CONSUMER PROTECTION

# CON Job

## State "certificate of necessity" laws protect firms, not consumers.

BY TIMOTHY SANDEFUR | *Pacific Legal Foundation*


When St. Louis businessman Michael Munie decided to expand his moving business to operate throughout the state of Missouri, he thought it would be a simple matter of paperwork. After all, he already held a federal license allowing him to move goods across state lines. But when he filed his application, he discovered that, under a 70-year-old state law, officials in Missouri's Department of Transportation were required to notify all of the state's existing moving companies and allow them the opportunity to object to his application. When four of them did file objections, department officials offered Munie the choice of withdrawing his application or appearing at a public hearing where he would be required to prove that there was a "public need" for his moving business. The law is not clear on how exactly he would do this — "public need" is not defined, nor are there any rules of evidence or procedure in the statute. And even if he managed to prove a "public need," the department would take anywhere from six months to a year to make a final decision. In the face of such complications, Munie chose to withdraw his application and ask instead for limited permission to operate within a portion of St. Louis. His competitors had no objection to that, and he was given the restricted license.

Bizarre as this law might seem, it is only one of dozens of such requirements, generally called "certificate of necessity" (CON) laws, that exist across the country, governing a variety of industries, from moving companies and taxicabs to hospitals and car lots. A legacy of the early 20th century, CON laws restrict economic opportunity and raise costs for products and services that consumers need. Unlike traditional occupational licensing rules, they are not intended to protect the public by requiring business owners to demonstrate professional expertise or education. Instead, these laws are explicitly designed to restrict competition and boost the prices that established companies can charge.

### The Rise of CON

CON laws were originally devised to regulate railroads and other public utilities. They first appeared in Massachusetts in the 1880s, and were soon taken up in other states, where they were often applied to streetcar lines.

As William K. Jones explains in his 1979 *Columbia Law Review* history of CON laws, Progressive Era proponents offered five main justifications for these restrictions: they would

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Sandefur wishes to thank Tarren Bragdon of the Maine Heritage Policy Center for helpful research.

- prevent “wasteful duplication” of services,
- prevent “ruinous competition,”
- ensure that regulated entities would continue to serve out-of-the-way customers,
- promote private investments in public service industries, and
- forestall certain kinds of externalities.

Many economists and social theorists of the time believed competition was economically inefficient because it wasted resources on, say, multiple railroad lines between the same destinations. Worse, they thought competition fostered the “boom-and-bust” cycle that drove out investment and ultimately left customers without the products and services they needed.

Although economists have discredited those theories in the decades since, many found them persuasive at the time, due in no small part to the frequency of fraud in railroad construction schemes. Shady businessmen would sometimes sell stock in prospective railroad lines that would never be constructed, or would build shoddy railroads and abscond with the investors’ money. CON laws were expected to protect consumers by requiring pre-approval of any proposed line.

CON rules were also expected to counteract the economic inefficiencies that government regulations themselves caused. Railroads were often legally barred from charging market rates for travel or refusing unprofitable carriage. This created an incentive for rivals to engage in “cream-skimming” — i.e., maximizing profits by serving only large population centers and bypassing unprofitable routes or out-of-the-way customers. By preventing more efficient competition, CON laws would help railroads turn a profit despite being burdened with regulatory costs. As the New York Board of Railroad Commissioners explained in 1884, “When the State has undertaken the control of railroads by the creation of supervisory boards, and has determined to exact the highest standard of service at reasonable rates of freight and fare, it would certainly seem as if a corresponding obligation rested upon it to protect existing railroads from useless and disastrous competition by unnecessary new ones.”

Progressives also expected CON rules to promote investment in public utilities at a time when many such utilities were financed by private industry. This rationale harkened back to the famous 1837 Supreme Court decision, *Charles River Bridge v. Warren Bridge*, in which the Supreme Court refused to close down a publicly financed free bridge that the city of Boston constructed adjacent to a privately financed toll bridge. The investors in the toll bridge complained that the new, free bridge would destroy the value of their investment, and argued that their government permit should be interpreted as a promise from the city that it would not let a new business undercut their anticipated income. But the Court ruled that corporate charters would not be read as monopoly privileges except in rare cases; states could allow expanded competition even if it meant ruin for some investors.

