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CONSTITUTIONALITY OF ECONOMIC DEVELOPMENT-RELATED IN-STATE PREFERENCES

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You asked if a state would violate the Dormant Commerce Clause by imposing in-state preferences on the businesses awarded state economic development funds. The answer to this question requires a legal opinion, which the Office of Legislative Research is not authorized to give. Consequently, you should not regard this report as one.

SUMMARY

The federal courts have not ruled on whether a state program imposing in-state preferences on businesses receiving economic development funds would violate the U.S. Constitution's Commerce Clause. Consequently, a case challenging the constitutionality of such policy would be one of first impression. Nevertheless, case law on in-state preferences in procurement and other matters suggests the analysis a court might go through to adjudicate the case.

THE COMMERCE CLAUSE AND ECONOMIC DEVELOPMENT

On the surface, the Commerce Clause simply authorizes Congress to regulate interstate commerce without mentioning the states. But the U.S. Supreme Court has interpreted the Clause to grant that power only to

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Congress, basing its interpretation on the founders intent to create a national market by preventing states from imposing customs and tariffs on goods crossing state lines. Consequently, the Court has decided many cases involving state laws affecting interstate commerce, and legal scholars cite those cases as evidence of a "Dormant Commerce Clause Doctrine" (DCCD).

State economic development programs are vulnerable under that doctrine if they go beyond financing private business development projects to requiring the participating businesses to undertake the projects only with in-state contractors, vendors, and residents. Such programs are vulnerable to a DCCD challenge because they deny out-of-state businesses and residents an economic opportunity.

An in-state preference can survive the challenge if it falls under the Court's "market participant exception," which is based on a distinction the Court has made between states using their sovereign powers to tax and regulate business transactions and their proprietary powers to buy and sell goods and services in the open market. Economic development programs providing financing without imposing in-state preferences appear to meet the exception, but those that also impose such preferences complicate the analysis.

One commentator suggested the decision could turn on whether the Court focuses on the exercise of (1) the sovereign power, specifically the law specifying how economic development recipients must spend the state funds or (2) the proprietary power, specifically, ensuring that the spill over benefits of state funded economic development projects rebound to in-state businesses and residents. Another commentator suggested that the Court might base its decision on the extent to which the in-state preferences impact the market (i.e., downstream regulatory effects).

The Commerce Clause is not the only constitutional platform for challenging economic development programs imposing in-state preferences. A 1984 U.S. Supreme Court decision involving a Camden New Jersey resident hiring preference suggests that such programs could be challenged under the Constitution's Privileges and Immunities Clause, which entitles the citizens of one state to all the privileges and immunities granted by the other states.

INTERPRETING THE COMMERCE CLAUSE

Exclusive Federal Power

By requiring businesses receiving economic development funds to use in-state businesses and workers, a state could affect interstate commerce and possibly run afoul of the U.S. Constitution's Commerce Clause. The Clause gives Congress the exclusive power to "regulate commerce with foreign nations, and among the several states, and with the Indian tribes" (Article 1, § 8, Clause 3). U.S. Supreme Court has interpreted the Clause as an express grant of authority to Congress and an affirmative limitation on the rights to states to regulate commerce within their own borders.

The interpretation of "commerce" determines the dividing line between federal and state power. Some argue that it refers simply to trade or exchange while others contend that it covers a broad range of commercial and social intercourse between citizens of different states. Despite the range of meanings attributed to commerce, the Clause clearly covers:

1. the terms and conditions governing the sale of good and services and restrictions on the types of goods shipped (i.e., channels of commerce);

2. trucks, rail, planes, and other "instrumentalities" used to conduct commerce;

3. things moving in the "interstate stream of business;" and

4. any commercial activity that "substantially affects interstate commerce."

Limits of State Power

Although the Clause explicitly gives Congress the power to regulate interstate trade, it is silent on whether states can also regulate that trade. The Court, though, has interpreted this exclusive grant of power as prohibiting states from passing laws that discriminate against people and businesses in other states or excessively burden their ability to engage in interstate commerce. This interpretation of the Clause is referred to as the "Dormant Commerce Clause Doctrine."

DCCD Applied to State Economic Development

To determine if a state law violates the DCCD, a federal court would examine the law, on its face, for blatant discrimination against out-of-state goods or services, applying a "strict scrutiny test." If the law is facially discriminatory, the state must prove that the law (1) addresses a legitimate goal, one that does not discriminate against out-of-state people and businesses and (2) that there is no other less discriminatory way to do so. If the court were to apply this test to an economic development program that imposes in-state preferences on business participants, it might decide the matter based on whether those preferences deny economic opportunities to out-of-state businesses and residents.

If the court, instead, finds that the law is not facially discriminatory, it might weigh its benefits against the extent to which it burdens interstate commerce (i.e., "balancing test"). In contrast to the strict scrutiny test, the balancing test tends to favor the government, with the court often upholding the law. If the court were to apply the balancing test to the economic development program described above, it might decide the matter based on whether the economic benefits outweigh the harm to interstate commerce.

