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Note

Ratcheting Up Federalism: A Supremacy Clause Analysis of NAFTA and the Uruguay Round Agreements

Julie Long

The North American Free Trade Agreement[1] (NAFTA) and the Uruguay Round Agreements[2] represent an unprecedented step toward the full globalization of the U.S. economy.[3] The

1. President Bush signed the North American Free Trade Agreement on December 17, 1992. H.R. REP. No. 103-361(I), 103d Cong., 1st Sess. 7 (1993), *reprinted in* 1993 U.S.C.C.A.N. 2552, 2557. Congress approved it through the NAFTA Implementation Act on December 8, 1993. Pub. L. No. 103-182, 107 Stat. 2057 (1993) [hereinafter NAFTA Act]. The agreement provides for the liberalization of trade relations between the U.S., Canada, and Mexico. *See infra* notes 63-64 and accompanying text (discussing the mechanics of NAFTA and the Uruguay Round Agreements).

2. The United States signed the Uruguay Round Agreements, negotiated under the auspices of the General Agreement on Tariffs and Trade 1947 (GATT), on April 15, 1994. H.R. REP. No. 103-826(I), 103d Cong., 2d Sess. 11 (1994), *reprinted in* 1995 U.S.C.C.A.N. 3773, 3782. Congress approved it through the Uruguay Round Agreements Act on December 8, 1994. Pub. L. No. 103-465, 108 Stat. 4813 (1994) [hereinafter Uruguay Round Act]. The agreement provides for the liberalization and expansion of world trade and the development of a framework through which members negotiate international terms of competition. *See infra* notes 63-64 and accompanying text (examining the mechanics of NAFTA and the Uruguay Round Agreements).

3. In his Presidential Message submitted to Congress with the proposed Uruguay Round Agreements Act, President Clinton characterized the agreements as the "broadest, most comprehensive trade agreements in history. They are vital to our national interest and to economic growth, job creation, and an improved standard of living for all Americans." PRESIDENT'S MESSAGE TRANSMITTING THE URUGUAY ROUND TRADE AGREEMENTS, *reprinted in* URUGUAY ROUND TRADE AGREEMENTS, TEXT OF AGREEMENTS, IMPLEMENTING BILL, STATEMENT OF ADMINISTRATIVE ACTION AND REQUIRED SUPPORTING STATEMENTS 1 (1994). One commentator characterized the Uruguay Round Agreements as "among the most important legislative verdicts of this decade - decisively shaping the United States' relationship with the world in the 21st century." Peter Behr, *GATT is Legislative Landmark but Trade Remains a Divisive Issue*, WASH. POST, Dec. 2, 1994, at A26. In addition, one commentator compared the World Trade Organization ("WTO"), the organization created as the administrative organ of the Uruguay Round Agreements, to the United Nations and described it as "a powerful international body, equipped to bring down barriers

agreements encompass promises on the part of the signatories to set the terms of competition through international negotiation,[4] and to ensure that internal measures at the central and at lower government levels do not interfere with the expansion and increased efficiency of international trade.[5] Just as the states in 1787 were required to adjust their use of power to the new realities of the Federal Constitution,[6] the states in 1995 must adjust, albeit in a more limited way,[7] to the requirements of federal participation in the international economic system that NAFTA and the Uruguay Round Agreements represent.

The trade agreements signify the federal government's attempt to realign federalism; in other words, to draw a new dividing line between the powers of the federal government and the constitutionally-guaranteed powers of the states.[8] As this Note argues, U.S. accession to NAFTA and the Uruguay Round Agreements challenges traditional state powers in the name of

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to trade, investment and economic growth worldwide." Peter Behr, *Congress to Cast Vote on Historic Trade Pact*, WASH. POST, Nov. 28, 1994, at A1.

Commentators likewise have characterized NAFTA as a "watershed event" that signals "an historic turning point" for the United States. JUDITH H. BELLO ET AL., THE NORTH AMERICAN FREE TRADE AGREEMENT: A NEW FRONTIER IN INTERNATIONAL TRADE AND INVESTMENT IN THE AMERICAS 5 (Judith H. Bello et al. eds., 1994).

4. *See infra* notes 67-82 and accompanying text (discussing agreements embodied in NAFTA and the Uruguay Round Agreements).

5. *See infra* notes 67-82 and accompanying text (discussing agreements embodied in NAFTA and the Uruguay Round Agreements).

6. *See generally* Merrill Jensen, *The Ideal of a National Government During the American Revolution, in* ESSAYS ON THE MAKING OF THE CONSTITUTION 61-87 (Leonard W. Levy ed., 1969) (describing the formulation of a national government in the post-Revolutionary War period). The Articles of Confederation, which governed the United States before the ratification of the Constitution, granted to the central government only weak powers. MERRILL JENSEN, THE ARTICLES OF CONFEDERATION: AN INTERPRETATION OF THE SOCIAL-CONSTITUTIONAL HISTORY OF THE AMERICAN REVOLUTION 1774-1781, 109 (1940). By contrast, the Constitution created a strong central government and required the states to surrender a degree of their sovereignty to that government. *Id.*

7. NAFTA and the Uruguay Round Agreements do not represent a transfer of sovereignty, as did the adoption of the U.S. Constitution. *See, e.g.*, Jessica Matthews, *GATT: False Claims, Red Herrings*, WASH. POST, Nov. 28, 1994, at A25 (asserting that the U.S. has not transferred sovereignty to the WTO). They provide a more limited expression that the member states intend to set the terms of competition between them through negotiations among the central governments. *See infra* notes 63-82 and accompanying text (analyzing the contents of NAFTA and the Uruguay Round Agreements).

8. States' rights and the proper line between state and federal power are a preoccupying interest of the Rehnquist Court. For an account of the Supreme Court's recent moves in this area, see Robert Pear, *Source of State Power is Pulled From the Ashes*, N.Y. TIMES, Apr. 16, 1995, at A-11, and Richard C. Ruben, *Court Bolsters 10th Amendment*, A.B.A.J., Apr. 1995, at 78.

free international trade in a way that never before has been accomplished. This "ratcheting up"[9] of federal power remains tempered, however, by powerful constitutional checks on the ability of the federal government to intrude upon areas of law traditionally reserved to the states.[10] The agreements, therefore, create fertile ground for a constitutional conflict.

Using elements of state corporate tax as an example,[11] this Note will demonstrate how the Supremacy Clause of the U.S. Constitution is useful in overcoming this tension by providing a basis upon which a private party can attack a state law that conflicts with the trade accords. This Note recognizes, however, that a wholesale invalidation of a state law potentially in conflict with federal goals is neither politically feasible nor necessarily

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9. "Ratcheting up" illustrates the shifting of power that occurs when a federal body joins or accedes to a supranational organization whose authority overlaps the authority of the lower levels of government. In doing so, the federal government passes some degree of its sovereignty or discretion, and, by implication, the discretion of its constituent governments, to the supranational body. This necessarily causes a re-drawing of the line between the powers that the federal government retains and the powers that state governments retain. Power-sharing between two levels becomes power-sharing at three levels. Such power-sharing forces states to contend with two higher levels of authority. With this shifting of power comes a realignment of responsibility between the federal and state governments. This Note demonstrates that NAFTA and the Uruguay Round Agreements provide excellent examples of this process. Freedom to develop a tax system is one state power that federal accession to the supranational organization transfers, in some degree, to the federal level.

See also GEORGE A. BERMANN ET AL., CASES AND MATERIALS ON EUROPEAN COMMUNITY LAW 16-19, 46-47 (1993) (noting a continuing debate concerning "ratcheting up" in the European Union as a result of the Treaty on European Union).

10. *See, e.g.*, New York v. United States, 112 S. Ct. 2408, 2417, 2434-35 (1992) (finding that the Tenth Amendment prohibits Congress from forcing states to dispose of their own radioactive waste); Gregory v. Ashcroft, 111 S. Ct. 2395, 2399-2403 (1991) (holding that state voters have the power to determine the qualifications of their national representatives); National League of Cities v. Usery, 426 U.S. 833, 839-40 (1976) (holding that the Commerce Clause does not grant plenary authority to Congress), *overruled by* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 531 (1985) (5-4 decision) (rejecting the "traditional government function" test that National League of Cities established).

11. NAFTA and the Uruguay Round Agreements may affect many areas of law traditionally reserved to the states in the same way that they affect state tax laws. For example, many commentators argue that environmental and labor legislation affect the terms of competition and function as non-tariff barriers to trade. *See, e.g.*, Ursula Kettlewell, *GATT - Will Liberalized Trade Aid Global Environmental Protection?*, 21 DENV. J. INT'L L. & POL'Y 55, 56-57 (1992). If these laws vary from state to state, they arguably represent the same barrier to entry as variable tax systems. *See infra* notes 117-129 and accompanying text (examining the effect of state tax laws on international trade).

good policy.[12] As a result, in keeping with preemption doctrine that governs other areas in which federal and state governments have equally vital, defensible interests, the federal judiciary must develop a balancing test to help determine when, and if, it will invalidate a state law in conflict with federal goals embodied in the trade agreements.[13]

Part I of this Note explores Supremacy Clause jurisprudence, particularly as applied when a state and the federal government have equally defensible, constitutionally explicit interests at stake. Part II establishes that, because of the trade agreement obligations and the implementing legislation objectives, state laws that discriminate against foreign parties are susceptible to a Supremacy Clause challenge. Part III proposes a set of factors useful in balancing the state and federal interests involved. This Note concludes that the federal courts should invalidate state laws only when the disruption to the federal system that the state law causes outweighs the state's legitimate policy concerns.

I. TAXATION, INTERNATIONAL TRADE, AND THE CONSTITUTION

Article I, section 8 of the U.S. Constitution establishes that the primary authority to conduct international economic relations lies with the Congress.[14] The President also has the authority, in his own right, to conduct international affairs.[15] States, therefore, cannot participate actively in international affairs and in the regulation of international commerce.

In spite of this check on state power, regulations that states promulgate in areas traditionally reserved to them increasingly

12. *See* KENNETH STARR ET AL., THE LAW OF PREEMPTION 1-4, 40-55 (1991) (discussing the advantages and disadvantages of an expansive use of the Supremacy Clause to invalidate state legislation arguably in conflict with federal laws).

13. *See infra* notes 135-145 and accompanying text (discussing the implementation of a judicial balancing test for questionable state laws).

14. "The Congress shall have Power To . . . regulate Commerce with foreign Nations . . . ." U.S. CONST. art. I, § 8, cl. 3.

