A LICENSE TO GROW:

Ending State, Local, and Some Federal Barriers to Innovation and Growth in Key Sectors of the U.S. Economy

Kauffman Task Force on Entrepreneurial Growth | January 2012
Executive Summary

Innovation and rapid economic growth require not only a facilitative legal infrastructure, which the United States already has to a significant degree, but also no or low legal barriers to entry into productive lines of activity.

Unfortunately, despite the deregulation of price and entry controls over the past three decades at the federal level in much of the transportation industry and some of the telecommunications industry, the U.S. legal landscape still is littered with legal entry barriers. These impediments exist primarily at the state and local levels, where they essentially have operated under the radar.

This white paper outlines some of the remaining state barriers and a few federal ones and how they prevent disruptive innovations by entrepreneurs and established firms alike that potentially could bring new and more efficient business models to the market. In the case of the legal sector, the barriers we identify not only adversely affect legal innovation, but also impede innovation in other sectors of the economy. Similarly, in health care, pharmaceuticals, K–12 education, the financing of growth businesses, and many consumer services, legal obstructions hinder innovation and the provision of efficient, affordable, high-quality services and products.

We conclude by surveying the main options for reducing or eliminating these impediments, proposing, in effect, ways to provide a “license to grow.” Although most of the ideas we list are relevant only to state and local governments, we do not recommend, however tempting it may be, federal preemption as the means to their abolition. Apart from the political difficulty of gaining consensus on a sensible preemption approach in a time of deep partisanship with the Congress, it is not necessary for citizens to look to Washington to solve all problems.

There is value not only in state experimentation, but danger in one-size-fits-all proscriptions imposed by the federal government. Therefore, we opt instead for a more flexible “mutual recognition” approach that would require some federal action—a simple law requiring states...
to recognize licenses granted in other states’ licensing systems—but not a detailed set of universally applicable limits on states’ licensing systems. Fortunately, there are models for mutual recognition. For example, driver’s licenses are recognized in all states in the country, while the European Union uses mutual recognition in the regulation of financial matters.

To be sure, it is important that state and local licensing reforms ensure that consumers can make informed choices among providers once existing restrictions are lifted, and that they are protected from provider abuses. But existing barriers to entry are not the only means for protecting consumers from unscrupulous practices. Regulation and liability rules, coupled with reputational risks for bad behavior that the Internet can amplify, can offer equal, if not better, consumer protection without the negative impacts on innovation and efficiency that entry barriers entail.

This white paper is an extension of the Startup Act (http://www.kauffman.org/research-and-policy/startup-act.aspx), in which the Kauffman Foundation outlined ways the federal government can stimulate new company formation and growth, encouraging economic growth across the economy. In a companion to this report, the Foundation also will publish a separate template for state and local “Startup Acts”—in reality, both executive and legislative measures—that would reinforce and amplify the impact of startup-friendly policies at the federal level. This particular white paper focuses primarily on removing state and local impediments to entrepreneurial growth and thus, we hope, will make an important contribution to the public policy debate in its own right.

Many of the ideas outlined here also will be included in a summary fashion in the companion Kauffman report on a broader startup agenda for state and local governments. As prior Kauffman research has made clear, new firm formation and growth are critical to job creation and economic growth in general. The persistently high rates of unemployment since the financial crisis of 2007–2008 and the decline in formation rate of new employer firms in recent years make a startup agenda at all levels of government more urgent than ever.

Legal Barriers to Innovation and Growth In Key Sectors

We begin by outlining barriers to innovation and entrepreneurship in key sectors which, even if they once could be justified, now unnecessarily impede efficient, quality competition from alternative providers. Competition has been made possible through technological advances and better sources of information, the Internet in particular, and other factors. It is no longer necessary to use the functional equivalent of a shotgun to kill every fly.

