

# THE EVOLUTION OF SHERMAN ACT JURISDICTION: A ROADMAP FOR COMPETITIVE FEDERALISM

Bruce Johnsen\* & Moin A. Yahya\*\*

Choose your rut carefully; you'll be in it for a long time.<sup>1</sup>

## INTRODUCTION

Scholars and jurists increasingly acknowledge that the U.S. Supreme Court's Commerce Clause jurisprudence desperately needs a new direction.<sup>2</sup> Even Laurence Tribe, widely regarded as a liberal commentator, concedes that until very recently the Court's decisions in this area came dangerously close to foreclosing it from imposing any kind of principled constitutional limitation on the scope of Commerce Clause jurisdiction.<sup>3</sup> Chief Justice Rehnquist has openly admitted that much of the case law in this area is less than a model of clarity.<sup>4</sup> In what has been heralded by some as the Rehnquist Court's "celebrated project to re-establish structural constitutional principles on federalism,"<sup>5</sup> and by others more prosaically as "the new federalism,"<sup>6</sup> recent Supreme Court cases have imposed Tenth Amendment

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\* Professor of Law, George Mason University School of Law. J.D., Emory University, 1985; Ph.D., University of Washington, 1987.

\*\* Assistant Professor of Law, University of Alberta School of Law. J.D., George Mason University School of Law, 2003. Ph.D., University of Toronto, 2000. We thank Amitai Aviram, Peter Carstensen, Paul Edwards, Richard Epstein, Michael Greve, Doug Ginsberg, Eugene Kontorovich, Robert Levy, Tom Morgan, Dan Polsby, Ron Rotunda, and Ilya Somin for helpful comments and encouragement on earlier drafts. We also thank the American Enterprise Institute, the Law and Economics Center at George Mason University School of Law, and the Institute for Humane Studies Summer Graduate Research Fellowship for generous financial support. This Article has benefited from comments at the 2002 Western Economic Association International annual meetings, at the 2003 Canadian Law and Economics Association annual meetings, at the 2004 American Law and Economics Association annual meetings, and in the Robert A. Levy Fellows Workshop in Law & Liberty at George Mason University School of Law.

<sup>1</sup> South Dakota farm-road sign.

<sup>2</sup> See U.S. CONST. art. I, § 8, cl. 3 (granting Congress the "power . . . [t]o regulate commerce with foreign nations, and among the several states, and with Indian tribes").

<sup>3</sup> 1 LAURENCE TRIBE, AMERICAN CONSTITUTIONAL LAW 816 (3d ed. 2000).

<sup>4</sup> See *United States v. Lopez*, 514 U.S. 549, 559 (1995) (holding that the Gun-Free School Zones Act of 1990 exceeds Congress's authority to regulate commerce).

<sup>5</sup> Michael Greve, *Collision Court: Upcoming Clash Between Federalism and Pre-emption is Foretold* in Geier v. American Honda *Opinions*, LEGAL TIMES, June 12, 2000, at 74.

<sup>6</sup> See generally Ronald D. Rotunda, *The New States' Rights, the New Federalism, the New Commerce Clause and the Proposed New Abdication*, 25 OKLA. CITY U. L. REV. 869 (2000) (distinguishing modern day federalism from traditional federalism based on states' rights).

constraints on federal commerce power,<sup>7</sup> limited the local application of federal regulatory statutes to Congress's unmistakable intent,<sup>8</sup> and most importantly found that local non-economic activities lie outside the constitutional scope of Commerce Clause jurisdiction.<sup>9</sup> Yet, in spite of indications the Rehnquist Court is inclined to seek a new direction, it remains to be seen how it might do so in a way that minimizes troublesome conflicts with the existing body of constitutional precedent. This Article shows that the Court can look to the evolution of Sherman Act<sup>10</sup> jurisdiction to realign its approach to Commerce Clause jurisdiction to restore the balance of dual sovereignty while posing little immediate threat to constitutional precedent.

The first of two steps is for the Court to fully embrace competitive federalism as the long-run framework within which to gradually narrow the evolving contours of Commerce Clause jurisdiction.<sup>11</sup> Competitive federalism has experienced growing appreciation among political scientists, economists, and constitutional scholars,<sup>12</sup> with some

<sup>7</sup> *E.g.*, *New York v. United States*, 505 U.S. 144, 176–77 (1992) (holding that Congress cannot compel states to provide for the disposal of the radioactive waste generated within their borders or to take title to the waste in the alternative).

<sup>8</sup> *E.g.*, *Solid Waste Agency v. United States Army Corps of Eng'rs*, 531 U.S. 159, 174 (2001) (holding that the Clean Water Act could not be applied to an abandoned sand and gravel pit); *Jones v. United States*, 529 U.S. 848, 859 (2000) (using statutory construction to conclude that an owner-occupied residence does not qualify as property used in commerce).

<sup>9</sup> *See, e.g.*, *United States v. Morrison*, 529 U.S. 598, 627 (2000) (holding that 42 U.S.C. § 13,981, which provides a federal civil remedy for victims of gender-motivated violence, goes beyond Congress's Commerce Clause authority); *United States v. Lopez*, 514 U.S. 549, 567–68 (1995) (holding that the Gun-Free School Zones Act of 1990 exceeds Congress's authority to regulate commerce).

<sup>10</sup> Sherman Act, ch. 647, 26 Stat. 209 (1890).

<sup>11</sup> Competitive federalism is also variously known as “the economics of federalism,” Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 28 (1983), and “market-preserving federalism,” Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 14 (1995).

<sup>12</sup> *See generally* COMPETITION AMONG STATES AND LOCAL GOVERNMENTS: EFFICIENCY AND EQUITY IN AMERICAN FEDERALISM (Daphne A. Kenyon & John Kincaid eds., 1991) (examining interjurisdictional competition from economic, historical, and political science perspectives); THOMAS R. DYE, AMERICAN FEDERALISM: COMPETITION AMONG GOVERNMENTS xv (1990) (setting forth a theory of competitive federalism: “the encouragement of rivalry among state and local governments to offer citizen-taxpayers the best array of public services at the lowest costs”); James M. Buchanan & Charles J. Goetz, *Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model*, 1 J. PUB. ECON. 25 (1972) (providing a critical re-examination of the Tiebout model for local goods provision, with an emphasis on efficiency limits); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (arguing that there should be as much federal interest in the conduct of the corporation itself as in the market for its securities); Easterbrook, *supra* note 11 (arguing that competition among states may lead to better regulation); William A. Fischel, *Fiscal and Environmental Considerations in the Location of Firms in Suburban Communities*, in FISCAL ZONING AND LAND USE CONTROLS 119 (Edwin S. Mills & Wallace E. Oates eds., 1975) (extending the Tiebout model to include nonresidential land use); Wallace E. Oates & Robert M. Schwab, *Economic Competition Among Jurisdictions: Efficiency Enhancing or Distortion Inducing?*, 35 J. PUB. ECON. 333 (1988) (examining the normative implications of compe-

even suggesting it has been the driving force of sustained economic development in modern times.<sup>13</sup> There is no doubt the U.S. Constitution establishes a federal system, but this says nothing about what determines the proper balance of dual sovereignty. Under competitive federalism, state and federal governments compete with one another to provide regulation to a mobile citizenry. State regulation under local “police powers” is justified when economic markets fail to allocate resources efficiently due to economic spillovers—so-called “externalities”—that separate the parties who benefit from those who bear costs of an activity. When confined to a single state, competition from other states ensures that the state’s regulators have sufficient incentive to address economic spillovers. In the face of interstate spillovers, however, individual states will misallocate political resources by engaging in too little regulation of their internal economic markets. Federal regulation of economic markets under the Commerce Clause is justified only when competition between states leads to a political market failure.

This approach has been criticized as a prescription for how the Court should determine the limits of federal commerce power because those seeking regulation can always make a plausible claim that the activity in question generates an interstate economic spillover, while in fact they are motivated by private rent seeking.<sup>14</sup> Through-

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tion among local jurisdictions to attract new industry and income); Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the “Race-to-the-Bottom” Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992) (arguing that federal regulation dealing with the race-to-the-bottom is likely to produce undesirable results); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985) (exploring state competition from an empirical perspective); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987) (using Delaware as an example of successful state competition in corporate law); Roberta Romano, *State Competition for Corporate Charters*, in THE NEW FEDERALISM: CAN THE STATES BE TRUSTED? 129 (John A. Ferejohn & Barry R. Weingast eds., 1997) (describing how states’ laws enable competition for corporate charters and how Delaware has succeeded in attracting corporations); Carol M. Rose, *Planning and Dealing: Piecemeal Land Controls as a Problem of Local Legitimacy*, 71 CAL. L. REV. 837 (1983) (arguing that the proper mode for ensuring reasonable zoning variance decisions is to adopt a mediation model similar to a market-mimicking model); Rotunda, *supra* note 6 (describing the Supreme Court’s recent Commerce Clause jurisprudence and placing it within its historical context); Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956) (presenting an economic model that yields a solution for achieving the optimal level of expenditures for local public goods); Weingast, *supra* note 11 (analyzing federalism’s self-enforcing restraints against confiscating the wealth of citizens in the context of three rapidly developing economies); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing that state corporate legal systems protect shareholders and that state regulation is generally preferable to federal).

<sup>13</sup> See Weingast, *supra* note 11, at 1 (“Federalism proved fundamental to the impressive economic rise of . . . the United States in the 19th and early 20th centuries.”).

<sup>14</sup> Nelson Lund, *Federalism and Civil Liberties*, 45 U. KAN. L. REV. 1045, 1047 (1997) (arguing that it is difficult to realize the benefits of federalism because the obstruction of rent-seeking

out this Article we remain agnostic on this issue. Whether a federal regulation is driven by public interest or rent seeking, our sole concern is with how the Court can gradually identify and screen out applications of antitrust regulations that do not plausibly involve interstate economic spillovers. The Court can thereby move toward the proper balance of dual sovereignty, and political competition should increasingly limit the sum of economic rents the respective sovereigns are able to extract.<sup>15</sup>

Competitive federalism has clear implications for the evolution of Sherman Act jurisdiction. This evolution provides a useful roadmap to help the Court find the appropriate jurisdictional balance for its general Commerce Clause jurisprudence. It is both fitting and instructive that case law under one of the nation's first pieces of Commerce Clause legislation would provide such a roadmap,<sup>16</sup> for this is where judicial understanding of the relevant market failure can be expected to have evolved furthest to reduce legal uncertainty raised by the statutory shock. Passed in response to fears that the great trusts were beyond the power of any state to effectively regulate owing to a political market failure,<sup>17</sup> the Sherman Act prohibits only restraints of trade or commerce "among the several States."<sup>18</sup> For more than eighty years following passage of the Act, the Court struggled to identify the nature of the market failure resulting from various business practices alleged to restrain. This led to a patchwork of conflicting decisions, judicial confusion over the proper objective of the Act, and condemnation of business activities now widely recognized as pro-competitive. As economic theory progressed it gave the Court increasing insight into the nature and effect of various trade re-

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cannot be disentangled from the costs of federalism, such as encouragement of negative externalities and free riding).

<sup>15</sup> Cf. Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987) (describing ways other than rent creation that politicians can gain from private parties). We discuss the issue of rent seeking more fully *infra* text accompanying notes 272-73.

<sup>16</sup> The first piece of federal Commerce Clause regulation was the Interstate Commerce Act, ch. 104, 24 Stat. 379 (1887).

<sup>17</sup> See, e.g., Andrew I. Gavil, *Reconstructing the Jurisdictional Foundation of Antitrust Federalism*, 61 GEO. WASH. L. REV. 657, 658-60, 660 n.9, 689-91, 690 n.147 (1993) (describing the enactment of the Sherman Act as resulting from the states' inability adequately to regulate trusts); cf. Easterbrook, *supra* note 11, at 41 n.40 (noting that the Supreme Court made state regulation of trusts difficult because the Court held that states could not regulate goods in interstate commerce).

<sup>18</sup> Section 1 of the Sherman Act reads as follows: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal." Sherman Act, ch. 647, § 1, 26 Stat. 209 (1890). Section 2 of the Act reads as follows: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor . . ." *Id.* § 2.

straints. Driven largely by the Chicago School of economics,<sup>19</sup> anti-trust scholars began to develop and test hypotheses regarding a host of business practices that were argued to restrain trade.<sup>20</sup> This process eventually generated a body of scientific knowledge sufficiently reliable to support expert testimony on the nature of the market failure associated with trade restraints,<sup>21</sup> now widely regarded as the defendants' exercise of market power. The problem with market power is not that it allows firms to suppress competition or earn monopoly profits, but that it may lead them to misallocate resources by reducing output and raising prices to consumers. Courts and commentators now largely agree that the exclusive substantive objective of the Sherman Act is to promote consumer welfare.<sup>22</sup>

Case law under the Sherman Act has since evolved toward a body of clear, workable substantive rules. But relying uncritically on the substantial effects test from its decisions on general Commerce Clause jurisdiction, the Court has routinely upheld applications of the Sherman Act to restraints that harm consumers only locally, if at all. The Court's most recent jurisdictional decision under the Act indicates that it has yet to recognize the consumer welfare standard's profound jurisdictional implications. In *Summit Health, Ltd. v. Pinhas*,<sup>23</sup> a narrow majority of the Court found that an alleged conspiracy by a chain of hospitals to exclude a single doctor from the Los Angeles market for eye surgery had a sufficient nexus to interstate commerce to support jurisdiction under the Act. The Court reasoned that the defendants' alleged restraint on the practice of ophthalmological services should be measured by its impact on other market participants not just by its impact on the respondent.<sup>24</sup> Joined in dissent by three members of the Court, Justice Scalia noted that the majority's "analysis tells us nothing about the substantiality of the impact

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<sup>19</sup> Some have criticized the Chicago School for being ideologically motivated. Whether true or not, this criticism is largely irrelevant because the Chicago School focused on scientific hypothesis testing. The spirit of this approach can be found in Milton Friedman's pioneering essay, *The Methodology of Positive Economics*, in *ESSAYS IN POSITIVE ECONOMICS* 3 (1953) (describing how economics can be used to predict phenomena through hypothesis testing).

<sup>20</sup> This literature is too large to reference in full. Perhaps the first contributor was John McGee, who suggested in an early article that predatory pricing is irrational and that according to the trial record of *Standard Oil Co. v. United States*, 221 U.S. 1, 69 (1911), the Standard Oil Company never actually used it. John S. McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case*, 1 J.L. & ECON. 137 (1958).

<sup>21</sup> D. Bruce Johnsen, Daubert, *The Scientific Method, and Economic Expert Testimony*, 9 KAN. J.L. & PUB. POL'Y 149 (1999) (addressing the admissibility of economic expert testimony under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993)).

<sup>22</sup> See *Reiter v. Sonotone Corp.*, 442 U.S. 330, 343 (1979) (citing ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 66 (1978) and concluding that Congress intended the Sherman Act to be a "consumer welfare prescription").

<sup>23</sup> 500 U.S. 322 (1991).

<sup>24</sup> *Id.* at 331.

on interstate commerce generated by the particular conduct at issue here.”<sup>25</sup> He also argued that the Sherman Act does not “prohibit all conspiracies that have sufficient constitutional ‘nexus’ to interstate commerce to be regulated. It prohibits only those conspiracies that are ‘in restraint of trade or commerce among the several States.’ This language commands a judicial inquiry into the nature and potential effect of each particular restraint.”<sup>26</sup>

Following *Summit*, federal courts have regularly entertained cases in which the interstate exercise of market power is so unlikely that the defendants’ restraint should be presumed as a matter of law to be purely intrastate.<sup>27</sup> In the spirit of Justice Scalia’s dissent, the second step the Court should take to realign its approach to Commerce Clause jurisdiction is to overturn *Summit* by formally recognizing the jurisdictional implications of the consumer welfare standard. If the market failure justifying federal regulation of trade restraints is the exercise of market power, and if the problem with market power is that it injures consumers by raising prices, then, according to competitive federalism, trade restraints that do not plausibly increase prices to consumers outside the home state should lie beyond federal reach.

*Summit*’s expansive test for federal antitrust jurisdiction stands in contrast to the Court’s more recent decisions addressing Congress’s general Commerce Clause jurisdiction, which, though themselves supported by only narrow majorities, reflect the Court’s growing appreciation for competitive federalism. In *United States v. Lopez*,<sup>28</sup> for example, the Court struck down the federal Gun-Free School Zones Act (1990) as beyond Congress’s Commerce Clause jurisdiction because the criminal activity it addressed was neither commercial nor economic in nature and therefore could not possibly have had a substantial effect on interstate commerce. In *United States v. Morrison*,<sup>29</sup> the Court more recently struck down the civil remedy provision of the Violence Against Women Act (1994), again because the criminal activity it addressed was neither commercial nor economic in nature. As Chief Justice Rehnquist noted in both majority opinions, to find otherwise would convert the Commerce Clause into a general police

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<sup>25</sup> *Id.* at 336 (Scalia, J., dissenting).

<sup>26</sup> *Id.* at 333–34 (Scalia, J., dissenting) (citation omitted).

<sup>27</sup> Perhaps in an effort to highlight the absurdity of the majority’s holding in *Summit*, Judge Posner of the United States Court of Appeals for the Seventh Circuit noted in reviewing a post-*Summit* challenge to Sherman Act jurisdiction that if two children operating competing lemonade stands agreed to fix prices there is no clear principle preventing them from being subject to the jurisdiction of the Act, even though “the effect on the national economy would be slight.” *Hammes v. AAMCO Transmissions, Inc.*, 33 F.3d 774, 780 (1994).

<sup>28</sup> 514 U.S. 549, 566–67 (1995).

<sup>29</sup> 529 U.S. 598, 613 (2000).

power constitutionally reserved to the states under the Tenth Amendment.<sup>30</sup> The Court's obvious appreciation for competitive federalism in *Lopez* and *Morrison* suggests that it may be inclined to continue in this direction in future cases.

The remainder of this Article builds the normative case in favor of competitive federalism and shows how its implications for Sherman Act jurisdiction can be used to guide the evolution of general Commerce Clause jurisdiction. Part I reviews the relevant case law. It begins with a brief look at a selection of notable cases on general Commerce Clause jurisdiction and then turns specifically to the case law on Sherman Act jurisdiction. Our intent in reviewing this body of law is merely to lay a foundation to show that the geographic market power test is broadly consistent with Commerce Clause case law as it has evolved over the past 180 years.

Part II describes the simple economics of market power and illustrates the practical approach antitrust regulators have developed under the 1992 Horizontal Merger Guidelines ("Merger Guidelines") to define the relevant product and geographic markets.<sup>31</sup> This approach uses the *geographic antitrust market* to assess the likely effect of horizontal mergers on market power and consumer welfare, but we show it can easily be adapted to assess the interstate effects of any category of trade restraints.

Part III describes what we characterize as the *geographic market power test* for Sherman Act jurisdiction.<sup>32</sup> According to this test, to establish federal jurisdiction under the Act the complainant must allege and ultimately prove that the defendant has a sufficiently large share of the geographic antitrust market that it can plausibly exercise market power "in more States than one."<sup>33</sup> Although straightforward, this jurisdictional test is novel, substantively reasoned, and completely consistent with the methodology antitrust regulators use under the Merger Guidelines to evaluate the substantive merits of horizontal mergers.<sup>34</sup> The geographic market power test resolves a number of troubling inconsistencies in the Court's case law on federal antitrust jurisdiction.

Part IV demonstrates the analytical force of the geographic market power test. We show that it is consistent with the statutory intent

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<sup>30</sup> *Id.* at 618; *Lopez*, 514 U.S. at 567.

<sup>31</sup> 1992 Horizontal Merger Guidelines, 57 Fed. Reg. 41,552 (Sept. 10, 1992) [hereinafter Merger Guidelines].

<sup>32</sup> D. Bruce Johnsen & Moin A. Yahya, *A Geographic Market Power Test for Sherman Act Jurisdiction*, in *COMPETITION LAWS IN CONFLICT* 223 (Michael S. Greve & Richard A. Epstein eds., 2004).

<sup>33</sup> This was Justice Marshall's interpretation of "among the several states" in *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 194 (1824).

<sup>34</sup> Merger Guidelines, 57 Fed. Reg. at 41,554, § 1.1.

behind the Sherman Act, and that within the framework of competitive federalism it is the only economically sensible approach to setting appropriate limits on federal antitrust jurisdiction. Moreover, the geographic market power test will resolve the current turmoil over Sherman Act jurisdiction in the federal circuits and hasten the rate at which the Court's understanding of novel business practices evolves.

Part V concludes by sketching a model of how case law evolves in response to the judicial uncertainty created by statutory shocks. We show that the geographic market power test is a compelling step in the evolution of Sherman Act jurisdiction and that it provides the Court with a useful roadmap to realign its approach to general Commerce Clause jurisdiction. The legal uncertainty that attends most regulatory statutes prevents the Court from acting too quickly, but as the Court gradually accumulates the stock of knowledge necessary to identify the geographic scope of the underlying market failure, it can and should require an increasingly clear nexus between the proscribed conduct and an interstate spillover. This will allow the Court to achieve a balance of dual sovereignty consistent with competitive federalism while posing little immediate threat to constitutional precedent.

## I. A BRIEF HISTORY OF FEDERAL COMMERCE CLAUSE JURISDICTION

[A]dmittedly, our case law [on 'substantial effects'] has not been clear . . . .<sup>35</sup>

Every first-year law student learns that the federal government derives its sovereign authority from a limited set of powers enumerated in the Constitution. Although the Supremacy Clause ensures that these powers are plenary,<sup>36</sup> and the Necessary and Proper Clause ensures that they include the power to do whatever is necessary to effectuate them,<sup>37</sup> any power not specifically conferred on the federal government by the Constitution is expressly reserved to the sovereign states, or to the people, by the Tenth Amendment.<sup>38</sup> These residual powers include the states' local "police powers." Various enumerated federal powers have proven to be elastic, but perhaps none more so than the Commerce Clause, whose jurisprudence prescribes the delicate balance of dual sovereignty characteristic of our federal system. This section briefly reviews the Supreme Court's case law on federal Commerce Clause jurisdiction in four parts.

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<sup>35</sup> *Lopez*, 514 U.S. at 559 (Rehnquist, C.J.).

<sup>36</sup> U.S. CONST. art. VI.

<sup>37</sup> *Id.* art. I, § 8.

<sup>38</sup> The Tenth Amendment to the U.S. Constitution reads: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." *Id.* amend. X.