15. *See* Dames & Moore v. Regan, 453 U.S. 654, 668-69 (1981) (reading broadly a statutory authority grant to the President in the area of international affairs); Consumer's Union of U.S., Inc. v. Kissinger, 506 F.2d 136, 143 (D.C. Cir. 1975), *cert. denied*, 421 U.S. 1004 (1975) (holding valid several non-binding export quotas that the Executive negotiated, although the President did not follow the express legislation in the field, because Congress does not occupy exclusively the field of international commerce); United States v. Curtiss-Wright Export Corp., 299 U.S. 304, 319-20 (1936) (holding that the President is the nation's representative in the foreign affairs arena).

impact international trade because of the ever increasing globalization of the U.S. economy.[16] State corporate income apportionment systems provide one example of such regulations.[17] With the growth of multinational corporations over the last fifty years, taxing jurisdictions, including the U.S. states, have struggled to develop income apportionment systems that both minimize double taxation and ensure that each jurisdiction taxes its fair share of income.[18] What has emerged is a multitude of different systems among the U.S. states[19] competing against an international system of agreement[20] where one particular method

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16. According to the Statistical Abstract of the United States, U.S. direct investment abroad increased almost one and one-half times from 1980 to 1991. U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 811 (1994). U.S. exports rose from $42.7 billion in 1970 to $464.8 billion in 1993, and U.S. imports over the same period increased from $40.0 billion to $580.5 billion. *Id.* at 818. In addition, foreign direct investment in the United States increased almost 500% from 1980 to 1992. *Id.* at 808.

17. At the root of the conflict lies the states' use of a method of apportioning income that multinational corporations earn that is wholly different from, and incompatible with, the system that the rest of the world uses. Recognizing that the use of varying tax rates and systems in different jurisdictions hampers trade, national governments have agreed to use one system of income tax accounting, the separate accounting method, by which each government ascertains the income attributable to it. *See* Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2273 (1994) (describing the separate accounting method that states use); 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES 8-28 to 8-34 (2d ed. 1993) (discussing generally the separate accounting method); David Greenberg, Comment, *California's Franchise Tax Board: A Bull in the International China Shop:* Barclays Bank International, Ltd. v. Franchise Tax Board, 6 TRANSNAT'L LAW. 463, 467 (1993) (analyzing recent Supreme Court jurisprudence on the issue of state taxation of multinational corporations); Elizabeth Harris, Note, *Desperate for Revenue: The States' Unconstitutional Use of the Unitary Method to Apportion the Taxable Income of Foreign Corporations*, 19 HASTINGS CONST. L.Q. 1077, 1078 (1992) (discussing state taxation of multinational corporations).

18. For a summary of tax systems in OECD countries, see generally ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TAXATION IN OECD COUNTRIES (1993).

19. The states, faced with the rights and obligations of the U.S. federal system and the varying demands of their constituencies, have developed tax systems that differ essentially from the international standard. Harris, *supra* note 17, at 1079-80. *See infra* note 20 (discussing the international standard). Using a system known as formulary apportionment, a state determines what portion of a multinational's income is attributable to it by applying a formula tied to indicators of the company's economic activity in the state to a measurement of the company's overall income. *See generally* HELLERSTEIN & HELLERSTEIN, *supra* note 17, at 8-36 to 8-38 (discussing formulary apportionment); Harris, *supra* note 17, at 1080 (discussing formulary apportionment).

20. Separate accounting, used throughout the international system, treats affiliated members of a business as wholly separate entities for tax accounting purposes. Ferdinand P. Schoettle, Some Perspectives from the GATT Pertain-

of apportionment was adopted.[21] This has led to disruption of

ing to Commerce Clause Challenges to State Taxes 20-22 (Oct. 1994) (unpublished manuscript, on file with the *Minnesota Law Review*). Members of the same business must conduct all transactions at "arm's length" through the use of imputed prices, as though the members deal with unrelated entities. Harris, *supra* note 17, at 1078; Greenberg, *supra* note 17, at 466-67. The separate entities must maintain accounts based on imputed prices for the goods and services they "buy" and "sell" with other members of the business. HELLERSTEIN & HELLERSTEIN, *supra* note 17, at 8-28. This treats the separate business as a stand-alone entity, and allows the company to compute the income attributable to it. For a case study of the application of imputed prices in the petroleum industry, see Jean-Thomas Bernard & Robert J. Weiner, *Multinational Corporations, Transfer Prices, and Taxes: Evidence from the U.S. Petroleum Industry*, *in* TAXATION IN THE GLOBAL ECONOMY 123 (Assaf Razin & Joel Slemrod eds., 1990).

The taxing jurisdiction then computes and taxes only the income that directly is attributable to the members residing within its borders. Harris, *supra* note 17, at 1079. *See also* HELLERSTEIN & HELLERSTEIN, *supra* note 17, at 8-28 (describing methods commonly used to allocate income through the separate accounting method). The U.S. government uses the separate accounting method when it taxes foreign corporations. Harris, *supra* note 17, at 1079.

21. Interestingly, states originally favored the separate accounting method. HELLERSTEIN & HELLERSTEIN, *supra* note 17, at 8-28. States originally regarded separate accounting as the most precise and accurate method of apportioning income. *Id.* As multistate and multinational corporations began to dominate the economy after World War Two, however, criticism of separate accounting mounted. *Id.* at 8-29. Commentators generally assert that separate accounting has three defects. First, the accounting required to maintain adequate records of the business transactions that allow the system to work are complicated and therefore expensive. *Id.* at 8-29 to 8-30. Second, separate accounting relies on the use of imputed prices, or transfer prices, at which a company values the transactions that take place between members of the business family. *Id.* Reliance on imputed prices requires a comparison of the transaction with one taking place in the open market. *Id.* Often, however, the necessary data for comparison is absent, and the resultant imputed price is not accurate. *Id.* at 8-30 to 8-31. Finally, the separate accounting system ignores the reality of the business world. *Id.* at 8-31. Commentators also assert that there are many fallacies inherent in dividing up a unitary business and treating each part as equivalent to a separate business. *Id.* at 8-31 to 8-32. Other commentators argue that the separate accounting method is inferior because it allows corporations to shelter income in states or countries with low tax rates by using creative accounting techniques. *See* Harris, *supra* note 17, at 1079; Greenberg, *supra* note 17, at 467.

The states now, however, favor the formulary apportionment method for a variety of reasons. They argue that it is impossible to separate the income earned by a multinational corporation in one jurisdiction from that which it earns in other areas, as is required by the arm's length approach. Harris, *supra* note 17, at 1079. The functions performed in various jurisdictions, the states assert, often are interrelated, and they cannot be accounted for in the manner required in the international system. *Id.* In addition, the states believe that the arm's length method allows corporations to shelter income in jurisdictions with low tax rates by using accounting techniques that obscure the identity of the jurisdiction in which the income actually was generated. *Id.*

Multinational corporations and foreign governments, however, oppose the use of the formulary apportionment method. *See* Brief for the Petitioner at 22-

trade relations[22] as U.S. trading partners and multinational corporations protest discriminatory state systems.[23] NAFTA and

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28; Brief of the Government of the United Kingdom as amicus curiae Supporting Petitioner at 13-24; Brief for Keidanren (Japan Federation of Economic Organizations) as Amicus Curiae in support of Petitioner at 15-21; Brief of the Member States of the European Community and the Governments of Australia, Austria, Canada, Finland, Japan, Norway, Sweden, and Switzerland as Amicus Curiae in support of the petitioner at 4-17, Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268 (1994) (Nos. 92-1384, 92-1839).

22. *See supra* notes 17, 19, 21 and accompanying text (discussing different tax systems' effects on trade relations).

23. One type of formulary apportionment method, the combined reporting method, is especially dissatisfactory to international actors. Under this method, the taxing jurisdiction treats an affiliated business as a unitary group, and allocates income through the use of an apportionment formula. The generally-used formula averages the payroll, property, and sales figures of the local member and compares that figure with the corporation-wide averages to determine what percentage of business is attributable to activities located in the state. Harris, *supra* note 17, at 1080. The taxing jurisdiction then applies this percentage to a measure of the overall income of the corporation to calculate the portion of income attributable to the corporation's activities in that state. *Id.* This figure is the taxable income for the local activity.

Only four states use this method, which thirteen states once practiced. *Id.* at 1080-81. The four states are California, Alaska, North Dakota, and Montana. *See* ALASKA STAT. § 43.20.072 (1990); CAL. REV. & TAX CODE §§ 25120-25140 (West 1992); MONT. CODE ANN. §§ 15-31-301, 15-31-305 (1993); N.D. CENT. CODE § 57-38-12 (1983 & Supp. 1991).

All four states allow the corporation to select the "water's edge" alternative. HELLERSTEIN & HELLERSTEIN, *supra* note 17, at 8-187; Harris, *supra* note 17, at 1081. This variant measures income by averaging the property, payroll, and sales figures, and then compares the averages to income earned in the United States. *Id.* at 1081. The world-wide combined reporting (WWCR) method, a more stringent alternative at issue in *Barclays*, 114 S. Ct. at 2271-72, formed the basis for much litigation. This variation of the combined reporting method compared the average of the three elements of the formula with the global income averages for the corporation. *Id.*

Although forty-five states use a three-factor formulary apportionment known as the "Massachusetts formula," the methods by which each state arrives at the pertinent figures differ in each state. HELLERSTEIN & HELLERSTEIN, *supra* note 17, at 9-8 tb. 9-1, 9-23 to 9-25 (describing the states' differing formulary apportionment methods). Moreover, calculation of income earned through other means, such as real and intangible personal property, differs between many states. *Id.* at 9-25 to 9-45.

International actors opposed to the formulary apportionment method argue that it, and especially its combined reporting variation, overestimates income attributable to the state. *See id.* at 8-34 (discussing how this overestimation can occur). By tying the apportionment formula to indicators such as average business expenses and sales figures, states skew the income calculation in favor of high-cost jurisdictions. *Id.* at 8-74 to 8-75. In addition, because the state apportionment formulas are not consistent with each other, a multinational doing business in several different U.S. states runs a serious risk of double taxation on the same income. *See Barclays*, 114 S. Ct. at 2279-80 (accepting plaintiff Barclays' assertion that multinational enterprises subjected to the

the Uruguay Round Agreements, together with principles of U.S. law applicable to the trade accords,[24] indicate that the varying state tax systems are susceptible to invalidation because of federal obligations resulting from the trade accords.[25]

A. TAX SYSTEMS AND THE U.S. CONSTITUTION

State income apportionment systems provide insight into a Supremacy Clause analysis of state laws that conflict with the trade accords. Historically, plaintiffs challenged these systems on other grounds. As a result, the Supreme Court has developed a large body of jurisprudence in the area.[26] More importantly, because the cases generally deal with foreign trade, the Court's reasoning, especially in the Commerce Clause area, often alludes to Supremacy Clause concepts. This section will outline briefly the traditional Commerce Clause challenges to state income apportionment systems, and then develop the elements of a successful Supremacy Clause action.

1. Traditional Constitutional Treatment of Income Apportionment Cases

The constitutionality of state income apportionment systems has divided the states and multinational corporations for many years.[27] Traditionally, a foreign corporation challenged

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WWCR system would face a higher risk of double taxation because California had higher wage, property, and sales costs than other jurisdictions).

Because foreign multinationals conduct a significantly greater portion of their business in overseas, low-cost areas than do domestic multinationals, the risk of double taxation for this subgroup of multinationals arguably is even higher. *Id.* at 2277 & n.11. Finally, those opposed to formulary apportionment cite greatly increased costs, because a business must maintain a different accounting system for each U.S. state in which it does business, as well as for the separate accounting system that the rest of the world uses. *Id.*

24. With respect to this Note, the relevant principles of U.S. law include aspects of constitutional law and the implementing legislation that brought the trade agreements into U.S. law.

