

# Competitive federalism, government's dual role and the power to tax

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**Abstract.** Theories of competitive federalism generally focus on *exit* as the principal mechanism for making governments responsive to the interests of those who are subject to their powers. This paper draws attention to the fact that democratic governments act in two distinguishable roles, as ‘territorial enterprises’ and as ‘club enterprises’. As *territorial enterprises* they define and enforce the rules and terms that apply to everybody, whether citizen or alien, who resides and/or operates within their jurisdictional boundaries. As *club enterprises*, they define and enforce the rules and terms of *membership* in the respective polity. The focus of this paper is on the implications of the fact that ‘exit’ means something different when one looks at governments’ role as territorial enterprises (exit = leaving the territory) in contrast to their role as club enterprises (exit = giving up one’s membership status/citizenship).

## 1. Introduction

In terms of Hirschman’s (1970) useful distinction, persons can respond to a government’s performance in two ways, by ‘voice’ and by ‘exit’, by voicing or not voicing discontent and by exiting from or remaining within the respective jurisdiction. They can seek to assert their interests via the political process, by voting and by lobbying. And they can ‘vote with their feet’, leaving a jurisdiction that offers them less attractive terms than they can find elsewhere. At least since Tiebout’s (1956) seminal essay ‘A Pure Theory of Local Expenditures’, economists have paid considerable attention to the fact that in a world in which people are free to move or to relocate their resources between jurisdictions the exit mechanism can help to align the interests of taxpayers with the services governments provide.<sup>1</sup> Tiebout’s contribution has stimulated a body of literature, in particular in public finance, on ‘competitive federalism’.

The present paper focuses on an aspect that has found little attention in the literature on competitive federalism, an issue that the founder of the German

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<sup>1</sup> That the exit option, i.e. the mobility of persons and resources between jurisdictions works as a constraint on government’s taxing power has often been recognized – See Vaubel (2008) for the history of thought on how the exit option serves as a constraint on government.

public finance journal *Finanzarchiv*,<sup>2</sup> Georg Schanz, raised more than one hundred years ago in an article entitled ‘On the issue of tax liability’. In this paper, Schanz argued that due to the mobility of persons and economic activities – primarily between local communities but more and more also across national boundaries – polities increasingly host people within their territory who are not their citizens while, at the same time, many of their own citizens operate in other jurisdictions (Schanz, 1892: 6). This fact, so Schanz (*ibid.*: 8) concluded, must be taken into account in taxation policy if a correspondence between taxpayers and beneficiaries of public services is to be maintained.<sup>3</sup>

In the sections that follow I shall take a closer look at the fact that, as suggested by Schanz, in a mobile world, a distinction must be drawn between two different capacities in which individuals may be subject to a state’s taxing power. On the one hand, they may be subject to the power of a state as a *territorial enterprise*, i.e. as the organization that defines and enforces the terms under which persons<sup>4</sup> are permitted to reside and/or to operate within its respective jurisdictional boundaries. On the other hand, they may be subject to the power of a state as a *club enterprise*, i.e. as the organization that defines and enforces the terms of membership in the polity. The focus of the argument to be developed below will be on the implications that follow from the fact that ‘exit’ has a different meaning when individuals act in their capacity as *citizens–members* as opposed to their capacity as, what I shall call, *jurisdiction users*. The emphasis will be on the difference between a government’s power to tax its own citizens *in their capacity as citizens*, and its power to tax *jurisdiction users*, aliens as well as its own citizens *in their capacity as jurisdiction users*.

## 2. The democratic polity as territorial enterprise and as club enterprise

A theory of taxation must have as its conceptual basis a theory of the state. How the state is conceived provides the criterion against which potential alternative theories of taxation are to be judged. The *democratic* polity, the principal subject of the present inquiry, is conceived here, following Rawls’s (1971: 84) well-known definition, as ‘a cooperative venture for mutual advantage’,<sup>5</sup> or, as I prefer to call it, a *citizens co-operative*. This label is meant to underscore two things. First, that the democratic polity is, like any private-law

2 The *Finanzarchiv*, founded in 1884 and since 2006 published as *FinanzArchiv/Public Finance Analysis*, is one of the world’s oldest academic journals in economics.