The ruling was a momentous victory for private enterprise because it restricted the ability of established industries to block new competitors. But it also created a disincentive to the creation of public works, as Justice Joseph Story warned in his dissenting opinion: “[I]f the government means to invite its citizens to enlarge the public comforts and conveniences, to establish bridges, or turnpikes, or canals, or railroads, there must be some pledge that the property will be safe … and that success will not be the signal of a general combination to overthrow its rights and to take away its profits.” Like patents, which create temporary monopolies as an incentive to innovation, some social scientists saw CON laws as an effective compromise between the need for competition and the need to encourage private investment in public services.

Finally, some Progressives promoted CON requirements out of a belief that the “chaotic” free market should be replaced by “rational” planning, undertaken by expert agencies. The Progressives envisioned disinterested bureaucrats, insulated from

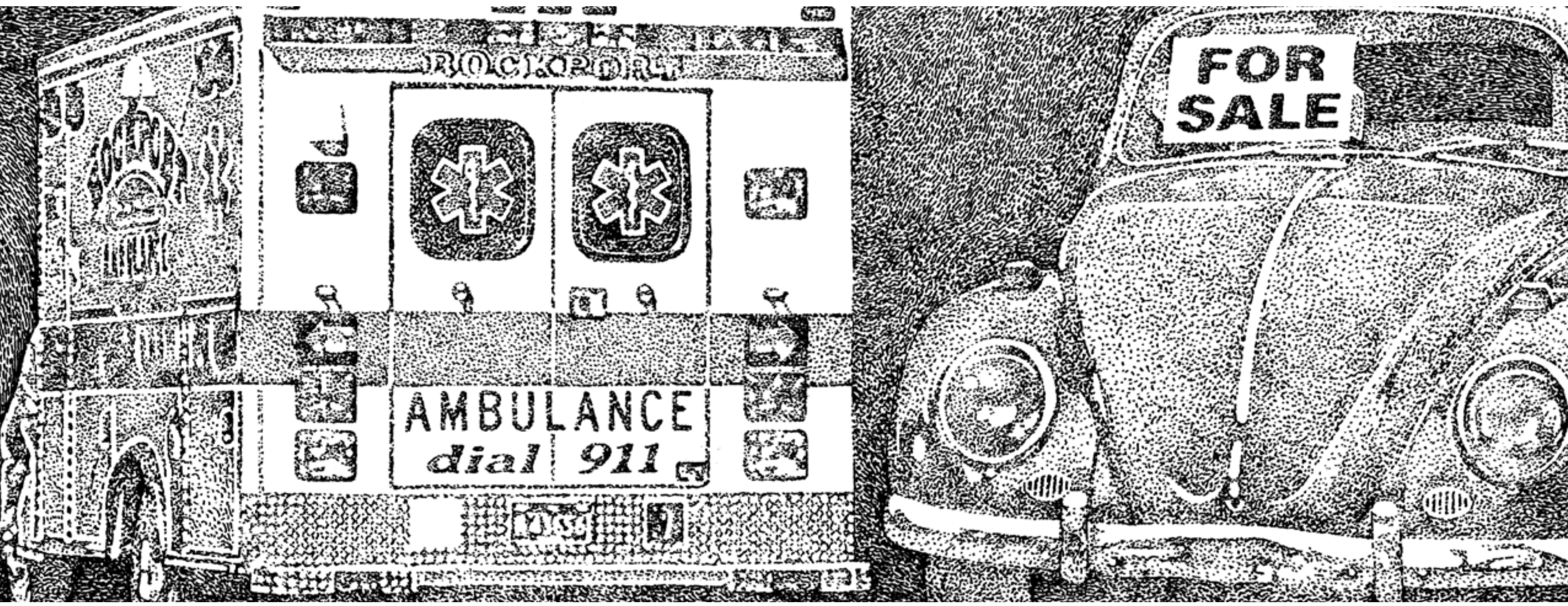


ILLUSTRATION BY MORGAN BALLARD

democratic pressures, precisely organizing the provision of goods and services to consumers. A New York court expressed skepticism about this idea in a 1908 case, when a railroad appealed the denial of permission to expand: "It is not possible either for the State Commission or the Interstate Commission to ascertain and enforce a reasonable rate either for passengers or freight in the way that can be ascertained by the establishment of competition," wrote the judge. But this was a rare exception. Despite their reputation, most "*Lochner* era" courts upheld these restrictions, allowing legislatures to regulate business as they saw fit.