25. *See infra* notes 90-129 and accompanying text (discussing the susceptibility of state tax laws to federal preemption challenges).

26. *See generally Barclays*, 114 S. Ct. 2268 (discussing a foreign corporation's challenge of California's income apportionment system); Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983) (discussing a corporation's challenge of California's income apportionment system).

27. *See, e.g., Barclays*, 114 S. Ct. at 2271 (discussing a foreign corporation's challenge of a state income apportionment system); Colgate Palmolive Co. v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268, 2271 (1994); (discussing a domestic corporation's challenge of a state income apportionment system); *Container Corp.*, 463 U.S. at 163-65 (discussing a corporation's challenge of a state income apportionment system). *See also California at Bay Over Unitary Tax,*

the constitutionality of a state tax system under the Commerce Clause.[28] The Supreme Court, however, in its 1994 decision in

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Euromoney Corporate Finance, Feb. 18., 1991, at 47, *available in* WL, Int-News database (indicating that "multinationals have been challenging worldwide combined reporting ever since California started vigorously applying it in the early 1970s.").

28. *See, e.g.*, Wardair Can., Inc. v. Florida Dep't of Revenue, 477 U.S. 1, 3, 13 (1986) (refusing to hold unconstitutional under the Dormant Commerce Clause a Florida fuel tax); *Container Corp.*, 463 U.S. at 162-63, 197 (holding valid under the Commerce Clause the unitary method of taxation as applied to a domestic multinational corporation); Japan Line, Ltd. v. County of L.A., 441 U.S. 434, 435-36, 454 (1979) (holding unconstitutional under the Commerce Clause a California *ad valorem* property tax on instrumentalities of foreign trade); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 289 (1977) (holding unconstitutional under the Commerce Clause a state tax on the "privilege of doing business").

When applying the Commerce Clause to state tax systems, the Supreme Court has balanced the competing interests of free trade with the states' right to share in the revenue that is earned through such trade. RONALD D. ROTUNDA, MODERN CONSTITUTIONAL LAW 132 (2d ed. 1985). In its latest attempts, beginning primarily with its decision in *Complete Auto Transit*, 430 U.S. 274 (1977), the Court has shifted the focus of its jurisprudence from a more formalistic analysis of the type of tax at issue, ROTUNDA, *supra* at 132, to an analysis of the practical consequences of the state tax in question. LAWRENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW, § 6-15, at 288-289 (2d ed. 1988).

In *Complete Auto Transit*, the Court developed a four-part test by which courts should scrutinize state taxes for Commerce Clause compliance. 430 U.S. at 279. A state law is permissible under the *Complete Auto Transit* test if it is "applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Id.*

The Court extended this test two years later to international commerce with its decision in *Japan Line*, 441 U.S. at 436. *Japan Line* concerned a California *ad valorem* tax applied to instrumentalities of international commerce. *Id.* at 435-36. The Court held that when international commerce is implicated, a court must supplement the *Complete Auto Transit* test with a determination as to whether the tax results in a substantial risk of international multiple taxation, and whether the tax impairs the ability of the federal government to speak with one voice. *Id.* at 451. The petitioners did not argue that the federal regulation preempted the state law, but the court recognized that, even if the federal government had not established a sufficient regulatory scheme, the national interests remain a factor. *Id.* at 448.

The *Container Corp.* Court applied its *Japan Line* decision to a unitary income tax levied on a domestic multinational corporation. 463 U.S. at 185-197. The Court held that the California law, as applied to a domestic multinational, met the *Japan Line* test. *Id.* at 184. The Court asserted that the instant case differed from the situation presented in *Japan Line* in three ways. First, *Container Corp.* involved a California income tax, while *Japan Line* involved a property tax. *Id.* at 188 (citing Mobile Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 445 (1980)). Second, the Court asserted that, although double taxation occurred in both cases, unlike the *Japan Line* situation, the California statute at issue in *Container Corp.* did not create inevitable double taxation. *Id.* Finally, the incidence of the California income tax in *Container Corp.* fell on a

Barclays Bank PLC v. Franchise Tax Board of California,[29] effectively neutralized this line of attack.[30] Barclays argued that the California income apportionment system violated the Commerce Clause because, while all multinationals faced potential double taxation under the California system, this result is more likely for foreign-owned multinationals than for domestic multinationals.[31] As a result, Barclays argued, the law unconstitutionally discriminated against foreign multinational corporations.[32]

In denying Barclays' request to invalidate the law, the Court asserted that California's system did not produce inevitable double taxation.[33] In addition, because Barclays had the ability to lobby the California legislature, and successfully had done so,[34] Barclays' assertion that it was not a citizen of California did not entitle it to Federal Commerce Clause protection.[35] The Court further held that, because the federal government had not stated sufficiently its preference for an alternate method of apportionment, the law did not impair the federal govern-

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corporation domiciled in the United States rather than on the foreign owners of an instrumentality of foreign commerce, as in *Japan Line*. *Id.* The Court concluded that these differences insured an insubstantial risk of international multiple taxation and a continued ability on the part of the federal government to speak with one voice. *Id.* at 193-97. Nevertheless, the Court specifically reserved the question of how it would resolve the case if the taxpayer were a foreign-owned multinational corporation. *Id.* at 189 n.26. The Court squarely addressed this issue eleven years later in a challenge to the same California unitary income tax in *Barclays*.

29. 114 S. Ct. 2268 (1994).

30. The *Barclays* Court held that, in spite of the challenger's status as a foreign taxpayer, the California tax did not violate the *Complete Auto Transit* or *Japan Line* requirements. *Id.* at 2279-81. The Court held that the taxpayer's factual change from a domestic to a foreign entity did not suffice to change the *Container Corp.* outcome. *Id.* at 2279. Moreover, the Court found it possible, although concededly less likely, that Barclays would suffer double taxation under the arm's length approach as well. *Id.* *See supra* note 20 (discussing the arm's length approach).

31. *Barclays*, 114 S. Ct. at 2279.

32. *Id.*

33. *Id.* at 2280-81.

34. Barclays and numerous other interested parties stridently lobbied the California legislature and eventually convinced it to modify its corporate tax code. *Id.* at 2273. While the industry groups did not convince California to abandon the unitary method entirely, California did agree to adopt the "water's edge" alternative. *See* Harris, *supra* note 17, at 1096 (discussing the burdens placed on foreign business concerns by California's tax scheme); Greenberg, *supra* note 17, at 467 (discussing Barclays' objection to California's tax scheme). *See also*, *supra* note 23 (describing the "water's edge" alternative approach).

35. *Barclays*, 114 S. Ct. at 2281.

ment's ability to speak with one voice.[36] In so deciding, the Supreme Court virtually removed the Commerce Clause as a method to protest a seemingly discriminatory state apportionment system.[37] *Barclays* arguably closed the door on any further use of the Commerce Clause in income apportionment cases. Nevertheless, traditional Supreme Court Commerce Clause jurisprudence opens a window to the use of the Supremacy Clause as a defense against discriminatory apportionment systems.[38] Specifically, the Supreme Court recognized in a variety of cases that state tax laws that discriminate against foreign-owned interests can compromise the ability of the federal government to speak with one voice.[39] This theory, although developed under challenges based on the Commerce Clause, is the essence of a Supremacy Clause argument.

Despite these signals, plaintiffs generally have not attempted to base a claim on Supremacy Clause principles. Plaintiffs have failed to do so primarily because the Court has indicated that the current level of federal regulation of state tax schemes does not create a body of law adequate to meet preemption requirements.[40] Ironically, *Barclays* made its way through the California and federal courts at the same time that the federal government negotiated and adopted NAFTA and the Uru-

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36. *Id.*

37. Prior cases specifically reserved the fact pattern in Barclays, which involved a foreign-owned multinational that challenged a state tax system that could result in double taxation. *See supra* note 28 (noting the Court's reservation of this issue in Container Corp. of Am. v. California Franchise Tax Bd.). The Court previously decided and dismissed the claims of domestic multinationals regarding similar laws. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 163-65 (1983).

38. This argument may extend only to foreign-owned multinationals because NAFTA and the Uruguay Round Agreements include concessions between foreign governments. Domestic multinationals would have more difficulty arguing successfully that interests that are infringed by another domestic government should be protected because of concessions to foreign countries' governments that the federal government negotiated.

39. The Court first applied the "one voice" doctrine to a state tax that discriminated against foreign entities in Japan Line v. County of L.A., 441 U.S. 434, 451 & n.14 (1979). The Court applied the doctrine to a unitary income tax in *Container Corp.*, 463 U.S. at 189-187, and the Court applied the doctrine to a foreign owner impacted by a unitary income tax in *Barclays*. 114 S. Ct. at 2279-86. The plaintiff corporations in these cases did not set forth a Supremacy Clause challenge, but the Court, concerned about the nature of international relations and the ability of the federal government to speak with one voice, added this preemption-like element to its Commerce Clause analysis.

40. *See, e.g.*, Wardair Can., Inc. v. Florida Dep't of Revenue, 477 U.S. 1, 7 (1986) (failing to recognize a federal policy that could be characterized as "one voice").

guay Round Agreements. These agreements, in contrast to the tax treaties and industry regulation schemes available in previous cases, do supply an adequate basis on which to argue that federal law developed pursuant to the trade accords preempts discriminatory state tax laws.

2. The Elements of a Supremacy Clause Challenge

The Supremacy Clause establishes that the Constitution and the federal laws and treaties that flow from it are superior to state law.[41] Consequently, when state and federal laws necessarily conflict,[42] the Constitution requires courts to follow federal law and to invalidate the incompatible state rule.[43] The Supreme Court, however, because of strong federalist concerns, traditionally has hesitated to preempt state laws.[44] As a result, analysis in this field is an imprecise exercise in statutory interpretation.[45] In addition, the Court is particularly reluctant to

41. U.S. CONST. art. VI, § 2. Chief Justice Marshall explicitly recognized the hierarchy of the federal system in Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 233-40 (1824).

42. Necessary conflict can mean actual or implicit conflict resulting from the federal government's determination that only it can legislate in a given field. *See infra* notes 45-61 and accompanying text (discussing preemption and federalism concepts).

43. Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 176-78 (1963) *aff'g in part and rev'g in part* 368 U.S. 965 (1962).

44. The Court's reluctance stems mainly from the desire to respect the federal divisions and the system of checks and balances carefully framed in the Constitution, and in particular, in the Tenth Amendment. TRIBE, *supra* note 28, § 6-25, at 479-80; STARR ET AL., *supra* note 12, at 1-4. *Compare* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 547-55 (1985) (upholding a federal wage law against a state Commerce Clause challenge) *with* New York v. United States, 112 S. Ct. 2408, 2417, 2434-35 (1992) (invalidating a federal radioactive waste disposal plan on Tenth Amendment grounds).

