

Functional, Overlapping, Competing Jurisdictions: Redrawing the Geographic Borders of Administration

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A. Decentralisation and Administrative and Political Competition

The primary task of democratic governments is to provide those goods and services desired by the population, which are not provided by the market in a satisfactory way. The basic idea of the economic approach to federalism is that decentralized government activity serves to better meet the preferences of individuals, when such goods and services are produced. The notion of competition is transferred from the market to government. The role of firms competing for the outlays of consumers is substituted by governmental jurisdictions seeking to attract individuals and firms by offering them an attractive combination of public services and taxes. In both cases, the constitution has to establish the terms under which this competition takes place. In the case of the market, the most important condition is the guarantee of property rights, in the case of federalism the allocation of the power to tax. Yet there is an important difference between market and federal competition. The first is based on consumers (buyers) being able to choose between various suppliers. The second additionally establishes competition between political suppliers for votes.¹ The goods and services offered by government can more narrowly be geared to those demands which differ according to geographical location:

- geography and physical characteristics, e.g. between mountainous regions and plains; or between rural areas and cities;
- ethnicity, culture and traditions;
- economic structure, e.g. with respect to the share of agricultural and industrial production and services; and

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¹ See *J.A. Schumpeter*, *Capitalism, Socialism and Democracy* (1st ed.), New York 1942; *A. Downs*, *Anthony*, *An Economic Theory of Democracy*, New York 1957; and *A. Breton*, *Competitive Governments. An Economic Theory of Politics and Public Choice Finance*, New York 1996.

- social structure, e.g. with respect to income distribution, the share of young families with children and retired persons.

These differences obviously lead to varying demands for public activity, e.g. with respect to the expenditures desired for education or social services. In a purely technocratic concept of politics, a centralized government can meet such geographically differing demands. But such a notion utterly neglects human behavior, and essentially assumes an omniscient and benevolent social planner. A long time ago, Smith for the economy,² and Hayek for society as a whole,³ rejected this idea from the theoretical point of view. The sudden collapse of the Soviet-style countries demonstrated that this notion neither worked in reality. In the political sphere, decentralization has clear informational advantages because local politicians and administrators are better aware of the local needs and constraints. Even more important are the incentives motivating local governmental decision-makers to care for the wishes of the local population that elects them.

The Economic Theory of Federalism⁴ has focused on four important theoretical elements of decentralization:

*Fiscal Equivalence*⁵ — Each jurisdiction should extend over geographical space in such a way that the recipients of the benefits and the tax payers correspond as closely as possible. Spatial external effects – positive spillovers where nonpayers benefit from public services, and negative spillovers where outsiders are burdened with costs – are therewith evaded. The various public activities are to be attributed to the most appropriate government level.

*Clubs*⁶ — These are institutions offering public goods – i.e. goods from whose benefits nobody can be excluded – to its members, only. The optimal size of a club is reached when the marginal utility received, corresponds to the marginal cost induced by an additional member. A club thus has a limited spatial extension, and only those persons are to be admitted who are prepared to carry the marginal cost they impose.

² A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, New York 1776 (reprinted 1980).

³ F.A. von Hayek, *The Constitution of Liberty*, London 1960. F.A. von Hayek, *Competition as Discovery Procedure*, in F.A. von Hayek (ed.), *New Studies in Philosophy, Politics, Economics and the History of Ideas*, London 1978, pp. 119-130.

⁴ W.E. Oates, *Fiscal Federalism*, New York 1972; W.E. Oates, (ed.), *The Political Economy of Fiscal Federalism*, Lexington 1977; R.M. Bird, *Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralization*, 46 *National Tax Journal* 1993, pp. 201-221. R.P. Inman & D. Rubinfeld, *The Political Economy of Federalism*, in D.C. Mueller (ed.), *Perspectives on Public Choice: A Handbook*, Cambridge 1997, pp. 73-105.

⁵ M. Olson, *The Principle of 'Fiscal Equivalence': The Division of Responsibilities among Different Levels of Government*, 59 *American Economic Review* 1969, pp. 479-487. See also, Oates, *Fiscal Federalism*, 1972, *supra* note 4; M. Olson, *Towards a More General Theory of Governmental Structure*, 76 *American Economic Papers and Proceedings* 1986, pp. 120-125.

