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What About Free Trade Within the United States?

Trade liberalization—first with Canada and now with Mexico—has become a much publicized goal of U.S. policymakers. But, surprising as it may seem, the United States has yet to establish a single internal market. Even as fast-track negotiations for a U.S.–Mexico free trade agreement progress, interstate trade restraints on goods and services are distorting prices at home.

The impact of these trade barriers could intensify as the political and economic relationships of Western European countries become stronger. The possibility of a federal system of European states united in a central European government and free of internal impediments to trade—a United States of Europe—seems plausible as these nations move closer to economic integration. And as these countries achieve barrier-free trade, they could gain a competitive advantage over U.S. firms.

Interstate Barriers to Trade

On the face of it, the concept of interstate trade barriers is anomalous. After all, the constitutional union of the several states, which had already joined together under the Articles of Confederation, was implemented in large part to ensure a free internal market. The commerce clause of the U.S. Constitution has traditionally been viewed as a bulwark against barriers to interstate trade (*see the box titled "Constitution of the United States"*).

Unfortunately, however, the constitutional protection against trade is limited for two principal reasons. First, the Supreme Court has tended to focus more on the *form* of interstate barriers to trade than their content.[1] Second, the Supreme Court has generally limited constitutional protection to trade in commodities, leaving the service sector substantially unprotected from interference with interstate trade by state governments.

While the Supreme Court has been fairly consistent in prohibiting states from levying any type of import duty or discriminatory taxation on commodities produced in other states, it has permitted any number of other types of interstate barriers to trade in commodities to arise.

Trade Restraints on Commodities

The typical form of restriction on interstate trade in commodities involves administrative restrictions on imports, particularly agricultural goods. For instance, from 1967 until the mid-1970s, Texans could not purchase grapefruit imported from Florida. Likewise, from 1925 to 1973, California residents were barred from purchasing avocados grown in Florida.[2] Such administrative impediments to interstate trade cannot be written explicitly against imports from another state. A state cannot simply say that it is illegal to import avocados or grapefruit from Florida. But the California avocado ordinance banned avocados with less than 8 percent oil content, and Florida avocados typically contain less oil than the critical level defined in the California statute.

Similarly, the state of Texas defined a mature grapefruit as containing nine parts sugar to one part acid; Florida grapefruit typically contains seven and one-half parts sugar to one part acid.

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This definition rendered such Florida grapefruit immature and inedible under Texas law.

These nontariff barriers on interstate trade are typically enacted under the guise of protecting the health and safety of a state's residents. The Texas law was later repealed, and the California statute against Florida avocados was struck down. As two analysts observed, there was no "noticeable health deterioration of the local population."[3]

While tariffs on goods, especially import tariffs, have generally been forbidden by the courts, nontariff barriers to trade flourish. By definition, a nontariff barrier does not involve an explicit tax, but its effects are similar to levying a tax. Less of the good will be traded and consumed, and the cost of the good will be higher. In the process, consumers are made worse off.

By focusing on the form of interstate trade barriers—namely, whether there is an import duty or a discriminatory tax—the Supreme Court has generally missed the important point that the same harmful effects are being produced by nontariff barriers as the framers of the Constitution intended to prevent by inclusion of the commerce clause.

Nontariff barriers to trade are more pernicious than tariff barriers for at least three reasons. First, a nontariff barrier has the disadvantage of restricting supply and raising prices without even yielding any tax revenue. At least a tariff produces some benefits to partially offset its distorting effects.[4] Second, a nontariff barrier is more likely to prevent all trade in a good; such is the case with some administrative barriers to interstate trade in agricultural goods. With a tariff, the consumer retains the choice to purchase the imported good at a higher price.

Finally, and perhaps most important, controlling the multiplication of nontariff barriers is far more difficult than halting the spread of tariffs. Nontariff barriers are less obvious than tariffs and hence are more easily imposed as a form of redistributive activity. Undoubtedly for this reason, the courts have been more successful in preventing the imposition of tariffs on interstate trade than inhibiting the construction of nontariff barriers.