The primary challenge in removing these legal barriers is that powerful interests with a stake in the status quo will resist change as long as possible, while the diverse and unorganized beneficiaries of change, new entrants and consumers, may not even be aware of how they lose from this protection of the existing order. The prospects for even moderately paced change under these circumstances are doubtful at best, but we nonetheless highlight the steps that would be most helpful in the hope that, when the appropriate opportunities arise, policymakers will be armed and ready to implement some or all of the following ideas.

Legal Services

States license lawyers and, in the process, impose barriers on the delivery of legal services. Anyone who engages in the practice of law in any state without a license to practice in that state risks substantial penalties. Even lawyers who are fully licensed and competent to practice law in one state may be penalized for practicing law in other states.

Moreover, the term “practice of law” itself is not clearly defined, anywhere. The term potentially extends to any specific advice designed for a particular person and any representation of another person in court. When the American Bar Association attempted in 2002 to create a model definition of the practice of law—to bring some
clarity to the array of vague and circular approaches followed in many states—the language it proposed was so overbroad and protectionist that both the Department of Justice and the Federal Trade Commission objected. As the joint letter opinion concluded, “the proposed definition is not in the public interest because the harms it imposes on consumers by limiting competition are likely much greater than any consumer harm it prevents.”

The current licensing requirements impose significant barriers on innovation and growth in the legal industry, which has annual revenues of $200 billion, even before counting the money corporations spend on their lawyer-employees (Winston, Crandall, and Maheshri, 2011). Although licensing regimes vary in detail, their basic structure is quite uniform across states: Essentially, anyone who wants to convey information designed to guide a particular person’s compliance with the law must comply with the licensing requirements. This uniformity amounts to a functional equivalent of a cartel of state bars and judges (who already regulate the legal profession in many states) who discourage state competition with respect to attorney licensing. This cartel, in turn, imposes several formidable requirements on aspirants to the bar.

First, all who engage in the practice of law, whether or not they call themselves “lawyers,” must have three years of schooling at a law school (and in many states at an ABA-approved law school (accreditation is a separate process that creates barriers to entry, but that is not a matter directly within the control of states). For many individuals who know the area of law in which they plan to specialize, the three-year curriculum requires excessive and costly training in non-essential subjects. For others who haven’t yet made this decision, the additional course load may be beneficial, but it is not at all clear that formal training beyond, say, two years, is more cost-effective than on-the-job training in particular subject areas.

In any event, at the end of this three-year course of study, law students must take a lengthy bar exam, preparation for which often (if not typically) entails paying for expensive bar review courses in each state in which they plan to practice. Ask most lawyers whether they remember much from the bar exam and they are likely to tell you that they expunged the memory of it as soon as they left the exam room.

When the aspirant is finally licensed, in most states he or she must comply with continuing legal education requirements that vary from state to state, have very little quality controls, and can require the lawyers to purchase still more costly educational materials (although some CLE opportunities are free).

A lawyer who obtains a mandatory license to practice in a state then must comply with that state’s rules on legal ethics, which also vary across state borders and have elements that apparently are intended to prevent the practice of law from resembling a “business.” Some elements, such as the duty of loyalty to the client and avoidance of conflicts of interest, are quite legitimate. However, those portions of the ethics rules that bar lawyers from practicing law in firms that are owned all or in part by non-lawyers have much less justification. For example, it is widely believed that, when some relaxation of the rules on non-lawyer firm ownership was proposed by an American Bar Association Commission on Multidisciplinary Practice in 1999–2000, the ultimate defeat of the reform proposal (which would have facilitated ownership by service providers from multiple professions) in the ABA House of Delegates was the result of resistance from the largest law firms, which fear competition from the large accounting firms).

These numerous requirements impose substantial needless costs. First, the one-size-fits-all approach to

---

licensing everybody who engages in the broadly defined practice of law prevents the development of low-cost methods of delivering certain types of legal services. In a less-regulated world, these might include legal/business counselors for entrepreneurs and small firms and the handling of routine legal issues like estate administration, divorces, and bankruptcies by people trained in these specific areas but who would not have to take the full and costly array of legal courses required of traditional law students. Such specialized practitioners could be not only as good as lawyers for the particular services they perform, but, in many cases, actually could be better because they would have more relevant, recurring experiences in the very specific areas in which they practice.