⁶ J.M. Buchanan, *An Economic Theory of Clubs*, 32 *Economica* 1965, pp. 1-14.

*Voting by Foot*⁷ — Competition between jurisdictions is brought about by citizens' mobility. Public jurisdictions can be considered as enterprises offering local services in return for taxes. The citizens migrate to those jurisdictions that have the most favorable relationship between services and tax prices. The induced competition forces the jurisdictions to take the citizens' wishes into account and to supply services at the lowest cost possible. The same holds for the location decision of firms.

*Exit and Voice*⁸ — In addition to being able to choose between the supply of various jurisdictions, citizens may also participate in the political decisions of the jurisdictions they belong to either by voting in elections or by referenda. They may moreover make themselves heard by protests, demonstrations, strikes and uprisings. Initially, exit and voice were seen as substitutes. A citizen choosing to leave a jurisdiction has little incentive to take the trouble of protesting. However, the relationship may, under particular conditions, be complementary. Thus, when the government of the GDR had to grant exit to its citizens (via Hungary to the West), this was generally interpreted as a sign of weakness of the Communist regime. As a consequence, demonstrations were perceived to be less dangerous and more promising, and therefore grew into a mass movement (the so-called 'Monday Demonstrations') eventually forcing the resignation of the regime.

Most countries in today's world, in particular the large ones, have a federal constitution. Prominent examples are the United States and Canada in North America; Mexico, Argentina and Brazil in South America; Germany and Russia in Europe; or India in Asia. Recently, some formerly highly centralized countries such as Spain and the United Kingdom have experienced strong decentralization tendencies. Centralized countries such as France or the Netherlands have become an exception but it should also be noted that federalism has been notably undermined by the central government in many countries, examples being the United States and Germany. 'Federal' countries exhibit vastly different extents of decentralization and of competencies attributed to lower levels of the governmental organization. For federalism to work in a satisfactory way, there are two crucial conditions to be met:

First, the subunits must have the *power to tax* citizens for the functions they perform. This forces them to balance the benefits and costs of government activities. At the same time, this gives the subunits a certain degree of independence from the central government. This requirement is not met in most 'federations'. As a consequence, local politicians engage in widespread rent seeking activities with the central administration. They have to please the political decision-makers in the center to obtain funds. Once granted, they have

⁷ C.M. Tiebout, A Pure Theory of Local Expenditure, 64 *Journal of Political Economy* 1956, pp. 416-424.

⁸ A.O. Hirschman, *Exit, Voice and Loyalty*, Cambridge, 1970; See also, A.O. Hirschman, *Exit, Voice, and the Fate of the German Democratic Republic*, 45 *World Politics* 1993, pp. 173-202.

few incentives not to spend them completely as such funds have the character of a 'free good'. The local politicians' rent seeking activities also encompass subsidies to cover budget deficits. Such an institutional landscape fosters fiscal irresponsibility at the local level. As this 'irresponsibility' is a direct consequence of the high degree of centralization, it does not occur when the local politicians have the competence to balance revenues and expenditures in their own jurisdiction. If it turns out that they are incapable of doing so, the citizens will throw them out of office.

This points to the second crucial condition for a well-functioning federalism. The local politicians must be *elected by the citizens of their jurisdictions*, and not by a larger electorate, let alone being appointed by the central government. This requirement aligns the politicians' incentives with the wishes of the local population.

Most presently existing federal governments do not meet these two requirements, or do so only to a small degree. For that reason, a new type of federalism is proposed which seeks to combine the four aspects of federalism discussed above:

- it meets the condition of 'fiscal equivalence' by suggesting a network of multiple and overlapping governmental units;
- it is based on well-defined members and administrative boundaries according to the public functions to be performed and thus is comparable to a 'club';
- it is competitive by allowing exit and entry of members according to the 'voting by foot' mechanism; and
- it adds political competition via elections and referenda and thus enables 'voice'.

This new concept for administrative decentralisation – denominated by the acronym 'FOCJ' according to '*Functional, Overlapping, Competing Jurisdictions*' is proposed in section II. Section III discusses the strengths and weaknesses of FOCJ, and the following section IV refers to historical and contemporary examples of similar governmental units. Section V offers concluding remarks.