Trade Restraints in Services

Restrictions on trade in services far outnumber in scope and importance those on commodities. This means that the sector constituting by far the major share of national output is more exposed to trade barriers. The private service sector now accounts for more than 60 percent of national output.

The list of restrictions on interstate trade in services is mind-boggling. Virtually every professional is subjected to restrictive practices, practices that loom large when the issue of selling the services across a state border arises.

The restrictive practices begin with requiring professionals to obtain certification or licenses to practice in a state. This requirement will ordinarily result in clients paying higher prices and confronting fewer choices because of the restriction on the supply of providers in that profession. The monopolization of the profession is protected by not permitting practitioners licensed in other states to enter practice freely in the state in question.

Though varying in details with respect to professions and states, the basic model is applicable to scores of professions. One study found that in 1969 there were more than 2,800 state laws affecting labor supplied by a wide variety of professionals, including healthcare professionals, lawyers and teachers.[5]

The trade-distorting effects of such barriers have been well documented; they are not trivial. A 1975 study found that the legal control over optometrists in some states caused eyeglass prices to be 25 percent to 40 percent higher than in states with less restrictive laws.[6]

There is no reason to suppose that similar results do not hold for other professions. What the case of optometrists illustrates is that while state law can restrict migration of purveyors of services, it cannot generally restrict migration by consumers of those services. Thus, consumers of a professional service who are lucky enough to live near borders of less restrictive states pay far less for professional services than do others in their own state.

The result should not be surprising for Texans accustomed to arbitrage across the U.S.–Mexico border. What may be surprising, however, is the applicability of the economic analysis of trade barriers to understanding internal trade within the United States.

Banking and the Principle of Mutual Recognition

Many of these issues are applicable to banking. After all, banking is a financial service. The effects of restrictions on the sale of this financial service are not fundamentally different from those on any other service.[7]

Two dramatic sources of change have affected banking perhaps more than any other service. First, there are the ongoing technological revolutions in computing and telecommunication that have forever transformed the industry. These revolutions have dramatically lowered the cost of delivering bank services, impeding attempts to locate the provision of many banking services in a particular political and regulatory jurisdiction.

Second, another source of change for U.S. banking is the ongoing political change in Western Europe. Europe's move to a single internal market was hastened by a very important court decision—the Cassis de Dijon decision—handed down in 1979 by the European Court of Justice (*see the box titled "The Cassis de Dijon Decision"*).

The case did not receive much attention in 1979 when it was decided. But when the time came to set the rules for the new single market to which Europeans were evolving in the mid-1980s, the spirit of the decision was embodied in the principle of mutual recognition. Briefly stated, the principle of mutual recognition guarantees that each member state of the European Community (EC) will recognize the others' rules and regulations. There are minimum criteria to be established by the EC, but as long as national rules meet these criteria, they must be recognized as valid by all member states.

Consider the implications for banking. In Europe, by Jan. 1, 1993, banking regulation will functionally be set by home rule. If a bank is chartered in the Netherlands and meets the Dutch rules for safety and soundness, that bank has an absolute right to operate in any member state. Each member state must recognize that the Dutch are implementing in their own way the common goals and standards on which they all agreed and not question the method of implementation. For instance, the Dutch bank can operate under Dutch banking law in France, even if Dutch banking law is more liberal than French banking law. Even if French banks are positively disadvantaged, the Dutch bank is free to do anything that Dutch banking law permits.[8]

The implications of this principle are many. First and foremost, it will accomplish exactly what the framers intended. It will produce a single market. Any bank that can do business in one country can do

The Cassis de Dijon Decision

Dijon is a French city most famous for making Grey Poupon mustard. It also makes *crème de cassis*, a blackberry liqueur. At issue in a 1979 case was whether free trade entailed merely treating the goods of a foreign producer in a nondiscriminatory fashion. Nondiscrimination is a criterion of the General Agreement on Tariffs and Trade (GATT). More specifically, the court questioned whether the German government could exclude French crème de cassis from importation because it did not conform to German rules for alcoholic beverages. There was no discrimination because a German manufacturer could not have legally made this product in Germany. The German government thus argued that its ban of crème de cassis was consistent with free trade because it treated French goods just as it treated German goods. In American parlance, the German government maintained it was providing a level playing field for German and non-German producers.[1]

The European Court upheld a much more stringent standard for free trade. It concluded that the German government could not exclude crème de cassis unless the government demonstrated that the ban was required for reasons of health, consumer protection, tax policy or fair trading. The Germans are masters at deducing reasons of public policy to impede the flow of goods traded. For instance, for several years they were able to keep out imported distilled mineral water, arguing that bubbles are needed in mineral water to kill microbes. So it was only a matter of public health to ban this dangerous mineral water that lacked bubbles. But even the Germans could not finesse the Cassis de Dijon decision.