Economic Protectionism

The U.S. Supreme Court applied the above tests to strike down laws insulating a state from interstate competition. For example, in *South-Central Timber Development, Inc. v. Wunnicke* (467 U.S. 82 (1984)) the Court struck down an Alaska law that required parties buying discounted timber from state-owned land to process some of that timber in the state before exporting it.

Whether a federal court would similarly strike down an economic development program imposing in-state preferences turns on whether the state adopted them to shield in-state businesses from interstate competition. In reaching its decision, the court might consider if the state, by imposing such preferences, was participating in the market or regulating it. When the state acts as a market participant, it, like any other participant, can buy or sell goods and services on its terms. When it acts as a market regulator, though, it affects transactions between other market participants, such as those between a business and the contractors it hires to build a factory.

DCCD'S MARKET PARTICIPANT EXCEPTION

The distinction between market participant and market regulator could determine how a federal court rules on a state economic development program imposing in-state preferences. The courts have exempted states from the DCCD when they participate in the market to favor their respective residents and organizations (i.e., "market participant exception"). States often do this when they buy or sell goods and services (Coenen, "Untangling the Market-Participation Exemption in the Dormant Commerce Clause," *88 Michigan Law Review 395*).

Applying the Market Participant Exception

The courts have not ruled on whether the market participant exception covers in-state preferences tied to economic development funds, but their decision could depend on whether they focus on the action or the law that authorized it. To understand this distinction, assume that an out-of-state construction company challenged a state law requiring a business awarded state funds for developing a new corporate headquarters to contract only with in-state construction companies.

If the court focuses on only the action—requiring the business to contract only with in-state construction companies—it might find that the state was participating in the market, using its proprietary power to ensure that in-state contractors benefit from state funded economic development projects. On the other hand, if the court focuses only on the law mandating the preference, it might find that the state was using its sovereign powers to influence the market's natural operation.

Downstream Effects

Regardless of whether the court focuses on the state's action or the authorizing statute, it might base its decision on whether the action has downstream regulatory effects. Such effects could arise if the state requires (1) the business receiving the economic aid to contract only with in-state contractors, (2) the contractors to contract only with in-state subcontractors, and (3) the contractors and subcontractors to hire only in-state workers.

But it is not clear how the court would assess these effects. Although it "distinguishes between regulation and market participation," the "exemption to the market participant doctrine for downstream effects has not been well explained," University of Maryland Law School Professor David S. Bogen wrote ("The Market Participant Doctrine and the Clear Statement Rule, 29:543 *Seattle University Law Review* 543).

For example, the Court found no downstream effects when it upheld a Boston executive order requiring city public works contractors to hire city residents. The order applied to contracts to which the city was not a party (i.e., the contracts between the contractors and the people they hire) (*White v. Massachusetts Council of Construction Employers, Inc.* 460 U.S. 204 (1983)). But, the Court found such effects when it overturned the Alaska law allowing parties to buy discounted state timber if they agreed to process some of that timber in the state before exporting it (*South-Central Timber,* supra).

In that decision, the Court suggested that the issue turns more on the magnitude of the downstream effects. "Unless the 'market' is relatively narrowly defined, the [market participant] doctrine has the potential of swallowing up the rule that States may not impose substantial burdens on interstate commerce even if they act with the permissible state purpose of fostering local industry." As Bogen explained, "if the definition of the market is tied to the burdens on interstate commerce, the analysis may turn on fact-specific economic determinations of how large the impact on interstate commerce might be."

If a court were to rule on an economic development program that imposed in-state preferences, it might start by determining the economic magnitude of all state and privately funded business development projects and the relative share of those funded under the program. If that share is relatively small, the court might determine that the program has a marginal impact on interstate commerce and uphold it under the market participant exception.

PRIVILEGES AND IMMUNITIES CLAUSE

Even if an economic development program imposing in-state preferences falls under the market participant exception, it could still be vulnerable to challenges under the Constitution's Privileges and Immunities Clause (Amendment XIV, § 1, Clause 2), which entitles the citizens of each state to all the privileges and immunities granted to those in other states.

In *United Building and Construction Trades Council v. Mayor of Camden*, the U.S. Supreme Court cited the Commerce and Privileges and Immunities clauses. First it ruled that Camden could, "without fear of violating the Commerce Clause, pressure private employers engaged in public works projects funded in whole or in part by the city to hire city residents" (465 U.S. 208 (1984).

But that power is not absolute because “the same exercise of power to bias the employment decisions of private contractors and subcontractors against out-of-state residents may be called to account under the Privileges and Immunities Clause,” to which the market participant exception does not apply. Consequently, “a determination of whether a privilege is ‘fundamental’ for the purposes of that Clause does not depend on whether the employees of the private contractors and subcontractors engaged in public works projects can or cannot be said to be ‘working’ for the city.”

Instead, the determination depends on whether a state can demonstrate why it needs to impose a resident hiring preference. In *United Building*, the Court remanded the case to the New Jersey Supreme Court to determine if the state’s economic problems warranted the preference, “implying that the city could restrict its payments to its citizens,” Bogen wrote. The case “suggests that a reflexive preference that excludes out-of-state residents from jobs without a corresponding need for in-state residents would indicate bias and prejudice against outsiders that would harm the Union.”

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