B. A Network of Competing Administrative Units

The federal units here proposed are called 'FOCJ' according to the acronym of its essential characteristics:⁹

⁹ The concept is the result of joint research with Reiner Eichenberger. See *B.S. Frey & R. Eichenberger, Competition among Jurisdictions. The Idea of FOCJ*, in *Lüder Gerken (ed.), Competition among Jurisdictions*, London 1995, pp. 209-229; *B.S. Frey & R. Eichenberger, FOCJ: Competitive Governments for Europe*, 16 *International Review of Public Economics* 1996, pp. 315-327; *B.S. Frey & R. Eichenberger, The New Democratic Federalism for Europe: Functional Overlapping and Competing Jurisdictions*, Cheltenham 1999.

1. *Functional (F)*: The new governmental units extend over areas defined by the tasks or functions to be fulfilled;
2. *Overlapping (O)*: In line with the many different tasks (functions) there are corresponding governmental units extending over different geographical areas which necessarily intersect;
3. *Competing (C)*: Communes – or in certain cases individuals – may choose to which governmental unit they want to belong, and they have political rights to express their preferences directly via initiatives and referenda;
4. *Jurisdictions (J)*: The units established are governmental, they have enforcement power and can, in particular, levy taxes.

FOCJ form a governmental system in an essential aspect differing from the one suggested in the traditional Economic Theory of Federalism. This theory analyzes the behavior of *given* political units at the different levels of government, while FOCJ *emerge* in response to the '*geography of problems*'.¹⁰ The four elements of FOCJ are now discussed in more detail.

I. Functions

A particular public service that benefits a certain geographical area should be financed by the people living in that area, i.e. there should be no spill-overs. The different governmental units can cater for differences in the populations' preferences or, more precisely, to the citizenry's demands. To minimize cost, these units have to exploit economies of scale in production. As the latter may strongly differ between functions (e.g., between schools, police, hospitals, power plants and defense) there is an additional reason for uni-functional (or few-functional) governmental units of different sizes. This endogeneity of the size of governmental units constitutes an essential part of FOCJ.

II. Overlaps

FOCJ may overlap in two respects:

¹⁰ The general idea of FOCJ may be found in *C.L. Montesquieu, De l'esprit des lois*, Paris 1749; *J. Burnheim, Is Democracy Possible?: The Alternative to Electoral Politics*, Cambridge 1985, also discusses several elements. In economics, a related idea has been suggested by *G. Tullock, The New Federalist*, Vancouver 1994; *A. Casella & B.S. Frey, Federalism and Clubs: Towards an Economic Theory of Overlapping Political Jurisdictions*, 36 *European Economic Review* 1992, pp. 639-646, discuss the concept and refer to relevant literature. *Centre for Economic Policy Research (CEPR), Flexible Integration. Towards a More Effective and Democratic Europe*, London 1995, develops the idea of *flexible integration* where all the members of the future EU would have to participate in a 'common base' comprising the four freedoms but also the transfer programmes, and may opt to enter 'open partnerships'.

FOCJ catering to different functions may intersect; Two or more FOCJ catering for the same or different functions may geographically intersect (a large number of school-FOCJ may, for instance, exist in the same geographical area). An individual person or a political community normally belongs to various FOCJ at the same time. FOCJ need not be physically contiguous, and they need not have a monopoly over a certain area of land. This concept therefore completely differs from archaic nationalism with its fighting over pieces of land. It also breaks with the notion of federalist theory that units at the same level may not overlap.

III. Competition

The heads of FOCJ are induced to conform closely to their members' preferences by two mechanisms:

The individuals' and communities' possibilities to *exit* mimics market competition. Migration is only one means of exit. Membership in a particular FOCUS can often be discontinued without changing one's location. Exit is not restricted to individuals or firms; political communities as a whole, or parts of them may also exercise this option. Moreover, exit may be total or only partial. In the latter case, an individual or community only participates in a restricted set of FOCUS activities. For FOCJ to effectively establish competition between governments, exit should be as unrestrained as possible. In contrast, entry need not necessarily be free. As for individuals in Buchanan-type clubs, jurisdictions and individuals may be asked a price if they want to join a particular FOCUS and benefit from its public goods. The existing members of the particular FOCUS have to democratically decide whether a new member pays an adequate entry price and thus is welcome.