45. TRIBE, *supra* note 28, § 6-25, at 480. Federal law provisions that conflict directly with state law provisions preempt the state law provisions. *See id.*, § 6-26, at 481-97. For example, if Congress passes a law requiring all states to use a particular apportionment system, the federal requirement preempts a state law that does not incorporate this system. A state law can be preempted as conflicting with federal regulations, however, even if the two are not facially contradictory. *Id. See Xerox Corp. v. County of Harris*, 459 U.S. 145 (1982), *infra* note 53 and accompanying text (discussing the Supreme Court's rationale in a case involving a state excise tax that hindered a federal objective to encourage free trade).

An important caveat to this analysis, however, is that the Court requires narrow and concrete federal objectives. *See* Silkwood v. Kerr-McGee Corp., 464 U.S. 238, 257-58 (1984) (holding that a generalized congressional desire did not suffice to trigger the preemption doctrine). *See also* Ferebee v. Chevron Chem. Co., 736 F.2d 1529, 1532, 1539-42 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1062 (1984) (rejecting preemption where Congress failed to evince a clear federal ob-

act when the federal law requires preemption of a state law in an area traditionally reserved to the states, such as taxation.[46]

Recognizing that there is considerable overlap between them, the Supreme Court requires sufficient evidence of three elements before it will preempt a law in an area traditionally reserved to the states.[47] First, there must exist a significant and

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jective). *But see* Cipollone v. Liggett Group, Inc., 789 F.2d 181, 184-88 (3d Cir. 1986) (holding that federal cigarette labeling requirements preempted a state tort law), *cert. denied*, 479 U.S. 1043 (1987). *Compare* Philko Aviation, Inc. v. Shacket, 462 U.S. 406, 407 (1983) (preempting a state law regarding transfers of airplane titles because Congress intended under the Federal Aviation Act to create a central clearing house for recording titles) *with* Commonwealth Edison Co. v. Montana, 453 U.S. 609, 612, 636-37 (1981) (finding a broadly-declared congressional purpose to encourage the use of coal insufficient to preempt a state law applying a coal severance tax).

Additionally, when a complainant challenges a law in an area traditionally reserved to the states, the courts tolerate a level of tension between the state and federal schemes in order to preserve important state prerogatives. *Silkwood*, 464 U.S. at 253-56. In such cases, courts have developed balancing schemes to determine when a law is valid or invalid under the Supremacy Clause. *Id.*

A court also will preempt state law when Congress has chosen to "occupy the field." *See* TRIBE, *supra* note 28, at 497-501. The Supreme Court developed the standard by which it would analyze this concept in Florida Lime & Avocado Growers v. Paul. 373 U.S. 132 (1963). In that case, the Court held that federal legislation would not oust a state law without "an unambiguous congressional mandate to that effect." *Id.* at 147.

When the regulation relates to an area in which the states traditionally have reserved powers, however, the threshold for federal occupation of the field is even higher. *See infra* note 56 and accompanying text (discussing the Supreme Court's threshold for occupation of a field).

The Court, however, tempers this heightened standard to some degree when the area traditionally reserved to the states is one in which the federal government also has a vital interest. Hines v. Davidowitz, 312 U.S. 52, 73-74 (1941). The *Hines* Court invalidated a state alien registration law, finding federal regulation of immigration sufficiently encompassing, given the relative importance of the federal and state interests at stake, to allow only federal law to govern. *Id.* Significantly, the *Hines* Court placed higher priority on preserving the federal power to regulate foreign affairs exclusively than on preserving the state police power at stake in that case. *Id.* at 62, 73-74.

46. *See supra* note 45 and accompanying text (discussing preemption and federalism); *see infra* note 58 and accompanying text (noting the Court's reluctance in one particular instance to preempt a state aviation fuel tax where federal law did not indicate sufficiently a federal intent to displace the state law).

47. *See supra* note 45 (discussing preemption and federalism). One commentator asserts that the Supreme Court has three categories of preemption. TRIBE, *supra* note 28, § 6-25, at 481 n.14. These include "express preemption," in which Congress has declared specifically its intention to displace state regulation in an area; "implied preemption," in which Congress has "impliedly precluded" state action as the result of the structure of objectives of federal law; and "conflict preemption," in which Congress did not explicitly intend to preempt state activities, but the state law conflicts explicitly with the federal law

well-developed body of federal law.[48] For example, the Supreme Court in *Wardair Canada, Inc. v. Florida Department of Revenue* refused to preempt a state tax on aviation fuel because the Federal Aviation Act did not create a sufficient body of regulation to warrant preemption.[49] Conversely, in *Commonwealth Edison Co. v. Montana*, the Court declined to preempt a state tax on coal because a broadly-defined congressional goal to encourage the use of coal did not indicate sufficiently that Congress intended to prevent this type of state action.[50]

Next, the plaintiff must prove that the federal government explicitly or implicitly intended to replace incompatible state law in light of the federal government's own legislation in the field.[51] For example, in *Florida Lime & Avocado Growers v. Paul*, the Supreme Court held that federal legislation would not preempt a state law without "an unambiguous congressional mandate to that effect."[52] In addition, if the Court finds that the state regulation seriously would hamper the realization of clear federal objectives, it will assume that Congress intended to displace state law in the area, and will preempt the state regulation. In *Xerox Corp. v. County of Harris*, the Supreme Court preempted a state excise tax because use of the state scheme would hinder seriously the realization of a clear federal objective to encourage free trade.[53] Furthermore, in *Hines v. Davidowitz*, the Court invalidated a state alien registration law, finding fed-

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or is "an obstacle to the accomplishment of federal objectives." *Id.* The commentator, however, does not organize his own analysis around these three categories, and indicates that they are "anything but analytically air-tight." *Id. See also* STARR, *supra* note 12, at 19-34 (analyzing the Supremacy Clause in three main categories with numerous subparts). In spite of these various taxonomies, this Note contends that if a plaintiff can prove the three elements listed above, it will establish a "prima facie case" of preemption.

48. *See supra* note 45 and accompanying text (noting that one element of preemption involves narrow and concrete federal objectives).

49. 477 U.S. 1, 3, 13 (1986). *Compare Philko*, 462 U.S. at 407 (preempting a state law regarding the transfer of airplane titles because the Federal Aviation Act created a well-defined scheme through which Congress intended to establish nation-wide regulation of the sales of aircraft).

50. 453 U.S. 609, 612, 633-36 (1981).

51. *See supra* note 47 and accompanying text (noting that congressional intent to occupy a field of law is an element of preemption).

52. 373 U.S. 132, 147 (1963).

53. 459 U.S. 145, 151-54 (1982). The Court found that the tax on goods held while awaiting shipment abroad conflicted with Congress's creation of a series of duty-free areas. *Id.* at 154. Congress designed the areas in order to encourage the use of American ports, and although Congress did not prohibit specifically state taxation, taxation detracted from the federal policy in question. *Id.*

eral regulation of immigration sufficiently encompassing, given the relative importance of the federal and state interests at stake, to allow only federal law to govern.[54] The *Hines* Court believed that preserving the exclusive federal power to regulate foreign affairs warranted priority over preserving states' police power, and that Congress therefore intended to preempt any attempts at state control.[55]

However, when the federal regulation concerns an area in which the states traditionally have reserved powers, such as taxation, the threshold to prove that Congress intended to displace state law is higher. In *Rice v. Santa Fe Elevator Corp.*, the Court stated that "in a field which the States have traditionally occupied . . . we start with the assumption that the historic . . . powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress."[56]

Finally, the state law must be wholly incompatible with the federal legislative and regulatory scheme.[57] Specifically, once a court determines that the relevant body of federal law in an area suffices to trigger the Supremacy Clause, and that Congress intended to override existing state regulation in that area, the court must conduct a case-by-case analysis of each challenged state law to determine if that law is incompatible with the federal scheme.[58]

Courts, however, allow some tension between state and federal schemes in order to preserve important state prerogatives, especially in an area traditionally reserved to the states.[59] For example, in *Silkwood*, the Supreme Court refused to preempt state tort laws although they arguably conflicted with federal regulation of nuclear energy facilities.[60] The Court found the state law not so incompatible with the federal scheme so as to

54. 312 U.S. 52, 73-74 (1941).

55. *Id.* at 62, 73-74.

56. 331 U.S. 218, 230 (1947).

57. *See supra* note 45 and accompanying text (noting that courts tolerate some level of tension between state and federal laws).

58. *See* Wardair Can., Inc. v. Florida Dep't of Revenue, 477 U.S. 1, 3, 12 (1986) (refusing to preempt a state tax on aviation fuel because the federal body of law in the area did not indicate sufficiently a federal intent to displace the state legislation).

59. *See* Silkwood v. Kerr-Mcgee Corp., 464 U.S. 238, 241, 257-58 (1984).

60. *Id.*

warrant interference in a field traditionally reserved to state discretion.[61]

As these elements demonstrate, at the heart of Supremacy Clause analysis lies a balancing of state and federal interests. The court essentially must decide whether the state and federal regimes can co-exist, which arguably strengthens the role of the states in the federal system, or whether the federal law must prevail. The process becomes especially complex and important when the balance also involves a third, supranational layer whose interest may be adversely impacted by a field in which state competence is particularly high. One example includes the situation in which state tax schemes affect international trade. If the court favors the federal scheme and preempts the state's law, it strengthens the federal government at the expense of the state. It also strengthens a global system that arguably is beyond the control of our federalist system.

When courts face such a decision, past Supreme Court jurisprudence requires them to develop and adhere to a comprehensive balancing method. Such a method must protect state interests and yet ensure that the federal government retains the flexibility to meet the nation's goals in the global economy.

The next section, by demonstrating the comprehensive nature of the trade accords, lays the groundwork for two further points. It first provides the basis on which a Supremacy Clause challenge of state laws in conflict with the trade accords rests. It then illustrates how U.S. courts can work within the system to appropriately balance competing state, federal, and global interests.

B. THE INTERNATIONAL TRADE AGREEMENTS

NAFTA and the Uruguay Round Agreements do not have direct force in U.S. law. Instead, they require a separate law to bring them into effect.[62] Thus, an analysis of their significance must examine not only the terms of the agreements themselves,

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61. *Id.* at 256-58. *See also* Ferebee v. Chevron Chem. Co., 736 F.2d 1529, 1539-43 (D.C. Cir. 1984) (holding that the Federal Insecticide, Fungicide, and Rodenticide Act did not preempt a state's ability to regulate pesticide manufacturing and labeling). *But see* Cipollone v. Liggett Group, Inc., 789 F.2d 181, 184-88 (3d Cir. 1986) (holding that federal cigarette labeling requirements preempted state tort law).

62. *See generally* John H. Jackson, *Status of Treaties in Domestic Legal Systems: A Policy Analysis*, 96 AM. J. INT'L L. 310 (1992) (reviewing the domestic legal effect and implementation of international agreements in U.S. law).

but also the terms of the implementation acts that brought them into U.S. law.