Second, the broad definition of the practice of law implies that sophisticated technologies such as software for drafting contracts can be deemed to be providing individualized legal advice, and thus potentially in violation of state licensing rules (Kobayashi & Ribstein 2011). Such software increasingly is capable of integrating consumers’ needs, based on their responses to questionnaires, and templates to produce contracts and other legal documents that may well be of higher quality than those produced by general practice lawyers hired by many small businesses and middle-class clients. The regulation of the “practice of law,” therefore, directly inhibits information technology from delivering legal services much more cheaply and perhaps even more effectively.

Third, the ethical rules concerning the practice of law prevent the use and development of business structures that have already greatly increased the scale and reduced the cost of services across other sectors of the economy. In particular, the prohibition against having non-lawyer owners of firms engaged in law practice inhibits the development and diffusion of a wide variety of potentially more efficient business structures, including low-cost legal providers, publicly financed legal services organizations, and firms combining legal and other services such as accounting, finance, and business consulting.

These constraints on innovation result from the broad nature of the regulation of the practice of law, but also of the regulatory structure that entitles each state to separately regulate what could and should be a national legal information industry. The current licensing system potentially subjects those practicing law to multiple regulatory requirements while inhibiting parties’ ability to choose from competing regulatory regimes.

Consumers, entrepreneurs, and established businesses all pay for the excess cost and barriers to innovation created by an archaic and effectively cartelized system of regulation. The most recent comprehensive empirical analysis estimates that the total annual cost of these barriers is $10 billion per year (Winston, Crandall, and Maheshri, 2011).

Health Services

The medical profession, like the legal profession, broadly regulates the practice of medicine. Just as the regulation of lawyers requires extensive training even for certain types of jobs that do not require it, so, too, physician licensing laws prevent those without extensive medical training from dispensing relatively simple advice without the same advanced training required for more complex services.

To their credit, twenty-three states allow “nurse practitioners” to practice without supervision by a physician. These professionals generally must take twelve to sixteen months of classes after college, including clinical courses that provide experience treating patients. Although they earn less than half of what physicians make, studies show their care on routine matters is at least as good as that given by physicians. The example of nurse practitioners suggests that the medical profession may, in some respects, represent a better licensing model than the legal profession.

does. Instead of barring everybody from engaging in the generally defined “practice of medicine” unless they have had extensive education and examination, the medical profession recognizes specialties such as nurse practitioners or chiropractors, who can offer quality patient care in appropriate circumstances at lower cost. State medical licensing laws, however, are still far from optimal. We discuss below some ways federal law may be used to break down unreasonable state barriers. But the example of gradations of licensing, even in the important and high-risk field of medicine, suggests that uniform and inflexible lawyer licensing is not the only possible model.

Drug Approval and Liability

Before a drug manufacturer can sell a drug to the public, the drug must undergo extensive testing and approval by the federal Food and Drug Administration. This process requires that the drug be not only safe, but also effective. After the drug is sold to the public, drug manufacturers continue to face litigation for harms caused by the drug they may or may not have foreseen prior to sale. The cost of the testing and approval process, risk of lost research and development costs from non-approval, and potential tort liability for approved products significantly reduce the returns from the development of new drugs by reducing the number of drugs that can be expected to be profitable. The costs of tort liability for FDA-approved drugs, in particular, are exacerbated by the exposure of pharmaceutical companies to claims under numerous state laws. Because courts focus on several different factors in determining which state’s law applies, a drug company may not be able to determine at the time of manufacture which legal standard will apply to its conduct. Markets clearly are a reasonable alternative to some regulation. Consumers have good reason to buy drugs only from reputable firms. Firms therefore have strong incentives to develop and nurture reputations for safe and effective products. Consumers also will be reluctant to buy drugs without adequate information. Unlike the early days of drug sales, which gave rise to the Food and Drug Act, significant information from sellers, competitors, health organizations, and other third-party intermediaries and other consumers is cheaply and readily available on the Internet. Pharmaceutical companies will find little market for their products if they refuse to disclose information about them.