The right to *vote* establishes political competition. The citizens must be able to directly elect the persons managing the FOCJ, and should be given the right to initiate popular referenda on specific issues. These democratic institutions are known to raise efficiency in the sense of meeting individual preferences¹¹.

IV. Jurisdictions

A FOCUS is a democratic administrative unit with authority over its citizens, including the power to tax. According to the two types of overlap, two forms of membership can be distinguished:

The lowest political unit (normally the political communes), and all corresponding citizens automatically become citizens of the FOCJ to which their

¹¹ For elections, see: *A. Downs*, *An Economic Theory of Democracy*, New York 1957; *D.C. Mueller*, *Public Choice II*, Cambridge 1989. For referenda see, *T.E. Cronin*, *Direct Democracy. The Politics of Initiative, Referendum and Recall*, Cambridge 1989; *B.S. Frey*, *Direct Democracy: Politico-Economic Lessons from Swiss Experience*, 84 *American Economic Review* 1994, No. 2, pp. 338-348.

community belongs. In that case, an individual can only exit via mobility.

Individuals may freely choose whether they want to belong to a particular FOCUS. While they are its citizens, they are subject to its authority. Some FOCJ may be non-voluntary in the sense that an individual must belong to a FOCUS providing for a certain function. For instance, a citizen has to belong to a school-FOCUS, and must pay the corresponding taxes (an analogy here is health insurance which in many countries is mandatory but where individuals are allowed to choose an insurance company). The citizens of such a school-FOCUS may then decide that everyone must pay taxes in order to finance a particular school, irrespective of whether one has children. With respect to FOCJ providing functions with significant redistributive effects, a minimal regulation by the central government may grant that, e.g., citizens without children do not join 'school-FOCJ' which in effect do not offer any schooling and therefore have correspondingly low (or zero) taxes.

C. Strengths and Weaknesses of FOCJ

I. Advantages

FOCJ compare favorably to traditional forms of federalism with respect to the governments' incentives and possibilities to satisfy heterogeneous preferences of individuals. Due to the concentration on one functional area, the citizens of a particular FOCUS have better information on its activity, and are in a better position to compare its performance to other governments. As many benefits and costs extend over a quite limited geographic area, FOCJ often tend to be small, which is also helpful for voters' evaluations. The exit option opened by the existence of overlapping jurisdictions is also an important means to make one's preferences known to governmental suppliers.

FOCJ are moreover able to provide public services at low cost because they are formed in order to minimize interjurisdictional spill-overs and to exploit economies of scale. When the benefits of a specific activity indivisibly extend over large areas, and there are decreasing cost, the corresponding optimal FOCUS may cover many communities, several nations, or even Europe as a whole. Defense against outward aggression may be an example where the appropriate FOCUS may extend over the whole of Europe (even beyond the European Union).

The threat of dissatisfied citizens or communities to exit a FOCUS, and the benefit of new citizens and communities joining, gives the politicians in charge an incentive to take the preferences of the citizens into account and to provide the public services efficiently. FOCJ may also break up the politicians' cartel to competent outsiders. While all-purpose jurisdictions attract persons with broad and non-specialized knowledge to become politicians; in FOCJ, persons with a well-grounded knowledge in a particular functional area (say education or refuse collection) are successful.

A federal web composed of FOCJ certainly affects the role of the nation-states. They will certainly lose functions they presently do not fulfil according to the population's preferences, or which they produce at higher cost than FOCJ designed to exploit cost advantages. On the other hand, the scheme does not propose to do away with nations but allows for multi-national as well as small-scale alternatives where they are desired by the citizens. Nation-states subsist in so far as they provide functions efficiently according to the voters' preferences.

II. Alleged Problems

The following four disadvantages are often advanced against the concept of FOCJ.

Overburdened Citizens. In a federal system of FOCJ, each individual is a citizen of various jurisdictions. As a consequence, individuals may be overburdened by voting in elections and referenda taking place in each FOCUS. However, citizens in a direct-democratic FOCUS find it much easier to politically participate as they have only to assess one or a few concrete issues at a time.