Part I.A examines the early era, beginning with Justice Marshall's famous opinion in *Gibbons v. Ogden*.<sup>39</sup> The ensuing case law during this era focused largely on the resolution of conflicts between state laws that discriminated against interstate commerce and unexercised federal commerce power—the so-called “negative,” or “dormant,” Commerce Clause. By the end of the era it tended toward a narrow and formalistic reading of the Commerce Clause. Part I.B examines the transitional era beginning with passage of the Sherman Act, marking the rise of the affirmative Commerce Clause. During this time, the Court gradually broadened federal authority over interstate commerce, ultimately rejecting, distinguishing, or simply ignoring many of its early decisions.<sup>40</sup> The transitional era witnessed a stunning increase in the number of federal statutes and culminated in the wake of the New Deal with the Court's famous decision in *Wickard v. Filburn*.<sup>41</sup> *Wickard* dramatically broadened federal commerce power by extending it to purely local activity that, when aggregated horizontally across all those covered by the regulation, “exerts a substantial economic effect on interstate commerce.”<sup>42</sup> Part I.C examines the modern era, focusing largely on federal antitrust jurisdiction under *Wickard*'s aggregated substantial effects test up through the Court's decision in *Summit*.<sup>43</sup> This era has been marked by a virtual proliferation of federal statutes tied to the Commerce Clause, many of them having little to do with obviously commercial activity. In upholding these statutes, the Court continued to expand general federal commerce power under the aggregated substantial effects test, leading to realistic concerns that federal authority had completely swallowed the local police powers of the several states.<sup>44</sup> Part I.D examines the Court's case law following *Summit*, which appears to embrace the framework of competitive federalism and may signal a post-modern

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<sup>39</sup> 22 U.S. (9 Wheat.) 1 (1824).

<sup>40</sup> See RONALD D. ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE §§ 4.6–4.8 (3d ed. 1999) (documenting the Court's Commerce Clause jurisprudence between 1888 and the present).

<sup>41</sup> 317 U.S. 111 (1942).

<sup>42</sup> *Id.* at 125.

<sup>43</sup> *Summit Health, Ltd. v. Pinhas*, 500 U.S. 322, 328–29 (1991) (“During the past century . . . the federal power over commerce . . . [has] experienced similar expansion.”).

<sup>44</sup> See TRIBE, *supra* note 3, at 816 (observing the “increasingly untenable position of claiming the power to strike down invocations of the Commerce Clause, while at the same time applying a set of doctrines that made it impossible actually to exercise this power”); Rotunda, *supra* note 6, at 902 (reviewing “commandeering” concerns over congressional direction of state legislative action and holding that “the ultimate purpose of the separation of powers . . . is to protect individuals”); see also Archibald Cox, *The Role of Congress in Constitutional Determinations*, 40 U. CINN. L. REV. 199, 259 (1971) (discussing the possibility of a comprehensive affirmative action program nationwide).

era destined to impose real constraints on federal Commerce Clause jurisdiction.

### A. *The Early Era*

In *Gibbons v. Ogden*, the Court struck down a New York law granting a monopoly to Robert Fulton over the transport of passengers by steamboat between New Jersey and New York because it directly conflicted with a federal statute regulating the “coasting trade.”<sup>45</sup> In prescribing the limits of federal authority over interstate commerce, Marshall found that “[c]ommerce among the States, cannot stop at the external boundary line of each State, but may be introduced into the interior.”<sup>46</sup> He went on to elaborate in the following famous passage, which the Court has interpreted at various times to support both narrow and broad federal commerce powers:

Comprehensive as the word “among” is, it may very properly be restricted to that commerce which concerns more States than one. . . . The enumeration presupposes something not enumerated; and that something . . . must be the exclusively internal commerce of a State[, which does] not affect other States, and with which it is not necessary to interfere, for the purpose of executing some of the general powers of the government.<sup>47</sup>

This statement draws an illusive distinction between state authority over completely internal commerce—which is reserved to the states—and federal authority over internal commerce that affects other states—which is the proper subject of federal regulation. In practice, the distinction has proven difficult to apply with any kind of precision because Marshall declined to provide a functional blueprint for identifying the nature of the “effects” necessary to resolve the balance of dual sovereignty. As we show later, the simple economics of market power provides such a blueprint in the field of antitrust that might usefully be generalized to other fields.

In *Cooley v. Board of Wardens*,<sup>48</sup> the petitioner challenged an 1803 Pennsylvania statute requiring vessels sailing in or out of the port of Philadelphia to employ a local pilot to navigate the Delaware River. After Cooley refused the services of a pilot for his vessels, the Philadelphia Board of Wardens assessed him one-half the normal pilotage fee required by the statute. Being licensed under the federal statute to carry on the coasting trade, Cooley demurred, claiming the Pennsylvania statute was invalid under the dormant Commerce Clause.

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<sup>45</sup> *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1 (1824).

<sup>46</sup> *Id.* at 194.

<sup>47</sup> *Id.* at 194–95.

<sup>48</sup> 53 U.S. (12 How.) 299, 318 (1851).

According to Justice Curtis, whether unexercised federal commerce power over a particular subject is exclusive depends crucially on the nature of the subject. “[T]he power to regulate commerce[] embraces a vast field, containing . . . exceedingly various subjects, quite unlike in their nature; some imperatively demanding a single uniform rule . . . and some, like the subject now in question, as imperatively demanding that diversity, which alone can meet the local necessities of navigation.”<sup>49</sup> In his view, “the nature of [pilotage] is such as to leave no doubt of the superior fitness and propriety, not to say the absolute necessity, of different systems of regulation, drawn from local knowledge and experience, and conformed to local wants.”<sup>50</sup> Justice Curtis thus made an early assertion of competitive federalism as the proper framework for identifying the nature of the effects necessary to resolve the balance of dual sovereignty.

The ensuing case law, much of it addressing dormant commerce powers, led the Court to a narrower and more formalistic view of federal commerce jurisdiction, while at the same time developing the concept of exclusive “state police powers” under the Tenth Amendment.<sup>51</sup> The Court’s increasing formalism gradually gave weight to the now discarded notion—characterized as “dual federalism”—that state and federal powers repose in separate geographic “spheres of sovereignty.”<sup>52</sup> Most notably, in *Wabash, St. Louis & Pacific Railway Co. v. Illinois*,<sup>53</sup> the Court found that a state statute prohibiting discrimination in railroad rates “for any distance within the State” would not have conflicted with the federal commerce power if its application had been confined to shipments occurring completely within the state. The Court struck down the statute in the case at hand, however, because it prohibited discrimination against shipments originating in Illinois but bound for other states.<sup>54</sup>

Perhaps the Court’s most formalistic statement of dual sovereignty came in *Kidd v. Pearson*.<sup>55</sup> In upholding a state statute allowing the importation and sale of intoxicating liquors within the state but prohibiting in-state manufacture, even for export, the Court stated:

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<sup>49</sup> *Id.* at 319.

<sup>50</sup> *Id.* at 320.

<sup>51</sup> Edward S. Corwin, *The Passing of Dual Federalism*, 36 VA. L. REV. 1, 15 (1950) (discussing emergence of “police power” concept in the Taney Court).

<sup>52</sup> See Gavil, *supra* note 17, at 678 n.90 (“Under the theory of dual federalism, the states and the federal government were viewed as co-sovereigns, with distinct and inviolable spheres of authority.”); Bruce Little, Note, *A Case of Judicial Backsliding: Artificial Restraints on the Commerce Power Reach of the Sherman Act*, 1985 U. ILL. L. REV. 163, 168 (1985) (describing the view that interstate commerce involves the flow of goods across state lines).

<sup>53</sup> 118 U.S. 557 (1886).

<sup>54</sup> *Id.* at 571–72.

<sup>55</sup> 128 U.S. 1 (1888).

If it be held that [commerce] includes the regulation of all such manufactures as are intended to be the subject of commercial transactions in the future, it is impossible to deny that it would also include . . . every branch of human industry. . . . [I]t would follow as an inevitable result that the duty would devolve on Congress to regulate all of these delicate, multiform, and vital interests—interests which in their nature are and must be, local in all the details of their successful management.<sup>56</sup>

Such a scheme, the Court insisted, would be impracticable.

### B. *The Transitional Era*

*United States v. E.C. Knight Co.*<sup>57</sup> was the first case to address the extent of federal antitrust jurisdiction under the Commerce Clause and it proved to be a false start. The restraint in question was a proposed horizontal combination between five sugar manufacturers that would have allowed its largest member, the American Sugar Refining Company, to control roughly ninety-eight percent of domestic sugar refining capacity. Relying heavily on *Kidd's* statement of dual federalism, the Court conceded that the combination would establish a "monopoly in manufacture," but found that it was nonetheless beyond the federal power to regulate under the Commerce Clause. In the Court's reasoning,

the power to control the manufacture of a given thing involves in a certain sense the control of its disposition . . . and although the exercise of that power may result in bringing the operation of commerce into play, it does not control it, and affects it only incidentally and indirectly. Commerce succeeds to manufacture, and is not a part of it.<sup>58</sup>

*E.C. Knight's* formalistic approach began to unravel only six years later in *Swift & Co. v. United States*,<sup>59</sup> where the Court struck down a collusive agreement between the dealers of sixty percent of the fresh meat in the country. Although their agreement to reduce the prices at which they bought livestock and raise the prices at which they sold fresh meat at wholesale applied to transactions strictly within single states, the Court had little trouble finding the agreement well within the reach of federal commerce power. Justice Holmes summarily dismissed *E.C. Knight's* formalistic view of federal commerce power in favor of a more functional approach, concluding that "commerce among the States is not a technical legal conception, but a practical one, drawn from the course of business."<sup>60</sup> The Court lay to rest any doubt about the status of *E.C. Knight* in its landmark decision in *Stan-*

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<sup>56</sup> *Id.* at 21.

<sup>57</sup> 156 U.S. 1 (1895).

<sup>58</sup> *Id.* at 12.

<sup>59</sup> 196 U.S. 375 (1905).

<sup>60</sup> *Id.* at 398.

*dard Oil Co. v. United States*,<sup>61</sup> where it expressly rejected as “unsound” the formalistic distinction between commerce and manufacture. Its case law thereafter began to embrace the more functional approach Holmes shaped in *Swift*.

In the *Shreveport Rate Case*,<sup>62</sup> the Court upheld an Interstate Commerce Commission order aimed at preventing discriminatory railroad rates by equalizing rates between Louisiana and Texas with those between equally-distant points entirely within the state of Texas. Undermining its earlier decision in *Wabash*, the Court found that the economic effects of purely intrastate activities of various rail carriers were so closely and substantially related to their interstate activities that Congress has the power to “prevent the common instrumentalities of interstate and intrastate commercial intercourse from being used in their intrastate operations to the injury of interstate commerce”<sup>63</sup> as long as federal control of intrastate rates is “essential or appropriate to the security of that traffic . . . [and] the efficiency of the interstate service . . . .”<sup>64</sup>

Roughly fifteen years later, Franklin Roosevelt’s unprecedented New Deal legislation ushered in a host of conflicts between state police powers and the affirmative Commerce Clause. Initially, in *A.L.A. Schechter Poultry Corp. v. United States*<sup>65</sup> and *Carter v. Carter Coal Co.*,<sup>66</sup> the Court retreated to the distinction between direct and indirect effects on commerce it had relied on in *E.C. Knight*. Striking down the wages and hours provisions of the National Industrial Recovery Act,<sup>67</sup> the Court in *Schechter* found that persons employed in purely intrastate activities have only an indirect effect on interstate commerce and therefore fall outside the reach of federal commerce power.<sup>68</sup> Roosevelt’s Court Packing Plan quickly put an end to this retreat.<sup>69</sup> In *NLRB v. Jones & Laughlin Steel Corp.*, the Court addressed a challenge to the National Labor Relations Act of 1935,<sup>70</sup> which prohibited employers from engaging in various “unfair labor practices affecting

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<sup>61</sup> 221 U.S. 1, 69 (1911).

<sup>62</sup> *Houston, E. & W. Texas Ry. Co. v. United States*, 234 U.S. 342, 360 (1918) [hereinafter *Shreveport Rate Case*].

<sup>63</sup> *Id.* at 353.

<sup>64</sup> *Id.* at 351. For a detailed discussion of the *Shreveport Rate Case*, see Richard A. Epstein, *The Proper Scope of the Commerce Power*, 75 VA. L. REV. 1387, 1415–21 (1987).

<sup>65</sup> 295 U.S. 495 (1935).

<sup>66</sup> 298 U.S. 238, 304 (1936) (“Mining brings the subject matter of commerce into existence, Commerce disposes of it.”).

<sup>67</sup> 15 U.S.C. §§ 703-10, ch. 90, 48 Stat. 195 (1933) (as amended and modified by Act of June 14, 1935, ch. 246, 49 Stat. 275).

<sup>68</sup> *Schechter*, 295 U.S. at 543.

<sup>69</sup> See Epstein, *supra* note 64, at 1443; Rotunda, *supra* note 6, at 872 n.12.

<sup>70</sup> 29 U.S.C. § 151, ch. 372, 49 Stat. 449 (1935).

commerce."<sup>71</sup> Although purporting to preserve the distinction between commerce among the several states and commerce completely internal to states,<sup>72</sup> Chief Justice Hughes abandoned *Schechter's* direct-indirect effects distinction. Instead, he found that the reach of the federal commerce power is necessarily a question of degree, extending to intrastate activities having "such a close and substantial relation to interstate commerce that their control is essential or appropriate to protect that commerce from burdens and obstructions."<sup>73</sup>

Five years later, in *Wickard v. Filburn*,<sup>74</sup> the Court cemented *Jones & Laughlin Steel's* "close and substantial relation" approach, finally putting to rest the formalistic distinctions it relied on in *Wabash*, *Kidd*, *E.C. Knight*, and *Schechter* and expanding federal commerce power to what may be "the outer limits" of the constitutional authority. In *Wickard*, the Agricultural Adjustment Act<sup>75</sup> imposed a national quota on the "marketing" of wheat, and the Secretary of Agriculture's marketing orders in turn allotted the national quota to individual farms, including Filburn's. When Filburn produced what the Court conceded was a "trivial" amount of wheat in excess of his allotment purely for use and consumption on the farm, the Secretary assessed him a marketing penalty. Filburn claimed the marketing quotas were beyond the reach of federal commerce jurisdiction because they applied to strictly local production and consumption whose effects on interstate commerce, if any, were merely "indirect."<sup>76</sup> The Court flatly rejected Filburn's claim. Noting that Justice Marshall's opinion in *Gibbons* "described the federal commerce power with a breadth never yet exceeded,"<sup>77</sup> Justice Jackson found that Congress can regulate even local production for farm use that is trivial by itself if, aggregated horizontally across many local producers, "it exerts a substantial economic effect on interstate commerce" by displacing market trans-

<sup>71</sup> 301 U.S. 1, 22 (1937).

<sup>72</sup> As the Court put it,

The congressional authority to protect interstate commerce from burdens and obstructions . . . must be considered in the light of our dual system of government and may not be extended so as to embrace effects upon interstate commerce so indirect and remote that to embrace them, in view of our complex society, would effectually obliterate the distinction between what is national and what is local and create a completely centralized government.

*Id.* at 36-37.

<sup>73</sup> *Id.* at 37.

<sup>74</sup> 317 U.S. 111 (1942).

<sup>75</sup> 7 U.S.C. §§ 1281-1407, ch. 30, 52 Stat. 31 (1938).

<sup>76</sup> *Id.* at 119.

<sup>77</sup> *Id.* at 120. Jackson also made the following point: "At the beginning Chief Justice Marshall described the federal commerce power with a breadth never yet exceeded. He made emphatic the embracing and penetrating nature of this power by warning that effective restraints on its exercise must proceed from political rather than from judicial processes." *Id.* (citation omitted).

actions that would otherwise occur.<sup>78</sup> We characterize this as the *cumulative* or *aggregated* “substantial effects” test for federal commerce jurisdiction.<sup>79</sup>

### C. *The Modern Era*

Three years after its expansive decision in *Wickard v. Filburn*, the Court decided *Mandeville Island Farms, Inc. v. American Crystal Sugar Co.*,<sup>80</sup> specifically relying on *Wickard*'s horizontal aggregation principle to establish Sherman Act jurisdiction over an agreement among local sugar beet refiners. The complaint alleged that the defendant, one of three refiners located in northern California, conspired with the other two refiners to revise the standard form contract they used to buy beets from nearby growers. Prior to the revision, growers' receipts from refiners were based on a formula multiplying the number of pounds of beets purchased by the percentage of the refiner's net returns per pound of beets from sugar sales, all adjusted by the tested sugar content of the grower's beets over the period covered by the contract.<sup>81</sup> The revised contracts specified instead that the grower's receipts were to be determined by the average net return of all three refiners combined.

The plaintiffs, a group of growers that had agreed to the revised contract, later brought an action under the Sherman Act alleging the defendant's actions illegally fixed the price of sugar beets and thereby restrained interstate commerce in sugar.<sup>82</sup> Yet, the district court judge inferred just the opposite from the face of the contracts contained in the complaint, according to which the price of sugar in interstate commerce determined the price the defendant refiners paid per pound of raw beets to the growers. To expedite an appeal on the question of federal jurisdiction, the district court allowed the

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<sup>78</sup> *Id.* at 125.

<sup>79</sup> It is worth noting that Congress specifically anticipated the problem posed by the cumulative effects of non-market production by including wheat grown and used for home consumption in the Act's definition of the national marketing quota. *Id.* at 118–19.

<sup>80</sup> 334 U.S. 219 (1948).

<sup>81</sup> The contracts also specified that the growers would buy all seed from the refiner, cultivate beets only on specifically designated land, and sell exclusively to the refiner. Further, the refiner had a right to supervise the planting, cultivation, irrigation, and harvesting of the beets, including “the right to ascertain quality through growing and harvesting seasons by sampling and polarizing.” *Id.* at 222–23. The contracts therefore consisted of a bilateral sharing arrangement between each refiner and the growers with whom it had entered into contracts, with each grower's relative share being adjusted according to the measured sugar content of its own beets. The sugar content of the growers' beets, the price per pound of refined sugar net of the refiner's selling costs, and the growers' production costs per pound determined their profits. The refiners' production costs and the price of refined sugar net of selling costs determined their profits.

<sup>82</sup> *Id.* at 226 n.6.

plaintiffs to amend their complaint to eliminate the allegation that the defendant's restraint "affected the price of sugar in interstate commerce," in essence replacing it with the charge that the restraint of trade in beets independently affected interstate commerce.<sup>83</sup>

Writing for the Supreme Court, Justice Rutledge found that the three refiners were the only practical market for the petitioners' beets owing to high transport costs and barriers to entry by competing refiners. As a result, the conspirators controlled the quantity of sugar manufactured and sold in interstate commerce from northern California.<sup>84</sup> In response to the defendant's claim that the three refiners were powerless to affect the national price of sugar, Rutledge found "[t]he idea that stabilization of prices paid for the only raw material consumed in an industry has no influence toward reducing competition in the distribution of the finished product, in an integrated industry such as this, is impossible to accept."<sup>85</sup> Drawing on *Wickard's* horizontal aggregation principle, he reasoned that

Congress' power to keep the interstate market free of goods produced under conditions inimical to the general welfare may be exercised in individual cases without showing any specific effect upon interstate commerce; it is enough that the individual activity when multiplied into a general practice . . . contains a threat to the interstate economy that requires preventive regulation.<sup>86</sup>

In *United States v. Oregon State Medical Society*,<sup>87</sup> the Court took a more limited approach to federal commerce power. There, the government brought a civil action to enjoin various medical associations and doctors that had joined together to provide affordable prepaid medical plans to subscribing patients entirely within the state of Oregon. Because the plans drew providing doctors from the patients' local community and because the doctors associated themselves exclusively with either the state or the county medical society's plan, the government claimed the arrangements amounted to territorial allocations in restraint of interstate commerce under Sections 1 and 2 of the Sherman Act. Justice Jackson rejected the Government's claim noting that there was no evidence of an attempt by the defendants to withhold medical service. According to Justice Jackson, the only interstate commerce involved related to a few "sporadic" and "incidental" payments to "out-of-state doctors" for patients who happened to be temporarily away from their local service areas in Oregon.<sup>88</sup> This was insufficient to show a restraint of trade in interstate commerce.

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<sup>83</sup> *Id.* at 247.

<sup>84</sup> *Id.* at 240-41.

<sup>85</sup> *Id.* at 241.

<sup>86</sup> *Id.* at 236 (citations omitted).

<sup>87</sup> 343 U.S. 326 (1952).

<sup>88</sup> *Id.* at 338-39.



Instead, he reasoned that the government would have had to show interstate commerce was adversely affected *specifically* by the “allocation of territories by doctor-sponsored plans, [but as] far as any evidence brought to [the Court’s] attention discloses, the activities of the latter are wholly intrastate.”<sup>89</sup> In the antitrust setting, Justice Jackson apparently eschewed application of the horizontal aggregation principle he had announced in *Wickard*. This surely would have allowed him to find a substantial effect on interstate commerce if he had chosen to follow Justice Rutledge’s use of horizontal aggregation in *Mandeville Island Farms*.<sup>90</sup>

In the midst of the Great Society programs of the 1960s, the Court handed down a number of decisions dramatically expanding general federal commerce power under the substantial effects test while failing to identify any principled limitation on its application.<sup>91</sup> The most obvious expansion was driven by the compelling social objective in the realm of civil rights, where the underlying evil—racial discrimination—had little obvious connection to commercial activity. This expansion is most clearly evident in *Katzenbach v. McClung*,<sup>92</sup> *Heart of Atlanta Motel, Inc. v. United States*,<sup>93</sup> and *Daniel v. Paul*,<sup>94</sup> where the Court relied on both horizontal and vertical aggregation to show that the defendants’ seemingly local activities substantially affected interstate commerce. The Court’s reasoning went something like this: Even if a particular instance of racial discrimination in a local restaurant’s food sales does not, by itself, substantially affect interstate commerce, it is sufficient if that restaurant’s vertically related inputs, say, its raw food supplies, are “in commerce.” This is because the food supplies of all restaurants engaged in racial discrimination, when aggregated horizontally, comprise a substantial portion of interstate commerce. If such restaurants were magically to vanish—that is, but-for their existence—the economic effect on the quantum or character of interstate commerce would surely be substantial in some way. These cases explicitly reject any requirement that the party asserting Commerce Clause jurisdiction show a nexus between the spe-

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<sup>89</sup> *Id.*

<sup>90</sup> 334 U.S. 219 (1948).

<sup>91</sup> Given that the Sherman Act’s reach is said to be coincident with the limits of constitutional commerce power, the underlying tension between *Mandeville Island Farms* and *Oregon State Medical Society* was thereby resolved in favor of *Mandeville Island Farms*. Perhaps, however, *Mandeville Island Farms* and *Oregon State Medical Society* can be distinguished procedurally. *Mandeville Island Farms* involved an appeal from a pre-trial dismissal, whereas *Oregon State Medical Society* involved an appeal from a dismissal following a full trial on the merits.