The question is how much and what type of regulation efficiently balances the risk of harm from bad products against the potentially significant loss of valuable innovation from over-regulation. The current system poses a high likelihood of over-regulation because of its combination of the costly FDA drug approval process with the potentially high costs of state tort liability. Federal regulators have a significant incentive to over-regulate because they get none of the advantages from beneficial drugs but potentially bear the blame for approving products that prove unsafe. State tort law is particularly problematic because it exposes manufacturers to unpredictable risks, the high administrative costs of the U.S. legal process, and state competition to attract litigation, which can benefit lawyers at consumers’ expense. Further, regulators face strong incentives to resolve doubts about safety against approval because they are more likely to be blamed and punished for unsafe drugs than for the drugs that consumers never see.

In light of the high costs of the tort system, it seems clear that tort liability need not be combined with FDA regulation in its current form. If FDA regulation is retained, one possible minimal reform is for states to deny punitive damages in state tort litigation for drugs that have been approved by the FDA. Alternatively, or in addition to this measure, the federal government should consider dropping the efficacy requirement for FDA approval and letting the market determine that outcome.

Education

Admittedly, there are many aspects of effective K–12 reform. One concerns the optimal compensation and incentive system for teachers. On the one hand, lockstep seniority compensation does not reward good performance.
On the other hand, tying teacher compensation to student performance on standardized tests can have perverse impacts: teaching to the test and thus stifling creativity, or providing incentives for cheating, which has occurred all too frequently in school systems across the country.

K–12 education in the United States has other notorious shortcomings. Although the field seems ripe for innovation, new developments have been limited as a result of powerful resistance by teachers’ unions. In addition, rigid state laws defining who can teach students prevent many highly motivated and experienced people from other walks of life from becoming teachers in their second or third careers.

There also are questions concerning the measurement of student performance, teaching methods, and curriculum. The main response to these challenges has been the imposition of rigid national testing standards through the federal No Child Left Behind law. While debate certainly will continue over the merits of this law, there is clearly room for more reform ideas.

Charter schools already provide valuable experimentation and helpful competition with public schools. Yet laws in many states sharply restrict approval of charter schools. Apart from the problems this causes in states themselves, these laws also may impede the growth of national charter school organizations that could take advantage of economies of scale to develop and test new types of certification, curricula, student testing, and teacher compensation. The patchwork of state regulation has stifled competition and limited innovation in public education to the detriment of its customers—its students and our future generations.

Other Occupational Restrictions

Occupational licensing has spread through the economy like a virus, creating new regulated professions daily, including, among many others, witches, tour guides, horse teeth floaters, and cat groomers. Licensing regulation enables incumbent providers to thwart competition and innovation by raising entry barriers to entrepreneurs who may be able to deliver these services at lower cost and/or higher quality. To the extent public safety is a concern, tort liability for negligence and fraud would adequately protect the public.

These are not new observations. The costs and inefficiencies of occupational licensing regimes were thoroughly documented in a comprehensive study conducted by Morris Kleiner in 2006 (Kleiner) and updated in Kleiner’s collaborative work with President Obama’s choice for Chairman of the Council of Economic Advisors (Kleiner and Krueger, 2010). In 2008, nearly 30 percent of the U.S. workforce was required to hold a license, up from just 10 percent in 1970 (Kleiner, 2011). The challenge for state and local governments is to begin acting on the ample body of research that indicates the inefficiencies and costs of excessive occupational licensing.