Overburdened Consumers. An individual is confronted with a multitude of suppliers of public services which arguably makes life difficult. This is the logical consequence of having more options to choose from, and is similar to supply in the private sector. If citizens find it to be a problem, a governmental or a private advisory service can be established which offers information and support for the consumers' decisions.

'Need' to Co-ordinate the Activities of FOCJ. While co-ordination is obviously often needed, co-ordination between governments is not good by itself. It sometimes serves to build cartels among the members of the 'classe politique' who then evade or even exploit the population's wishes¹². As far as welfare increasing co-ordination is concerned, its need is reduced because the FOCJ emerge in order to minimize externalities. If major spill-overs between FOCJ exist, new FOCJ will be established by the citizens taking care of these externalities.

Redistribution. It has often been claimed that all forms of federalism - including FOCJ - undermine redistributive policies. This fear is unwarranted as the citizens still can express their solidarity towards persons with low income (in particular by establishing a FOCUS designed for redistribution). Moreover they can still undertake redistribution to insure themselves against future loss of income. Only as far as redistribution is a pure public good and thus must be enforced to prevent free-riding, a problem may arise. Recent empirical

¹² *Centre for Economic Policy Research (CEPR)*, Making Sense of Subsidiarity: How Much Centralization for Europe?, London 1993; *R. Vaubel*, The Political Economy of Centralization and the European Community, 81 *Public Choice* 1994, pp. 151-190. See also, *Frey*, Direct Democracy: Politico-Economic Lessons from Swiss Experience, pp. 338-348, *supra*, note 11.

research¹³, however, suggests that substantial redistribution is feasible in federal systems.

D. Historical and Actual Cases

Decentralised, overlapping political units have been an important feature of European history. The competition between governments in the Holy Roman Empire of German Nations, especially in today's Italy and Germany, has been intensive. Many of these governments were of small size. Some scholars attribute the rise of Europe to this diversity and competition of governmental units fostering technical, economic and artistic innovation¹⁴. While the Chinese were more advanced in many respects, their superiority ended with the establishment of a centralized Chinese Empire¹⁵. The unification of Italy and Germany in the 19th century - often praised as a major political achievement - partially ended this stimulating competition between governments and led to deadly struggles between nation states. Some smaller states evaded unification; Liechtenstein, Luxembourg, Monaco, San Marino and Switzerland stayed politically independent, and at the same time grew rich.

The above-mentioned governmental units were not FOCJ in the sense outlined in this contribution but they shared the characteristic of competing for labor and capital (including artistic capital) among each other. However, history also reveals examples of jurisdictions close to FOCJ. The problems connected with Poland's strong ethnic and religious diversity (Catholics, Protestants and Jews) were at least partly overcome by jurisdictions organized along these features, and not according to geographical boundaries¹⁶. The highly successful Hanse prospered from the 12th to the 16th century, and comprised inter alia Lübeck, Bremen, Köln (today German), Stettin and Danzig (today Polish), Kaliningrad (today Russian), Riga, Reval and Dorpat (today parts of the Baltic republics), Groningen and Deventer (today Dutch). London (England), Bruges and Antwerp (today Belgian) and Novgorod (today Russian) were

¹³ *S.D. Gold*, Interstate Competition and State Personal Income-Tax Policy in the 1980s, in *D.A. Kenyon & J.Kincaid (eds.)*, Competition Among States and Local Governments, Washington DC 1991, pp. 205-217; *G. Kirchgässner & W.W. Pommerehne*, Tax Harmonization and Tax Competition in the European Community: Lessons from Switzerland, 60 *Journal of Public Economics* 1996, pp. 351-371.

¹⁴ *F.A. von Hayek*, The Constitution of Liberty, London 1960; *E.L. Jones*, The European Miracle? (2nd ed.), Cambridge 1987; *E. Weede*, The Impact of Interstate Conflict on Revolutionary Change and Individual Freedom, 46 *Kyklos* 1993, pp. 473-495.