1. The Trade Accords

NAFTA[63] and the Uruguay Round Agreements[64] represent the federal government's intention to bind the United States to the terms of competition that it negotiates with foreign govern-

63. The North American Free Trade Agreement is an extensive and comprehensive arrangement designed to liberalize reciprocally and to open U.S., Canadian, and Mexican markets. H.R. REP. No. 103-361(I), *supra* note 1, at 8, *reprinted in* 1993 U.S.C.C.A.N. at 2558-59. The member countries intended NAFTA to be the sole framework through which the members continue to develop their future trade relations. North American Free Trade Agreement, Dec. 8 and 17, 1992, Can.-Mex.-U.S., art. 102, para. 1(b), (c), (f) *reprinted in* 32 I.L.M. 289; 32 I.L.M. 605. [hereinafter NAFTA]. Article 102, which lays out the objectives of NAFTA, states that the agreement seeks to promote conditions of fair competition, to increase substantially the investment opportunities available in the territories of the parties, and most importantly to establish a framework for further cooperation designed to expand and enhance the benefits of the agreement. *Id.*

Under the auspices of Article XXIV of GATT 1994, NAFTA establishes a free trade area with common external tariffs and eliminates duties and other restrictive regulations on a substantial portion of the trade between member countries. H.R. REP. No. 103-361(I), *supra* note 1, at 9, *reprinted in* 1993 U.S.C.C.A.N. at 2559.

NAFTA itself contains eight parts, covering trade in goods; technical barriers to trade; government procurement; investment, services and related matters; intellectual property; administration; and exceptions to the agreement. NAFTA, pts. 2-8; *see also* BELLO ET AL., *supra* note 3, at 5-7 (describing the provisions of NAFTA). Following the successful Canada-U.S. Free Trade Agreement, NAFTA extends the tariff reductions achieved in that agreement to the Mexican market. *Id.* at 5. NAFTA also opens and liberalizes trade in services between the U.S., Canada, and Mexico. *Id.* To ensure that surges in imports do not lead governments to undermine the provisions of the agreement, NAFTA contains bilateral, multilateral, general, and product-specific safeguard measures. *Id.* at 6. NAFTA also contains a chapter outlining treatment of, and protection for, intellectual property rights in the three Member States. *NAFTA, supra* ch. 16. Finally, NAFTA contains chapters detailing anti-dumping and countervailing duty measures, *id.* ch. 19, rules of origin requirements, *id.* ch. 4, investment rules, *id.* ch. 12, and competition policy. *Id.* ch. 15.

NAFTA also implements an extensive dispute resolution mechanism that provides for adjudication of disputes arising from the application of the agreement. *Id.* arts. 2001-22. This provision is significant because a member's compliance demonstrates a willingness not only to agree to an encompassing structure of arrangements, but also to be judged and bound by extranational authorities. Significantly, NAFTA Chapter 20 (dispute resolution) refers only to "Parties" to the agreement. *Id.* ch. 20. Although NAFTA does not specifically define "Parties," its preamble indicates that the agreement is between the Governments of the United States of America, Canada, and the United States of Mexico. *Id.* pmbl. Specifying the treaty along these national government lines, NAFTA effectively nullifies a state's right to represent itself and incorporates the state's interests into the national or federal interest.

ments.[65] The global trading system, as defined by NAFTA and

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64. The Uruguay Round Agreements intend to encompass virtually all of the United States' trading partners, and 111 countries, including the United States, signed them. H.R. REP. No. 103-826(I), *supra* note 2, at 10, *reprinted in* 1995 U.S.C.C.A.N. at 3782. As with NAFTA, the purpose of the Agreements is to "provide the common institutional framework for the conduct of trade relations among its Members." Agreement Establishing the World Trade Organization, Apr. 15, 1994, art. II, para. 1, *in* H.R. Doc. No. 316, 103d Cong., 2d Sess. 1327 (1994) [hereinafter WTO]. Additionally, the agreements intend to establish "the forum for negotiations among its Members concerning their multilateral trade relations." *Id.* art. III, para. 2.

Three treaties form the bulk of the Uruguay Round Agreements. GATT 1994 is a code of rules applying to government action, and a series of tariff bindings that regulate international trade in goods. JOHN H. JACKSON ET AL., LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS: CASES, MATERIALS AND TEXT ON THE NATIONAL AND INTERNATIONAL REGULATION OF TRANSNATIONAL ECONOMIC RELATIONS 278 (Draft 3d ed. 1994). Its basic purpose is to restrain governments from imposing or continuing to impose various measures that distort or restrict international trade. *Id.*

The General Agreement on Trade in Services (GATS) covers such sectors as tourism, banking, communications, medical, legal, insurance, brokerage, and transport. *Id.* GATS uses analogies to GATT rules to regulate these services. *Id.* at 279. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) provides rules requiring governments to ensure a certain minimum level of protection for patents, copyrights, industrial designs, trademarks, business secrets, and similar matters. *Id.*

The Uruguay Round Agreements also contain mandatory dispute settlement rules that allow an aggrieved government to rescind negotiated concessions automatically when a dispute resolution panel has adjudicated a case in its favor. Understanding of Rules and Procedures Concerning the Settlement of Disputes, Apr. 15, 1994, art. 22, para. 6, *in* H.R. Doc. No. 316, at 1654 [hereinafter DSU]. As with NAFTA, only national governments (to be precise, separate customs territories) may be represented in the WTO dispute settlement system, even if the conflict involves a constituent government's law. *Id.* art. 2, para. 1. Finally, each agreement has exceptions to the general rules laid out above that allow nations to adopt inconsistent legislation when necessary to promote public health, national security, and other delineated items. *See* General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, art. XX [hereinafter GATT 1994]; General Agreement on Trade in Services, Apr. 15, 1994, pt. II, art. XIV, *in* H.R. Doc. No. 316, at 1586 (1994) [hereinafter GATS].

65. U.S. states, by the terms of NAFTA, the Uruguay Round Agreements, and the U.S. Constitution, cannot act independently of the federal government in areas that the trade agreements cover. The WTO, for instance, indicates that any "State or separate customs territory possessing full autonomy in the conduct of its external commercial relations . . . may accede to this Agreement . . . ." WTO, *supra* note 64, art. XII. *See also* NAFTA, *supra* note 63, art. 2204.

The U.S. Constitution, furthermore, grants to Congress primary authority in international economic affairs. U.S. CONST. art I, § 8, cl. 3. The Constitution, however, requires Congress to share this power with the Executive Branch, and it allows Congress to delegate all implementation powers to the Executive Branch. *See supra* note 15 and accompanying text (reviewing caselaw that indicates that Congress's power in the field of international commerce is not exclusive). As a result, only the federal government may set and negotiate the terms of competition of international trade. States, on the other hand, are not mem-

the Uruguay Round Agreements, bases itself on presumably equal concessions granted between trading partners that are designed to expand and improve trade.[66] To accomplish this, the two trade accords rely on several main premises. First, members will negotiate the conditions governing international trade.[67] The accords further require members to prevent internal non-tariff barriers from negating the value of the negotiated concessions.[68] Two clauses enforce and protect these important pillars of the agreements. The Most Favored Nation (MFN) clauses[69] state that when a member grants any advantage to another member it must grant the same advantage to the like products of every other member "immediately and unconditionally."[70] The National Treatment clauses[71] require members to

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bers of trade agreements and do not have the authority under U.S. law to conduct external relations. Thus, state acts that impact the negotiated trade agreement terms arguably are unconstitutional.

66. JACKSON ET AL., *supra* note 64, at 335.

67. *See* United States - Taxes on Petroleum and Certain Imported Substances, GATT Doc. L/6175 (June 17, 1987) (Can., E.E.C. & Mex. v. U.S.), para. 5.1.9., *reprinted in* GATT, Basic Instruments & Selected Documents 136 (34th Supp. 1988) [hereinafter Taxes on Petroleum and Certain Imported Substances]. Although the cited GATT jurisprudence does not have specific precedential value for NAFTA or WTO dispute resolution panels, JACKSON ET AL., *supra* note 64, at 335, past GATT panel decisions will influence heavily both the Uruguay Round and NAFTA. The new trade agreements specifically have incorporated elements of GATT 1947 and because GATT panel decisions represent the most complete, and thus the most influential, body of interpretation of international agreements available in the trade and commercial setting. *Id.*

68. *See infra* notes 69-75 and accompanying text (discussing the policies of the various trade agreements on the issues of national treatment and Most Favored Nation clauses); Taxes on Petroleum and Certain Imported Substances, *supra* note 67, para. 5.1.9; United States - § 337 of the Tariff Act of 1930, GATT. Doc. L/6439 (Nov. 7, 1989), para. 5.10, GATT, Basic Instruments & Selected Documents (34th Supp. 1988).

69. NAFTA does not contain one provision dealing solely with MFN, but it includes MFN clauses in various portions of the agreement. *See, e.g.*, NAFTA, *supra* note 63, arts. 308, 1003, 1103, 1203, 1406, 1703 (requiring Most Favored Nation treatment for rates of duty on certain goods, in government procurement, for investors and investments, for cross-border trade in services, and for financial services). However, NAFTA provides for exceptions to these MFN requirements. *See, e.g.*, *id.*, Annex IV: Schedule of the United States (claiming exceptions to Article 1103 for aviation, fisheries, maritime matters, and telecommunications). The Uruguay Round Agreements contain an MFN clause that generally is applicable, unless otherwise noted, to all parts of the agreements. GATT 1994, *supra* note 64, art. I.

70. The actual language in the current GATT agreement states:

> [W]ith respect to customs duties and charges . . . [the] method of levying such duties and charges . . . and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in [the National Treatment Clause], any advantage . . . granted by any [GATT member] to any product

apply the same internal taxes, charges, and regulations to imported products as they would to their own like domestic products.[72]

Moreover, the Uruguay Round Agreements and NAFTA oblige state and provincial governments to conform to the agreements.[73] Both agreements direct central governments to take reasonable action to enforce the international obligations at

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> originating in any [other GATT member] shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other [GATT members].

GATT 1994, *supra* note 64, art. I.

71. NAFTA does not have one consolidated National Treatment provision. Rather, it contains clauses in the various separate portions of the Agreement. For example, Article 301 spells out national treatment for trade in goods. NAFTA, *supra* note 63, art. 301. The article states that "[e]ach party shall accord national treatment to the goods of another Party in accordance with Article III of the General Agreements on Tariffs and Trade (GATT)." *Id.* para. 1. In addition, Article 301 defines national treatment "with respect to a state or province [as] treatment no less favorable than the most favorable treatment accorded by such state or province to any like, directly competitive or substitutable goods . . ." *Id.* para. 2.

Chapter 11 deals with investment. Its National Treatment section requires that "[e]ach party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments." *Id.* art. 1102. Section 2 of Article 1102 extends national treatment to the investments themselves, and section 3 indicates that, for state and provincial governments, "national treatment" means treatment no less favorable than the most favorable treatment accorded by the state or provincial government to that party's investors or investments. *Id.* § 2.

"National treatment" thus requires that state governments not treat investments owned by foreigners less favorably than investments owned by a state citizen. This implies that state tax systems violate the agreement if they cause foreign-owned multinationals more likely to face double taxation than multinationals registered in that state.