Finance

The refinements and translations of ideas into commercially viable goods or services requires capital. The federal securities laws allow startup firms to raise money by providing a mechanism that guarantees to investors that the firms’ disclosures are truthful. However, if taken too far, these disclosure obligations can be a powerful drag on innovation and entrepreneurship by actually impeding fundraising by new firms. The federal Securities Act of 1933 requires that a firm issuing a “security” must undergo an extensive, costly, and tricky registration process. The term “security” is a large umbrella term that courts have held to include “investment contracts,” which can be any kind of investment scheme, no matter how small. The Act, as well as decades of rules promulgated by the Securities and Exchange Commission, provides a wide array of complex exemptions that can trap legally unwary entrepreneurs.

The federal securities laws have created a legal minefield for even the smallest businesses seeking any sort of funding. An example is “crowd funding,” by which small entrepreneurs can seek small contributions from many
investors through Internet sites such as Kiva, Kickstarter, and IndieGoGo. These fundraising efforts may constitute securities offerings under the Securities Act of 1933, thus subjecting the entrepreneurs to registration requirements unless they are able to find an exemption. Further, the websites themselves are subject to potential liability as brokers or investment advisers. (We note, approvingly, that the Administration has proposed some regulatory adjustments in this area, and that there is some interest and support in Congress for widening existing exemptions to permit more crowd funding).

The burdens imposed by the securities laws on small firms do not stop with initial fundraising. The Sarbanes-Oxley Act imposes onerous monitoring requirements, particularly regarding internal controls auditing. These requirements affect smaller firms especially because the cost of establishing monitoring systems are similar regardless of firm size, and because younger and more innovative firms tend to have more challenges anticipating and solving internal controls issues. Even assuming that internal controls reporting helps investors and thus decreases the costs of capital (holding other factors constant), at some point the direct costs of internal controls and the indirect costs of discouraging risk-taking exceed the benefits of reporting. Considerations such as these led Congress to include an exemption from audited internal controls reporting in the Dodd-Frank financial reform law for firms with less than $75 million in market capitalization. However, this exemption still leaves many relatively small public firms subject to mandates better suited to larger firms, and deters exempted firms from growing out of the exemption.

The Kauffman Foundation has promoted an even better solution to Sarbanes-Oxley, one developed by Professors Henry Butler and Larry Ribstein. That idea, at least as proposed in the Startup Act, would permit the shareholders of firms with capitalization under $1 billion to choose whether their firms will be SOX-compliant, and specifically whether to comply with the internal controls auditing requirements of that law. An alternative approach would be to give all newly public firms the ability to opt out of SOX compliance within, say, the first five years of going public. This second alternative would not limit choice to firms below a certain size, and thus would give companies with much larger IPOs or later valuations the ability to choose whether to comply. In either case, the theory behind shareholder choice is that SOX was enacted to protect shareholders. Why not permit shareholders to make the benefit-cost calculation whether SOX compliance benefits the company’s share price (or its volatility) or not? This is surely a better alternative than imposing a one-size-fits-all benefit-cost determination by federal policy makers.

Approaches for Reducing/Eliminating Barriers to Innovation and Entry

We now turn to new approaches to lawmaking that can broadly reduce barriers to entry for entrepreneurs and encourage competition among existing businesses.

Some of these suggestions involve relatively straightforward recommendations to Congress to modify federal regulation. The more interesting challenge, however, is how to reduce or eliminate entry barriers in law, health services, and education that are maintained by states and localities. The balance of this essay surveys the main options, indicating our preference for one in particular, namely, mandatory mutual recognition, and closes by discussing how productive change at the state and local levels might come about.

Limits on Federal Regulation

Some federal regulation, despite laudable objectives, overreached and imposes burdens that disproportionately affect small firms. Examples already cited include the 1933 Securities Act and the Sarbanes-Oxley Act, both of which impair firms’ ability to raise capital.

Modifications of these particular laws can only be implemented at the federal level. However, legislation is not necessarily the only option. For example, while statutory change would be necessary to provide shareholder choice
for firm compliance with the provisions of SOX, regulatory change by the SEC could remedy the crowd-sourcing problem.