¹⁵ *Hung Mo Pak*, Effective Competition, Institutional Choice and Economic Development of Imperial China, 48 *Kyklos* 1995, pp. 87-103; *N. Rosenberg & L. E. Birdzell*, How the West Grew Rich. The Economic Transformation of the Industrial World, London 1986.

¹⁶ *G. Rhode*, Staaten-Union und Adelsstaat: Zur Entwicklung von Staatsdenken und Staatsgestaltung in Osteuropa, vor allem in Polen/Litauen, im 16. Jahrhundert, 9 *Zeitschrift für Ostforschung* 1960, pp. 185-215; *H. Haumann*, Geschichte der Ostjuden, 5th ed., München 1999.

Handelskontore or associated members. It was clearly a functional governmental unit providing for trade rules and facilities and was not geographically contiguous.

In two countries, functional, overlapping and competing jurisdictions exist (but they do not in all cases meet all the requirements of FOCJ specified above).

In the *United States*, *special districts* play a significant role in the federalist system, and their number has substantially increased over the last decades. While some of the special districts are dependent, others are both autonomous and democratically organized. According to empirical research¹⁷ the latter type is significantly more efficient. Not surprisingly, existing municipalities make an effort to prevent the emergence of these more efficient governmental units. Thus, for example, in various states a minimum population size is required and various administrative restrictions are imposed.

In *Switzerland*, there exists a multitude of governmental units some of which coming close to FOCJ. In addition to the 26 cantons there are roughly 8,000 communes of various forms. The most important are the 2,940 political communes which define citizenship (i.e. a Swiss is not citizen of the nation but of a political commune). These communes have considerable autonomy, in particular they have wide-ranging authority to impose income and property taxes. As a consequence, the tax rates between neighbouring political communes may strongly differ - a factor inducing political competition between communes, and bundles of public services and taxes favorable to the citizens. In addition to political communes, there are roughly 5,000 overlapping, functional special communes. The most important are school communes offering education for the children of one or several political communes. They are public jurisdictions levying their own taxes whose rate is determined by citizens' meetings. Other functional, democratic, and overlapping communes are those established by the protestant and catholic churches. A citizen may freely choose to which one he or she desires to belong, but once a member, one has to pay an appropriate tax. In addition to these and other types of communes there are many thousands of 'communal units' ('*Gemeindeverbände*' or '*Zweckverbände*') founded by the communes to deal with specific tasks such as canalization, hospitals, old age homes or refuse collection. These units have, however, no independent power to tax and there are rarely direct participation rights by the citizens. This short discussion of the Swiss federal system at the local level¹⁸ shows that FOCJ are a practical possibility but that they have not yet been developed to their full extent.

E. Concluding Remarks

In view of the major advantages of FOCJ the economist's standard question

¹⁷ S.L. Mehay, The Effect of Governmental Structure on Special District Expenditures, 44 *Public Choice* 1984, pp. 339-348.

¹⁸ See more extensively, J. De Spindler, FOCJ. Ein Konzept zur Neuordnung der Zusammenarbeit öffentlicher Gebietskörperschaften, Bern 1998.

arises: if this type of federalism is so good, why has it so far rarely been put into practice?

The organization of states today does not follow the model of FOCJ for two major reasons. An obvious, but crucial one, is that individuals and communities are prohibited from establishing such jurisdictions, and in many countries of the European Union, communities are not even allowed to formally collaborate with each other without the consent of the central government¹⁹.

Secondly, FOCJ violate the interests of politicians and public officials at higher levels of government. FOCJ reduce these politicians' power. It increases citizens' influence by introducing mechanisms of competition by exit and entry, and by direct democratic elements. Government politicians regularly oppose these institutions because they restrict their power.

A federal system of FOCJ will not arise if these barriers are not overcome. A necessary condition are new constitutional rules allowing the formation of FOCJ and giving to the citizens and to the governments the right to appeal to the Constitutional Court if they are blocked.

Functional, overlapping and competing jurisdictions certainly constitute only one step towards more effective public administration. But in view of the monopolistic organization of most, and often all, public activity, FOCJ may constitute a major advance toward a more democratic and at the same time more efficient society.

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¹⁹ L.J. Sharpe (ed.), *The Rise of Modern Government in Europe*, London 1993.

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