<sup>92</sup> 379 U.S. 294 (1964).

<sup>93</sup> 379 U.S. 241, 247–48 (1964).

<sup>94</sup> 395 U.S. 298 (1969).

cific instance of racial discrimination and an effect on interstate commerce.

By 1975, the vertical aggregation principle on which the Court relied in the civil rights cases began to creep into its decisions on Sherman Act jurisdiction. In *Goldfarb v. Virginia*,<sup>95</sup> the Court considered a challenge to the Fairfax County Bar Association's ("FCBA") minimum fee schedule. When the plaintiffs were unable to find an attorney willing to perform an examination for their residential real estate closing for a reduced fee, they filed a class action suit alleging that the FCBA's minimum fee schedule violated Sections 1 and 2 of the Sherman Act.<sup>96</sup> Writing for a unanimous Court, Chief Justice Burger reasoned that, as a practical matter, title examinations are indispensable to the financing of real estate transactions because lenders require them as a condition for making a loan. Since a substantial volume of real estate loans originated outside the state, and "[g]iven the substantial volume of commerce involved, and the inseparability of [title examinations] from the interstate aspects of real estate transactions," he concluded that "interstate commerce has been sufficiently affected,"<sup>97</sup> regardless of whether the fee schedule could be shown to reduce the number of title examinations or increase fees. Thus, according to Burger's assessment, but-for the availability of all title examinations aggregated horizontally the market for a vertically-related input in the stream of commerce—real estate financing—would surely suffer a substantial economic effect sufficient to support federal jurisdiction.<sup>98</sup>

In *Hospital Building Co. v. Trustees of Rex Hospital*,<sup>99</sup> the Court extended the cumulative effects test to a local hospital's alleged attempt to restrict the supply of hospital beds. The substance of the petitioners claim was that Rex Hospital and others conspired to monopolize the hospital business in Raleigh, North Carolina, by attempting to prevent the petitioner from expanding its hospital facilities in that market. Although the petitioner's hospital business was strictly local, it asserted the necessary connection to interstate commerce because a substantial portion of its own medicines and supplies, insurance proceeds, management services, and construction loans came from outside the state. The district court dismissed the petitioner's amended complaint because it failed to allege a sufficient nexus between the

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<sup>95</sup> 421 U.S. 773 (1975).

<sup>96</sup> 15 U.S.C. § 1 (2004).

<sup>97</sup> *Id.* at 785.

<sup>98</sup> Justice Burger went on to note that "there may be legal services that have no nexus with interstate commerce and thus are beyond the reach of the Sherman Act," but he gave no indication of how a party might make such a factual showing within the parameters set by the remainder of his opinion. *Id.* at 785–86.

<sup>99</sup> 425 U.S. 738 (1976).

claimed violations of the Sherman Act and interstate commerce, but in doing so it apparently failed clearly to indicate whether it had based its dismissal on lack of subject matter jurisdiction or on the petitioner's failure to state a claim upon which relief could be granted. Sitting en banc, the court of appeals affirmed, finding that the petitioner's hospital business was strictly local and that the petitioner failed adequately to allege in the amended complaint that the respondents' actions had or would likely have had an effect on any market price or a substantial effect on interstate commerce.

The Supreme Court reversed the lower courts. Stating that the basis for the district court's dismissal was irrelevant, Justice Marshall argued that "[i]n either event, the critical inquiry is into the adequacy of the nexus between respondents' conduct and interstate commerce that is alleged in the complaint."<sup>100</sup> Marshall went on to find that "[a]n effect can be 'substantial' under the Sherman Act even if its impact on interstate commerce falls far short of . . . affecting market price."<sup>101</sup> He concluded that the petitioner's complaint was wholly adequate to state a claim in this case because it "fairly [alleges that the] conspiracy, to the extent it is successful, will place 'unreasonable burdens on the free and uninterrupted flow' of interstate commerce."<sup>102</sup>

In spite of the Court's back-door acceptance of horizontal aggregation in *Mandeville Island Farms* and vertical aggregation in *Goldfarb*, most circuits continued to require Sherman Act plaintiffs to establish jurisdiction in one of two ways. The plaintiff could claim either that the allegedly unlawful conduct itself took place "in commerce" or that the allegedly unlawful conduct had a "substantial effect" on interstate commerce, even though it took place intrastate. In *McLain v. Real Estate Board*,<sup>103</sup> however, the Court found Sherman Act jurisdiction where the defendants' broader business activities, aggregated vertically, were in interstate commerce even though the allegedly unlawful conduct was not.

The plaintiff class of real estate buyers in *McLain* claimed that real estate brokers in the greater New Orleans area had engaged in a massive conspiracy to fix commission rates, split fees, and suppress useful market information. The only connection between the conspiracy and interstate commerce shown by the plaintiffs was that brokers routinely, though gratuitously, advised buyers on how to obtain title insurance and financing, often from sources outside Louisiana. The district court found that the defendants' brokerage activity occurred

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<sup>100</sup> *Id.* at 742 n.1.

<sup>101</sup> *Id.* at 745.

<sup>102</sup> *Id.* at 746.

<sup>103</sup> 444 U.S. 232 (1980).

entirely in Louisiana and that the plaintiffs failed to allege, as required by *Goldfarb*, that the provision of insurance and financing constituted a large volume of interstate commerce inseparable from brokerage services. Accordingly, it dismissed the complaint for lack of federal jurisdiction, and the court of appeals affirmed.<sup>104</sup>

Chief Justice Burger reversed the lower courts, finding that they had misinterpreted *Goldfarb*. That case, he asserted, addressed the "in commerce" test rather than the "substantial effects" test. To establish that the defendants' activities were in the stream of commerce, it was necessary to show that they were an "integral part of an interstate transaction."<sup>105</sup> As in *Goldfarb*, such a showing is unnecessary where the alleged basis for federal jurisdiction is the substantial effects test, which "in no way restricted it to those challenged activities that have an integral relationship to an activity in interstate commerce."<sup>106</sup> As Burger described the substantial effects test:

To establish the jurisdictional element of a Sherman Act violation it would be sufficient for petitioners to demonstrate a substantial effect on interstate commerce generated by respondents' [broader] brokerage activity. Petitioners need not make the more particularized showing of an effect on interstate commerce caused by the alleged conspiracy to fix commission rates, or by those other aspects of respondents' activity that are alleged to be unlawful. . . . If establishing jurisdiction required a showing that the unlawful conduct itself had an effect on interstate commerce, jurisdiction would be defeated by a demonstration that the alleged restraint failed to have its intended anticompetitive effect. This is not the rule of our cases.<sup>107</sup>

Given the uncontroverted testimony from local lenders that an appreciable amount of their residential real estate loans occurred in interstate commerce, Burger concluded that "there remains only the requirement that respondents' activities which allegedly have been infected by a price-fixing conspiracy be shown 'as a matter of practical economics' to have a not insubstantial effect on the interstate commerce involved."<sup>108</sup> The infected activities version of the substantial effects test apparently requires the plaintiff to allege only that the defendants' unlawful conduct stands to have a "not insubstantial effect" on interstate commerce because, being interstate, the defendants' broader vertically-related business activities, such as title insurance and real estate financing, can be presumed to have a substantial

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<sup>104</sup> The district court dismissed the complaint for failure to state a claim under FED. R. CIV. P. 12(b)(6), while the court of appeals affirmed the district court's ruling for failure of subject matter jurisdiction under FED. R. CIV. P. 12(b)(1).

<sup>105</sup> *McLain*, 444 U.S. at 244.

<sup>106</sup> *Id.*

<sup>107</sup> *Id.* at 242.

<sup>108</sup> *Id.* at 246 (quoting *Hosp. Bldg. Co. v. Trustees of Rex Hosp.*, 425 U.S. 738, 745 (1976)).

economic effect on interstate commerce when aggregated horizontally across all defendants. That is, but-for the defendants' allegedly unlawful conduct, the economic effect on the quantum or character of interstate commerce would be substantial, and this, according to Burger, was enough to carry the plaintiffs' jurisdictional burden.

Finally, in *Summit Health, Ltd. v. Pinhas*,<sup>109</sup> the Court established its most expansive version of the substantial effects test, finding that a Sherman Act defendant's entire line of business can be infected by an economically trivial local restraint. The plaintiff in that case was a licensed and very skilled eye surgeon who refused to hire the services of a physician's assistant as required by the defendants' hospital policy. In response, the defendants—including the hospital at which the plaintiff held staff privileges, its parent corporation, and several of the plaintiff's fellow doctors who served on the hospital's peer review board—initiated peer review proceedings resulting in severe restrictions on the plaintiff's practice and an impending group boycott of his services by the defendants and other hospitals throughout the Los Angeles area.<sup>110</sup> The plaintiff filed a complaint in federal court alleging, among other things, that the defendants had conspired to drive him out of the Los Angeles market by boycotting his services in an effort to increase their market share.<sup>111</sup> To establish federal jurisdiction under the Sherman Act, the plaintiff alleged that the defendant corporate parent's hospitals served nonresident patients, received reimbursements from out-of-state insurers and the federal government, purchased supplies from the stream of commerce, and distributed peer review reports across state lines.<sup>112</sup> In response to the defendants' contention that the plaintiff's complaint failed to describe an adequate nexus between the alleged group boycott and interstate commerce, the district court dismissed the complaint.<sup>113</sup> The court of appeals reversed, finding that "as a matter of practical economics' the hospital's 'peer review process in general' obviously affected interstate commerce."<sup>114</sup>

Writing for the majority,<sup>115</sup> Justice Stevens found that the petitioner was unquestionably engaged in interstate commerce even though its primary activity involved the provision of general health care services in a local market. Echoing the court of appeals, Stevens reasoned that "[a]s 'a matter of practical economics,' the effect of

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<sup>109</sup> 500 U.S. 322 (1991).

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.* at 327-28.

<sup>113</sup> *Id.* at 322.

<sup>114</sup> *Id.* at 328.

<sup>115</sup> Chief Justice Rehnquist and Justices White, Marshall, and Blackmun concurred in the opinion.

such a conspiracy on the hospital's 'purchases of out-of-state medicines and supplies as well as its revenues from out-of-state insurance companies' would establish the necessary interstate nexus."<sup>116</sup> In response to the petitioners' claim that a boycott of a single surgeon was insufficient to establish jurisdiction, Stevens reasoned that the mere existence of an illegal agreement violates the Act regardless of its actual effects and that, if successful, the conspiracy would surely have reduced the supply of eye surgery in the Los Angeles market.<sup>117</sup> Quoting *McLain*, he found that the respondent "need not make the more particularized showing of an effect on interstate commerce caused by the alleged conspiracy to fix commission rates, or by those other aspects of respondents' activity that are alleged to be unlawful."<sup>118</sup> What is more, according to Stevens, "[t]he competitive significance of respondent's exclusion from the market must be measured, not just by a particularized evaluation of his own practice, but rather, by a general evaluation of the impact of the restraint on other participants and potential participants in the market from which he has been excluded."<sup>119</sup>

In his dissent, Justice Scalia argued that the Act's language, "in restraint of trade or commerce among the several States,"<sup>120</sup> does indeed require the Court to examine the nature and likely effect of the restraint in each particular case. In his view, *McLain*'s "infected activity" test was the result of the Court's confusion over the law.<sup>121</sup> Scalia argued that the Court could easily have found jurisdiction in *McLain*, given the massive conspiracy being alleged, but instead it resorted to the infected activities test under the mistaken belief that "focusing upon the effects of the restraint itself would require plaintiffs to prove their case at the jurisdictional stage. That belief was in error, since the prior approach had simply assumed, rather than required proof of, the success of the conspiracy."<sup>122</sup> As a result, Justice Scalia lamented, the Court missed an opportunity to clear up the confusion in the circuits following *McLain* and had in fact made things worse. To establish Sherman Act jurisdiction in this case, he observed:

[The Court] looks *neither* to the effect on commerce of the restraint, *nor* to the effect on commerce of the defendants' infected activity, but rather, it seems, to the effect on commerce of the activity from which the plaintiff has been excluded. As I understand the Court's opinion, the test of Sherman Act jurisdiction is whether the entire line of commerce from

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<sup>116</sup> *Summit*, 500 U.S. at 329 (citations omitted).

<sup>117</sup> *Id.* at 331.

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* at 332.

<sup>120</sup> *Id.* at 333–34.

<sup>121</sup> *Id.* at 335.

<sup>122</sup> *Id.* (citation omitted).

which Dr. Pinhas has been excluded affects interstate commerce. Since excluding him from eye surgery at Midway Hospital effectively excluded him from the entire Los Angeles market for eye surgery . . . the jurisdictional question is simply whether that market affects interstate commerce, which of course it does. This analysis tells us nothing about the substantiality of the impact on interstate commerce generated by the particular conduct at issue here.

Determining the “market” for a product or service, meaning the scope of other products or services against which it must compete, is of course necessary for many purposes of antitrust analysis. But today’s opinion does not identify a relevant “market” in *that* sense. It declares Los Angeles to be the pertinent “market” only because that is the entire scope of Dr. Pinhas’ exclusion from practice. . . . I cannot understand why “market” in the Court’s peculiar sense has any bearing upon this restraint’s impact on interstate commerce, and hence upon Sherman Act jurisdiction. The Court does not even attempt to provide an explanation.<sup>123</sup>

Thus, the Court took vertical and horizontal aggregation to the extreme; but-for the entire Los Angeles market for eye surgery, the effect on the quantum or character of interstate commerce would be substantial, and the plaintiff’s complaint was sufficient to establish federal jurisdiction. Justice Scalia emphasized the absurdity of the Court’s but-for approach in pointedly observing that if “the alleged conspirators in the present case had decided to effectuate the ultimate exclusion of Dr. Pinhas, *i.e.*, to have him killed, it would be absurd to think that the *world market* in eye surgery would thereby be affected.”<sup>124</sup> As Justice Scalia asserted, the Court’s inference that competition in the Los Angeles market could have been affected by the exclusion of a single surgeon from the Los Angeles market therefore ignores the “‘practical economics’ of the matter.”<sup>125</sup>

#### *D. The Post-Modern Era?*

Beginning in the early 1990s, the Court began to limit the scope of federal commerce power. The ensuing line of cases raises the prospect that the Rehnquist Court has entered a post-modern era in which it will continue to set limits on Congress’s regulatory authority under the Commerce Clause. Whether or not this is true remains to be seen, but the case law thus far suggests that the Court has embraced the framework of competitive federalism in this field to guide its decisions.

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<sup>123</sup> *Id.* at 336–37 (footnote omitted).

<sup>124</sup> *Id.* at 338.

<sup>125</sup> *Id.*

In *New York v. United States*,<sup>126</sup> the Court addressed the limits imposed on federal regulatory authority by the Tenth Amendment. There, the Low-Level Radioactive Waste Policy Amendments Act of 1985<sup>127</sup> imposed on states the obligation to dispose of radioactive waste generated within their borders. The Act provided for a system of incentives to encourage the states to comply with this obligation. Among other things, the “take title” incentive required states that failed to provide for disposal of radioactive waste generated within the state to assume title and take possession of the waste and to bear any liability imposed on the generator arising from their failure to do so.

The State of New York and two of its counties brought suit against the United States seeking a declaratory judgment that the incentive system was in conflict with the Tenth Amendment. The Court found that, although severable from the rest of the Act, the take title incentive was unconstitutionally coercive and therefore fell outside Congress’s enumerated powers. In Justice O’Connor’s words:

Because an instruction to state governments to take title to waste, standing alone, would be beyond the authority of Congress, and because a direct order to regulate, standing alone, would also be beyond the authority of Congress, it follows that Congress lacks the power to offer the States a choice between the two. . . . Either way, “the Act commandeers the legislative processes of the States by directly compelling them to enact and enforce a federal regulatory program” . . . .

. . . .

. . . Whether one views the take title provision as lying outside Congress’ enumerated powers, or as infringing upon the core of state sovereignty reserved by the Tenth Amendment, the provision is inconsistent with the federal structure of our Government established by the Constitution.<sup>128</sup>

In *United States v. Lopez*,<sup>129</sup> the Court struck down the federal Gun-Free School Zones Act,<sup>130</sup> specifically rejecting unconstrained aggregation to establish a substantial effect on interstate commerce. As Chief Justice Rehnquist stated for the majority,

possession of a gun in a local school zone is in no sense an economic activity that might, through repetition elsewhere, substantially affect any sort of interstate commerce. . . .

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<sup>126</sup> 505 U.S. 144 (1992).

<sup>127</sup> Pub. L. No. 99-240, 99 Stat. 1842 (1986) (codified at 42 U.S.C. §§ 2021–2022).

<sup>128</sup> *Id.* at 176–77 (citation omitted).

<sup>129</sup> 514 U.S. 549 (1995).

<sup>130</sup> 18 U.S.C. § 922(q), Pub. L. No. 101-647, 104 Stat. 4844 (1990).



[To hold otherwise] would bid fair to convert congressional authority under the Commerce Clause to a general police power of the sort retained by the States.<sup>131</sup>

In a concurring opinion, Justice Thomas noted the many inconsistencies in the substantial effects test and singled out the aggregation principle for special criticism. In his view, under this principle,

Congress can regulate whole categories of activities that are not themselves either “interstate” or “commerce.” In applying the [substantial] effects test, we ask whether the class of activities *as a whole* substantially affects interstate commerce, not whether any specific activity within the class has such effects when considered in isolation.

The aggregation principle is clever, but has no stopping point. . . . [O]ne *always* can draw the circle broadly enough to cover an activity that, when taken in isolation, would not have substantial effects on commerce.<sup>132</sup>

In *United States v. Morrison*,<sup>133</sup> the Court struck down the civil remedy provision of the Violence Against Women Act of 1994,<sup>134</sup> specifically rejecting Congress’s reliance on the aggregation principle to establish a substantial effect on interstate commerce. According to Chief Justice Rehnquist, it is unworkable to extrapolate a “but-for causal chain from the initial occurrence of violent crime . . . to every attenuated effect upon interstate commerce. If accepted, [this] reasoning would allow Congress to regulate any crime as long as the nationwide, aggregated impact of that crime has substantial effects on employment, production, transit, or consumption.”<sup>135</sup>

Various Justices in *Lopez* and *Morrison* implicitly relied on the framework of competitive federalism as a basis for resolving the balance of dual sovereignty. In *Lopez*, Justices Kennedy and O’Connor emphasized the importance of political innovation:

While it is doubtful that any State, or indeed any reasonable person, would argue that it is wise policy to allow students to carry guns on school premises, considerable disagreement exists about how best to accomplish that goal. In this circumstance, the theory and utility of our federalism are revealed, for the States may perform their role as laboratories for experimentation to devise various solutions where the best solution is far from clear.

If a State or municipality determines that harsh criminal sanctions are necessary and wise to deter students from carrying guns on school premises, the reserved powers of the States are sufficient to enact those

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<sup>131</sup> *Id.* at 567.

<sup>132</sup> *Id.* at 600 (citation omitted).

<sup>133</sup> 529 U.S. 598 (2000).

<sup>134</sup> Pub. L. No. 103-322, 108 Stat. 1902 (1994) (codified at 42 U.S.C. § 13,701)

<sup>135</sup> *Id.* at 615.

measures. Indeed, over 40 States already have criminal laws outlawing the possession of firearms on or near school grounds.<sup>136</sup>

More recently, in *Solid Waste Agency v. United States Army Corps of Engineers*,<sup>137</sup> the Court struck down the Corps' regulation of "isolated wetlands" pursuant to the Migratory Bird Rule.<sup>138</sup> In the majority's view, the rulemaking authority Congress granted to the Corps under the Clean Water Act<sup>139</sup> lacked the clear expression of congressional intent to encroach on the traditional state police powers necessary to support the Migratory Bird Rule. Notable in this decision is Justice Stevens's dissent, joined by three other Justices, which makes a strong theoretical case for competitive federalism as a basis for federal regulation:

[T]he migratory bird rule does not blur the "distinction between what is truly national and what is truly local." Justice Holmes cogently observed in *Missouri v. Holland* that the protection of migratory birds is a textbook example of a *national* problem. The destruction of aquatic migratory bird habitat, like so many other environmental problems, is an action in which the benefits (*e.g.*, a new landfill) are disproportionately local, while many of the costs (*e.g.*, fewer migratory birds) are widely dispersed and often borne by citizens living in other States. In such situations, described by economists as involving "externalities," federal regulation is both appropriate and necessary.<sup>140</sup>

Nothing in this statement is inconsistent with the reasoning the majority used to arrive at its decision. It appears that the majority simply considered migratory bird populations' use of isolated wetlands to be so remote from Congress's purpose in passing the Act that the Corps' adoption of the Migratory Bird Rule required a specific congressional grant of rule making authority.

## II. PRACTICAL ANTITRUST ECONOMICS

"Congress designed the Sherman Act as a 'consumer welfare prescription.'"<sup>141</sup>

Early on in the development of Sherman Act case law, the Court groped for a clear standard by which to evaluate trade restraints. Candidates included the "concern for small dealers and worthy men," the maintenance of reasonable prices, the maintenance of large numbers of competitors, the fragmentation of markets, and the sup-

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<sup>136</sup> *Lopez*, 514 U.S. at 581 (citations omitted).

<sup>137</sup> 531 U.S. 159 (2001).

<sup>138</sup> 51 Fed. Reg. 41,208, 41,217 (Nov. 13, 1986).

<sup>139</sup> Pub. L. No. 92-500, 86 Stat. 816 (1972).

<sup>140</sup> *Id.* at 195 (citations omitted).

<sup>141</sup> Nat'l Collegiate Athletic Ass'n v. Bd. of Regents, 468 U.S. 85, 107 (1984) (quoting Reiter v. Sonotone, 442 U.S. 330, 343 (1979)).

pression of "great aggregations of capital."<sup>142</sup> The result was a confused and often pernicious body of antitrust precedents. Antitrust scholars and jurists now largely agree that the exclusive goal of the Sherman Act and other antitrust laws is to promote "consumer welfare," as most forcefully advanced by Robert Bork.<sup>143</sup> According to the consumer welfare standard, business arrangements that create market power invariably generate allocative inefficiency reflected in reduced output and higher prices to consumers.<sup>144</sup> But they may also generate offsetting productive efficiency by integrating operations and lowering production costs, which tends to increase output and lower prices. Consumer welfare is best served by prohibiting business arrangements whose probable net effect is to reduce output and raise prices; that is, to restrain trade.