However, all three NAFTA members have taken exception to the National Treatment provisions. *Id.* Annex VII, § A (claiming reservations to national treatment for several areas pertaining to the financial services portion of NAFTA).

72. The actual text of the GATT 1994 article pertaining to national treatment with respect to internal taxes states:

> The products . . . of any [GATT member] imported directly into . . . any other [GATT member] shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in [the Most Favorable Nation clause].

GATT 1994, *supra* note 64, art. III, para. 2.

73. NAFTA, *supra* note 63, art. 105; GATT 1994, *supra* note 64, art. XXIV, para. 12.

lower government levels.[74] If the central government cannot succeed in securing state conformity, the agreements authorize retaliation by aggrieved trading partners.[75]

Especially significant are the pacts within NAFTA and the Uruguay Round Agreements relating to trade in services and investment.[76] For the first time, the federal government has negotiated arrangements designed to regulate international trade in services and investment.[77] As a result, areas such as banking,

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74. NAFTA, *supra* note 63, art. 105; GATT 1994, *supra* note 64, art. XXIV, para. 12.

75. NAFTA, *supra* note 63, art. 2019; DSU, *supra* note 64, art. 22, para. 6.

76. *See* GATS, *supra* note 64; NAFTA, *supra* note 63, pt. 5. GATT did not consider income taxes to be taxes on products. JACKSON ET AL., *supra* note 64, at 511. Therefore, Article III of GATT did not cover discriminatory income taxes. Past commercial practices primarily are responsible for this inconsistency. *See* KENT HIGGON HUGHES, TRADE, TAXES, AND TRANSNATIONALS: INTERNATIONAL ECONOMIC DECISION MAKING IN CONGRESS 88 (1979). Traditional economic principles assume that, in a competitive situation, the profit-maximizing firm will bear the burden of the corporate income tax in the short run. *Id.* In the long run, however, some portion of the tax probably will shift back to labor. *Id.* If the markets are imperfect, it is likely that the consumer will absorb the tax by paying higher prices. *Id.* As a result, the income tax acts like a direct tax. *Id.* Early agreement at the GATT allowed parties to rebate indirect taxes, but not direct taxes. *Id.* Moreover, because only goods crossed borders, the earlier GATT agreement did not address the larger questions of discriminatory income taxes.

Arguably, with the extension of the international trade regime to services and investments, this should be changed. GATT established the existing rule primarily to control disguised subsidies to exports and non-tariff barriers to imports by rebating taxes on exports and imposing taxes on imports. *Id.* Since only goods entered and left countries, the problem of a discriminatory income tax levied directly on a business entity was not an issue. Any levied tax had to be on the product and had to be nondiscriminatory. GATT 1994, *supra* note 64, art. III, para. 2. The established rule prevents states from imposing discriminatory income taxes on imports. Since service providers and investors now will cross borders with increased ease, GATT's concept of non-violation nullification and impairment may indicate that discriminatory income taxes, such as the unitary tax and the checkerboard tax systems of U.S. states, violate GATS and NAFTA. *See* Taxes on Petroleum and Certain Imported Substances, *supra* note 67, para. 5.1.3. (discussing the GATT concept of non-violation nullification and impairment).

77. Annex I(A) of the Uruguay Round Agreements is the Multilateral Agreement on Trade in Goods. It consists of the text of the 1947 GATT, incorporated by reference, and a series of protocols and understandings adopted during the various rounds of negotiation. GATT 1994, *supra* note 64, Annex I(A). The Uruguay Round Agreements, however, do not contain merely an agreement on trade in goods, as did the 1947 GATT. They also contain agreements on trade in services, *id.* Annex I(B), on trade-related aspects of intellectual property rights, *id.* Annex I(C), a dispute settlement understanding, *id.* Annex II, a trade policy review mechanism, *id.* Annex III, and a series of plurilateral agreements. *Id.* Annex IV.

investment services, tourism, and insurance, traditionally subject primarily to state regulation, now fall under the federally-mandated trade regulations.[78]

Finally, both agreements contain elaborate dispute settlement understandings that remove the settlement of conflicts from diplomatic and national judicial arenas.[79] This demonstrates a member's willingness not only to agree to an all-encompassing structure of arrangements, but also a willingness to be judged by extranational authorities. A dispute panel decision has no binding precedence in U.S. law, and a state law is not "preempted" by an adverse finding.[80] If the responsible government does not change the offending law, however, the aggrieved trading partner has the right to retaliate as governed by the dispute resolution agreements.[81] Moreover, even if the infraction is the result of a state or local government's law, only the national government is represented at the dispute panel.[82]

2. The Implementing Legislation in the United States

Congress adopted two similar pieces of legislation to bring the Uruguay Round Agreements[83] and NAFTA[84] into U.S. law. Both pieces of legislation approve the agreements themselves, and both make necessary changes to federal law to meet the obligations of the trade accords.[85] In addition, the implementation acts spell out the relationship of the trade agreements to federal, state, and local law.[86] Section 102 of each of the acts is the most significant to a Supremacy Clause argument. These sections require the President of the United States to work toward achieving conformity of state laws with the requirements of NAFTA and the Uruguay Round Agreements, and they establish a consultation procedure designed to enhance cooperation between

78. NAFTA and the Uruguay Round Agreements contain significant exceptions to the requirements for national treatment and most favored nation status in these areas. *See supra* notes 69-71 and accompanying text (detailing these exceptions).

79. NAFTA, *supra* note 63, ch. 20; DSU, *supra* note 64, art. 22, para. 6.

80. Uruguay Round Act, *supra* note 2, § 102(c)(2)(A); NAFTA Act, *supra* note 1, § 102(b)(2).

81. DSU, *supra* note 64, art. 22; NAFTA, *supra* note 63, art. 2019.

82. DSU, *supra* note 64, art. 2, para. 1 (specifying that only "members" may be present at dispute proceedings); NAFTA, *supra* note 63, art. 20.

83. *See* Uruguay Round Act, *supra* note 2.

84. *See* NAFTA Act, *supra* note 1.

85. *Id.* § 101; Uruguay Round Act, *supra* note 2, § 101.

86. NAFTA Act, *supra* note 1, § 102(a), (b); Uruguay Round Act, *supra* note 2, § 102(a), (b).

the state governments and the Office of the United States Trade Representative.[87] Section 102 also denies private causes of action,[88] and it denies the states a role in the international dispute settlement systems established by the trade agreements.[89]

II. PREEMPTING STATE TRADE BARRIERS

Part I established that a plaintiff must establish three elements to prosecute successfully a Supremacy Clause challenge to state law. This section demonstrates why state tax laws that function as barriers to trade by discriminating against foreign enterprises are vulnerable to a preemption challenge under the new trade regime. Many observers believe that state apportionment systems are a barrier to trade.[90] As a result, these systems form the backdrop for this analysis.

A. A Body of Law Expressing Narrow Goals

Preemption doctrine requires that a significant body of federal law narrowly express federal goals before a court will preempt state laws in an area traditionally reserved to the states.[91] By approving NAFTA and the Uruguay Round Agreements and integrating them into U.S. law through implementing legislation, the federal government has developed the necessary scope of regulation to satisfy this element of Supremacy Clause analysis.[92] Specifically, the body of regulation flowing from NAFTA and the Uruguay Round Agreements expresses two narrow goals.

87. NAFTA Act, *supra* note 1, § 102(a), (b); Uruguay Round Act, *supra* note 2, § 102(a), (b).

88. NAFTA Act, *supra* note 1, § 102(c); Uruguay Round Act, *supra* note 2, § 102(b)(1)(B), (C).

89. NAFTA Act, *supra* note 1, § 102(a), (b); Uruguay Round Act, *supra* note 2, § 102(a), (b).

90. *See supra* notes 17, 19, 21 and accompanying text (noting that the states' use of the formulary apportionment system is incompatible with the separate accounting method of apportionment that the national governments agreed to use).

91. *See supra* note 45 and accompanying text (noting that the Court has held that federal law preempts state law only when the state impeded a federal objective expressed through clear and well-developed federal regulations).

92. *See supra* notes 63-89 and accompanying text (discussing the federal government's extensive obligations under NAFTA and GATT and the resulting federal laws passed in order to meet those obligations).

1. Favoring Process Over Substance: The Trade Accords Create a Set of Rules and Define the Players

Acting within its authority to regulate foreign commerce,[93] the federal government bound the nation to the rules contained in the trade accords.[94] In doing so, the federal government reserved to itself exclusively the right to negotiate and adjudicate the terms of international competition. More important than the actual rules established by the trade agreements is the codification of a process by which members agree to address virtually every aspect of international trade.[95] The federal government always has had significant rules and treaties in place to govern foreign economic relations.[96] The trade accords, however, extend GATT 1947's process-oriented approach[97] to most sectors of the world economy. Although the new service and investment agreements leave much to future negotiation, the World Trade Organization's[98] (WTO) procedures and preferences[99] bind the contracting parties in their regulation of these areas of trade. Significantly, the trade accords reserve to the na-

93. *See supra* note 14 and accompanying text (noting Congress's constitutional grant of authority to conduct international economic relations).

94. *See supra* notes 63-89 and accompanying text (noting that Congress passed the NAFTA Implementation Act and the Uruguay Round Act, which both approve the agreements and make the necessary changes in federal law).

95. *See supra* notes 3, 63-64 and accompanying text (discussing the extensive scope of the NAFTA and the Uruguay Round Agreements' provisions that seek to increase worldwide economic growth).

96. For example, Title VII of the Tariff Act of 1930, 19 U.S.C. §§ 1202-1300 (1988), is the basic U.S. antidumping law. The U.S. also has established comprehensive control of exports through the Export Administration Act, 50 U.S.C. app. §§ 2401-2420 (1991 & Supp. 1995). Of course, GATT 1947 regulated trade in goods, but it was not explicitly part of U.S. law. *See infra* note 101 (noting that GATT 1947 never was adopted into U.S. law). The United States also enters into numerous tax treaties and bilateral trade treaties. *See, e.g.*, Convention Between United States and United Kingdom for Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5668, 5687. Two recent cases litigating the validity of states' tax apportionment systems concerned this treaty. *See* Barclays Bank PLC v. Franchise Tax Bd. of Ca., 114 S. Ct. 2268, 2284 (1994); *In re* Reuters Ltd. v. Tax Appeals Tribunal, 623 N.E.2d 1145, 1146 (N.Y. 1993).

97. *See* JACKSON ET AL., *supra* note 64, at 124.

98. The WTO is the organization created by the Uruguay Round Agreements to administer the Agreements themselves. *See supra* note 64 and accompanying text (describing the establishment of the WTO).

99. These procedures and preferences primarily include a preference for tariffs, requirements to limit internal regulation, and multilateral negotiations to secure conceptually-equal concessions for all contracting parties. *See supra* notes 63-82 and accompanying text (explaining the major agreements in NAFTA and GATT).

tional government the right to participate in the trade negotiations.[100]

This change from regulation of substance to regulation of process[101] indicates that the federal government has exclusive control over the terms of competition in foreign trade. If the federal government set only substantive rules, the preemption doctrine would tolerate state rules in areas that the federal scheme does not cover explicitly.[102] Because the federal system establishes a process for developing rules in which the states cannot participate directly, however, there is no room for state action affecting the terms of competition that result from the negotiation. As a result, any state law that disturbs the federal terms of competition by either offering additional assistance or erecting increased barriers violates the federal government's expressed prerogatives.