More broadly, all new major federal rules (those with an impact of $100 million or more, as defined by the Office of Management and Budget or the Congressional Budget Office) should be subject to sunset and review requirements, while all new regulations should pass a common-sense benefit-cost test. Each of these reforms is featured in the proposed federal Startup Act.

**State Experimentation**

State regulation can be obstructive, particularly in such areas as professional licensing and liability, which in turn affects businesses nationwide. However, state experimentation can be positive as well. As already noted, some states have liberalized licensing of nurse practitioners and charter schools. Over time, as more positive experiences are gained from these experiments, the lessons will, we hope, spread to other states. State regulation also can offer alternative approaches that are more likely than federal regulation to take into account diverse local and regional situations and to evolve to reflect ever-changing conditions.

The broad challenge is to rein in regulation that unduly restricts innovation, such as the regulation of lawyers and health professionals discussed above, while encouraging useful state experimentation. To some extent, market forces and the mobility of people and firms can effectuate change over time. Regulated parties can avoid states with harsh regulation more easily than they can federal regulation. Their customers and consumers who are left behind can be a political force for deregulation (O’Hara & Ribstein, 2009).

State reform can take a long time, however, especially when interests that benefit from the status quo almost certainly will defend it against meaningful change. The potential role of the federal government in meaningfully accelerating this process is, then, a natural point of interest.

One potential means is constitutional litigation.

Baseless regulation can run afoul of the due process or equal protection clauses. Discrimination against interstate commerce may be unconstitutional under the “dormant” commerce clause. While the Supreme Court may use these doctrines to limit the worst regulations, doctrinal development at the constitutional level is a slow and uncertain process. Its pace obviously depends on the composition of the Court and, in any event, is inherently slowed by the doctrine of stare decisis, which gives deference to existing precedents.

The following sections suggest two alternative approaches by which the federal government’s power could be harnessed to speed up the dismantling or easing of onerous state rules that limit entrepreneurial activity.

**Federal Preemption**

One obvious approach to controlling state barriers to innovation is for the federal government simply to preempt state laws that limit competition in the areas already identified and substitute a single, more entrepreneur-friendly law that applies nationwide. Preemption would bypass the slow process of state evolution and fill the substantial space left by constitutional protections, but it also runs the risk of imposing ill-suited requirements on all states. Broad preemption also would stop useful state experimentation and very likely not adapt well to changes in technologies and voter preferences. Moreover, there may be formidable difficulties assembling a coalition at the federal level to overturn state statutes that are supported by powerful local interest groups.

Further, Congress also often does not make the preemptive effect of federal laws clear, leaving a significant role for federal courts and administrative agencies to interpret Congressional intent. The subsequent judicial and agency actions may depend as much on a decision-maker’s regulatory philosophy as on the language of the federal statute. A recent memorandum issued by President Obama illustrated the importance of regulatory philosophy to preemption by articulating:
“...the general policy of my Administration [is] that preemption of State law by executive departments and agencies should be undertaken only with full consideration of the legitimate prerogatives of the States and with a sufficient legal basis for preemption. Executive departments and agencies should be mindful that in our Federal system, the citizens of the several States have distinctive circumstances and values, and that in many instances it is appropriate for them to apply to themselves rules and principles that reflect these circumstances and values. As Justice Brandeis explained more than 70 years ago, ‘[i]t is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.’”4

There is an inherent tension, however, between the salutary “laboratory” Justice Brandeis envisioned and a single powerful state, the federal government, effectively imposing its regulatory views on the whole country. Although the Presidential memorandum recognizes the possibility of a “legal basis” for preemption, administrative agencies have significant discretion in finding such a basis, and the memorandum places a thumb on the scale against exercising this discretion to preempt. This can be significant in a case like Wyeth v. Levine (2009) where the Supreme Court allowed a case to proceed against a drug manufacturer based on an FDA-approved label because Congress had not explicitly preempted liability under state law.