Based on the consumer welfare standard, Bork rationalized the use of a *per se* rule against "naked" horizontal restraints of trade such as price fixing, proposed a market share test for horizontal mergers, and persuasively argued that all vertical restraints should be subject to a full evidentiary inquiry under the rule of reason.<sup>145</sup> As a result, the case law has become clearer and more predictable, with the adoption of an output test to distinguish *per se* restraints from those best addressed under a full reasonableness inquiry, a full reasonableness inquiry for vertical division of territories and vertical maximum retail prices, and a virtual presumption that predatory pricing is economically irrational. Horizontal merger policy has evolved toward a workable set of market share tests for identifying the mergers antitrust agencies can be expected to challenge for the likely exercise of market power.

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<sup>142</sup> BORK, *supra* note 22, at 51 (describing standards noted by Justices Peckham and Hand).

<sup>143</sup> *See id.* at 61 ("The legislative history of the Sherman Act . . . displays the clear and exclusive policy intention of promoting consumer welfare.").

<sup>144</sup> Even early on, the Court considered the enhancement of prices to be the primary evil to which the Sherman Act was directed:

Without going into detail and but very briefly surveying the whole field, it may be with accuracy said that the dread of enhancement of prices and of other wrongs which it was thought would flow from the undue limitation on competitive conditions caused by contracts or other acts of individuals or corporations, led, as a matter of public policy, to the prohibition or treating as illegal all contracts or acts which were unreasonably restrictive of competitive conditions, either from the nature or character of the contract or act or where the surrounding circumstances were such as to justify the conclusion that they had not been entered into or performed with the legitimate purpose of reasonably forwarding personal interest and developing trade, but on the contrary were of such a character as to give rise to the inference or presumption that they had been entered into or done with the intent to do wrong to the general public and to limit the right of individuals, thus restraining the free flow of commerce and tending to bring about the evils, such as enhancement of prices, which were considered to be against public policy.

Standard Oil Co. v. United States, 221 U.S. 1, 58 (1911) (White, J.).

<sup>145</sup> *See* BORK, *supra* note 22, at 67 ("The *per se* rule against naked price fixing . . . can be explained only by a preference for consumer welfare as the exclusive goal of antitrust.").

Part II.A briefly describes the simple economics of market power. Part II.B describes the practical analytical framework that antitrust agencies use to identify the extent of the market for assessing the effect of horizontal mergers on market power. Part II.C briefly describes how this framework can be adapted to assess the scope of price effects for the purpose of establishing federal jurisdiction under the geographic market power test.

### A. *The Economics of Market Power*

Consider an isolated island economy in which there are a large number of consumers and 100 wealth-maximizing widget firms, all of whom face the same production technology and therefore operate at the same scale.<sup>146</sup> For simplicity, assume that consumers believe there are no close substitutes for widgets and that any transaction costs consumers would ordinarily face in arbitraging the price of widgets across firms are zero. Under these circumstances, the "representative" firm shown in Figure 1 illustrates a competitive widget market in which no firm is able to exercise market power and resources are allocated efficiently.  $D_r$  reflects this firm's *pro rata* share of total market demand for widgets and MC reflects its marginal cost of producing widgets.  $D_r$  slopes down because the value consumers place on additional widgets declines as their consumption rate rises. MC slopes up because the value of the resources taken from other sectors of the economy to produce widgets increases as the rate of widget production rises.<sup>147</sup> The intersection of  $D_r$  and MC determines the equilibrium market price,  $P^*$ , and the representative firm's rate of production,  $Q^*$ .

Because the marginal value consumers place on widgets is exactly equal to the marginal cost of widget production, this equilibrium achieves allocative efficiency in the sense that it maximizes the surplus value of widget production. The representative firm collects  $P^*Q^*$  revenue from consumers and earns producer surplus equal to area DFI, while consumers earn a surplus equal to area DFA.<sup>148</sup> There is no way to reallocate resources to improve one party's welfare without reducing another party's welfare by a greater amount.

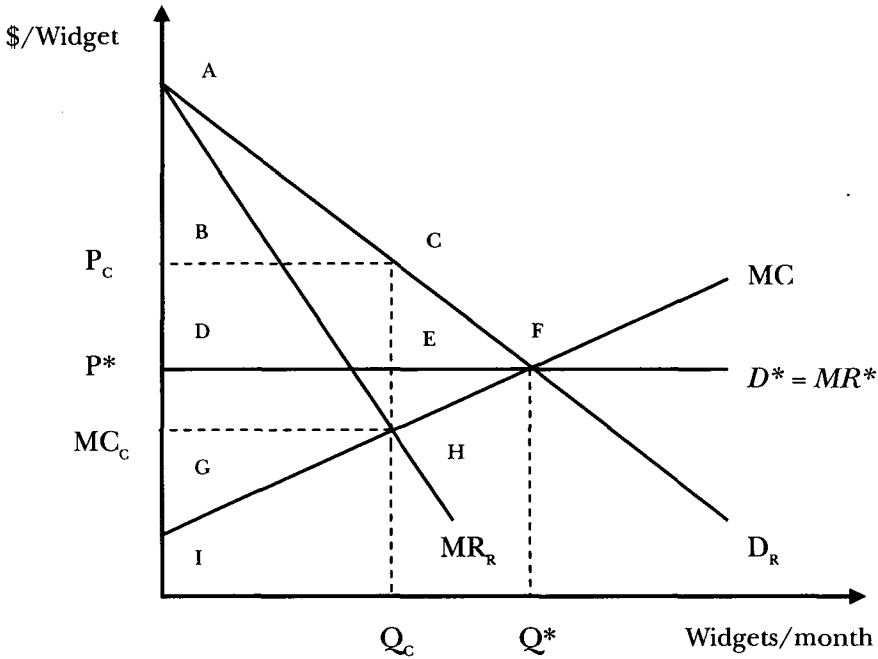
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<sup>146</sup> The persistence of 100 equal-size firms requires diseconomies of scale for any firm that attempts to expand production beyond its current scale.

<sup>147</sup> We assume there are no spillovers or externalities in either consumption or production, so that  $D_r$  and MC reflect all social costs and benefits.

<sup>148</sup> Producer surplus is defined as total revenue,  $P^*Q^*$ , minus the area under MC up to  $Q^*$ , while consumer surplus is defined as the area under  $D_r$  up to  $Q^*$  minus total expenditures,  $P^*Q^*$ .

FIGURE 1: MARKET POWER



It is important to understand that  $D_R$  is not the demand curve perceived by the representative firm if it considers adjusting its rate of output unilaterally. Rather,  $D_R$  indicates its *pro rata* share of total market sales to consumers if all firms charge the same price. If the price of inputs critical to the widget production process were to decline, for example,  $MC$  would shift down and its intersection with  $D_R$  would accurately describe the resulting equilibrium for the representative firm. All firms would increase their production rate and decrease price identically because consumers would stand ready to arbitrage any price differences between firms. If any single firm unilaterally lowers price even slightly below  $P^*$ , consumers would react by offering to shift all their purchases to it. However, since the firm can sell as many widgets as it wants at  $P^*$ , it has no incentive to lower price. Alternatively, consumers would react decisively to even a modest increase in price above  $P^*$  by a single firm, shifting all of their purchases to the remaining ninety-nine firms and leaving the recalci-

trant firm with zero sales.<sup>149</sup> Thus, if any single firm considers adjusting price, while other firms maintain price at  $P^*$ , it faces a demand curve equal to  $D^*$  that is horizontal, or perfectly elastic, at  $P^*$ . Because the firm receives  $P^*$  on every unit it sells,  $D^*$  is coincident with its marginal revenue curve,  $MR^*$ . Recognizing it can have no influence on the market price by adjusting production, the firm takes the competitive market price as given and is completely devoid of market power.

It is fairly easy to see the effects of market power by hypothesizing that the island's widget firms suddenly gain the ability to coordinate production, either by colluding or by merging into a single firm. By coordinating, they are able to exercise market power, which is simply the ability to raise price above  $P^*$  without experiencing a complete loss of sales. Unlike the situation described above, the representative firm now perceives a demand curve equal to  $D_r$ . Since  $D_r$  is downward sloping, as the firm raises price it sells fewer widgets, but because consumers have imperfect substitutes for widgets they do not reduce their purchases to zero. Under the standard assumption that firms must charge a uniform price for all the widgets it sells, the representative firm's marginal revenue is now shown by  $MR_r$ .<sup>150</sup> To maximize wealth, the firm reduces its rate of output to  $Q_c$ , where  $MR_r$  intersects  $MC$ , and then charges the highest possible uniform price at which all  $Q_c$  widgets can be sold. This occurs at  $P_c$ . The motivation for exercising market power is that it may increase the firm's total surplus, now equal to total revenue ( $P_c Q_c$ ) minus the area under  $MC$  up to  $Q_c$ . This corresponds to area  $BCHI$ .<sup>151</sup>

The problem with market power is not specifically that it allows colluding widget firms to earn additional profits, but that it allows them to earn additional profits by reducing output below  $Q^*$ , which leads to allocative inefficiency. At the lower production rate of  $Q_c$ , the value consumers place on the marginal widget increases to  $P_c$ , while the cost of the marginal widget in terms of the value of resources forgone in production falls to  $MC_c$ . The difference is what Frank Easterbrook has characterized as the "monopoly overcharge."<sup>152</sup> Too few widgets are produced, too few resources are devoted to widget production, and too many resources are devoted to non-widget sectors of the economy where they provide a smaller surplus. Con-

<sup>149</sup> This assumes the diseconomies of scale experienced by the remaining firms from expanding output by  $(1/99) \times Q$  times their share of the recalcitrant firm's normal sales are trivial. Otherwise, as production costs increase, the equilibrium market price must rise. This effect is relevant to our discussion of geographic market power, *infra* Part II.B.

<sup>150</sup> The uniform pricing constraint essentially assumes away price discrimination.

<sup>151</sup> The exercise of market power increases the firm's total surplus if area  $BCED$  exceeds area  $EFH$ .

<sup>152</sup> Easterbrook, *supra* note 11, at 39.

sumers would have valued the production that has been lost equal to the area under  $D_R$  from  $Q^*$  to  $Q_c$ , while the costs saved are equal only to the area under  $MC$  between these two points. In total, the island economy loses consumer and producer surplus equal to area  $CFH$ , often characterized as the “deadweight loss due to monopoly” or simply as the “welfare triangle.”<sup>153</sup> Unlike the situation depicted above in which widget firms are unable to coordinate, resources can now be reallocated to improve the parties’ net welfare. This is exactly what the Sherman Act is designed to achieve under the consumer welfare standard.

The exercise of market power under these circumstances is a textbook example of a market failure, in which the decision maker—the organization of colluding firms—is unable to capture the full benefit from expanding output because some of the benefit spills over to consumers. This is because the private benefit to colluding firms, reflected by  $MR_R$ , declines more rapidly as production rises than the social benefit to consumers, reflected by  $D_R$ . The market failure is a direct result of the requirement that the cartel charge a uniform price for all the widgets it sells. Starting at any arbitrary price and production rate along  $D_R$  in Figure 1, to increase sales under the uniform price constraint the cartel must reduce price on the additional widgets it wants to sell *and* on the widgets it would have sold absent the price reduction. The price reduction on these *intramarginal* widgets spills over to consumers, who otherwise would have purchased them at the higher price. The firm naturally fails to consider the spillover in determining its wealth-maximizing rate of production; it produces too little because it is unable to realize the full value of production as revenue, hence the market failure.

Many of the trade restraints addressed by the Sherman Act arise from horizontal arrangements between firms that would otherwise act as rivals. Horizontal arrangements involving no integration of productive activity are considered the most likely to result in the exercise of market power. The most obvious example is collusive agreements between independent firms to restrict production and raise prices. Horizontal division of territories or customer allocations between independent firms can have the same effect on production and prices. These are thought to be the most serious types of horizontal trade re-

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<sup>153</sup> BORK, *supra* note 22; Arnold C. Harberger, *Monopoly and Resource Allocation*, 44 AM. ECON. REV. 77 (1954). Note that consumer surplus declines by the difference between area  $DFA$  and area  $BCA$ . Of this difference, recall that  $BCED$  is transferred to producers. In certain circumstances, producers may dissipate some or all of this value in an effort to effect the transfer. These losses, which result from productive inefficiency, must be added to the deadweight loss for some purposes. See RICHARD A. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 11 (1976) (describing the loss to society when consumers continue to purchase products at monopoly prices).

straints because the participating firms remain independent. As a result, they are treated as unreasonable *per se* in the antitrust case law.<sup>154</sup> Horizontal mergers between competing firms can also lead to reduced output and increased prices, but given that the participating firms integrate their productive activities, antitrust economists believe any resulting allocative inefficiency may be offset by productive efficiencies that allow the new firm to cut production costs and possibly prices.<sup>155</sup> These types of restraints are evaluated with a full evidentiary inquiry into their reasonableness.

### B. Market Definition and Market Power

As Justice Scalia noted in his *Summit* dissent, antitrust analysis requires the definition of an appropriate market.<sup>156</sup> The foregoing model can be used as the basis for identifying the extent of the market and assessing the likely effect of trade restraints on market power. It is important to keep in mind that there is no theoretically “correct” market in any given setting; the broader the market is defined, all else being equal, the smaller the combined market share of a specific group of coordinating firms and the less likely their restraint is to create market power. There are two dimensions to any market definition: the relevant product and the relevant geographic scope. Because our ultimate concern is the proper limit of Sherman Act jurisdiction—an inherently spatial concern—our primary focus is on the geographic scope of the market. Before proceeding, however, it is necessary to briefly explain how to identify the relevant product.

In describing the widget market on our hypothetical island economy, we finessed the problem of defining the relevant product by assuming widgets have no close substitutes in consumers’ perception. In reality, if a group of firms raises the price of their product relative to competing products, consumers are likely to substitute the low-priced product for the high-priced product, thereby limiting the firms’ ability to sustain the price increase. Consumers’ willingness to substitute between alternatives in the face of a relative price change determines the extent of the product market. In antitrust law, the more closely two goods compete, the more likely they are to be con-

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<sup>154</sup> BORK, *supra* note 22, at 107–26.

<sup>155</sup> For example, J.D. Rockefeller’s Standard Oil Trust led to dramatic reductions in the price of kerosene and other petroleum products. DOMINICK T. ARMENTANO, *THE MYTHS OF ANTITRUST* 77 (1972). See generally McGee, *supra* note 20. The same can be said for internal growth to monopoly, as in the case of Alcoa or Microsoft. For a good exposition of how these three cases are similar, see DAVID S. KOPEL, *ANTITRUST AFTER MICROSOFT: THE OBSOLESCENCE OF ANTITRUST IN THE DIGITAL ERA* (2001).

<sup>156</sup> *Summit Health, Ltd. v. Pinhas*, 500 U.S. 322, 333 (1991).



sidered in the same product market precisely because variations in their relative prices will cause consumers to substitute between them.

It is fairly easy to imagine that widgets compete for consumers' favor with other products within a broader product category, just as aluminum ingot competes with other metals, cellophane competes with other flexible wrapping materials, and Brand X CD players compete with other audio equipment such as FM radios, cassette players, and DVD players. Naturally, the broader the product category the less likely it is to have viable substitutes and the more likely a price increase is to persist. In the face of an increase in the price of Brand X CD players, consumers are very likely to find viable substitutes among other brands of CD players and all other types of audio equipment. In the face of an increase in the price of all brands of CD players, however, consumers are far less likely to find viable substitutes among all other types of audio equipment. How to identify suitably close substitutes *in practice* is a question that must ultimately be answered empirically. Based on cross-elasticities between substitute product categories, economists can, in principle, identify the most narrowly defined product category for which a price increase is likely to persist if imposed by all sellers of that product. This product category identifies the relevant product market for antitrust purposes.

To determine whether a given restraint is likely to result in the creation of market power we must also identify the relevant geographic market. The geographic scope of an *economic* market has been defined as "that set of suppliers and demanders whose trading establishes the price of a good . . . 'within which the price of a good tends to uniformity, allowance being made for transportation costs.'"<sup>157</sup> A workable empirical test for this definition is the similarity of price movements within the market. But neither this definition, nor its empirical counterpart, are especially useful in an antitrust setting because they assume the events that cause prices to change are beyond the discretion of market participants.<sup>158</sup> By way of example, in the island widget economy we hypothesized an exogenous economy-wide decline in the price of inputs critical to the widget production

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<sup>157</sup> George J. Stigler & Robert A. Sherwin, *The Extent of the Market*, 28 J.L. & ECON. 555, 555 (1985) (quoting I ALFRED MARSHALL, PRINCIPLES OF ECONOMICS 325 (Variorum ed. 1961)); see also William M. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 937 (1981) (stating that market power is the ability of a firm or group of firms to raise a price above competitive levels without losing sales to the extent that it is unprofitable and the new price needs to be rescinded). For an alternative method of defining markets in mergers cases based on "marketing concepts," see Thomas W. Dunfee et al., *Bounding Markets in Merger Cases: Identifying Relevant Competitors*, 78 NW. U. L. REV. 733 (1984).

<sup>158</sup> See Kenneth G. Elzinga & Thomas F. Hogarty, *The Problem of Geographic Market Delineation in Antimerger Suits*, 18 ANTITRUST BULL. 45, 48 (1973) ("[P]rice data are of little use in geographic market delineation—at least for antimerger enforcement . . .").

process and found that arbitrage would cause all firms to increase output and reduce price. In antitrust, however, the focus is on the ability of a group of coordinating firms to restrict output and raise price by restraining trade to market power. Since the island's economic market had distinct limits due to its geographic isolation, a hypothetical cartel of all widget firms was able to do this successfully.

What has been characterized as the "geographic *antitrust* market" may be either broader or narrower than the economic market.<sup>159</sup> The accepted method of identifying the geographic antitrust market is the "hypothetical monopolist test," which is formalized in the Merger Guidelines and used by antitrust agencies to assess the probable effect of horizontal mergers on market power.<sup>160</sup> According to this test, for any pair of firms proposing to merge the antitrust market is defined as the *narrowest* geographic area containing the merging firms in which all firms in the area, by coordinating their operating decisions, can profitably sustain a small but significant increase in the price of the relevant product above what would prevail absent the restraint.<sup>161</sup>

To show how this test works, we return to our isolated island economy. For simplicity, assume the island is perfectly round and that consumers and producers are evenly distributed within its borders, depicted by Circle E in Figure 2. We assume transportation costs for all firms on the island increase at a constant rate with distance. We then consider a subgroup of firms that include the firms proposing to merge, say those within Circle A, and ask whether, by acting in concert, they can profitably sustain a small but significant increase in the price of widgets. If not, then Circle A does not represent a geographic market for antitrust purposes because no single firm or narrower subgroup of firms within Circle A could hope to sustain a price increase if all the firms in Circle A acting together are unable to do so. The geographic antitrust market is broader than Circle A because outside firms must be added to the subgroup before it can hope to exercise market power. Suppose we expand the subgroup to include all firms in Circle B and again find that these firms acting together are unable profitably to sustain a price increase. By proceeding incrementally in this fashion, we can identify the narrow-

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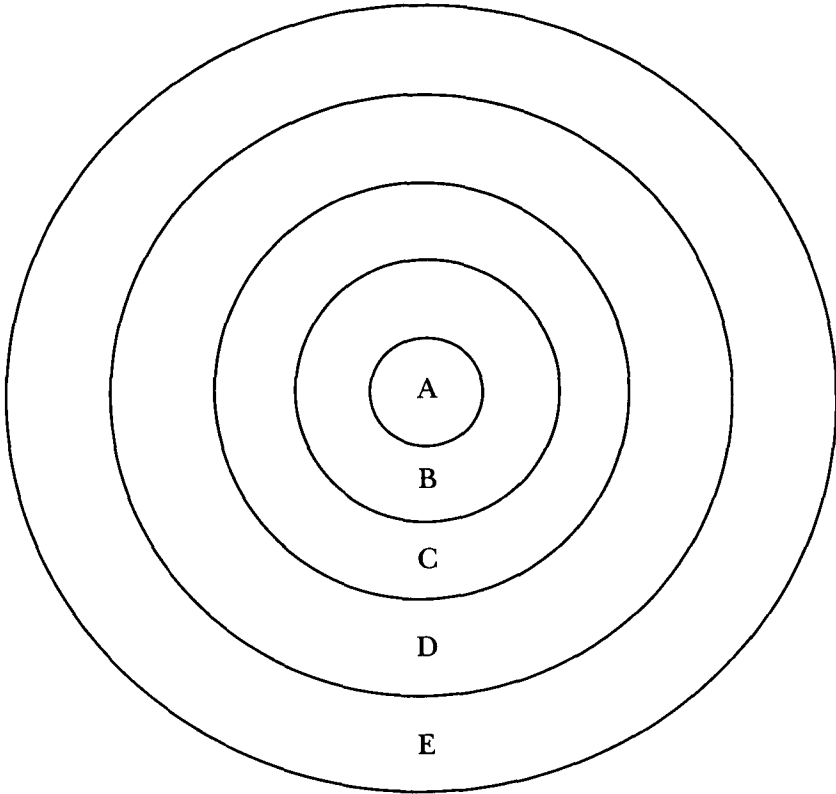
<sup>159</sup> David T. Scheffman & Pablo T. Spiller, *Geographic Market Definition Under the U.S. Department of Justice Merger Guidelines*, 30 J.L. & ECON. 123 (1987) (discussing antitrust markets versus economic markets).

<sup>160</sup> Other empirical tests for identifying the antitrust market can be found in HERBERT HOVENKAMP, *ECONOMICS AND FEDERAL ANTITRUST LAW* §§ 3.2-3.6, at 59-77 (1985), and Gregory J. Werden, *The History of Antitrust Market Delineation*, 76 MARQ. L. REV. 123 (1992).

<sup>161</sup> See Scheffman & Spiller, *supra* note 159, at 125-26 (discussing the Merger Guidelines' definition of antitrust markets).

est geographic market in which the associated firms are capable of exercising market power. Suppose this coincides with Circle C.

FIGURE 2: HYPOTHETICAL MONOPOLIST TEST



The geographic antitrust market, depicted in Circle C, may be narrower than the entire island economy. For this to be true, the firms outside Circle C must have sufficiently limited productive capacity such that they are unable to expand output enough to completely undermine the cartel. With the higher price set by the firms inside Circle C, outside firms will attempt to arbitrage the price difference by expanding their production and selling into the colluders' market. As they do so, they will succeed in taking a portion of sales away from the colluders, but their marginal production costs will eventually increase so much that they will no longer be willing to expand. The resulting hypothetical equilibrium is one in which prices

throughout the island economy are higher than they would be absent the colluders' exercise of market power, with any price differences reflecting transportation costs. This condition confirms that the entire island is an *economic* market even though the antitrust market is narrower.