2. Expansion of International Trade

The structure and depth of NAFTA and the Uruguay Round Agreements demonstrate first the federal government's strong commitment to liberalize and strengthen international trade, and second, that the federal government intended to meet this commitment through the structure of the trade agreements.[103] Congress recognized, for instance, that NAFTA "provides a solid framework for the liberalization of trade barriers throughout the Western Hemisphere. . . . [and] should also provide the catalyst

100. The implementing legislation for both trade accords allows for extensive cooperation and consultation between the federal and state governments, but the consultations do not bind the federal government. *See supra* notes 83-89 and accompanying text (describing the accords and the relationship between the federal and state governments outlined in them).

101. Although GATT 1947 also established procedures that obligated the United States to negotiate concessions with other GATT members, GATT 1947 never was officially "adopted" into U.S. law, JACKSON ET AL., *supra* note 64, at 306, and it remained limited to trade in goods. *See supra* note 77 (discussing the GATT 1947 and GATT 1994 differences). *See also* JACKSON ET AL., *supra* note 64, at 849 (noting that GATT 1947 did not cover trade in services).

102. *See supra* notes 57-61 and accompanying text (observing that the Court has refused to preempt a state law when a federal regulation in a particular area either did not indicate sufficiently a federal intent to preempt or did not impair completely the state law).

103. *See* H.R. REP. No. 103-826(I), *supra* note 2, at 16, *reprinted in* 1994 U.S.C.C.A.N. at 3788 (discussing the benefits of the Uruguay Round Agreements); H.R. REP. No. 103-361(I), *supra* note 1, at 8-9, *reprinted in* 1993 U.S.C.C.A.N. at 2558-59 (discussing the benefits of NAFTA).

for negotiations to liberalize trade barriers on a multilateral basis."[104]

The federal government viewed the trade accords as a method through which U.S. trade would expand.[105] Congress stated that "NAFTA will enable the United States to take advantage of U.S. economic strengths and remain the world's biggest and best exporter."[106] In addition, NAFTA and the Uruguay Round Agreements include rules and processes designed to liberalize and expand international trade in government procurement and services.[107] Although the agreements allow nations to reserve exceptions in the newly-added sectors,[108] the trade accord members' inclusion of these areas in the formal negotiating process signifies a desire to expand trade by putting previously undiscussed topics on the table. Consequently, any state law that explicitly or implicitly works to reduce trade violates clearly-expressed federal goals.

B. INTENT TO PREEMPT

Preemption doctrine next requires the complainant to establish that the federal government intended to preempt state authority. In creating this significant and comprehensive body of law to govern international trade, the federal government intended to supersede inconsistent state laws.[109] The federal government established this intention in several ways. First, the federal government's accession to a negotiating system that generally is limited to national-level governments demonstrates its intention to rule out state activity.[110]

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104. H.R. REP. No. 103-361(I), *supra* note 1, at 8-9, *reprinted in* 1993 U.S.C.C.A.N. at 2558.

105. *Id.*

106. *Id.*

107. *See supra* notes 63-82 and accompanying text (discussing the provisions of NAFTA and the Uruguay Round Agreements).

108. *See* JACKSON ET AL., *supra* note 64, at 278-79 (stating that GATS provisions regarding new subjects contained exceptions similar to those included in GATT).

109. *See supra* note 45 and accompanying text (discussing the presumption of federal intent to preempt state law when state law hinders the realization of a clear federal objective). Interestingly, this element also is required under Commerce Clause "one voice" analysis, and plaintiffs seldom could meet it. *See supra* notes 29-37 and accompanying text (discussing the Supreme Court's Commerce Clause jurisprudence).

110. *See supra* notes 77, 79-82 and accompanying text (discussing the exclusiveness of the national government's role in both NAFTA and the Uruguay Round Agreements).

The NAFTA Implementation Act, furthermore, explicitly recognizes that states must change any law inconsistent with NAFTA. The Act directs the U.S. Trade Representative (USTR) to assist the states in identifying laws that may not conform to the agreement.[111] The Act also charges the USTR with establishing a process by which it will address issues relating to the agreement that will have, or could have, a direct impact on the states.[112]

The legislative history of the NAFTA Implementation Act paints an even clearer picture. In the House of Representatives Report that accompanied the NAFTA Implementation Act, Congress explicitly asserted that "the Agreement prevails over inconsistent State or local law"[113] and indicated that NAFTA obligations apply to state and local governments, as well as to the federal government.[114]

The Uruguay Round Implementation Act contains similar language. Like the NAFTA Implementation Act, it requires consultation between the USTR and the states to achieve state conformity with the Agreements.[115] Finally, in the House Report prepared pursuant to the passage of the Uruguay Round Agreements Implementation Act, Congress indicated that it clearly understood and intended that the terms of the trade accord would preempt incompatible state law. In particular, Congress stated that the "President shall consult with the States . . . to achieve conformity of state law and practices with the agreements."[116]

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111. NAFTA Act, *supra* note 1, at § 102(b)(1)(B).

112. *Id.*

113. H.R. REP. No. 103-361(I), *supra* note 1, at 3, *reprinted in* 1993 U.S.C.C.A.N. at 2553.

114. "NAFTA obligations generally apply to State and local, as well as Federal, laws and regulations . . . ." *Id.* at 14, *reprinted in* 1993 U.S.C.C.A.N. at 2528. The text of a letter from the United States Trade Representative to Representative Henry Waxman indicates congressional awareness that obligations resulting from NAFTA may preempt state and local laws. *Id.* at 169, *reprinted in* 1993 U.S.C.C.A.N. at 2899. Specifically, the letter indicates United States Trade Representative Michael Kantor's desire that "the language of the draft NAFTA implementing bill . . . not unnecessarily interfere with state and local laws." *Id.*

115. Uruguay Round Act, *supra* note 2, § 102(b)(1)(B).

116. H.R. REP. No. 103-826(I), *supra* note 2, at 23-34, *reprinted in* 1994 U.S.C.C.A.N. at 3795-96.

C. INCOMPATIBILITY BETWEEN THE STATE AND FEDERAL SYSTEMS

Finally, preemption doctrine also requires that a particular state law be clearly incompatible with the federal system before the court may invalidate it, even when the federal law provides for preemption.[117] The following analysis applies preemption doctrine to state tax systems to demonstrate how a state law potentially is incompatible with the federal trading system.

1. Effect of State Tax Laws on the Exclusive Federal Right to Set Terms of Competition

State tax laws and other internal regulatory measures affect the profitability of doing business in a jurisdiction, and, consequently, they are factors in a company's decision to conduct business in a particular location.[118] Against this backdrop of existing internal regulations, the United States negotiates through the trade accords to define the terms of competition and to give trade partners additional access to U.S. markets in return for theoretically equal concessions.[119] State laws that differ from the structure presumed by the federal government in its negotiations change the resulting terms of competition,[120] thereby disrupting the balance of negotiated concessions that the federal government and the trade accord system strive to achieve.

For example, the federal government may agree to ease establishment requirements governing the ability of foreigners to open banks in the United States. In return, the United States would receive more favorable trading conditions from other trade agreement members. If a state subsequently taxes foreign banks at a higher rate than it taxes domestic banks, however, foreign banks that wish to establish in that state may view the concession as less valuable than the federal government intended it to be. As a result, the state law erodes the value of the concessions granted by the federal government, and changes the

117. *See supra* notes 45, 57-58 and accompanying text (noting that courts often tolerate some tension between state and federal laws).

118. *See* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TAXATION IN OECD COUNTRIES 49 (1993).

119. *See supra* notes 66-68 and accompanying text (noting that both NAFTA and the Uruguay Round Agreements are premised on trade accord members' granting of concessions).

120. *See supra* notes 94-108 and accompanying text (discussing the federal government's negotiation of the terms of the trade agreements in an effort to expand international trade).

terms of competition negotiated through the trade accords. This state action violates the exclusive right of the federal government to set international competitive parameters.[121]

2. Effect on the Federal Goal of Expanding Trade

Differing income tax rates hamper trade by acting as a barrier to entry and by suppressing overall return to capital in the economy.[122] If state tax rates differ from each other or from the rates set by the federal government, the state has violated directly the federal government's goal of expanding trade.[123]

Specifically, in a competitive market, the net return to capital invested in different sectors will be equal.[124] If the return is higher in one sector than another, investors will shift their capital to that sector, driving down the rate of return in the high-return area.[125] This process will continue until the returns again are equal between the sectors.[126]

Traditional economic analysis demonstrates the impact of a discriminatory tax across competing sectors.[127] In the absence of a tax, and holding all else equal, assume that the rates of return for domestic and foreign investors in State A and State B are both 8%. If State A introduces a 50% income tax charged only to foreign investors, while State B makes no change in its tax, the immediate or short-run effect is to drop the yield for

121. This type of tax also would violate federally-accepted substantive rules of the trade accords. *See supra* notes 63-82 and accompanying text (discussing the binding provisions of NAFTA and the Uruguay Round Agreements). Both NAFTA and the Uruguay Round Agreements require that national treatment be accorded to foreign investors and their investments. States' taxation of foreign banks at higher rates would violate this provision. Moreover, state tax laws that differ from the federal government's presumed norms violate WTO economic transparency requirements. The Uruguay Round Agreements and NAFTA are premised on the idea that trading partners can predict the result that will obtain from a concession they grant or receive. Varying state laws disrupt the partners' ability to predict the economic effect. The Agreements implicitly recognize this outcome in the clauses requiring state conformity. *See supra* notes 69-72 and accompanying text (discussing the MFN clauses and National Treatment clauses that require the equalization of internal taxes, charges, and regulations among members).

122. EDGAR K. BROWNING & JACQUELENE M. BROWNING, PUBLIC FINANCE AND THE PRICE SYSTEM 369-74 (1987).

123. *See supra* notes 98-108 and accompanying text (discussing the strong U.S. commitment to expansion of trade through negotiated concessions that are vulnerable to internal regulation).

124. BROWNING & BROWNING, *supra* note 122, at 369.

125. *Id.*

126. *Id.*

127. *Id.*

foreign owners in State A to only 4%. As a result, foreign investors have an incentive to shift capital away from State A to State B, where they can earn a higher rate of return. As the foreign capital moves away from State A, the rate of return in State A increases, while the return in State B decreases. This process continues until the rates of return again are equal in both states.

Assume equilibrium is reached at 6%. Because of the tax and the reduction in available capital, the before-tax rate of return in State A now must be 12%. Investors, however, may only keep 6%. They therefore receive a 25% lower return (from 8% to 6%) than they received before the income tax change.