One possible approach is for the courts to adopt the opposite presumption from that suggested in the President’s memorandum in certain types of cases where federal action is especially justified to remove state law barriers to interstate commerce. This would effectuate the Commerce Clause’s purpose by empowering Congress to lift excessive state law barriers to interstate commerce, such as state tort liability for drug-related health problems and injuries (O’Connor & Ribstein, 2011).

An alternative approach would be to enable manufacturers to choose between regulation and tort liability. Where the manufacturer elects FDA regulation, tort liability would be preempted. A manufacturer that bypasses the FDA approval process would be subject to state tort liability and required to clearly disclose the lack of FDA approval to consumers (Rubin). This could give innovative drugs an additional path to market by letting manufacturers that are confident in the safety of their drugs bypass regulators who may have over-cautious tendencies.

**Federal Protection of State Experimentation**

A middle ground between a single preemptive federal law and continuing experimentation at the state level would be for the federal government to set ground rules for states’ enforcement of other states’ regulatory decisions. This approach could take advantage of state diversity and experimentation while invoking limited federal power to protect firms from the potential chaos of multiple state regulatory regimes.

The Supreme Court decided on such an approach for consumer credit more than three decades ago. Prior to 1978, state and national banks were subject to state usury laws. Not only did usury rates vary from state to state, but the rule concerning which usury rate applied, the state of the borrower’s residence, the place of contract, or the bank’s home state, also varied (O’Connor & Ribstein, 2011). However, in the 1978 Marquette decision, the Supreme Court upheld the National Bank Act, which permitted national banks to charge the rate determined by the state in

---

which the bank is chartered. This rule was later extended to state-chartered banks and credit card fees.

The European Union has taken a similar approach. The Treaty of Rome guaranteed the “four freedoms” of movement of goods, services and establishment, persons and citizenship, and capital.⁵ These general principles underlie “mutual recognition,” a standard established by the European Court of Justice, which limits the extent to which European member state laws can be applied to burden commerce among member states. In general, host countries cannot bar people or firms based in other countries from doing business locally or discriminate against them in favor of local firms.⁶ For example, in contrast to the regulation of attorneys in the United States, a lawyer licensed in one European country cannot be barred from practice by another. However, the “host” country can apply some of the rules it applies to local firms to “foreign” firms, as well.

The United States could follow a similar approach for state licensing by mandating a “driver’s license” or “single passport” model to replace the current state licensing requirements, which vary drastically. This would permit providers of legal, health, and education services authorized in some states to engage in the same activities in other states.

More specifically, the “driver’s license” approach would require a state to authorize any professional licensed in his or her home state to practice in the host state. For example, a person licensed as a “business counselor” in Illinois could offer certain legal, accounting, and financial services in any state, including one that would require residents offering such services to obtain a license to practice law. A similar approach would apply to nurse practitioners or chains of charter schools.

Such a “driver’s license” or “mutual recognition” approach has several advantages over complete federal preemption. Most importantly, it does not impose a uniform model on all states, but rather lets states experiment with different approaches. This enables firms to pick regulatory regimes that best suit their businesses and the states to compete to provide the optimal regulatory balance. Productive change may occur more quickly if one or a few states make bold changes that catch on throughout the country, as opposed to trying to assemble a coalition of sufficient strength at the federal level to mandate a single federal law.

The main challenge of such an approach is to permit state experimentation without facilitating a “race to the bottom,” where the most lax state regime dominates. Each state has incentives to regulate the safety of services rendered by locally based practitioners to the states’ own residents. Under mutual recognition, these incentives would apply to practitioners’ licenses in other states. Furthermore, it is important to recognize that host states could regulate unsafe conduct without using their licensing laws to bar entry to the licensees of other states.

Although mutual recognition would continue to allow states to restrict the activities of their resident practitioners, it could put significant pressure on states to liberalize these restrictions. Once “foreign” providers of services are doing business in a “host” state that may not permit its own residents to practice under such circumstances, consumers and potential providers may press legislators to level the playing field so that home-state providers can offer the same services under the same conditions. This pressure would counteract the strong vested interests favoring existing barriers to entry.