There is nothing in this analysis that requires us to start the hypothetical monopolist test with Circle A. Quite the contrary; in the context of a real merger proposal the antitrust agencies begin with the narrowest geographic area that includes the merging firms, and, of course, they recognize that consumers are not uniformly distributed across space and that transportation costs can vary for many reasons. If, using the hypothetical monopolist test, the agencies find that these firms would be unable profitably to sustain a small price increase, they search for the narrowest geographic area that includes the next-best substitute for production at the merging firms' location and ask whether *all* firms in this area acting together could do so.

Having identified the geographic antitrust market in this way, the antitrust agencies attempt to determine whether a merger, presumably between only two firms, is likely to generate market power absent the cooperation of the nonmerging firms. Obviously, the smaller the merging firms' combined share of the geographic antitrust market the less likely they are to possess market power given that a hypothetical monopoly of all firms is just barely able to sustain a profitable price increase. The agencies account for market shares by calculating the share of production attributable to each firm in the market. They then calculate the Hirfindahl-Hirschman Index ("HHI") for the market by summing the firms' squared market shares.<sup>162</sup> For example, if the market contains five firms, each of which have market share of 20%, the HHI for the market is  $(.2^2) + (.2^2) + (.2^2) + (.2^2) + (.2^2) = .2$ , or 2000 by convention. The HHI gives proportionately greater weight to the market shares of the larger firms, reflecting the belief that a firm's influence in coordinating production in the market is more than proportionate to its market share. The antitrust agencies consider an HHI below 1000 to reflect an unconcentrated market. An HHI between 1000 and 1800 is said to be moderately concentrated, and an HHI above 1800 is said to be concentrated. It is widely understood, however, that these thresholds are imprecise and somewhat arbitrary indicators of market power.

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<sup>162</sup> The Hirfindahl-Hirschman index ("HHI") is the sum of the squares of the market share of each firm in the relevant market. See HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE § 12.4a2, at 512 (1999); KEITH HYLTON, ANTITRUST LAW: ECONOMIC THEORY & COMMON LAW EVOLUTION 328 (2003); RICHARD POSNER, ANTITRUST LAW 70 (2001).

The agencies' starting point for analysis of a given merger is to identify the defendants' geographic antitrust market, calculate the HHI, and then calculate the change in the HHI that would result from the proposed merger. As already explained, the resulting calculation is imprecise because, among other reasons, the effect of the merger on the defendants' combined market share will depend critically on the extent to which the merger generates productive efficiencies. A merger that generates few productive efficiencies while creating market power in the geographic antitrust market is likely to reduce the defendants' combined market share over time, while a merger that generates substantial productive efficiencies while creating little market power is likely to increase the defendants' combined market share over time.

For unconcentrated markets, the agencies presume little or no effect of the merger on the HHI. For markets whose post-merger HHI is between 1000 and 1800, the agencies presume a merger that increases HHI by less than 100 is unlikely to create market power, while a merger that increases HHI by more than 100 raises significant concerns over the creation of market power. For markets in which the HHI exceeds 1800 the agencies presume a merger that increases HHI by less than 50 is unlikely to create market power, while a merger that increases HHI by more than 50 raises significant concerns over the creation of market power. Where the post-merger HHI exceeds 1800, the agencies presume that mergers producing an increase in the HHI of more than 100 points are likely to create or enhance market power or facilitate its exercise.<sup>163</sup>

It is important to understand that the antitrust agencies face a tradeoff in identifying the geographic antitrust market. The wider the product and geographic market to which they apply the hypothetical monopolist test, the more likely it is that a hypothetical monopolist would be able to exercise market power in that market. However, by increasing the scope of the market in this way, they necessarily reduce the combined market share of the firms proposing to merge. Presumably, the agencies' recognition of this tradeoff at least partly explains why they identify the geographic antitrust market as the narrowest market in which a hypothetical monopolist could profitably sustain an increase in price.<sup>164</sup> In practice, the agencies use market share thresholds established under the Merger Guidelines<sup>165</sup>

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<sup>163</sup> For example, if two firms in an antitrust market of five equal-sized firms were to merge, the HHI would increase from 2000 to 2800. If two firms in an antitrust market of ten equal-sized firms were to merge, the HHI would increase from 1000 to 1200.

<sup>164</sup> Another rationale for choosing the narrowest market is that it leads to a standard basis for comparison across cases.

<sup>165</sup> 57 Fed. Reg. 41,552 (Sept. 10, 1992).

as crude proxies for the creation and probable exercise of market power, and the exact magnitude of the thresholds can therefore be adjusted to reflect the choice of the narrowest market. Federal courts are not bound by the Merger Guidelines,<sup>166</sup> but nevertheless many federal courts follow their approach to product and geographic market definition.<sup>167</sup> This is because the Merger Guidelines “represent mainstream economic thinking,” and are functionally equivalent to other tests that the courts have developed over the years.<sup>168</sup>

### C. *Adapting the Guidelines to the Issue of Jurisdiction*

Rather than focusing on the geographic scope of the price increase resulting from a given horizontal merger, the Merger Guidelines focus solely on whether the merger is likely to generate market power. To be useful in the context of a jurisdictional challenge, it is therefore necessary to adapt the Merger Guidelines’ underlying logic to assess the geographic scope of price effects resulting from market power. For example, the geographic antitrust market, as defined according to the hypothetical monopolist test, is likely to overlap one or more economic markets, “within which the price of a good tends to uniformity, allowance being made for transportation costs.”<sup>169</sup> An exercise of market power will cause a flow of goods into the geographic antitrust market as outside firms expand production in an attempt to arbitrage price differences within these overlapping economic markets. To some extent, prices will therefore rise outside the geographic antitrust market, possibly spilling over to neighboring states. Unless the defendants’ combined share of the geographic antitrust market is 100%, however, any such spillovers are less likely to occur. In defining the relevant market for antitrust jurisdiction, a proper test should formally recognize the tradeoff between the likelihood of interstate price spillovers and the likelihood that the defendants can effectively exercise market power within the geographic antitrust market as defined.

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<sup>166</sup> See *FTC v. PPG Indus., Inc.*, 798 F.2d 1500, 1503 n.4 (D.C. Cir. 1986) (“We note that the Department of Justice Guidelines offer a useful illustration of the application of the HHI, but are by no means to be considered binding on the court.”).

<sup>167</sup> See, e.g., *Cmty. Publishers, Inc. v. Donrey Corp.*, 892 F. Supp. 1146, 1153 n.6 (W.D. Ark. 1995) (discussing how the Merger Guidelines do not have “the force of law” but are still cited quite often), *aff’d sub nom. Cmty. Publishers, Inc. v. DR Partners*, 139 F.3d 1180 (8th Cir. 1998).

<sup>168</sup> *Id.*

<sup>169</sup> Stigler & Sherwin, *supra* note 157, at 555.

### III. THE GEOGRAPHIC MARKET POWER TEST FOR SHERMAN ACT JURISDICTION

If two children operating competing lemonade stands decided to fix prices, the effect on interstate commerce would be trivial . . . .<sup>170</sup>

Article III, Section 2, of the Constitution states that the federal courts have the power to adjudicate only “cases” or “controversies” “arising under” the Constitution and the “Laws of the United States.”<sup>171</sup> This passage establishes an important limitation on federal court jurisdiction that goes to the very heart of sovereignty. If a case or controversy does not *arise under* the Constitution or a federal statute, federal courts lack jurisdiction over the subject matter. “The requirement that jurisdiction be established as a threshold matter ‘springs from the nature and limits of the judicial power of the United States’ and is ‘inflexible and without exception.’”<sup>172</sup> Because the federal judicial power is limited, it is well settled that parties seeking redress in federal court must allege the facts necessary to support subject matter jurisdiction, and the court is free at any time during the proceedings to dismiss for lack of jurisdiction when the necessary facts come to light. In principle, the defendant has the right to rebut these allegations by presenting contrary evidence.<sup>173</sup> If the party asserting federal jurisdiction, for example a civil plaintiff suing under Section I of the Sherman Act for treble damages, is unable to provide substantial evidence to overcome the defendants’ rebuttal, the defendants can move to dismiss under Rule 12(b)(1) of the Federal Rules of Civil Procedure<sup>174</sup> for failure of subject matter jurisdiction, which thereby will be defeated.<sup>175</sup>

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<sup>170</sup> *Hammes v. AAMCO Transmission*, 33 F.3d 774, 780 (7th Cir. 1994) (Posner, J.).

<sup>171</sup> U.S. CONST. art. III, § 2, cl. 1.

<sup>172</sup> *Steel Co. v. Citizens for a Better Env’t*, 523 U.S. 83, 94–95 (1998) (Scalia, J.) (quoting *Mansfield, Coldwater & Lake Mich. Ry. Co. v. Swan*, 111 U.S. 379, 382 (1884)).

<sup>173</sup> As Justice Burger stated in *McLain*:

To establish jurisdiction a plaintiff must allege the critical relationship in the pleadings and if these allegations are controverted must proceed to demonstrate by submission of evidence beyond the pleadings either that the defendants’ activity is itself in interstate commerce or, if it is local in nature, that it has an effect on some other appreciable activity demonstrably in interstate commerce.

*McLain v. Real Estate Bd.*, 444 U.S. 232, 242 (1980).

<sup>174</sup> FED. R. CIV. P. 12(b)(1).

<sup>175</sup> Prior to *Summit*, the lower courts were split on whether the Sherman Act’s language “among the several states” was a 12(b)(1) jurisdictional issue or a 12(b)(6) failure to state a claim issue. Compare *McLain v. Real Estate Bd.*, 583 F.2d 1315, 1324 (5th Cir. 1978) (holding that dismissal should be based on lack of jurisdiction, i.e., a 12(b)(1) motion, and not a 12(b)(6) motion for failure to state a claim), *overruled on other grounds* by 444 U.S. 232 (1980), with *Zenith Radio Corp. v. Matsushita Elec. Indus. Co.*, 494 F. Supp. 1161, 1171–73 (E.D. Pa. 1980) (holding that failure to allege an effect on interstate commerce is a failure to state a

To establish Sherman Act jurisdiction under the geographic market power test, the plaintiff must allege that the defendants engaged in a restraint of trade that generated (or if successful would be reasonably likely to generate) market power that caused prices to rise in more states than one. More particularly, the complainant must allege that (1) the defendants supplied a particular product; (2) the defendants engaged in a contract, combination, or conspiracy in restraint of trade for the sale of that product; (3) the geographic antitrust market for the defendant's product was sufficiently large that a hypothetical monopolist could plausibly affect prices in more states than one; and (4) the defendants' activity generated sufficient market power within the geographic antitrust market to restrain trade and raise prices. As under the Merger Guidelines, market concentration could be expressed in terms of the HHI, and the likelihood that the restraint, if successful, would generate market power could be based

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claim and not a failure to allege subject matter jurisdiction, and should be dealt with as a 12(b)(6) motion).

We feel that it is a 12(b)(1) matter for three reasons. First, subject matter jurisdiction is concerned with the power of the court to hear the case in the first place and is clearly regarded as a threshold issue. *Steel Co.*, 523 U.S. at 88, 94. The language "among the several states" was essential to establish Congress's authority to regulate under the Commerce Clause and, therefore, the court needs to inquire into whether the alleged restraint could plausibly affect interstate commerce before hearing the merits of the claim. Second, in practice, a motion to dismiss for failure to state a claim under 12(b)(6) takes the pleadings of the plaintiff's complaint as true, and no external inquiry is allowed into the factual allegations (otherwise it becomes a motion for summary judgment). *E.g.*, *Pryor v. Nat'l Collegiate Athletic Ass'n.*, 288 F.3d 548, 560 (3d Cir. 2002) (holding that the district court's consideration of evidence outside the complaint did not convert defendant's 12(b)(6) motion into a motion for summary judgment).

As a general rule, the court may only consider the pleading which is attacked by an FRCP 12(b)(6) motion in determining its sufficiency. . . . The court is not permitted to look at matters outside the record; if such matters are considered, the FRCP 12(b)(6) motion to dismiss is, by the express terms of FRCP 12(b), converted into a motion for summary judgment.

*Id.* (quoting FEDERAL PROCEDURE, LAWYER'S EDITION § 62.508). Under the rules of notice pleading, the plaintiff can establish jurisdiction for the time being by properly pleading the facts in good faith, even if they are later controverted. The court should be permitted to hear defendants' offer of proof regarding the validity of the pleadings, just as it might if a case was brought under diversity jurisdiction and the parties were citizens of the same state. Finally, dismissal on grounds of jurisdiction usually does not have res judicata effects, and this will allow the plaintiff to pursue his claims in state court, if possible. *See Hitt v. City of Pasadena*, 561 F.2d 606, 608 (5th Cir. 1977) ("[D]ismissal on jurisdictional grounds alone is not on the merits and permits the plaintiff to pursue his claim in the same or in another forum."); *Wagner v. Magellan Health Servs., Inc.*, 121 F. Supp. 2d 673, 683 (N.D. Ill. 2000) (dismissing state law claims for lack of subject matter jurisdiction without prejudice so as to allow the plaintiff to pursue them in the state forum). Motions to dismiss for failure to state a claim, however, usually result in the plaintiff being given leave to amend, and the plaintiff will then allege facts, irrefutable at the pleadings stage, to establish jurisdiction. *See id.* at 673 (granting plaintiff leave to amend his pleadings to reallege RICO predicate acts after dismissing plaintiff's antitrust claims). But in principle, the defendants have the right to rebut the plaintiff's factual allegations regarding jurisdiction.



on the associated change in HHI from combining the defendants' market shares.<sup>176</sup>

In essence, the above procedures for establishing jurisdiction under the Act require the party asserting jurisdiction to allege a substantive nexus between the prohibited restraint and the interstate spillover that provides the foundation for federal jurisdiction. Chief Justice Burger rejected this approach in *McLain*, because he thought it would require the plaintiff to establish its entire substantive claim at the jurisdictional stage.<sup>177</sup> Justice Scalia correctly pointed out in his *Summit* dissent that Burger was mistaken because the Court was free to assume the success of the conspiracy and to evaluate the jurisdictional question accordingly.<sup>178</sup> Under the geographic market power test, a conspiracy to fix prices might be locally successful and yet the defendants' share of an interstate geographic antitrust market might be so small that the conspiracy could not plausibly be alleged to raise prices outside the state. Alternatively, the plaintiff might prevail on the jurisdictional question but ultimately fail on the merits by being unable to prove the existence of a conspiracy. Thus, proof of the conspiracy and its actual effects are invariably preserved for a trial on the merits.

The geographic market power test imposes an economically appropriate tradeoff on the plaintiff when alleging jurisdiction under the Act. The narrower the market the plaintiff alleges, the more likely a restraint by the defendants will generate market power. The narrower the market, however, the less likely a hypothetical monopolist could increase prices outside the state. Plaintiffs will naturally want to allege the narrowest market consistent with the plausible allegation of interstate price spillovers because this maximizes the defendants' measured share of the market, the HHI, and the resulting change in the HHI. The defendants can respond by offering to prove they have such a small share of the market that any exercise of market power is economically implausible. Alternatively, they can offer to prove that the geographic antitrust market alleged by the plaintiff is so narrow even a hypothetical monopolist would be unlikely to sustain a profitable price increase that substantially spilled across state lines. On either showing, the defendants' conduct would be presumptively intrastate and, unless rebutted by the plaintiff, would be sufficient to support a Rule 12(b)(1) motion for lack of subject matter jurisdiction.

One of the attractive attributes of the geographic market power test is that it imposes a tradeoff on the plaintiff's reliance on vertical

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<sup>176</sup> Merger Guidelines, 57 Fed. Reg. 41,552, 41,554 § 1.1 (Sept. 10, 1992).

<sup>177</sup> *McLain*, 444 U.S. at 243.

<sup>178</sup> *Summit Health, Ltd. v. Pinhas*, 500 U.S. 322, 335 (1991) (Scalia, J., dissenting).

aggregation without strictly preventing it, thereby providing the plaintiff with the flexibility to define the market according to the facts at its disposal and the circumstances of the particular restraint at issue. This is because defining the product category broadly to include vertically-related goods or services raises the plaintiff's evidentiary burden regarding the defendants' HHI and change-in-HHI. As in *McLain*, for example, the plaintiffs would be free to allege a relatively broad product category that includes complements to real estate brokerage such as financing and title insurance.<sup>179</sup> Although unlikely, it is economically possible that fixed minimum brokerage fees in the greater New Orleans area would cause such a dramatic decline in the number of real estate transactions that the price of financing and title insurance outside the state would substantially decline, possibly supporting a Sherman Act claim by lenders or title insurers. Including financing and title insurance in the product definition increases the likelihood that a hypothetical monopoly of the broad product category in the greater New Orleans area would have substantial interstate price effects. At the same time, however, by reducing the defendants' combined market share, it raises the plaintiff's burden of demonstrating that their restraint could plausibly have such an effect.<sup>180</sup> In any event, under the geographic market power test the likely interstate scope of price effects is a question of fact that Sherman Act defendants have a threshold right to resolve as a jurisdictional matter.

The tradeoff imposed by the geographic market power test has similar implications for horizontal aggregation. The plaintiff is free to allege a geographic antitrust market sufficiently broad that a hypothetical monopolist would be extremely likely to sustain a profitable increase in prices outside the state in question. However, defining the market broadly raises the plaintiff's jurisdictional burden elsewhere. In *Mandeville Island Farms*, for example, the Court hypothesized that the effect on interstate commerce would be substantial if all sugar refiners in the country adopted the same grower contracts as the defendant.<sup>181</sup> In essence, the Court applied the hypothetical monopolist test to the national market and concluded that interstate sugar prices would thereby suffer a substantial effect. But the Court

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<sup>179</sup> *McLain*, 444 U.S. at 235.

<sup>180</sup> Similarly, as in *Summit*, the plaintiff would be free to allege that the relevant product category includes an entire collection of vertically-related activities associated with general hospital services and that the relevant geographic antitrust market is the entire Los Angeles area. *Summit*, 500 U.S. at 324-25, 332-33. A hypothetical monopoly in such a broadly defined market might well cause the price of eye surgery to increase in neighboring states, but the exclusion of a single eye surgeon, or even a general firm policy of excluding surgeons from the market under prescribed circumstances would be extremely unlikely to generate market power.

<sup>181</sup> *Mandeville Island Farms, Inc. v. Am. Crystal Sugar Co.*, 334 U.S. 219, 236 (1948).

neglected to recognize that the refiners' share of such a broadly defined geographic antitrust market was absolutely trivial and beyond any plausible suggestion of market power. Whereas such unconstrained aggregation may be appropriate to establish constitutional jurisdiction in cases such as *Wickard*, where Congress has made specific findings as to the need for federal regulation, it is inappropriate to establish jurisdiction under general prohibitions such as the Sherman Act that require "a particularized judicial determination"<sup>182</sup> in light of the circumstances at hand and the underlying goal of the statute.<sup>183</sup>

Note that the geographic market power test in no way recognizes formalistic distinctions. Applied to the facts in *E.C. Knight*, for example, the geographic market power test would surely have found that the defendants' "manufacturing" operations caused sugar prices to rise in more states than one. Thus, the Court in *Standard Oil*<sup>184</sup> was correct in rejecting *E.C. Knight*.<sup>185</sup> Neither does the geographic market power test rely on the distinction between "direct" and "indirect" effects, although it will ordinarily give effects that are economically remote from the defendants' restraint limited weight in the jurisdictional calculus. Moreover, whether the defendants' goods are in the stream of commerce is neither a necessary nor a sufficient condition to establish federal jurisdiction. An effective restraint by firms whose sales are entirely within their home state may cause prices to increase outside the state even though the defendants' goods never cross state lines. Indeed, the likely effect of such a restraint would be to increase the flow of competitors' goods into the state and reduce the flow, if any, of the defendants' goods out of the state. Alternatively, the defendants may sell their goods in a national market in which they have absolutely no hope of affecting prices, even though they have market power in their local intrastate market. The sole question relevant to Sherman Act jurisdiction is whether the alleged restraint affects prices outside *any* state in which the restraint operates.

A second attractive feature of the geographic market power test is that it need not be applied identically to all restraints. No jurisdictional test can be expected to perform without error, but the geographic market power test establishes a substantively reasoned basis for Sherman Act jurisdiction that allows the legal system to iterate toward an articulate set of presumptions that minimize the weighted

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<sup>182</sup> *Summit*, 500 U.S. at 334 (Scalia, J., dissenting).

<sup>183</sup> *Wickard v. Filburn*, 317 U.S. 111 (1942).

<sup>184</sup> *Standard Oil Co. v. United States*, 221 U.S. 1, 58 (1911).

<sup>185</sup> *United States v. E.C. Knight Co.*, 156 U.S. 1 (1894).

sum of Type I and Type II errors.<sup>186</sup> In the context of antitrust, judicial measurement error is small enough that practical market share thresholds for HHI and changes in HHI can be established for various categories of restraints. Below these thresholds the exercise of market power is economically implausible and presumptively beyond federal jurisdiction. Different restraints would very likely be subject to different presumptions regarding the thresholds necessary for the plaintiff to make out a *prima facie* case for federal jurisdiction. In all cases, determination of the appropriate threshold would properly be tempered by the courts' recognition that the category of alleged restraints may, in fact, generate productive efficiencies that more than offset any associated allocative inefficiencies. Obvious horizontal pricing arrangements would no doubt be subject to a very low threshold, possibly approaching zero, as is currently the case, because it is relatively unlikely that such arrangements can generate offsetting productive efficiencies. Vertical price fixing and horizontal nonprice restraints might be subject to marginally higher thresholds because the likelihood that they can generate productive efficiencies is somewhat greater. Of course, the antitrust agencies would face a jurisdictional constraint in assessing purely local horizontal mergers that have thus far been formally absent.

#### IV. COMPETITIVE FEDERALISM, STATUTORY INTENT, AND PRACTICAL BENEFITS

The greatest threat to consumers' welfare is not states, and their competition, but a uniform national regimen that stifles the power of exit—that is, a monopoly of lawmaking.<sup>187</sup>

This section outlines the normative case in support of the geographic market power test. We show that it is consistent with the framework of competitive federalism and with the statutory intent behind the Sherman Act. We also show that it would resolve ongoing confusion in the lower federal courts and lead to more rapid evolution of substantive rules as the result of political competition over optimal antitrust policy.

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<sup>186</sup> Type I errors, false positives, can be seen as situations in which the court allows jurisdiction over defendants whose activities later prove on the merits to have no interstate price effect. Type II errors, false negatives, can be seen as situations in which the court denies jurisdiction to plaintiffs whose claims would prove on the merits to have a substantive interstate effect on interstate commerce.

<sup>187</sup> Easterbrook, *supra* note 11, at 50.