Unfortunately, return on investment in State B also is 25% lower, even though the tax does not apply to investments in that state. This lower return is a result of the flight of capital from State A.[128] Basic supply and demand analysis indicates that, because capital is more available, the cost of employing it will go down. The decreased rates of return further indicate that investment in both states also will decrease as investors look elsewhere for higher rates of return.

This analysis suggests that when income taxes between competitive jurisdictions differ, investment in general, not just investment in the taxing jurisdiction, will decrease. As a result, if a government wishes to pursue a policy of increased investment, it should attempt to stabilize tax rates across competitive jurisdictions.[129] In other words, if the U.S. government wishes to increase and liberalize international trade and investment, it must ensure that variations in state tax rates do not erode the rate of return available to foreign investors. The government can do this by attempting to equalize the tax rate applied to all investors in all states. If states' tax rates differ from state to state and between the states and the federal government, the above analysis indicates that the U.S. will be less competitive, as it will offer a lower rate of return on capital investment than will a country with a more uniform rate of income taxation. State tax systems that do, in fact, differ from the federal system therefore arguably violate the federal goal of expanding trade.

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128. *Id.*
129. *Id.*

III. A NEW BALANCING: READJUSTING SUPREMACY CLAUSE ANALYSIS FOR A THREE-TIERED STRUCTURE

If the United States is to retain its position as a world leader in advocating free trade, it must demonstrate that the federal government can achieve state conformity with federal trade positions. Equally important, however, is the need to ensure that the cost of conformity does not outweigh the benefits, and that the line between state and federal power is redrawn carefully and thoughtfully.

When the right of the federal government to regulate internal affairs or commerce conflicts with a state's right to exercise its tax or police power, the judiciary traditionally has sought to balance the needs of both sides. In the process, the judiciary has recognized the inevitable tension between the overlapping powers.[130] The scope of the trade accords ensures that the federal government's right to establish international trade regulations will overlap with states' traditional rights to tax, and to regulate labor, the environment, health and welfare, and many other areas. The tension between the federal and state schemes also affects individual rights and one's ability to conduct business profitably. As a result, individuals have a great interest in prompt and certain resolution of perceived incompatibility between state and federal laws.

Clear language in the trade agreements requires state governments to adjust incompatible state laws.[131] However, the agreements cannot form the basis of a suit by a private party to challenge a state law because the implementing legislation that brought the agreements into U.S. law specifically denies parties a private right of action.[132] Instead, if a private party wishes to invoke the requirements contained in the trade agreements, it either must rely on federal government action[133] or attempt to

130. *See supra* notes 45-61 and accompanying text (discussing the elements of a Supremacy Clause challenge).

131. NAFTA, *supra* note 63, art. 105; GATT 1994, *supra* note 64, art. XXIV, para. 12.

132. NAFTA Act, *supra* note 1, § 102; Uruguay Round Act, *supra* note 2, § 102. Moreover, the same sections of the Implementation Acts deny a private right of action that would require the federal government to take action against a recalcitrant state. NAFTA Act, *supra* note 1, § 102; Uruguay Round Act, *supra* note 2, § 102.

133. For example, the Statement of Administrative Action for the NAFTA Act indicates that the Act requires close cooperation between the federal and state governments to identify incompatible state laws, to grandfather the laws when possible, and to cooperate to resolve the differences when grandfathering

find a separate basis for a suit under another principle of U.S. law.

Recourse to the political solution embodied by federal government action most likely will result in a political answer. That is, an answer that is not reached by an impartial body acting according to a set of principles, but one that instead is influenced by the bargaining and gamesmanship inherent in the political arena. While a political solution may have its advantages, parties that are impacted adversely by state laws in conflict with the federally-adopted trade accords must have recourse to the court system to challenge those laws.[134]

Traditional Supremacy Clause analysis is designed to resolve conflicts between two levels of decision-makers whose competition is further restrained by a well-developed system of checks and balances. Conflicts that result from federal attempts to pass rulemaking discretion to a supranational body that is not required to live within the same rules call for a new, more detailed approach to balancing the interests involved. Hence, in addition to the traditional analysis to which a Supremacy Clause challenge is subjected, courts faced with a challenge involving a level of authority outside the federalist system must ask whether the benefit of passing that discretion to the supranational body is worth the cost to federalism as a whole. Courts should analyze potentially-conflicting laws on a case-by-case basis and invalidate only the most disruptive laws. Courts should not invalidate state laws that vary only minimally from federal norms, or that are unlikely to result in retaliation, even though the laws result in discriminatory or otherwise violative treatment of foreign parties.[135]

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is not possible. *North American Free Trade Agreement Implementation Act Statement of Administrative Action* 12, *reprinted in* 1 NORTH AMERICAN FREE TRADE AGREEMENT, TEXT OF AGREEMENTS, IMPLEMENTING BILL, STATEMENT OF ADMINISTRATIVE ACTION, AND REQUIRED SUPPORTING STATEMENTS 457-61 (1993).

134. The Constitution, through the Commerce Clause and the Equal Protection Clause of the Fourteenth Amendment, guarantees citizens the right to conduct business without discriminatory interference by or among the states. *See* U.S. CONST. art. I, § 8, cl. 3; *id.* amend. XIV. While political action creates a viable alternative that may provide an avenue for aggrieved citizens, access to the courts to protest an unconstitutional law is not annulled simply because political action aimed at changing the law also is available. Public interest groups, for instance, simultaneously can challenge laws in the courts and lobby legislators for changes in those laws.

135. A contracting party has the option of changing an offending law or absorbing the retaliatory consequences. *See supra* note 75 and accompanying text

In the wake of the trade accords, these proposed balancing steps offer a reasoned way to realign federal and state interests within traditional Supremacy Clause doctrine. The preceding analysis showed that state tax systems that result in unequal tax rates[136] among the states and between the states and the federal government are ripe for invalidation under the Supremacy Clause. The Constitution however, equally protects the states' right to tax and the federal government's right to regulate trade, and courts must examine the tension that results when a challenged state law is allowed to stand.[137] Because courts have not faced this question yet in terms of the new federal trade regime,[138] this section proposes several factors that courts can use to assess the tension between the state and federal system.

A. Is the Federal System a Reasonable Alternative?

A court first must determine if the federal system is a reasonable alternative to the state system. This can include an analysis of several interrelated issues, such as the amount and type of information available to state decision-makers when they adopted the state system, the appropriateness of the political context in which the state acts, and the constituency of the state in general.[139] This analysis allows courts to determine if the tax in question is necessary in order to meet a legitimate need of the state, or if it is the result of an improper effort to defeat, explicitly or implicitly, federal policy decisions.[140] In ad-

(noting that NAFTA and the Uruguay Rounds Agreements authorize aggrieved trading partners to retaliate under certain circumstances).

136. The effect is the same as long as the real tax rates differ. Of course, rates between the states are not even nominally the same. *See supra* note 23 and accompanying text (discussing different state taxing methods).

137. *See supra* notes 57-61 and accompanying text (discussing preemption doctrine in cases involving traditional state power).

138. Historically, in "one voice" or preemption cases challenging income apportionment systems, the Court never found the available federal body of law sufficient to meet preemption doctrine requirements. *See supra* note 39 and accompanying text (discussing the Court's early application of the "one voice" doctrine).

139. Harold G. Maier, *Preemption of State Law: A Recommended Analysis*, *in* Foreign Affairs and the U.S. Constitution 125, 132 (Louis Henkin et al. eds., 1990).

140. For example, a state could levy a tax to discourage foreign investment in a particular industry because it believes the federal government improperly balanced economic growth with environmental protection in setting liberal investment rules. It is uncertain whether or not a court would determine this motive improper. NAFTA specifically addresses environmental issues in the accompanying agreement on the environment; the Uruguay Round Agree-

dition, this analysis allows the court to judge the importance of the tax as a revenue generator for the state.

B. What Are the Consequences of Retaining the State Law?

If the state has made a legitimate policy decision to meet a need that the federal system cannot meet, or if the loss of that revenue generator will impede severely the functioning of the state, the court should examine the consequences of a decision to retain the state law.[141] Specifically, the court should consider whether the state law appears to violate a trade accord.[142] If the state law does violate the trade accord, the court next should consider the likelihood that a trading partner will retaliate if authorized to do so under the auspices of a trade accord.[143] Alternatively, if the law does not violate the trade accord, the court should consider the possibility that a trading partner will retaliate unilaterally on other grounds.[144] Finally, the court should consider on whom the retaliation likely will fall.

These factors will help the court to gauge the size and scope of the impact of retaining the state law. They also can be compared with the importance of the law to the state in answering the next question.

C. Is it Better to Absorb the Potential Retaliatory Costs?

If the court determines that retaliation is likely, either under a trade accord or unilaterally, it then must decide whether, in spite of the potential for retaliation, it is in the best interests of the country to accept the potential reprisals rather

ments, however, do not. GATT's record in balancing trade and the environment is mixed. *See* JACKSON ET AL., *supra* note 64, at 535-42 (discussing a GATT Secretariat report's analysis of the interaction between international trade and the environment).

141. Maier, *supra* note 139, at 132.

142. *See supra* notes 63-64 and accompanying text (discussing NAFTA and the Uruguay Round Agreements).

143. Throughout the history of GATT 1947, only one contracting party ever was authorized to retaliate, and the party ultimately declined to do so. JACKSON ET AL., *supra* note 64, at 330-31. One commentator observes that, since the DSU provides for a more "automatic" method of authorizing retaliation, it probably will lead to more frequent use of such actions. *Id.* at 331.

144. In Barclays Bank PLC v. Franchise Tax Bd. of Cal., 114 S. Ct. 2268 (1994), the United Kingdom threatened to retaliate if California did not alter its income apportionment system. *See* Brief of the Government of the United Kingdom as amicus curiae Supporting Petitioner, *supra* note 21, at 8.

than to invalidate the law.[145] In making the decision, a court should look at the probability and the potential size of the retaliation; the political and economic consequences to the nation as a whole if the state is allowed to violate the trade accord; and the magnitude of the hardship to the state if the court invalidates the law.

CONCLUSION

This Note presents an analysis of the application of NAFTA and Uruguay Round Agreements requirements to state law in general. As a result, this Note can serve as one starting point to investigate the possible consequences for the many state laws that impact international trade, such as those relating to environmental and labor regulation. The above analysis counsels that state regulations should remain in place, even when they conflict with trade accords, unless the potential commercial or political retaliation is too great to warrant retaining the regulation. This decision essentially will turn on the value that the United States and its citizens place on the benefits of the regulation, as opposed to an alternative method that is not violative of the trade accords.

Unfortunately, in the environmental and labor arenas, the alternative could mean less or no regulation at all. In light of the importance of these state interests, courts must determine more clearly the boundary between state authority over issues impacting international trade and the states' continued ability to exercise their constitutionally-reserved powers. This analysis offers one method of redrawing the federalist boundary between state and national power that considers and equally weighs both state and federal interests.

145. *See* JACKSON ET AL., *supra* note 64, at 560-61 (suggesting that it is appropriate in the environmental sector for the U.S. to "pay" for extra environmental protection by making additional concessions in trade negotiations instead of removing an offending law).