[1] Colchester, Nicholas, and David Buchan (1991), *Europower: The Essential Guide to Europe's Economic Transformation in 1992* (New York: Times Books, Random House): 79.

business across the whole community. This new development means a European market of 380 million vs. the U.S. market of 250 million.

Second, banking regulation will tend to conform to that of the most liberal state, with the constraint of a minimum standard at the EC level.[9] If regulations do not conform to that of the most liberal state, banks will migrate to the state with the most liberal chartering and regulatory system. In the previous example, if the French government did not relax its regulatory structure, French banks would seek a safe haven in the Netherlands. There is a perfect analogy in the United States to the rules for corporate chartering. Because Delaware early on established a favorable climate for corporate charters, it is legal home to a disproportionate number of corporations in the United States. Consequently, the laws regulating corporate chartering are more liberal in all other states than they would have been without the Delaware effect.

To understand better what is occurring in the EC, consider an analogy with the United States. If the principle of mutual recognition were to apply to American banking, then a bank chartered in California would have an unchallengeable right to offer banking services in Texas or any other state. Moreover, it would operate in Texas under California, not Texas, banking law. If California law permitted banks to sell insurance, then such banks could sell insurance in Texas. And if Texas banking law is less liberal than California's, there would be mounting pressure to liberalize Texas banking law. Otherwise, banks chartered in Texas would remain at a competitive disadvantage.

The effect of this system would be to accelerate liberalization of banking nationwide. The only operative change necessary would be to switch to home rule in regulation in the United States, away from the current U.S. system in which the host state sets the rules under which an out-of-state banking firm operates.[10] Because the EC made this switch, banking will be a single market in Europe, while it remains a fragmented market in the United States.

Lest anyone believe this is unthinkable in the U.S. context, remember that Europeans are only mimicking what they understand to be the American political and legal system. The U.S. Constitution explicitly incorporates a principle of mutual recognition in Article IV, Sections 1 and 2. The principle of mutual recognition operationalizes

Constitution of the United States

Commerce
Article I
Section 8. The Congress shall have Power…To regulate Commerce with foreign Nations, and among several States, and with the Indian Tribes.

Federalism
Article IV
Section 1. Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.

Article IV
Section 2. The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States.

A person charged in any State with Treason, Felony, or other Crime, who shall flee from Justice, and be found in another State, shall on Demand of the executive Authority of the State from which he fled, be delivered up, to be removed to the State having the Jurisdiction of the Crime.

No Person held to Service or Labour in one State, under the Laws thereof, escaping into another, shall, in Consequence of any Law or Regulation therein, be discharged from such Service or Labour, but shall be delivered up on Claim of the Party to whom such Service or Labour may be due.

Due Process
Article IV
Section 4. The United States shall guarantee to every State in this Union a Republican Form of Government, and shall protect each of them against Invasion; and on Application of the Legislature, or of the Executive (when the Legislature cannot be convened) against domestic Violence.

Article XIV
Section 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property without due process of law, nor deny any person within its jurisdiction the equal protection of the laws.

federalism. For states to be linked in a federalist system implies an acceptance of minimum standards of legal due process in each member state—as our Constitution explicitly requires. In the area of interstate trade, however, this constitutional protection has been accorded only to trade in physical goods, and not even consistently for them. Thus, Europe 1992 will allow the EC countries to leapfrog the United States into a true economic and possibly political federalism.

In the United States, the principle of mutual recognition has had wide scope. It accounts for the ability of commercial and industrial firms chartered in another state to operate under their own corporate charter in Texas. Each state is entitled to enact certain limitations on corporate conduct in the interest of public health and safety.

