier unregulated by the CAB, entered the [Texas] market with fares about 50 percent below those of its competitors ..." (Breyer 1982, 205)*

The Airline Deregulation Act of 1978 ended CAB regulation that virtually all economists regarded as harmful to the public interest. Respecting the limits on the power of the federal government imposed by a strict interpretation of the Commerce Clause left intrastate air travel free of CAB regulation and ultimately provided the evidence to support deregulation.

RECENT CASES INVOLVING THE COMMERCE CLAUSE

After the *Wickard* decision in 1942, the Commerce Clause seemed to authorize Congress to pass laws regulating anything it wanted to regulate. No law was struck down for violating the Commerce Clause until two decisions of the Rehnquist court – *United States v. Lopez* in 1995 and *United States v. Morrison* in 2000. I will not discuss those cases here, because they do not deal with economic issues and in a more recent case in 2005 a majority of the Court returned to the *Wickard* precedent and upheld an expansive interpretation of the powers granted by the Commerce Clause. That case, *Gonzales v. Raich*, involved defendants from California, which had legalized medical marijuana, who were growing marijuana for their own medical use and were prosecuted by the federal government.

Justice John Paul Stevens' majority opinion said,

> *"In Wickard, we had no difficulty concluding that Congress had a rational basis for believing that, when viewed in the aggregate, leaving home-consumed wheat outside the regulatory scheme would have a substantial influence on price and market conditions. Here, too, Congress had a rational basis for concluding that leaving home-consumed marijuana outside*

> *federal control would similarly affect price and market conditions." [Gonzales v. Raich, 545 U.S. 1 (2005) at 19]*

However, the Supreme Court was closely divided in this 5-4 decision. Justice Clarence Thomas voiced a vigorous dissent,

> *"Respondents Diane Monson and Angel Raich use marijuana that has never been bought or sold, that has never crossed state lines, and that has had no demonstrable effect on the national market for marijuana. If Congress can regulate this under the Commerce Clause, then it can regulate virtually anything – and the Federal Government is no longer one of limited and enumerated powers." [Gonzales v. Raich, 545 U.S. 1 (2005) at 57-58 (Thomas, J., dissenting)]*

A frequent question is whether Supreme Court Justices base their decisions on their own preferences about the desirability of public policies or about abstract Constitutional principles. Justice O'Connor's separate dissent is clearly an example of the latter. In her dissent she wrote

> *"If I were a California citizen, I would not have voted for the medical marijuana ballot initiative; if I were a California legislator I would not have supported the Compassionate Use Act. But whatever the wisdom of California's experiment with medical marijuana, the federalism principles that have driven our Commerce Clause cases require that room for experiment be protected in this case."*

Justice O'Connor's dissent echoes that of Justice Brandeis in *New Ice Co. v. Liebmann* (1932):

> *"It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." [Brandeis (1932), Dissent: New Ice Co. v. Liebmann, 285 U.S. 262, 52 S.CT., 371, 76 L.ED. 747]*

In contrast to Justice O'Connor, Justice Scalia concurred with the majority's judgment in *Gonzales v. Raich*, apparently seeing the Commerce Clause as giving the federal government unlimited power to pursue the war on drugs, although he offered a "more nuanced" opinion linking the powers derived from the Commerce Clause to the Necessary and Proper Clause. However, in the more recent case involving the Affordable Care Act, Justice Scalia did find that the Commerce Clause did not extend the power of the federal government to mandate health insurance.

As an economist, I have no professional expertise to evaluate the medicinal benefits of marijuana. But I think that the opposition to medical marijuana has less to do with doubts about its medical benefits and more to do with concerns that legalizing medical marijuana undermines the war

on drugs. Legalizing medical marijuana might undermine the drug war in two ways: (1) If marijuana is legally available for medical uses, some of it might enter the illegal market for recreational marijuana. (2) Statements that there are benefits to using marijuana – even if those statements are true – undermine the propaganda aspect of the war on drugs.

Economists do have something to say about the war on drugs. The interest groups benefitting from the prohibition of alcoholic beverages are described in Bruce Yandle's (1983) "Baptists and Bootleggers" model. This is not meant to single out a particular religious denomination. Yandle just liked the alliteration in the phrase "Baptists and bootleggers" and used "Baptists" to refer to anyone who supports a regulation for moral reasons, in the case of Prohibition because they believed the consumption of alcohol is harmful to people. But why would "bootleggers" who produce alcoholic beverages benefit from Prohibition? Obviously, those producers of alcoholic beverages who were put out of business by the enforcement of Prohibition did not benefit. But criminal organizations that sold booze during Prohibition benefited by the high prices they could charge when the government eliminated competition from small bootleggers and legitimate producers of alcohol. The film *Legends of the Fall* provides a great example of this.

There is a reason we call drug cartels "cartels." Cartels want to charge a monopoly price for their product, and the greatest threat to a cartel is the entry of competitors into their market. Government prosecution of small growers of marijuana keeps the black market price high and thereby benefits the drug cartels.

CONCLUSION

At the beginning of this lecture I proposed to ask

Has the Commerce Clause

(i) empowered the federal government to intervene when intervention would further the "public interest,"

(ii) allowed government intervention that does not serve the "public interest,"

(iii) prohibited undesirable government intervention, or

(iv) prohibited government intervention that would be desirable?

We have seen cases that fall into all of the first three categories. In the nineteenth century, federal preemption of deleterious state regulation served the public interest. We have also seen cases in the 1930s where a strict interpretation of the Commerce Clause limited deleterious federal legislation such as the N.I.R.A., while a more expansive interpretation allowed deleterious federal legislation such as the Agricultural Adjustment Act. Federal regulation of airlines was unquestionably constitutional under the Commerce Clause and may have been desirable regulation of a natural monopoly in the 1930s. Respecting the limits on the power of the federal government imposed by a strict interpretation of the Commerce Clause left intrastate air travel free of CAB regulation and ultimately provided the evidence to support deregulation when regulation no longer served the public interest.

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