## Reality Sets In

Whatever their original economic justifications, it was the anti-competitive nature of CON laws that quickly became their most prominent feature. Within 20 years of their invention, most states had expanded them to cover not only railroads but gas and electric companies, telephone and telegraph services, water works, and other industries. In 1913, New York enacted the first CON requirement for automobile buses, out of what the state's Public Service Commission called "a sense of fairness to the private interests already engaged in these fields of work" in the form of streetcars. The commission claimed it was not trying to prevent innovation and free enterprise, but its "sense of fairness" led it to do just that, and existing businesses almost immediately exploited the rules to exclude buses and jitneys from the market. In 1915, the commission refused to allow a jitney company to compete against a streetcar line, even though it acknowledged that the streetcars were providing poor service. "Competing companies, operating in a single field," the commission decided, "were never likely to achieve such secure financial standing as to enable them, collectively, to give as good service as a single well-regulated monopoly."

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Even assuming that the alleged inherent monopoly characteristics of the railroad or telephone industries justified restricting entry into those markets, no such rationale could apply to markets for automobile transportation, be it jitney, cab, or moving companies. Investment in those businesses was already well assured by low start-up costs and the greater flexibility of the services themselves. Whereas railroads found it difficult to tear out unprofitable tracks and relocate, a bus route could easily be changed to suit market conditions and taxis could travel wherever they had to. For the same reason, out-of-the-way customers were much better served by automobiles than railroads, so "cream-skimming" was not a serious concern. Thus in these markets, open competition was more likely to result in better consumer service than in deterred investment—and restricting entry meant increasing the cost of living and denying economic opportunity to potential entrepreneurs looking for honest work. CON laws imposed especially severe burdens on the taxi and moving van industries, which were particularly attractive to would-be business owners who lacked investment capital, industry connections, or political influence.

After all, it is impossible to really prove to a government agency that the public "needs" *any* new business. Many CON statutes give bureaucrats and applicants no meaningful instructions as to what evidence suffices to establish the existence of a "public need." For instance, until 2009, officials at the Oregon Department of Transportation, having no internal guidance as to what constitutes a "public necessity," were forced to rely on a set of non-binding "guidelines" prepared in the 1990s by the state's Public Utility Commission and intended for use in cases involving electric companies. But even aside from this legal vagueness, it is hard to imagine how any prospective business owner could ever prove that the public "needs" a new product or service. Professional market researchers, using state-of-the-art statistical methods, regularly err in predicting what consumers want. It would not have been possible 20 years ago to prove that the United States "needed" a new nationwide chain of coffee shops—yet Starbucks' spectacular success proves that it did. On the other hand, top executives at Coca-Cola failed in 1985 to realize that there was no "public need" for New Coke. If private industry regularly fails in determining what goods and services the public "needs," it is hard to imagine how a government agency, lacking either the tools or incentives that private industry enjoys, can make more accurate determinations. Requiring an unknown dreamer, with no political connections, reputation with consumers, or allies among local business magnates to persuade a government board to let him open a new business can often be a prohibitive cost. It is absurd to expect a would-be mover to ask potential customers to take time out of their work day to attend a government hearing and testify in favor of a business that does not yet even exist.

Worse still, some CON requirements are explicitly biased against the opening of new businesses, so that even testimony from potential customers might not be enough. Illinois, for example, requires prospective car dealerships to obtain a certificate from the state's Motor Vehicle Control Board before opening a franchise. Although many states regulate franchises for the legitimate purpose of protecting the franchisees against abuse by contracting parties, some of these laws contain protectionist CON-like requirements, and Illinois' may be the most anti-competitive of all. The statute allows existing car dealers to object to any proposed application, whereupon the board is required to weigh certain factors when evaluating the application — including such explicitly protectionist items as "the effect of an additional franchise ... upon the existing motor vehicle dealers" and "the permanency of the investment of the objecting motor vehicle dealer." Indeed, the statute declares that "good cause" for opening a new dealership "shall not be shown solely by a desire for further market penetration." Thus a desire to succeed is not sufficient reason to allow a new franchise to open. The state Supreme Court upheld this law against a 2007 lawsuit, despite a dissenting justice's complaint that "notwithstanding its seemingly lofty purpose of protecting 'the public interest and welfare' and 'consumers generally,' this Act is clearly nothing more than a protectionist measure favoring existing motor vehicle dealerships."