3 As Schanz put it: ‘As long as taxes are a general payment for expenditures of the community it will not be compatible with the nature of taxes if the community does not tax a number of people who benefit from its expenditures while taxing others who do not benefit’ (Schanz, 1892: 8; my translation, V.V.).

4 As used here, the term ‘person’ includes natural persons as well as legal entities.

5 Rawls (1999: 31): ‘(W)e seek a political conception of justice for a democratic society, viewed as a system of fair cooperation among free and equal citizens who willingly accept, as politically autonomous, the publicly recognized principles of justice determining the fair terms of that cooperation’.

co-operative (Genossenschaft),<sup>6</sup> a *member-governed organization*, i.e. an organization in which decision-making authority resides ultimately with its members. Second, that, again like in any private-law co-operative, individuals voluntarily participate only if they expect to benefit by their membership in the joint enterprise.<sup>7</sup>

This concept of the democratic state as a cooperative enterprise is at the core of James M. Buchanan's public finance theory. Buchanan's starting point is the contrast between two 'opposing theories of the state' (1960 [1949]: 8), an "organismic" theory' in which the state is 'conceived as a single organic unit' and an 'individualistic theory' in which 'the state is represented as the sum of its members acting in a collective capacity' (ibid.).<sup>8</sup> According to the individualistic assumptions, which he considers 'the only appropriate ones for democratically organized societies' (ibid.: 4), taxation can be viewed, so Buchanan (1984: 103) argues, 'as the cost side of an inclusive fiscal exchange process'. Taxes are conceived 'as "prices" that persons pay for the benefits provided by collectively financed goods and services made available to them by the government' (ibid.).<sup>9</sup> From such perspective, Buchanan (ibid.) adds, 'the limits to taxation are those determined by the preferences of the citizens themselves for collectively provided goods'.

In a democratic polity, a citizens co-operative, the authority to decide and act on behalf of the organized citizenry is delegated to an executive organ, the government.<sup>10</sup> For analytical purposes, the functions that a democratic

6 The German name for Switzerland, Eidgenossenschaft ('Eid' = oath), captures the co-operative nature of the Swiss confederation.

7 An early advocate of such an *individualist view* of the democratic state in ancient Greece was Lycophon (see Popper, 1966, vol. 1, 114ff.), one of the younger sophists. Lycophon argued 'that the state is not different from other human associations: one participates not to make sacrifices or to be harmed but to mutually benefit and assist each other, in order to be of mutual advantage where the power of the individual is not sufficient. . . . In the state, not different from a commercial partnership, one supports each other, but only on the condition of reciprocity such that there is a balance between what one contributes and what one receives' (Gerloff, 1928: 142; my translation, V.V.).

8 Like Buchanan, Wilhelm Gerloff, a German public finance economist and editor of the 'Handbuch der Finanzwissenschaft' (1926–1929, 2nd ed. 1952), has contrasted an individualistic and a social-organic approach as the 'two opposing views that pervade the history of the state and of legal philosophy and, in their application to taxes and duties, also the history of public finance. . . . The struggle between these two views of the nature of taxation and of the liability to pay taxes runs through the ages' (Gerloff, 1928: 142; my translation, V.V.).

9 In an essay '*Theory of Taxation*', submitted to the Swiss canton of Waadt in 1860, J.-P. Proudhon has argued: 'According to the principles of modern law, the general tendency of ideas and institutions, taxation is an expression of an exchange relationship between every citizen and a special kind of producer, called "State"; it is the price the former pay the latter for its services' (Proudhon, 2012 [1861]: 66; my translation, V.V.).

10 In speaking of government acting as executive organ of the citizenry, I distinguish between 'state' and 'government', the former denoting the organized collective that includes the citizens as its members, and the latter denoting the executive body through which the polity carries out its activities. – As the

government performs can be classified along various dimensions.<sup>11</sup> The distinction between governmental functions that I want to draw attention to is, as noted above, between government's roles as *territorial enterprise* and as *club enterprise*.