### A. *Competitive Federalism*

The theoretical foundation for competitive federalism derives from Charles Tiebout's pioneering 1956 essay, *A Pure Theory of Local Expenditures*.<sup>188</sup> Tiebout was concerned with analyzing the municipal supply of local public goods, such as roads, schools, and police and fire services.<sup>189</sup> In the face of literature concluding that the only mechanism for the provision of public goods was the ballot box, Tiebout demonstrated that a quasi-market mechanism could also work.<sup>190</sup> As long as consumers of local public goods have a large number of municipalities in which they can locate and are mobile and fully aware of the different patterns of taxation, expenditures, and levels of services provided by each municipality, then they can "vote with their feet" by exiting one municipality and relocating in a more hospitable one. Thus, while voting may dictate what level of services a municipality provides, competition among municipalities ensures that consumers will migrate to the municipality whose services match their preferences for public good provision and taxation. The normative implication is that to ensure all consumers receive the services they desire at the lowest cost, the size and scope of government should be kept small to promote political competition.<sup>191</sup>

The Tiebout model has been extended to analyze the government's provision of a host of public goods,<sup>192</sup> including law itself. Laws are a form of public good because once a court has established a given precedent, one person's reliance on it does not diminish others' ability to so rely. As with the provision of other public goods, the citizenry is best served if the provision of law is subject to political or inter-jurisdictional competition between local providers, at least to the extent that the effects of the law are confined to the jurisdiction. While the effects of some laws are strictly local and the effects of other laws national, Tiebout's vision for the provision of public goods can be achieved through a federal system in which the states and the

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<sup>188</sup> Tiebout, *supra* note 12.

<sup>189</sup> Public goods are those whose consumption by one person does not diminish others' ability to consume the good. See Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387, 387 (1954) (defining "collective consumption goods" and distinguishing them from "private consumption goods").

<sup>190</sup> Tiebout was responding to the literature at the time that suggested that there could be no market mechanism for the provision of public goods, and that a political solution was the only solution.

<sup>191</sup> Tiebout noted that until the 1930s expenditures by municipalities far exceeded expenditures by the federal government, and even in the 1950s when he wrote the article, federal expenditures net of defense spending were less than municipal expenditures. Tiebout, *supra* note 12, at 418.

<sup>192</sup> See, e.g., Easterbrook, *supra* note 11, at 34-35 (arguing that competition to avoid exit causes a strong tendency toward optimal legislation if certain conditions are satisfied, and using state competition for corporate charters as an example).

federal government have credible legislative and judicial powers, and healthy political competition maintains the balance of sovereignty.

The geographic market power test applies the framework of competitive federalism to the specific context of antitrust. The sole concern for Sherman Act jurisdiction under this test is whether the defendants' conduct in one state creates market power that spills across state lines in the form of higher prices. For those trade restraints whose price effects are confined to the defendants' home state, that state's antitrust regulators have sufficient incentive and resources to adequately address the problem. Political competition between states will result in optimal, though not necessarily uniform, antitrust policy with due regard for experimentation to address novel business practices tailored to local conditions.

When firms restrain trade in their home state unchallenged by home-state antitrust regulators and the price effects of market power spill across state lines, the citizens of neighboring states bear a portion of the losses. If the restraining firms are careful to keep their capital out of the neighboring state, there is little that the neighboring state's antitrust regulators can do to address the problem. With citizens of the home state bearing less than the full cost of the restraint, while receiving one hundred percent of the benefits (assuming the owners of the restraining firms are citizens of the home state), the state's antitrust regulators are unlikely to pursue antitrust policy with the same zeal as in the absence of a spillover. Federal antitrust regulation is warranted only in these cases.

The alternative view is that antitrust regulation is subject to such dramatic scale economies that unlimited federal authority is overwhelmingly efficient. This view could apply either to legal administration or to the stock of legal precedents itself. The geographic market power test in no way hinders the realization of scale economies in lawmaking. Because law is a public good, under the geographic market power test states can easily capture any scale economies attributable to federal lawmaking at no cost to the federal system simply by adopting federal rules to cover their purely internal activity if they so choose. Conversely, federal courts are free to rely on state court decisions covering novel questions of law or fact purely internal to the state. The geographic market power test in no way inhibits the inter-jurisdictional sharing of legal rules. Any state that chooses to adopt novel rules is either acting foolishly, in which case it will suffer from competition by other states, or it is acting properly in the interest of its own citizens as local consumers of law.

If the scale economies argument does not apply to lawmaking, it can only be based on scale economies in legal administration. But the claim that federal regulators or courts should have unlimited authority over the legal administration of all trade restraints amounts to a rejection of any kind of federalism whatsoever. In an area of law

whose primary concern is the suppression of economic market power, it is anomalous to suggest that political market power reposed exclusively in the hands of the federal government is in the long run best interests of the citizenry. A monopoly of legal administration is far more alarming than a monopoly of widget making.<sup>193</sup>

### B. Statutory Intent

According to the geographic market power test, the most important question when deciphering the limit of Sherman Act jurisdiction is whether the states are independently capable of addressing the defendants' exercise of market power.<sup>194</sup> This test appears consistent with the founders' intent including the Commerce Clause in the new Constitution and with a substantial body of subsequent Commerce Clause case law. It is widely recognized that the Commerce Clause was necessary to prevent states from engaging in protracted trade wars that stifled interstate commerce and undermined national prosperity. Trade wars are one form of interstate spillover in which the state erecting the trade barrier receives the benefits while imposing the costs on the citizens of other states. In this setting, the dormant Commerce Clause was sufficient to address the most salient interstate spillovers. However, this changed with industrialization, giving rise to the affirmative Commerce Clause as a basis for federal regulation.

As the nineteenth century drew to a close, state governments tried unsuccessfully to suppress the rise of business trusts and other horizontal combinations such as the Sugar Trust,<sup>195</sup> the Cotton Oil Trust,<sup>196</sup> and J.D. Rockefeller's infamous Standard Oil Trust.<sup>197</sup> It was widely believed at the time that only a federal statute could effectively combat the trusts because of their ability to evade the reach of state

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<sup>193</sup> Note that the current system does not strictly give the federal government a monopoly over antitrust enforcement because states are free to exercise their own limited antitrust policy. At the very least, however, this subjects the citizenry to concurrent antitrust jurisdiction. The existence of substantial differences between the application of federal and state antitrust law to completely local activities risks imposing unnecessary legal uncertainty on the citizenry. If, for example, a state was to permit certain horizontal pricing restraints in the face of federal *per se* prohibition, it would no doubt face a preemption challenge. Thus, the federal government currently has a virtual monopoly on antitrust lawmaking, except for noncommercial activity under the state action doctrine. See *infra* Part V.

<sup>194</sup> Note that an intermediate solution is an interstate compact subject to congressional blessing, which would presumably apply where the particular circumstances facing a small handful of states resulted in a spillover only as between them, such that congressional legislation aimed at the national economy would be redundant or counterproductive. See Michael S. Greve, *Compacts, Cartels, and Congressional Consent*, 68 MO. L. REV. 285, 369-70 (2003) (proposing a functional constitutional approach to Compact Clause analysis).

<sup>195</sup> *United States v. E.C. Knight Co.*, 156 U.S. 1 (1894).

<sup>196</sup> *Louisiana v. Am. Cotton Oil Trust*, 3 So. 409 (La. 1888).

<sup>197</sup> *Standard Oil Co. v. United States*, 221 U.S. 1, 58 (1911).

regulators merely by re-incorporating in a friendly state.<sup>198</sup> Indeed, Congress viewed *Wabash's* proscription of discrimination against interstate commerce as a major impediment to the states' ability to control the trusts unilaterally, as the trusts' goods invariably moved in interstate commerce.<sup>199</sup> This is the backdrop against which the Sherman Antitrust Act was conceived and finally passed in 1890. The legislative history of the bill clearly indicates that its proponents intended the Act to reach the outer limits of federal power over interstate commerce,<sup>200</sup> although they considered that power limited to the narrow confines of dual federalism as most recently expressed in cases such as *Wabash* and *Kidd*.<sup>201</sup> In the words of Senator Sherman, the bill's primary sponsor,

[t]he purpose of this bill is to enable the courts of the United States to apply the same remedies against combinations which injuriously affect the interests of the United States that have been applied in the several States to protect local interests. . . .

. . . If the combination is confined to a State the State should apply the remedy; if it is interstate and controls any production in many states, Congress must apply the remedy.<sup>202</sup>

Those who criticize legislative intent as a guide to judicial decision making may be correct that it is impossible to discern the intent of any collective body, and that in any event the legislative intent behind the Sherman Act is irrelevant given the inability of members of Congress to foresee the dramatic changes that have taken place in the national economy and the scope of general federal commerce power.<sup>203</sup>

<sup>198</sup> See Gavil, *supra* note 17, at 658–60, 689–91 (discussing the background and legislative history of the Sherman Act).

<sup>199</sup> See Easterbrook, *supra* note 11, at 41 n.40 (citing *Wabash* to illustrate the Court's refusal to allow states to regulate goods that moved in interstate commerce during the late nineteenth century).

<sup>200</sup> See Little, *supra* note 52, at 164–65 & nn.9, 12 & 194 (noting that the Sherman Act, as originally proposed, was to apply to all arrangements that prevented competition, and then was later revamped to apply to restraints of "trade or commerce among the several States" in order to allay Commerce Clause concerns); see also Gavil, *supra* note 17, at 693 & n.161 & 695 (noting that Congress "has never volunteered that . . . the Act [should be] read more narrowly than its potential," and "has manifested its desire to endorse the Court's expansive reading of Sherman Act jurisdiction").

<sup>201</sup> See Robert H. Bork, *Legislative Intent and the Policy of the Sherman Act*, 9 J.L. & ECON. 7, 31–35 (1966) (discussing Congress's perception that its commerce power was limited to solely interstate commercial interstate activities); see also Epstein, *supra* note 64, at 1413 (noting *Wabash's* role in the creation of the Interstate Commerce Commission); Gavil, *supra* note 17, at 682 n.114 (same).

<sup>202</sup> 21 CONG. REC. 2456–57 (1890).

<sup>203</sup> Easterbrook's view is that courts must resort to some substantive method for resolving the balance of dual sovereignty, and competitive federalism provides a superior framework. Easterbrook does not use the term "competitive federalism," but his notion of the "economics of federalism" is virtually identical. See Easterbrook, *supra* note 11, at 42 ("The economics of federal-



Yet even conceding all this, there is a measure of durability in Senator Sherman's statement as a manifestation of statutory intent. Whatever Congress may or may not have foreseen when it passed the Act, it clearly sought to resolve a political spillover between states that prevented them from unilaterally regulating the trusts. For the purpose of identifying the proper limits of Sherman Act jurisdiction today, it is just as relevant to inquire into the nature and scope of this spillover as it was in 1890. The most important change that has occurred in antitrust policy since 1890 is the level of understanding among courts and commentators about the economic effects of market power and the proper objective of the Act. That the Court's evolving economic understanding should lead it to revise the limits of Sherman Act jurisdiction to better account for the discernable scope of the underlying political spillover would seem uncontroversial.<sup>204</sup>

### C. *Practical Benefits*

Perhaps the most obvious general benefit of the geographic market power test is that it reduces the problem of concurrent antitrust enforcement. Subjecting all U.S. firms to federal enforcement by both the Department of Justice and the Federal Trade Commission, and to private civil actions in federal courts, is troublesome enough without adding concurrent state enforcement. As to purely local restraints, the geographic market power test takes a first step toward limiting concurrent enforcement. It is worth noting that increasing globalization is fast reducing the relative size of the U.S. economy in world markets and subjecting U.S. firms to increasing competition from foreign firms. Globalization no doubt has the effect of reducing the optimal scope of federal antitrust enforcement.<sup>205</sup> In response,

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ism offers a way to approach the state-federal relation with an eye to maximizing efficiency and thus to achieving the substantive goal of antitrust.”).

<sup>204</sup> Antitrust policy in the European Economic Union (“EU”) appears to follow the geographic market power test fairly closely. That is, authority over purely local restraints is left to the host country. Article 81 of the Treaty Establishing the European Community, which is the EU equivalent of the U.S. Constitution, prohibits restraints of trade “which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market.” Treaty Establishing the European Community, art. 81, Nov. 10, 1997, O.J. (C 340) 208 (1997).

<sup>205</sup> It is notable that Canada, whose merger guidelines are structurally similar to those in the United States, has much higher thresholds for merger approval. See COMPETITION BUREAU OF CAN., MERGER ENFORCEMENT GUIDELINES (2004), available at <http://cb-bc.gc.ca/epic/internet/incb-bc.nsf/en/ct02934e.html>. This is because a small open economy, such as Canada's, needs higher concentration ratios in order to achieve the economies of scale that reflect efficient production for its economy. Similarly, small states may wish to allow higher internal concentration than federal law would allow. A smaller state may wish to tolerate an unregulated oligopoly for other economic and political reasons. On the other hand, a larger state, such as California, may decide to impose harsher standards than its federal counterparts. Some states

rent seeking federal regulators inclined toward regulatory excess are likely to direct increasing attention to local markets for “non-traded goods” such as medical care, which, by definition, are largely insulated from the competitive effects of globalization.<sup>206</sup> The geographic market power test constrains any such excess in the face of what is a natural decline in the optimal scope of federal antitrust enforcement, and where state regulators are capable of addressing the local exercise of market power.

Note that under the current system a state can preclude federal antitrust regulators from attacking both the internal and external activities of firms doing business within the state by integrating into the activity in question. Under the state action doctrine established in *Parker v. Brown*<sup>207</sup> and upheld in *City of Columbia v. Omni Outdoor Advertising, Inc.*,<sup>208</sup> states are free from federal antitrust prohibitions as long as they refrain from acting in an overtly commercial capacity. To the extent the current system allows federal regulators *inefficiently* to expand their lawmaking power over otherwise private business activity that is purely internal to the states, as a second-best solution we would expect states to integrate into those activities at the margin to protect themselves from federal antitrust authority.<sup>209</sup> The adoption of the geographic market power test would therefore lead states to divest themselves of activities better performed by local private firms under the state’s choice of antitrust rules.

In his *Summit* dissent, Justice Scalia pointed out that *McLean* left the lower federal court decisions in disarray over the issue of Sherman Act jurisdiction and that the *Summit* majority missed an opportunity to clear up the resulting confusion when it found in favor of federal jurisdiction.<sup>210</sup> Since then, the lower courts have continued in disarray, with an unduly large number of suits aimed at purely lo-

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may wish to have no antitrust law whatsoever. Currently, a private plaintiff, or for that matter the federal government, may go to court to prevent local hospitals from merging. At a time when states may want to encourage consolidation to achieve economies of scale or better negotiate Medicare payments, the state may rationally wish to allow such mergers to proceed.

<sup>206</sup> The goods and services produced in purely local markets are best seen in the context of international trade as “non-traded goods.” Increased competition in global markets should have less of an effect on the price and output of nontraded goods than on the price and output of traded goods.

<sup>207</sup> 317 U.S. 341 (1943).

<sup>208</sup> 499 U.S. 365 (1991).

<sup>209</sup> In *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), the Court overturned *National League of Cities v. Usery*, 426 U.S. 833 (1976), after only nine years. The Court in *National League of Cities* found that the Commerce Clause does not empower Congress to enforce federal regulations that would interfere with the states’ “traditional governmental functions.” *Id.* at 852. The Court’s opinion in *Garcia* suggests that state governments may have been strategically gaming this protection by integrating into a host of normally private activities. *Garcia*, 469 U.S. at 537–47.

<sup>210</sup> *Summit Health, Ltd. v. Pinhas*, 500 U.S. 322, 336 (1991).

cal activities, many of which are arguably frivolous on either jurisdictional or substantive grounds. In a large number of these cases, plaintiffs succeed at the jurisdictional stage only to fail on the merits as a result of their inability to prove a substantive restraint of trade among the several states.

In *BCB Anesthesia Care, Ltd. v. Passavant Memorial Area Hospital Ass'n*,<sup>211</sup> the Seventh Circuit Court of Appeals affirmed the district court's dismissal of a Sherman Act claim brought by a physician against a local hospital. Whereas the district court dismissed the case on jurisdictional grounds, the Seventh Circuit granted summary judgment on the merits, noting the large number of Sherman Act cases in which physicians sue hospitals in federal court for revoking their staff privileges only to suffer dismissal on the merits.<sup>212</sup> A similar

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<sup>211</sup> 36 F.3d 664 (7th Cir. 1994).

<sup>212</sup> *Id.* at 667. The court provided many examples. See, e.g., *Balaklaw v. Lovell*, 14 F.3d 793 (2d Cir. 1994) (affirming the district court's dismissal of antitrust action by anesthesiologist challenging exclusive contract that excluded him from working at hospital); *Flegel v. Christian Hosp., N.E.-N.W.*, 4 F.3d 682 (8th Cir. 1993) (affirming dismissal of antitrust action against hospital by osteopaths denied privileges because they lacked certification from a particular organization); *Capital Imaging Assocs., P.C. v. Mohawk Valley Med. Assocs., Inc.*, 996 F.2d 537 (2d Cir. 1993) (affirming summary judgment for defendants in an antitrust action by radiologists challenging exclusive contract by hospital in Albany and upstate New York that excluded the radiologists); *Lie v. St. Joseph Hosp.*, 964 F.2d 567 (6th Cir. 1992) (affirming summary judgment for defendant in an antitrust action by a physician whose surgical privileges were suspended); *Tarabishi v. McAlester Reg'l Hosp.*, 951 F.2d 1558 (10th Cir. 1991) (granting judgment for defendants in an antitrust action against hospital by physician whose privileges were reduced after he opened up a treatment center); *Oksanen v. Page Mem'l Hosp.*, 945 F.2d 696 (4th Cir. 1991) (granting judgment for defendant hospital in an antitrust action brought by a physician who was suspended, put on probation and then terminated); *Bhan v. NME Hosps.*, 929 F.2d 1404 (9th Cir. 1991) (affirming summary judgment for defendant in an antitrust action by nurse anesthetist who was excluded by policy of allowing only physicians to perform anesthesia services); *Morgan, Strand, Wheeler & Biggs v. Radiology, Ltd.*, 924 F.2d 1484 (9th Cir. 1991) (affirming summary judgment for defendant in an action by radiologists challenging exclusive contract); *Todorov v. DCH Healthcare Auth.*, 921 F.2d 1438 (11th Cir. 1991) (affirming summary judgment for defendant in an antitrust action by physician who was denied radiology privileges); *Nurse Midwifery Assocs. v. Hibbett*, 918 F.2d 605 (6th Cir. 1990) (affirming denial of summary judgment in an action by midwives and obstetrician alleging they were prevented from operating a maternity practice or offering midwifery services at hospitals); *Beard v. Park-view Hosp.*, 912 F.2d 138 (6th Cir. 1990) (affirming dismissal of action by radiologist challenging exclusive contract); *Ezpeleta v. Sisters of Mercy Health Corp.*, 800 F.2d 119 (7th Cir. 1986) (affirming summary judgment for defendant in action by anesthesiologist whose staff privileges were terminated); *Goss v. Mem'l Hosp. Sys.*, 789 F.2d 353 (5th Cir. 1986) (affirming summary judgment for defendants in action by physician whose privileges were terminated); *Konik v. Champlain Valley Physicians Hosp. Med. Ctr.*, 733 F.2d 1007 (2d Cir. 1984) (affirming dismissal of action by anesthesiologist challenging contract); *Dos Santos v. Columbus-Cuneo-Cabrini Med. Ctr.*, 684 F.2d 1346 (7th Cir. 1982) (vacating preliminary injunction which was decided in favor of anesthesiologist challenging exclusive contract); *Cogan v. Harford Mem'l Hosp.*, 843 F. Supp. 1013 (D. Md. 1994) (granting summary judgment to defendant in action against hospital whose policy excluded unaccredited radiology centers); *Willman v. Heartland Hosp. E.*, 836 F. Supp. 1522 (W.D. Mo. 1993) (granting summary judgment for defendant hospitals in action by physician excluded after peer review); *Scara v. Bradley Mem'l Hosp.*, No. CIV-1-91-28, 1993 WL

case is *Brader v. Allegheny General Hospital*,<sup>213</sup> in which the Third Circuit Court of Appeals reversed the district court that had dismissed the physician's Sherman Act claim on jurisdictional grounds. The Third Circuit ruled that it was sufficient for the plaintiff simply to allege, without any evidentiary burden, that the defendant's activities were in or substantially affected interstate commerce. On remand, the district court granted the defendant's motion for summary judgment on the merits, and the Third Circuit affirmed on appeal.<sup>214</sup> The entire adjudication took an additional four years, and no doubt consumed considerable private and public resources. Under the geographic market power test, courts would likely dismiss these cases at the outset on jurisdictional grounds, or litigants would never file them in the first place.

Consider *Hamilton Chapter of Alpha Delta Phi, Inc. v. Hamilton College*,<sup>215</sup> where a group of fraternities sued a private college that required all students to live in college housing and participate in the college meal plan. The district court dismissed the case on jurisdictional grounds.<sup>216</sup> The Second Circuit Court of Appeals reversed, finding that the college's activities had the connection to interstate commerce necessary to support jurisdiction because many of its students were nonresidents.<sup>217</sup> On remand, the district court dismissed the case on the merits because the college lacked market power in housing.<sup>218</sup> Here, as in *Brader*, the final decision took four years from the initial dismissal on jurisdictional grounds but was finally decided on the basis of facts that could well have been used to defeat jurisdiction under the geographic market power test.<sup>219</sup>

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404150 (E.D. Tenn. Feb. 4, 1993) (granting summary judgment for defendants in action by anesthesiologist challenging exclusive contract); *Miller v. Ind. Hosp.*, 814 F. Supp. 1254 (W.D. Pa. 1992), *aff'd*, 975 F.2d 1550 (3d Cir. 1992) (dismissing action by physician whose privileges were terminated); *Jackson v. Radcliffe*, 795 F. Supp. 197 (S.D. Tex. 1992) (granting summary judgment for defendants on antitrust claim in action brought against hospitals that had terminated radiologist's contract).

<sup>213</sup> 64 F.3d 869 (3d Cir. 1995).

<sup>214</sup> *Brader v. Allegheny Gen. Hosp.*, 167 F.3d 832, 843 (3d Cir. 1999).

<sup>215</sup> 128 F.3d 59 (2d Cir. 1997).

<sup>216</sup> *Hamilton Chapter of Alpha Delta Phi, Inc. v. Hamilton Coll.*, Civ. A. No. 95-CV-0926, 1996 WL 172652, at \*9 (N.D.N.Y. Apr. 12, 1996).

<sup>217</sup> *Hamilton Coll.*, 128 F.3d at 67.