**Social cost |** CON requirements do more than just bar investment and stifle entrepreneurship; they also have unexpected and momentous social consequences. In 1955, when Martin Luther King and other civil rights leaders planned to boycott the segregated bus lines in Montgomery, Ala., they were well aware that the city's taxicab regulations posed a significant problem. Workers who relied on buses to get to work could only participate if they had alternative transportation. "For the first few days," King wrote later, "we had depended on the Negro taxi companies who had agreed to transport the people for the same ten-cent fare that they paid on the buses.... But ... Police Commissioner Sellers mentioned in passing that there was a law that limited the taxis to a minimum fare. I caught this hint and realized that Commissioner Sellers would probably use this point to stop the taxis from assisting in the protest."

King knew that a boycott organized in Baton Rouge two years earlier by preacher T. J. Jemison had collapsed in large part because of that city's taxicab regulations. So King organized a network of volunteer drivers called the Montgomery Improvement Association, whose drivers would provide 130 rides per car per day, and whose gas and car maintenance costs would be covered by donations collected at weekly church services. The association applied for a license to operate a taxi company but, unsurprisingly, their application was rejected. Although Montgomery officials allowed the association to operate its volunteer network for almost a year, they eventually filed a lawsuit to shut it down. On November 13, 1956, a state court agreed, issuing an injunction against King. Fortunately for the future of civil rights, the U.S. Supreme Court invalidated the segregation of Montgomery's bus lines that same day. Still, King had pledged that the boycott would continue until the city actually desegregated its buses, so his supporters were forced to walk to work for the last month of the boycott.

**Health care |** Possibly the most foolhardy CON requirements are laws that apply to hospitals. Originally adopted to prevent what economists saw as inefficient over-expansion of hospitals, the laws were soon captured by established interests that used them to raise the cost of medical services. In the 1970s, 49 states imposed CON requirements on hospitals, leading to higher costs and less innovation in medical care. Economist Thomas E. Getzen wrote in 1997 that "almost every well-established, wealthy, and politically connected hospital that applied for certification eventually got it, while denials fell disproportionately on outsiders that threatened the status quo or weaker institutions that lacked a constituency."

Federal CON requirements were repealed in the 1980s, but many states still employ them. For example, Hawaii bureaucrats held up construction of a new $220 million private hospital on Maui for years, forcing the island's 144,000 residents to depend on a single, state-run facility or on clinics. The State Health Planning Development Agency rejected a 2007 proposal to build a new, state-of-the-art facility, denying it a certificate of need because it would negatively affect the existing government-run hospital. The agency finally granted approval in 2009, and construction is now underway, but in the meantime victims of emergencies on the island's south side must still endure a 90-minute drive on a two-lane highway to reach the Maui Memorial Medical Center.

## CON and the Constitution

There is an obvious similarity between CON requirements and occupational licensing laws. Both are often justified by policymakers as protecting the public, but both often serve to protect incumbent providers.

Occupational licensing has its roots in the medieval guild system, but became a regular feature of American law only in the late 19th century. In the 1889 decision in *Dent v. West Virginia*, the U.S. Supreme Court upheld the constitutionality of a physician licensing law on the grounds that requiring doctors to have medical training was a legitimate way to protect consumers. But, the Court warned, licensing requirements that "have no relation to [the] calling or profession, or are unattainable by such reasonable study and application ... can operate to deprive one of his right to pursue a lawful vocation." In the 1950s, the justices reiterated this point, emphasizing that a state can use licensing laws only to ensure that professionals have proper training — not to prevent a disfavored group from entering a business: "A State can require high standards of qualification ... but any qualification must have a rational connection with the applicant's fitness or capacity to practice [the profession]."

CON laws, however, have nothing to do with an applicant's skills. They are used simply to impose an artificial order on the market, without regard to what consumers themselves want. The Supreme Court first addressed the constitutionality of CON rules in the 1932 case of *New State Ice Co. v. Liebmann*, when it invalidated an Oklahoma law that required prospective ice delivery businesses to prove to a government agency that there was a "public need" for a new ice company. In a decision by Justice George Sutherland, the Court found that this law did not protect consumers, but only protected established companies, depriving would-be entrepreneurs of their right to operate a business — a right English and American courts had protected for centuries. "[T]he practical tendency of the restriction," wrote Sutherland, "is to shut out new enterprises, and thus create and foster monopoly in the hands of existing establishments, against, rather than in aid of, the interest of the consuming public." The case was not about "regulation by the state to protect the consuming public.... The control here asserted does not protect against monopoly, but tends to foster it. The aim is not to encourage competition, but to prevent it; not to regulate the business, but to preclude persons from engaging in it."