Indeed, entrenched interest groups, perceiving mutual recognition as the proverbial nose under the tent
of even more controversial steps, may vigorously oppose federal regulation mandating this approach. On the other hand, mutual recognition might emerge as a workable compromise between those favoring complete federal preemption of state law and those insisting on maintaining the current state barriers to innovation.

The driver’s license approach would not solve all problems of multistate regulation. States still might impose diverse and burdensome disclosure measures or other regulations that could impede innovation by national firms. However, there are two broad ways in which sensibly tailored and limited federal preemption can address this problem while still allowing state variation.

First, federal law could limit particular types of state regulation that create the greatest barriers to innovative national firms. For example, federal law could provide for a driver’s license or mutual recognition approach and clarify which activities are governed by the practitioner’s or firm’s home state law, mandate certain minimum disclosure requirements, and preempt state disclosure rules. Federal law then could promote consumer awareness of the applicable regulatory regime, similar to the notice of federal drug approval discussed above, and then let the market evaluate the various regimes. Since most providers likely will be regulated under local law, a notice that some other law applies is likely to put consumers on guard. Providers will have an incentive to obtain local licenses except where another regime provides significant beneficial flexibility. This regime would be similar to current business association law, where firms are subject to the governance law of the chartering state and only to federal disclosure law, at least for large and interstate transactions.

Second, an alternative to the driver’s license approach, which may be appropriate in some contexts, is to enable firms to obtain federal charters for the lines of business we have discussed. States then would be required to recognize this charter and any accompanying information disclosure regime. This “dual chartering” approach has been used in the banking industry since the Civil War and could be adopted easily for legal, health, and education services, among others. As with the driver’s license, federal chartering could put competitive pressure on excessively strict state regulation.

Conclusion: The Political Economy of Change

This essay has discussed some approaches to changing state and federal law to reduce legal barriers to entry for innovators and entrepreneurs. In discussing this, one must ask the question of how to reduce political barriers erected by entrenched incumbent interest groups. There are several ways such a challenge could be overcome.

First, over time the electorate must be educated concerning the social costs of imposing barriers to entry for innovators. The interest groups that support these laws are quick to warn about the risks of new products, services, and business structures. It is important to counter these arguments by illustrating more clearly the costs of barriers to entry. These educational efforts might have particular traction at a time when society is searching for new ways to create jobs without spending more taxpayer money. Education ultimately convinced voters to accept deregulation of the transportation industry and could work now to open up other industries to innovation.

Second, the accumulating and increasing burden of more state and federal laws eventually will reach a point where even those who once were sympathetic with the goals of such regulation will recognize the costs. This includes large corporations stymied by increased regulation, consumers blocked from access to low-cost legal and medical services and products, and families deprived of better education for their children. Indeed, the need to drop barriers to innovation has become a civil rights issue in some of these contexts.

Third, increased global competition and the quickening pace of technology mean that government no longer
can contain innovation at the behest of strong interest groups. Consumers increasingly can obtain the goods and services they want that slip through the regulatory walls in the United States and abroad. For example, the United Kingdom, Europe, and Australia are deregulating their legal professions and soon will demonstrate the full potential of legal services and information products that are barred in the United States. It will be difficult to keep the doors barred in this country when consumers see what is available and functioning in other countries. Indeed, a working group of the American Bar Association published a report in April 2011 seeking feedback on different ownership structures for law firms.7

Fourth, these innovators, coupled with the rise of a new generation that has no vested interest in the status quo, will form interest groups that rival and ultimately exceed the power of the passing generation. At some point, this new wave will create a new and more innovative and entrepreneurial status quo.

SOURCES


Members of the
Kauffman Foundation Task Force
on Entrepreneurial Growth

Brian Broughman
Brink Lindsey
Anthony Luppino
Karl Okamoto
Mark Suchman

Robert Litan*
Larry Ribstein*

*Primary Drafters