Member states of the EC will also retain national jurisdiction for certain well-defined interests. At this time, however, it appears that EC policy will be to limit the ability of individual member states to argue health and safety reasons in defense of trade restrictions. This is the legacy of the Cassis de Dijon decision. This situation is not true in the United States in general. For many years, Texas protected its citizens from the dangers of out-of-state banking services. Now it does not seem that the dangers were any greater than from out-of-state grapefruit.

All this matters a great deal for American competitiveness. We are talking about opening our country to international trade when we have not yet opened it to free internal trade. As Europe's banking system moves into the 21st century, America retains an essentially 19th century banking system. We celebrate the importance of small business in the United States, yet all but the largest U.S. business firms have no effective access to any but their local bank. If American business is to grow and prosper in an increasingly competitive international market, then its banking system must change to facilitate that growth.

Implications

Europe is holding up our principles of political federalism and freedom of internal trade, reflected for us to contemplate anew. We are provided with an opportunity to reconsider these principles. As the millennium dawns, we have an opportunity to reconsider the rationale of restricting trade within our own borders. As we increasingly look outward and seek to extend free trade internationally, perhaps we should consider bringing its benefits to our own internal markets.

—Gerald P. O'Driscoll, Jr.

[1] Craig, Steven G., and Joel W. Sailors (1987), "Interstate Trade Barriers and the Constitution," *Cato Journal* 6 (Winter): 819–35.

[2] Craig and Sailors (1987, 824).

[3] Craig and Sailors (1987, 832). The number of administrative restrictions in agriculture is massive. Craig and Sailors (1987, 822) cite a 1952 study that found more than 1,500 laws impeding interstate trade in agricultural goods in just 11 Western states.

[4] Paradoxically, the producers of a good against which a trade barrier is erected can benefit from it. A trade barrier may enable foreign producers to obtain a scarcity or monopoly price for their product. They clearly prefer this situation to the case of a tariff, because the increased price in that case reflects the tariff. They may even prefer the restricted market over a competitive one. For example, Japanese car makers continue to adhere to voluntary import restraints even after the U.S. government reversed itself and dropped quotas on Japanese autos. In essence, the Japanese auto manufacturers are collecting revenue from a pseudo-tariff in the form of higher prices paid by U.S. consumers. With a tariff, at least the federal budget would be advantaged. Better still, of course, would be free trade.

[5] Craig and Sailors (1987, 823). The situation has improved somewhat with respect to lawyers. One-half of every state bar exam is now identical. With the exception of California, New Jersey and Florida, all states now grant reciprocity to those lawyers with five years of experience practicing law. Note, however, that the exceptions are empirically quite important.

[6] Benham, Lee, and Alexandra Benham (1975), "Regulating Through the Professions: A Perspective on Information Control," *Journal of Law and Economics* 18 (2, October): 421–47.

[7] The origin of special restrictions on banking is different from that for other services. Banking has always been treated as a special case in American political history. Moreover, populist sentiment was particularly directed against banking and resulted in many of the restrictions on banking that we have today (Clair, Robert T., and Gerald P. O'Driscoll (1991), "Learning from One Another: The U.S. and European Banking Experience," Federal Reserve Bank of Dallas Working Paper No. 9108, 2–10).

[8] There is still some scope for local (host state) control on specific issues, such as opening hours and consumer protection, and some details have not yet been worked out. The previous analysis, however, is a fair presentation of the direction of European banking policy (Colchester, Nicholas, and David Buchan (1991), *Europower: The Essential Guide to Europe's Economic Transformation in 1992* (New York: Times Books, Random House): 95–96).

[9] I am by no means offering a blanket endorsement of the emerging European banking structure. For instance, because of the large average size of its banks, the EC is particularly prone to evolving its own version of "too big to fail" (Clair and O'Driscoll 1991, 15–16).

[10] The change to home rule in American banking regulation would not alter the balance between state and federal regulation of banking. Indeed, home rule would avoid all the thorny issues raised by changing the balance between federal and state regulatory powers.