In both its roles a democratic government acts on behalf of the citizenry, and its mandate is to serve interests that the members of the citizens co-operative share in common. The difference between its two roles lies in the nature of the goods it provides in either capacity, namely '*territorial goods*' on the one hand and '*club goods*' on the other. As '*territorial goods*', I classify goods and services governments provide in their capacity as territorial enterprises. Their characteristic feature is that they are available to anybody who resides and/or operates within the territorial boundaries of the respective state.<sup>12</sup> In other words, they are available to all *jurisdiction users*, citizens and non-citizens alike. By contrast, the rubric '*club goods*' comprises goods and services that a government provides in its capacity as club enterprise. Access to these goods and services is limited to members of the respective citizens co-operative.

Figure 1 illustrates the relations between individuals in their different capacities, as *citizens–members* and as *jurisdiction users*, to the democratic state and to government in its two roles.

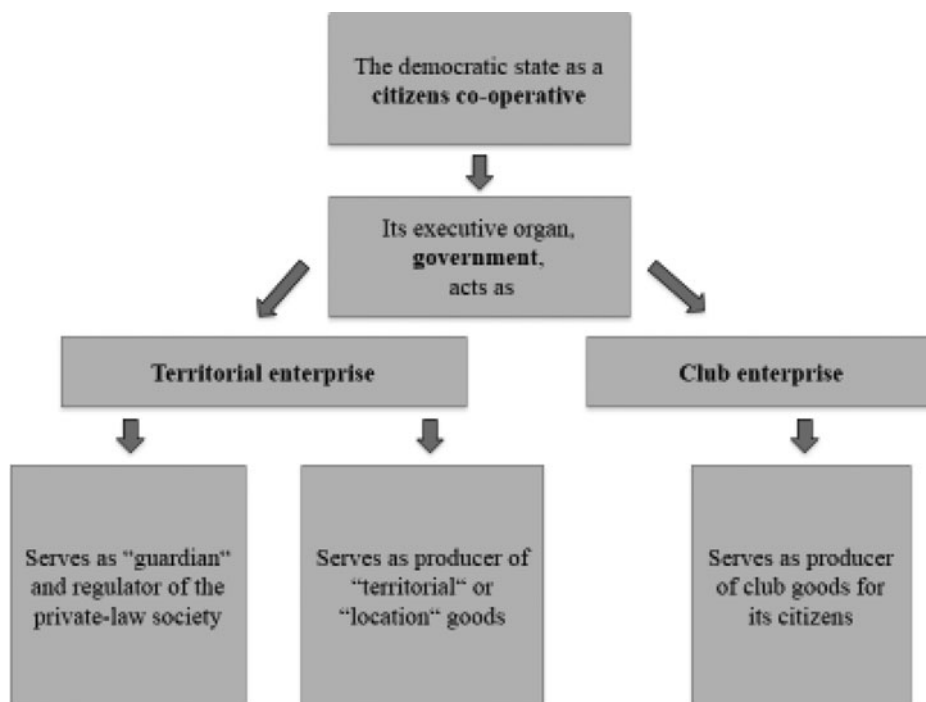
As *jurisdiction users*, individuals, citizens and aliens alike, are subject to the power of a state by virtue of their residing or operating within the state's territory. Accordingly, they can escape the respective government's authority by *leaving the territory*. In contrast to aliens, though, citizens are subject to their government's authority in a *dual capacity*, as *jurisdiction users* and as *members of the polity*. In the former capacity, they are free to decide whether they wish to use their home-state's territory for their private purposes or whether they prefer to pursue certain purposes – e.g. residence, employment, financial investment or business activities – in foreign jurisdictions. In other words, in their private capacity citizens are essentially in the same kind of relation to their home state as other jurisdiction users who, as non-citizens, use the state's territory for their private purposes. In their capacity as jurisdiction users, they can evade their home-state's authority by taking their private business elsewhere. By contrast, in their capacity as *citizens–members* they are subject to the rules that define the conditions of

German constitutional lawyer Preuss (1964 [1889]: 215) has put it: 'the government is an organ but not the organization of the people, the latter being the state' (my translation, V.V.).

11 Buchanan (1975: 68ff.) has coined the useful distinction between the '*protective state*' and the '*productive state*'. The '*protective state*' defines and enforces the private-law system and the public regulations under which the private-law society functions. The '*productive state*', in turn, serves as the enterprise through which the citizenry organizes the production of those goods and services that it judges to be inadequately provided for by the market. – Hayek (1973: 48) has drawn a similar distinction between the 'two distinct functions of government', 'the protective functions in which government enforces rules of conduct and its service function in which it needs merely administer the resources placed at its disposal'.