<sup>218</sup> *Hamilton Chapter of Alpha Delta Phi, Inc. v. Hamilton Coll.*, 106 F. Supp. 2d 406, 413-14 (N.D.N.Y. 2000).

<sup>219</sup> *Cf. Patel v. Scot. Mem'l Hosp.*, No. 95-2704, 1996 U.S. App. LEXIS 16421, at \*15-17 (4th Cir. July 10, 1996) (affirming dismissal on the merits and not on jurisdiction); *Tropical Air Flying Servs., Inc. v. Feliciano de Melecio*, 158 F. Supp. 2d 177, 188-89 (D.P.R. 2001) (dismissing antitrust action on merits but not on jurisdiction); *Lifeline Ltd. No. II v. Conn. Gen. Life Ins. Co.*, 821 F. Supp. 1201, 1210 (E.D. Mich. 1993) (dismissing antitrust action based on merits but not on jurisdiction); *Brown v. Our Lady of Lourdes Med. Ctr.*, 767 F. Supp. 618, 632 (D.N.J. 1991) (dismissing on the merits but not on jurisdiction). *But see Tice v. Hoff*, No. 92-15786, 1994 WL 315654, at \*1-2 (9th Cir. June 28, 1994) (affirming dismissal of claim on jurisdictional

In many Sherman Act cases following *Summit*, defendants have declined even to raise the issue of jurisdiction. Knowing the court will simply assume jurisdiction is satisfied,<sup>220</sup> they proceed to a trial on the merits. In *County of Tuolumne v. Sonora Community Hospital*,<sup>221</sup> for example, a family practice physician sued a local hospital, claiming the hospital's policy of granting the privilege to perform caesarian sections only to certified obstetricians or physicians passing rigorous special training violated the Sherman Act. The district court granted the hospital's motion for summary judgment, and the Ninth Circuit Court of Appeals affirmed. Nowhere in the decision is the issue of jurisdiction discussed, let alone adjudicated.

In *Wagner v. Magellan Health Services, Inc.*,<sup>222</sup> a psychiatrist sued a managed care organization claiming it had blacklisted him in violation of the Sherman Act. The plaintiff alleged that the relevant geographic market was the town of Barrington, apparently in an effort to make the defendant's measured market share and likely market power appear large. The defendant in this case did not even bother to move for dismissal for lack of jurisdiction. Yet, the district court granted the defendant's motion for summary judgment. According to the court, the plaintiff's case failed on the merits because the plaintiff did not allege that his loss resulted from actions that reduced output or raised prices for consumers.<sup>223</sup>

Other courts have dismissed Sherman Act cases on the merits without addressing jurisdiction.<sup>224</sup> The lesson from these cases is that defendants with legitimate jurisdictional claims would rather litigate on the merits outright than press their jurisdictional claims and face the uncertainty and expense of an appeal on jurisdictional grounds.<sup>225</sup>

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grounds because appellant failed to allege a connection to interstate commerce except for a conclusory allegation).

<sup>220</sup> The Court ostensibly foreclosed the assumption of jurisdiction in *Steel Co. v. Citizens for a Better Environment*, where Justice Scalia rejected the approach of several courts of appeals in assuming jurisdiction where the merits question is more readily resolved, and the prevailing party on the merits would be the same as the prevailing party if jurisdiction were denied. Scalia held that this approach "carries the courts beyond the bounds of authorized judicial action and thus offends fundamental principles of separation of powers." 523 U.S. 83, 94 (1998).

<sup>221</sup> 236 F.3d 1148 (9th Cir. 2001).

<sup>222</sup> 121 F. Supp. 2d 673 (N.D. Ill. 2000).

<sup>223</sup> *Id.* at 681.

<sup>224</sup> See, e.g., *Betkerur v. Aultman Hosp. Ass'n*, 78 F.3d 1079 (6th Cir. 1996) (affirming summary judgment with no discussion of jurisdiction); *Levine v. Cent. Fla. Med. Affiliates, Inc.*, 72 F.3d 1538 (11th Cir. 1996) (affirming dismissal on merits of antitrust action by physician against Orlando area hospital and other defendants including the hospital's parent corporation).

<sup>225</sup> See, e.g., *Mid-Mich. Radiology Assocs., P.C. v. Cent. Mich. Hosp., No. 94-CV-10057-BC*, 1995 WL 239360, at \*2 (E.D. Mich. Feb. 14, 1995) (dismissing an antitrust case where defendants argued for dismissal on the merits rather than on jurisdictional grounds because of the jurisdictional issue's unsettled nature).

These and many other cases suggest that Sherman Act defendants are being deprived of jurisdictional protections with little corresponding benefit other than the opportunity for plaintiffs to extract concessions by engaging in costly discovery and then proceeding to a full trial on the merits. In the physician termination cases, it is easy to imagine that hospitals have a legitimate stake in the conduct of their staff physicians but very difficult to imagine how a uniform national rule on the subject promotes consumer welfare in any way. With even a remote threat of treble damages, many defendants no doubt settle what should be considered frivolous federal claims. By establishing a clear and substantively reasoned basis for Sherman Act jurisdiction, the geographic market power test would prevent waste of judicial resources and restore defendants' jurisdictional protections. It holds out the prospect that the proper treatment of novel business practices can be more quickly and reliably discerned by allowing states to innovate their own rules where the resulting effects are completely internal to the state.

A virtual scientific revolution in economics over the past forty years has shown that competition leads private parties to choose the form of organization that internalizes, as far as possible, what would otherwise be economic market spillovers.<sup>226</sup> By allowing political competition between states to resolve any remaining internal spillovers according to local circumstances, the geographic market power test promises to hasten the rate at which substantive antitrust law evolves toward the optimal treatment of novel business practices alleged to restrain trade. The weight of federal antitrust case law and commentary makes it abundantly clear that considerable disagreement exists about the nature or effect of novel business practices. Federal courts have often failed to correctly assess many such practices, with a decidedly negative effect on consumer welfare during the interim. Examples include the Court's recent reversal of the *per se* rule against vertically imposed maximum prices,<sup>227</sup> its earlier reversal of the *per se* rule against vertically imposed exclusive territories,<sup>228</sup> and the advent of the characterization question to parse horizontal restraints that are unreasonable *per se* from those subject to a full reasonableness inquiry.<sup>229</sup> Even now, federal courts are struggling with

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<sup>226</sup> This revolution probably started in earnest with Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

<sup>227</sup> *State Oil. Co. v. Kahn*, 522 U.S. 3, 7 (1997).

<sup>228</sup> *Cont'l T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 58 (1977).

<sup>229</sup> *Broad. Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 U.S. 1, 19 (1979). The Court's tendency prematurely to condemn novel business practices under the *per se* rule is puzzling given the recognized judicial norm that the *per se* rule should apply only after the Court has had sufficient experience with the practice at hand to make an informed judgment regarding the probable effect on consumer welfare. See, e.g., *Arizona v. Maricopa County Med. Soc'y*, 457 U.S. 332,

the proper application of the Sherman Act to horizontal aggregations in so-called "network industries," for which the optimal tradeoff between allocative and productive efficiency is far from clear.<sup>230</sup> This is not to criticize our federal courts out of hand; it is simply to say that they have failed to preserve a federal system in which competitive state lawmaking could be mobilized to provide a more rapid information feedback mechanism as to the effect on consumer welfare of novel business practices.

The question antitrust regulators face in reviewing horizontal arrangements under the consumer welfare standard is whether the associated productive efficiencies, if any, are likely to offset the allocative inefficiency from the creation of market power. Because horizontal mergers are likely to enhance productive efficiency by integrating productive activity, their net effect after accounting for allocative inefficiency may be to increase consumer welfare, and federal courts therefore address them under the rule of reason.<sup>231</sup> Horizontal arrangements that involve no apparent integration of productive activity are considered unlikely to generate productive efficiency, but, following the Court's recognition of proper characterization, this presumption has changed.

Commentators now recognize that, even though horizontal restraints may generate market power, they may also generate offsetting productive efficiencies. Unadulterated naked price fixing between rival firms with large market share is unlikely to generate productive efficiencies, but, ever since the Court's decision in *United States v. Trenton Potteries Co.*,<sup>232</sup> business combinations seldom come so neatly packaged. Many horizontal business arrangements designed to avert moral hazard, agency, or other incentive problems may appear at first

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348 (1982) (holding that maximum fee agreement between two medical societies is *per se* unlawful under the Sherman Act despite the societies' argument that the agreement lowers health care costs).

<sup>230</sup> Cf. *United States v. Microsoft Corp.*, 253 F.3d 34, 118–19 (D.C. Cir. 2001) (affirming in part and remanding in part an antitrust decision against the operating system manufacturer). For an important scholarly work on network effects see S. J. Liebowitz & Stephen E. Margolis, *The Fable of the Keys*, 33 J.L. & ECON. 1 (1990) (discussing the theory that an inferior standard may succeed over a challenger because users will not adopt the challenger out of fear that it will not succeed, and examining evidence that the QWERTY keyboard is not clearly inferior to the unsuccessful Dvorak keyboard and thus does not strongly support the theory).

<sup>231</sup> One proxy for productive efficiency for an industry composed of publicly traded corporations is the effect of the proposed merger on nonmerging firms' stock prices. If these firms' stock prices decline in response to an unanticipated merger announcement, the inference—assuming that the antitrust agencies properly decline to challenge the merger—is that the proposed merger will reduce the merged firm's production costs and make it a more aggressive competitor. If these firms' stock prices increase, on the other hand, the inference is that they will be the fortunate beneficiaries of market power created by the merging firms.

<sup>232</sup> 273 U.S. 392 (1927) (holding that an agreement to fix uniform prices by companies controlling eighty percent of the market violates the Sherman Act).

glance to have the sole effect of generating market power for the participating firms, while on closer examination they are found to generate offsetting productive efficiencies. Examples include syndicates formed by investment banks to market initial public offerings of corporate stock,<sup>233</sup> vertically imposed resale price maintenance,<sup>234</sup> vertically imposed exclusive territories between horizontally situated retailers,<sup>235</sup> and copyright licensing arrangements.<sup>236</sup>

Although courts have yet to formally adopt a full reasonableness inquiry for horizontal restraints, they have done so where nonprice restraints are vertically imposed. But even for purely horizontal restraints, including price restraints, where the participating firms' combined market share is small and increasing over time, a compelling case can be made that, absent the use of exclusionary practices, the arrangement generates productive efficiencies that outweigh any allocative inefficiency from the creation of market power. Otherwise, the participating firms' combined market shares would decline over time as rivals expand production and undercut their prices.<sup>237</sup> By promoting inter-jurisdictional competition over optimal antitrust policy, the geographic market power test fosters experimentation and innovation and will more quickly resolve any uncertainties regarding the proper treatment of novel business practices.

One need not look very far to find evidence that state competition over antitrust policy will improve the judicial treatment of novel business practices. Recall the *Mandeville Island Farms* case, for example, where the defendant and its alleged co-conspirators sold their sugar into a national market in which their market share was so small they could not possibly have influenced sugar prices. As beet buyers, they may have enjoyed market power in northern California that allowed them to impose a monopsony underpayment on beet growers. But together with substantial evidence that sugar refining is subject to various incentive problems—including the difficulty of measuring sugar beet quality and the attendant moral hazard—the plaintiff's willingness to enter into the challenged contract *ex ante* raises at least a modicum of doubt that the contract constituted a naked re-

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<sup>233</sup> Cf. *United States v. Morgan*, 118 F. Supp. 621, 829 (S.D.N.Y. 1953) (holding that such a syndicate is not illegal under the Sherman Act).

<sup>234</sup> Cf. Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960) (explaining why some manufacturers prefer their products to be sold by retailers at a minimum retail price).

<sup>235</sup> Cf. *Cont'l T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 59 (1977) (holding that such arrangements should be judged under the rule of reason, rather than the *per se* rule).

<sup>236</sup> Cf. *Broad. Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 U.S. 1, 25 (1979) (remanding a challenge to such an arrangement under the Sherman Act to a district court for review under the rule of reason).

<sup>237</sup> The Court applied this reasoning in overturning the *per se* rule against vertical division of territories in *Continental T.V.*, 433 U.S. at 56.



straint.<sup>238</sup> More than likely, the agreement there was designed to avoid a moral hazard that otherwise would have increased transaction costs. Given that the market for sugar beets was entirely local, with no possibility that a monopsony underpayment could spill across state lines, *Mandeville Island Farms* stands as a poster child for the geographic market power test. By allowing the states to “perform their role as laboratories for experimentation . . . where the best solution is far from clear,”<sup>239</sup> the geographic market power test ensures that the entire body of antitrust law, both state and federal, will iterate more quickly toward the optimal set of legal rules.

## V. UNCERTAINTY, EVOLUTION, AND GENERAL COMMERCE CLAUSE JURISDICTION

The environment selects survivors . . . .<sup>240</sup>

The Court’s decisions in *Lopez* and *Morrison* suggest a majority of the Justices would like to establish a clear and substantively reasoned basis for limiting federal Commerce Clause jurisdiction in a way that is consistent with competitive federalism. In part, this appears to reflect the Court’s discomfort over its inability to establish bounds for the substantial effects test. As Justice Thomas stated in his *Lopez* concurrence, “[i]n an appropriate case, I believe that we must further reconsider our ‘substantial effects’ test with an eye toward constructing a standard that reflects the text and history of the Commerce Clause without totally rejecting our more recent Commerce Clause jurisprudence.”<sup>241</sup> The question is how. The Court can begin by overturning *Summit* and adopting the geographic market power test as the basis for Sherman Act jurisdiction. This would set the bounds of the substantial effects test in the antitrust context by requiring the party asserting jurisdiction to allege a substantial interstate spillover of market power.

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<sup>238</sup> See generally Jeanine Koenig Balbach, *The Effect of Ownership on Contract Structure, Costs, and Quality: The Case of the U.S. Beet Sugar Industry*, in *THE INDUSTRIALIZATION OF AGRICULTURE: VERTICAL COORDINATION IN THE U.S. FOOD SYSTEM* (Jeffrey S. Royer & Richard T. Rogers eds., 1998). Among other things, she reports that the American Crystal Sugar Company was ultimately bought by a cooperative of growers. This vertical integration by a horizontal combination of growers was apparently designed to reduce the transaction costs involved in measuring the quality of sugar beets.

<sup>239</sup> *United States v. Lopez*, 514 U.S. 549, 581 (1995) (Kennedy, J., concurring).

<sup>240</sup> Johnsen, *supra* note 21, at 154. This statement follows from Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 220–21 (1950) (arguing that biological theories of natural selection may be applied by economists to predict complex business behaviors).

<sup>241</sup> *Lopez*, 514 U.S. at 585 (Thomas, J., concurring).

In what follows, we sketch a model that shows how a common law judicial system evolves to reduce legal uncertainty in the face of positive administrative costs. We then show that the geographic market power test represents a compelling step in the evolution of Sherman Act jurisdiction that promises to dramatically reduce legal uncertainty. By adopting the geographic market power test for Sherman Act jurisdiction, the Court can redirect the evolution of general Commerce Clause jurisdiction while posing little immediate threat to the existing stock of constitutional precedents.

Regulatory statutes inject sudden uncertainty into a common law judicial system based on *stare decisis*, which is ideally suited to incremental adjustments in response to changing circumstances. Absent established precedent or clear understanding of the statute's objective, a common law system begins a slow iterative process of case-by-case adjudication to resolve the uncertainty.<sup>242</sup> The accumulated case law—including those cases establishing rules that were subsequently overturned or distinguished—eventually comes to embody a stock of knowledge that allows judges to economize on the costs of administering new cases as they arise. This process gradually adapts the form of legal rules to changed circumstances, filling out the interstices of the common law and reducing legal uncertainty.

The influence of legal uncertainty and costly administration on the expressed form of legal rules is evident from the evolution of Sherman Act case law.<sup>243</sup> We have already briefly recounted the evolution of the consumer welfare standard.<sup>244</sup> A similar evolutionary process has been at work regarding the Court's use of the rule of rea-

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<sup>242</sup> Uncertainty generates disagreement between potential litigants about the likely outcome of the dispute and raises the number of disputes that are litigated to judgment. For early work on the role of uncertainty in common law adjudication, see William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235, 259–84 (1979) (noting that the existing literature has generally overstated the tendency of a common law system to produce efficient rules); George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65, 65–75 (1977) (arguing that common law decision making facilitates the efficient allocation of resources); George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 4 (1984) (suggesting a model in which the determinants of settlement and litigation are solely economic factors); Paul H. Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 51, 51 (1977) (theorizing that the common law system is efficient due to utility maximizing decisions of disputants and not because of wise judicial decisions).

<sup>243</sup> From the outset, some members of Congress sought to keep legal uncertainty to a minimum by declaring that the Act was designed merely to apply the existing common law of trade restraints to those occurring *among the several states* (and to increase the associated penalties). See BORK, *supra* note 22, at 20 (noting that Sherman assured the Senate that his Act would merely “enact the common law”).

<sup>244</sup> For an interesting view of this evolution, see Mark Grady, *Toward a Positive Economic Theory of Antitrust*, 30 ECON. INQUIRY 225, 237 (1992) (describing various theories about the way common law changes over time, including the legal realist theory, economic theory, and Oliver Wendell Holmes's theory involving precedent and social values).

son to address specific trade restraints.<sup>245</sup> Early on, the Court established the *per se* rule to preclude a costly reasonableness inquiry into restraints such as price fixing that are so unlikely to benefit consumers that they can be presumed unreasonable as a matter of law even though there might be rare cases in which they benefit consumers.<sup>246</sup> The Court addresses the *per se* category of restraints in a perfunctory manner to devote its scarce judicial resources to resolving disputes in the presumptively reasonable category, for which the net effect on consumer welfare is a question of fact.<sup>247</sup> The underlying objective of the Sherman Act must therefore be some combination of consumer welfare and judicial economy, rather than consumer welfare alone, because unconditional pursuit of the consumer welfare standard

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<sup>245</sup> The Court adopted the rule of reason as a basis for assessing Sherman Act claims in *Standard Oil Co. v. United States*, 221 U.S. 1, 66 (1911). It eventually concluded that this rule would not allow it to entertain a defense to price fixing premised on the reasonableness of the defendants' prices. In *United States v. Trenton Potteries Co.*, 273 U.S. 392, 395–402 (1927), the Court therefore adopted a *per se* rule against price fixing, according to which, uncontroverted evidence of the existence of a horizontal price agreement raises an irrebuttable presumption that the restraint is unreasonable. The Court retreated slightly from the *per se* rule in *Appalachian Coals, Inc. v. United States*, 288 U.S. 344 (1933), by applying the rule of reason to a central agency for the sale of defendants' coal established in response to distressed industrial conditions during the Great Depression. Seeing that this led to a proliferation of horizontal arrangements ostensibly designed to "stabilize" prices, however, it quickly reversed itself in *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 223 (1940). There, it not only cemented the *per se* rule, but expanded it to apply to any concerted conduct between defendants with the intent to do anything that might affect prices in any way. For a more in-depth discussion of *Socony-Vacuum* and the property rights explanation for buying programs, see D. Bruce Johnsen, *Property Rights to Cartel Rents: The Socony-Vacuum Story*, 34 J.L. & ECON. 177 (1991). Naturally, such a broad *per se* rule was sure to sweep in any number of pro-competitive business arrangements and became increasingly suspect as the Court's experience with the case law and economic understanding of trade restraints progressed. The inevitable result was the evolution of the "characterization" question in *Broadcast Music, Inc. v. Columbia Broadcasting System*, 441 U.S. 1, 24 (1979), according to which some horizontal pricing arrangements—in this case a centralized method of licensing and monitoring the use of composers' copyrighted works—are not to be characterized as the kind that are illegal *per se*, and instead are to be assessed under a full rule of reason inquiry. Together with repeated declarations by the Court that it will not apply the *per se* rule to a category of business activity until it has had sufficient experience addressing it under the rule of reason, this evolution reflects an iterative process of legal decision making based on information feedback and the accumulation of specialized knowledge.

<sup>246</sup> Discussing *per se* rules, Bork stated:

*Per se* rules always contain a degree of arbitrariness. They are justified on the assumption that the gains from imposition of the rule will far outweigh the losses and that significant administrative advantages will result. In other words, the potential competitive harm plus the administrative costs of determining in what particular situations the practice may be harmful must far outweigh the benefits that may result. If the potential benefits in the aggregate are outweighed to this degree, then they are simply not worth identifying in individual cases.

BORK, *supra* note 22, at 18 (quoting *United States v. Container Corp. of Am.*, 393 U.S. 333, 341 (1969) (Marshall, J., dissenting)).

<sup>247</sup> For a similar view of the evolution of the rule of reason, see HYLTON, *supra* note 162, at 104–12, 130–31 (arguing that there is a utilitarian justification behind the Court's use of the *per se* rule, in that there are relatively few instances of socially beneficial price fixing).

would require the Court to engage in a full reasonableness inquiry in all cases. Rather than being the underlying objective, consumer welfare is merely a useful proxy for the objective that actually drives the Court's administration of the Act.<sup>248</sup> The important general point is that the cost of legal administration affects the expressed form of the legal rule—in this case the consumer welfare standard as limited by the *per se* rule<sup>249</sup>—causing it to depart from an unbiased pursuit of the statute's underlying objective.

A fitting principled statement of the Sherman Act's objective, and indeed the objective of any body of common law, is to promote the commonwealth.<sup>250</sup> The commonwealth is not simply the sum of individual wealth of the members of society. Much of that wealth is private and beyond the judiciary's practical sphere of influence in the garden variety of cases. The commonwealth includes the shared value of society's public goods, such as the judicial system itself, together with its accumulated body of common law precedents.<sup>251</sup> As a positive proposition, the judicial system promotes the commonwealth by selecting in favor of legal rules that increase the expected net present value of the investments private parties (including future generations) will make in reliance on these rules after deducting the social costs of administering them.<sup>252</sup> These costs consist of the direct costs courts incur to conduct legal proceedings, as well as the indirect costs, both of which can be seen as a type of friction or transaction cost broadly conceived, which impedes the effortless functioning of the legal system.

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<sup>248</sup> An appropriate restatement might be that courts should decide cases to maximize consumer welfare conditional upon the costs of legal administration being held constant. But even holding the costs of judicial administration constant, if consumer welfare was truly the objective of the Sherman Act, then horizontal combinations between consumers to establish market power in purchasing—so-called “monopsony” price fixing—as alleged in *Mandeville Island Farms*, 334 U.S. 219, 221 (1948), would be embraced by antitrust regulators and courts.

<sup>249</sup> For some purposes, scholars have found it worthwhile to distinguish between rules and standards. We do not rely on this distinction. *But see* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 560 (1992) (distinguishing rules from standards only by the “extent to which efforts to give content to the law are undertaken before [as with rules] or after [as with standards] individuals act”).