Justice Louis Brandeis wrote a lone dissent, arguing that states should be free to act as "laboratories" that could "experiment" with various kinds of economic legislation. But Sutherland refuted this argument succinctly: "[I]t would be strange and unwarranted doctrine to hold that they may do so by enactments which transcend the limitations imposed upon them by the Federal Constitution. The principle is imbedded in our constitutional system that there are certain essentials of liberty with which the state is not entitled to dispense in the interest of experiments.... [T]he theory of experimentation in censorship [is] not permitted to interfere with the fundamental doctrine of the freedom of the press. The opportunity to apply one's labor and skill in an ordinary occupation with proper regard for all reasonable regulations is no less entitled to protection."

The *New State Ice* case has never been overruled, but the Court cast doubt on it only two years later, in a momentous decision called *Nebbia v. New York*. *Nebbia* adopted the new theory called "rational basis scrutiny," under which states could control economic behavior with virtually no restraint by courts. "[A] state is free to adopt whatever economic policy may reasonably be deemed to promote public welfare," the justices held, "and to enforce that policy by legislation adapted to its purpose." This was the beginning of the Court's historic retreat from protecting the freedom of economic choice — what historians now call the "switch in time" when the Court began upholding the constitutionality of New Deal programs. Since then, the Supreme Court has frequently quoted Justice Brandeis's "laboratory" rhetoric while otherwise ignoring the Court's actual decision. In the meantime, states have expanded their CON requirements to apply to a broad number of industries.

**Reconsidering CON |** Fortunately, in recent years, courts and lawmakers have grown increasingly skeptical toward CON requirements. In 2005, the First Circuit Court of Appeals ruled that a Puerto Rico CON requirement for pharmacies unconstitutionally burdened interstate commerce because it did not apply to established, locally owned pharmacies. The law "permits an existing pharmacy to object simply because it fears additional competition," the judges wrote. "It permits the Secretary to deny a proposed pharmacy market access at its desired location simply to limit competition" and permits "a predominantly local group to manipulate the regulatory scheme for its own advantage."

In 2008, Portland, Ore., entrepreneur Adam Sweet challenged the constitutionality of that state's CON requirement for moving companies. Sweet had opened 2 Brothers Moving to help put himself through college, and the company soon became popular with medical professionals because of Sweet's skill in moving scientific equipment. His business grew through word of mouth until he was cited for operating without a license. Represented by attorneys at the Pacific Legal Foundation and aided by scholars at the Reason Foundation and the Cascade Policy Institute, Sweet brought a federal civil rights lawsuit arguing that the law violated the Fourteenth Amendment. Not long after the court rejected the state's effort to throw out his case, Sweet led a protest caravan of moving trucks — draped in banners reading "Let us compete!" and "Small business *moves* America!" — around the capitol building in Salem. The legislature got the message and repealed the law.

Two years later, Michael Munie ran into the Missouri CON requirement when he sought permission to expand his moving company. That statute, typical of CON requirements, had apparently been adopted with little consideration of the differences between public utilities and wholly private enterprises like the moving industry. Lawyers and economists had long complained that the law was outdated and wasteful; in a 1982 survey of Missouri's mover CON requirement, attorney Paul H. Gardner, Jr., explained, "Nothing in creditable economic theory suggests that this requirement serves any purpose but to restrict competition and derivative output." He added that granting incumbents a veto right over rival companies "costs the citizens of Missouri millions of dollars annually." But lawmakers refused to act, and established industries continued to enjoy their cartel privileges until 2010. That was when Munie filed a federal lawsuit, arguing that while Missouri could use its licensing laws to protect consumers or to ensure that business operated competently, it could not simply choose winners in the marketplace. The court denied the government's motion to dismiss, and in May of 2011, the Missouri legislature gave final approval to a bill that will repeal the mover CON law.

## Conclusion

Occupational licensing laws are among the most common abridgements of economic liberty, but CON rules are more pernicious. They do not even pretend to protect public safety by ensuring that practitioners are educated or skilled; they exist for the explicit purpose of preventing competition. Whatever merit that might have in the context of public utilities or natural monopolies, there is no reasonable foundation for applying such rules to moving companies, taxi companies, or hospitals. In these markets, CON restrictions unfairly favor entrenched private interests, increase the cost of living for consumers, destroy economic opportunity for the most vulnerable entrepreneurs, and in the case of hospitals, threaten Americans' very lives. Certificate of necessity laws are arbitrary, discriminatory, and economically foolish. R

### READINGS


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