<sup>250</sup> Wealth is the discounted present value of future income and therefore includes the long-run consequences of an action in the decision calculus. D. Bruce Johnsen, *Wealth is Value*, 15 J. LEGAL STUD. 263, 268–70 (1986).

<sup>251</sup> Some commentators may prefer the maximization of “social wealth,” “social utility,” or “social welfare” to “promotion of the commonwealth.” The important point is that consumer welfare clearly is not an accurate statement of what drives judicial decisions.

<sup>252</sup> This selection process favors legal rules that provide greater certainty, if for no other reason than that uncertain legal rules will generate divergent expectations by the parties to a dispute, who are then more likely to engage in litigation that eventually overturns them. *See* Priest & Klein, *supra* note 242, at 4 (noting that the information that parties possess about the likelihood of success at trial, based partly on knowledge of applicable legal precedent, is one determinant of settlement and litigation).

Indirect costs include those that private parties incur gathering the information to conform their conduct to the legal rule and, if they become litigants, to gather and present evidence regarding their conformity to the legal rule. Perhaps most important for our purposes, indirect costs also include the foregone opportunities the judiciary incurs in administering the law in various case categories, but also in accumulating a stock of knowledge to refine the body of legal rules to address new circumstances and to incorporate the flexibility to do so at low cost. Since legal rules merely serve as a proxy for the underlying objective of the law, their application is inherently uncertain, and the resulting adjudication will inevitably generate errors as revealed by legal commentators and subsequent courts addressing the same or similar issues. A cruder proxy might involve greater upfront uncertainty than the alternative, and yet the errors it generates may be more informative as to how it can be adapted to new cases, changes in related legal rules, or outside shocks such as social upheaval, scientific revolutions, or advancing technology. Even if a rule is ultimately overturned or distinguished, any systematic pattern in the errors it generated may provide useful information about the nature of the rule that should replace it. Formalistic bright-line rules such as *E.C. Knight's* distinction between manufacturing and commerce may be relatively clear and easily administered for garden variety cases, but they can fail miserably to accomplish the law's underlying objective where their application is inappropriate or uncertain. Because they generate very few nominal errors, moreover, they may end up providing little information about what rule should refine or replace them. A capacity for information feedback, learning, and flexibility constitute long-run investments that can allow the judiciary to gradually iterate toward a clear and substantively reasoned body of legal rules that promote the commonwealth.<sup>253</sup>

It follows as a positive proposition that the federal judiciary administers the balance of dual sovereignty under the Commerce Clause as if it was attempting to promote the commonwealth. Since judicial administration is costly, however, we would expect the expressed form of the legal rule to constitute a more or less crude proxy

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<sup>253</sup> See, e.g., William H. Page & Roger D. Blair, *Controlling the Competitor Plaintiff in Antitrust Litigation*, 91 MICH. L. REV. 111, 113 (1992) (“[Developing antitrust law] requires the gradual development of standards based upon the accumulated knowledge of antitrust cases and the prevailing economic wisdom.”). Our federal court system generates information feedback in many ways. We have already noted the role state courts can play under the geographic market power test in generating information feedback about strictly local restraints through application of their own specific antitrust laws. This information can feed into the federal system through cases involving diversity jurisdiction in which the federal court must apply state antitrust law, thereby providing federal judges with a basis for accumulating knowledge about the results of deviations from federal antitrust law.

for the commonwealth. Compared to the unconstrained substantial effects test, competitive federalism offers a suitably refined proxy for the optimal balance of dual sovereignty in antitrust, where the geographic market power test now allows courts to identify the interstate effects of trade restraint with relatively little error.

If this positive proposition is correct, then the evolution of Commerce Clause jurisdiction should not be inconsistent with competitive federalism's focus on interstate economic spillovers. Indeed, Marshall's central economic point in *Gibbons v. Ogden* was that commercial activities occurring outside a state may spill over state lines in a way that warrants federal regulation. Perhaps understandably, he failed to articulate any practical method of distinguishing the exact nature of the effects giving rise to exclusive federal jurisdiction.<sup>254</sup> In *Cooley v. Board of Wardens*, the Court found that the proper regulation of certain activities demands the discretion to meet local necessities, while the proper regulation of other activities demands a single uniform rule.<sup>255</sup> *Cooley* thereby approximated the central principle of competitive federalism, namely that some market failures are inherently local in nature and best left to the local sovereign while others are national in nature and best left to the federal government.

Perhaps *Kidd's* formalistic reliance on the distinction between commerce and manufacturing was a sufficient proxy for interstate economic spillovers to protect dormant commerce powers, but the rise of the affirmative Commerce Clause with passage of the Sherman Act appears to have changed that. Justice Holmes's decision in *Swift & Co. v. United States*, rejecting *E.C. Knight's* formalistic distinction between commerce and manufacturing as a basis for Sherman Act jurisdiction—itsself an unworkably crude proxy for interstate spillovers—correctly recognized that the economic effect of trade restraints can spill across state lines even though the defendants' products remain within the state.<sup>256</sup> Note that Holmes offered little to replace *E.C. Knight's* formalistic rule except the admonition that interstate commerce is a practical conception “drawn from the course of business.”<sup>257</sup> The *Shreveport Rate Cases* provided limited guidance several years later, finding that Congress has the power to regulate the “common instrumentalities” of interstate commerce such as railroad cars, even if those cars remain entirely intrastate, because restraints on intrastate rates can spill over to interstate rates.<sup>258</sup> Though

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<sup>254</sup> Cf. 22 U.S. (9 Wheat.) 1 (1824) (“But, in regulating commerce with foreign nations, the power of Congress does not stop at the jurisdictional lines of the several States. It would be a very useless power, if it could not pass those lines.”).

<sup>255</sup> 53 U.S. (12 How.) 299 (1851).

<sup>256</sup> *Swift & Co. v. United States*, 196 U.S. 375, 392 (1905).

<sup>257</sup> *Id.* at 398.

<sup>258</sup> 234 U.S. 342, 353 (1914).

“common instrumentalities” of interstate commerce is a crude proxy for interstate economic spillovers, the facts in that case suggest there could easily have been such a spillover. Of course, this rule is likely to err by condemning activities involving common instrumentalities of interstate commerce that generate no interstate spillover and by failing to condemn activities that do not involve common instrumentalities but do generate interstate spillovers. The same can be said for the Court’s occasional reliance on the “channels” of interstate commerce to support federal jurisdiction.<sup>259</sup>

*Wickard* gave us the aggregated substantial effects test, which, although it is generally a very crude proxy for interstate spillovers, was applied there in an economically plausible way.<sup>260</sup> The Court has repeatedly used an unconstrained version of this test to support federal jurisdiction over various activities, including racial discrimination. The geographic market power test is simply a reduced form of the unconstrained substantial effects test bounded by the requirement that the party asserting jurisdiction must allege a specific nexus, grounded in practical antitrust economics, between the defendant’s restraint and the interstate spillover of market power. Based on the geographic market power test’s constrained reliance on substantial effects, we now know that the defendants’ activities in *Mandeville Island Farms*, *Hospital Building*, *Goldfarb*, and *Summit* probably did not cause interstate economic spillovers of the kind the Sherman Act is meant to address.<sup>261</sup> These cases reveal systematic errors from the Court’s reliance on an excessively crude and uncertain proxy—the substantial effects test unconstrained by sound antitrust economics—to establish federal jurisdiction, and in hindsight the Court clearly erred by allowing the plaintiffs to establish jurisdiction. The substantial effects test therefore has the virtue of being flexible and in no way logically inconsistent with competitive federalism. Although it has generated a lot of litigation, it has also generated a large body of trial and appellate case law that provides useful information about the nature of the errors in its application and the best way to refine it as judicial understanding evolves.

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<sup>259</sup> See *Caminetti v. United States*, 242 U.S. 470, 491 (1917) (“[T]he authority of Congress to keep the channels of interstate commerce free from immoral and injurious uses has been frequently sustained, and is no longer open to question.”).

<sup>260</sup> *Wickard v. Filburn*, 317 U.S. 111 (1942), has proven wildly unpopular with political conservatives and others who favor limited federal powers, but this can only be because the marketing quotas for wheat appear to have been motivated by rent seeking. Conditional on agricultural price supports being in the national interest, which arguably requires a real stretch of the imagination, the underlying economic theory is perfectly sound and based on Congress’s specific finding that the supply of home grown wheat for on-the-farm consumption was sufficiently elastic that it could undermine any attempt to support national wheat prices because it would have resulted in an interstate economic spillover.

<sup>261</sup> See *supra* Part I.C.

Finally, in *Lopez* and *Morrison* the Court rejected the unconstrained substantial effects test and dispelled any suggestion that federal commerce power is limitless. These and other recent decisions by the Court relied on what looks like competitive federalism as the proper framework for resolving the balance of dual sovereignty. Perhaps these cases signal a new direction for the Court's Commerce Clause case law. Federal judges and the parties to Sherman Act litigation now have a clear economic methodology for identifying an interstate geographic antitrust market and assessing the likelihood that the defendants' alleged restraint, if successful, could plausibly cause prices to increase in that market. In addressing Sherman Act jurisdiction, the Court can now confidently reject the unconstrained substantial effects test in favor of the relatively clear geographic market power test. Lower federal courts can then begin requiring the party asserting jurisdiction to allege a specific substantive nexus between the defendants' restraint and the interstate spillover of market power, giving defendants a proper chance of prevailing on the threshold issue of jurisdiction.

Our earlier discussion showed that federal district courts have repeatedly granted antitrust defendants summary judgment on the merits for reasons that would have warranted dismissal for failure of subject matter jurisdiction. In light of the geographic market power test, these substantive decisions now appear as errors on the issue of jurisdiction. The overlap between substance and jurisdiction derives from the Act's language, which arguably makes restraints of trade "among the several states" both an element of the substantive offense and the basis for federal jurisdiction. Justice Scalia's recent decision in *Steel Co. v. Citizens for a Better Environment* reveals the source of information feedback from substance to jurisdiction.<sup>262</sup> In his words, "[d]ismissal for lack of subject matter jurisdiction because of the inadequacy of the federal claim is proper only when the claim is 'so insubstantial, implausible, foreclosed by prior decisions of this Court, or otherwise completely devoid of merit as not to involve a federal controversy.'"<sup>263</sup> This finding establishes an admittedly narrow basis for dismissing cases for weakness on the merits of the substantive federal claim, as where the mere existence of a trade restraint is in substantial doubt from the face of the plaintiff's claim.<sup>264</sup> But the window is presumably wide enough to support dismissal for failure of subject-matter jurisdiction when the specific weakness at issue is the plain-

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<sup>262</sup> 523 U.S. 83 (1998).

<sup>263</sup> *Id.* at 89 (quoting *Oneida Indian Nation v. County of Oneida*, 414 U.S. 661, 666 (1974)).

<sup>264</sup> An apt example is where the plaintiff tries to support a Sherman Act claim for price fixing by alleging that the defendants raised their prices simultaneously with no additional allegations that they agreed to do so.



tiff's inability to plausibly allege that the defendants' restraint caused prices to rise in more states than one. Because of the overlap, lower courts' understanding of the nature of various trade restraints is likely to improve with accumulated experience. Their understanding of the geographic scope of trade restraints is also likely to improve, and any revealed errors will continue to provide a mechanism for information feedback and learning.<sup>265</sup>

A potential criticism of the geographic market power test is that it appears to depart from the Court's repeated findings that the scope of Sherman Act jurisdiction is concurrent with the scope of federal Commerce Clause jurisdiction.<sup>266</sup> This criticism misses the mark for at least two reasons. First, the outer limits of Commerce Clause jurisprudence have been shaped by situations in which "Congress itself has defined the specific persons and activities that affect commerce and therefore require federal regulation."<sup>267</sup> As in *Wickard*, Congress made specific findings identifying the parties subject to the agricultural marketing quotas and noting the substantiality of the aggregate effect of homegrown wheat on national wheat prices. But as Justice Scalia quoted in *Summit*, "[t]he jurisdictional inquiry under general prohibitions like . . . § 1 of the Sherman Act, turn[s] . . . on the circumstances presented in each case and requir[es] a particularized judicial determination . . . ."<sup>268</sup> In applying the Sherman Act, courts are in no position to gather facts or make specific findings regarding parties outside the proceeding, and horizontal aggregation under the substantial effects test is appropriately limited in such cases.<sup>269</sup>

The second reason why the above criticism misses the mark is that the finding on which it relies is dictum. The general limits of Commerce Clause jurisdiction cannot be defined in a vacuum because the

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<sup>265</sup> Identifying the proper market power threshold for various restraints may take time. For example, where the lower federal courts might initially feel comfortable denying jurisdiction where the defendants are alleged to have engaged in horizontal division of territories and have an HHI of less than 1000 in the relevant interstate geographic antitrust market, after sufficient experience on the merits with such cases courts might raise the HHI threshold to 1600.

<sup>266</sup> See, e.g., *United States v. Frankfort Distilleries, Inc.*, 324 U.S. 293, 298 (1945) ("Congress, in passing the Sherman Act, left no area of its constitutional power unoccupied; it 'exercised all the power it possessed.'" (quoting *Apex Hosiery Co. v. Leader*, 310 U.S. 469, 495 (1940))); see also *Summit Health, Ltd. v. Pinhas*, 500 U.S. 322, 328–29 (1991) (discussing how the Commerce Clause and Sherman Act have "experienced similar expansion").

<sup>267</sup> *Gulf Oil Corp. v. Copp Paving Co.*, 419 U.S. 186, 197 n.12 (1974).

<sup>268</sup> *Summit*, 500 U.S. at 334 (quoting *Gulf Oil Corp.*, 419 U.S. at 197 n.12).

<sup>269</sup> *Mandeville Island Farms* stands as a stark example of the misuse of the aggregation principle. There, the Court hypothesized that national sugar prices would be substantially affected if other beet refiners across the county, which were not parties to the litigation, engaged in the same practice as the defendant. *Mandeville Island Farms, Inc. v. Am. Crystal Sugar Co.*, 334 U.S. 219, 236 (1948). The hypothesis is not only *ultra vires*, it is very likely wrong in the context of horizontal price agreements, where the most commonly observed pattern is for outside firms to undercut those engaged in a restraint.

measure of those limits depends on the statute in question, the form of the economic spillover it addresses, and judicial uncertainty regarding the nature and scope of the spillover. Even in the absence of uncertainty, specific activity that generates interstate economic spillovers in one setting may not do so in another; restraints of trade are a different animal than, say, racial discrimination, and the proper means of addressing them differ accordingly. What is more, uncertainty over the nature and scope of economic spillovers dictates that the Court rely on different proxies to identify the relevant spillovers in different settings. The level of uncertainty regarding trade restraints is now low enough that reliance on the geographic market power test's constrained substantial effects test is perfectly justified, even though the Court relies on a relatively unconstrained version of the substantial effects test in the area of civil rights.

Although the unconstrained substantial effects test appears vague and overly expansive, when applied to the issue of Sherman Act jurisdiction it has allowed for information feedback and provides the flexibility to adapt to advances in judicial understanding about the nature and geographic scope of the underlying market failure. The general point is that the judicial system is capable of gradually overcoming the uncertainty regulatory statutes create and allowing the Court to identify increasingly constrained versions of the substantial effects test. As with the Sherman Act, the substantive and jurisdictional inquiries in any Commerce Clause regulation overlap to some extent and are necessarily economic in nature. Over time, advances in economic understanding will identify the substantive nexus, if one in fact exists,<sup>270</sup> between the activity addressed by any regulatory statute and an interstate economic spillover. It is the identification of the substantive nexus that promises to bound the substantial effects test in any given setting and allow the Court to move toward a balance of dual sovereignty consistent with the framework of competitive federalism.

In our view, competitive federalism provides the ideal framework to guide the evolution of Commerce Clause case law, but as with consumer welfare it is simply a useful proxy for promoting the commonwealth. The consumer welfare standard has certainly proven to be a powerful expression of the Sherman Act's underlying objective; it has dramatically reduced legal uncertainty regarding a wide range of trade restraints, to say nothing of its role in guiding the economic methodology behind the geographic market power test. Competitive federalism is an equally powerful expression of the objective underlying the Commerce Clause. But just as the *per se* rule limits the Court's

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<sup>270</sup> It will ultimately be revealed if no such nexus exists and the statute must be overturned as beyond federal commerce power.

application of the consumer welfare standard to economize on the costs of judicial administration, some version of the substantial effects test would most likely limit the Court's application of competitive federalism. No proxy can be expected to perfectly identify its target.

In applying the Sherman Act, proxies for interstate market failures such as "channels" or "instrumentalities" of commerce are no longer helpful in assisting the trier of fact to determine whether an interstate spillover is more likely than not. They are simply too crude to be informative compared to the geographic market power test. These proxies may nevertheless be useful expressions of the jurisdictional limits of other federal regulatory statutes, but only because judicial uncertainty is so great that the Court must rely on them out of practical necessity. Together with the unconstrained version of the substantial effects test, they will no doubt generate informative errors regarding the scope of economic spillovers. At the same time, litigation on the merits of a statute will generate informative errors regarding the exact nature of the underlying market failure. As the case law on substance and jurisdiction evolves they should gradually converge, allowing the Court to identify the specific substantive nexus between the defendants' conduct and the relevant interstate spillover.

In the context of Commerce Clause regulation, many statutes are necessarily vague about the nature and scope of the underlying economic spillover, but it is plausible that they promote more or less compelling objectives, as with civil rights legislation. In the face of legal uncertainty and costly judicial administration, the Court simply must provide some measure of deference to federal statutes in assessing whether they fall within Congress's commerce powers. This conclusion follows reasonably from the nature of the respective sovereign powers. In the face of legal uncertainty, when the national government's enumerated powers appear to conflict with state governments' residual powers, the residual powers should yield because they provide the states with countless alternative courses of action. Indeed, this may explain the deference the Supremacy and Necessary and Proper Clauses seem to compel from the Court in applying various constitutional provisions. What is more, we would expect to find that deference being wider where legal uncertainty is greater. The unconstrained substantial effects test is merely a reflection of this deference born of practical necessity. It would be a grave mistake for the Court to reject the general principle that the activity a regulatory statute proscribes must bear a specific substantive nexus to an interstate economic spillover where the Court has yet to discern the exact contours of that nexus because it is unable to accurately measure the prohibited effects. For the ideal case in which the Court's economic understanding of the nature and geographic extent of the market failure is clear, as under the Sherman Act, federal jurisdiction properly requires the party asserting it to allege a substantive nexus be-

tween the defendant's conduct and the interstate spillover to which the regulation is directed. Short of the ideal case, however, the Court must invariably rely on more or less crude proxies for interstate spillovers in parsing the contours of federal jurisdiction. In this setting, the plaintiff should at least have the burden of demonstrating, on the merits, the existence of a substantive nexus between the defendant's conduct and the accepted proxy for interstate spillovers. Over time, the federal judiciary's experience with the substantive issues under various federal statutes should allow it to accumulate a stock of knowledge regarding the nature and scope of the underlying market failures,<sup>271</sup> to refine its proxies over time, and to gradually iterate toward the balance of dual sovereignty consistent with competitive federalism.

Under this approach, the charge to Congress in passing federal regulation should be to identify what it believes to be an economic market failure common to more states than one and to make a plausible case that the states, acting independently, face a political market failure precluding them from correcting the problem. This would provide the Court with a substantive basis for assessing whether the regulation falls within Congress's constitutional authority. The Court could then review the regulation under the rational basis or strict scrutiny standards, giving due deference to Congress to account for legal uncertainty and its own administrative costs, and uphold it, strike it down, or enforce it to the extent necessary to achieve legitimate congressional ends. Of course, Congress is unlikely to be able to identify the exact economic nature of the market failure in any given situation, just as it was unable to do so when it passed the Sherman Act. But competitive federalism provides a sufficiently broad framework so that the Court could nevertheless make an initial assessment that political competition between states is unlikely to resolve the problem as Congress has identified it, and then articulate the proper limits of Congress's regulatory response as it gains additional experience with the subject, quite possibly guided by concurrent advances in economic understanding. Of course the Court may err, but the important point is that it should take care to follow the general framework of competitive federalism so that over time the errors are self-correcting and the judicial process can select in favor of rules that promote the commonwealth.

We have already noted that some are skeptical that the framework of competitive federalism can be used to effectively limit federal

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<sup>271</sup> As under the Sherman Act, civil causes of action for violating federal statutes no doubt hasten the process of knowledge accumulation.

commerce powers.<sup>272</sup> It is absolutely correct that those engaged in rent seeking are normally clever enough to make a plausible case that the regulation they seek is designed to address an interstate economic spillover. This criticism would be crippling if the common law were static, but both our model of judicial uncertainty and the Court's recent decisions suggest that the federal judiciary is capable of learning and evolving to reduce legal errors over time. The response might be that this process is not fast enough, but the question then becomes "compared to what?" Apparently, the next best alternative with respect to a provision as vague as the Commerce Clause is to admonish judges to strictly construe the constitution, or return to original intent, to stop legislating, or simply to do nothing, none of which holds out much hope for progress. Political rent seeking no doubt occurs, but this is largely a red herring in our analysis because it occurs at both the federal and state levels. Those whose rent seeking is aimed at purely local markets, say, barbers seeking occupational licensing,<sup>273</sup> should have little reason to push for federal regulation. Instead, they will confine their lobbying efforts to their local or state governments. They will organize themselves nationally and push for federal regulation only if state regulation would result in interstate economic spillovers that undermine their ability to capture rents. Given that it can be quite difficult to distinguish public interest regulation from regulation motivated by rent seeking, a balance of dual sovereignty based on interstate economic spillovers pushes rent seeking activity into the proper political forum. It is then reasonable to rely on the political process to limit rent seeking and to focus on maintaining effective competition between the state and federal governments.

The evolutionary approach we outline in this Article is by no means perfect. It will require the Court to firmly imbed competitive federalism in its case law as a long-run evolutionary framework for redirecting Commerce Clause jurisdiction. We believe the Court's adoption of the geographic market power test for Sherman Act jurisdiction would be a powerful force in this regard. Its inevitable success in resolving the limits of Sherman Act jurisdiction would dramatically reduce legal uncertainty in applying competitive federalism to other regulatory statutes. It would also spark a sustained increase in scholarly attention to the nature and scope of market failures behind a host of federal statutes by those otherwise accustomed to

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<sup>272</sup> See, e.g., Lund, *supra* note 14, at 1047 ("[I]t is difficult in practice to realize all the benefits of federalism.").

<sup>273</sup> See George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 13-17 (1971) (using occupational licensing as an example of the use of the political process at the state level "to improve the economic circumstances of a group").

thinking such projects are fruitless because federal commerce power has no limits.