12 Preuss (1964 [1889]: 265) speaks of 'territorial sovereignty' as the authority to 'regulate the rights of residence and to set standards for the acquisition and exercise of all rights' (my translation, V.V.).

Figure 1. Government's dual role.



membership in their respective polity as long as they maintain their citizenship. They remain subject to the state's authority as a club enterprise, whether they reside in the state's territory or not, and can evade it only by terminating their membership in the citizens co-operative.<sup>13</sup>

The remaining sections examine the implications that follow from the distinction between government's two roles for the theory of competitive federalism.

### 3. Competitive federalism and the two roles of government

In his classic contribution to the theory of competitive federalism, Charles Tiebout took issue with the received Musgrave–Samuelson doctrine 'that no "market-type" solution exists to determine the level of expenditures on public

<sup>13</sup> Whether and to what extent governments are willing and capable to enforce the terms of membership on citizens-members outside of their own territory is, of course, an empirical matter. – On this issue Schanz (1892: 1f.) comments: 'A polity's domain of power is, in the first instance, limited to its own territory. ... Beyond the borders of its territory the common will is extremely reduced in its effectiveness; it can make itself effective only with citizens who, even though they live outside of the jurisdiction, want to maintain their citizenship, by threatening that, in case of non-compliance, they will be deprived of their citizenship' (my translation, V.V.).

goods' (1956: 416).<sup>14</sup> The core problem, so Tiebout argued, concerns 'the mechanism by which consumer-voters register their preferences for public goods' (ibid.). If such a mechanism existed, he notes, 'the appropriate benefit tax could be determined' (ibid.). Finding the current method of solving the problem through the political mechanism – namely, combining 'expenditure wants of a "typical voter" with an ability-to-pay principle on the revenue side' (ibid.)<sup>15</sup> – 'unsatisfactory', Tiebout posed the question whether a set of social institutions might be determined that would 'force the voter to reveal his preferences' (ibid.) and would allow 'to tax him accordingly' (ibid.: 418). As solution, he suggested a regime of competitive federalism in which 'consumer-voters' are free to choose among multiple local governments offering different combinations of public goods and tax burdens. The working principles of such a regime he described as follows.

The act of moving or failing to move is crucial. Moving or failing to move replaces the usual market test of willingness to buy a good and reveal the consumer-voter's demand for public goods. Thus, each locality has a revenue and expenditure pattern that reflects the desires of its residents. ... Just as the consumer may be visualized as walking to a private market place to buy his goods, the prices of which are set, we place him in the position of walking to a community where the prices (taxes) of community services<sup>16</sup> are set. Both trips take the consumer to market. There is no way in which the consumer can avoid revealing his preferences in a spatial economy. Spatial mobility provides the local public-goods counterpart to the private market's shopping trip (ibid.: 420, 422).

The fact I want to draw attention to is that in Tiebout's account local governments<sup>17</sup> are considered only in their role as *territorial enterprises*, as 'localities' in a 'spatial economy'. Their role as *club enterprises* is ignored. When the 'consumer-voter' is said to move 'to that community whose local government best satisfies his set of preferences' (ibid.: 418), it is his preferences for *territorial*

14 Tiebout (1956: 417): A 'public good is one which should be produced, but for which there is no feasible method of charging the consumer'. – Tiebout does explicate the normative criterion that the 'should' is meant to imply.

15 Lindahl (1919: 5) relates the conflict between the benefit and the ability-to-pay principle to the conflict between an individualist and an organic theory of the state: 'The contrast between the theory of "taxation according to interest" ... and a theory of "taxation according to the ability-to-pay" still persists. Basically, the supporters of an individualist theory of the state subscribe to the principle of an equivalence in exchange while the supporters of an organic concept of the state adhere to the ability-to-pay principle' (my translation, V.V.). – See Vanberg (2011, sect. 4) for a more detailed discussion of the contrast between the two principles of taxation.

16 In order to avoid definitional quibbles that the concept 'public good' may provoke I shall use here, as Tiebout does, the terms 'local public goods' and 'community services' interchangeably.

17 In a footnote, Tiebout (1956: 418, fn. 9) adds that his analysis 'also applies, with less force, to state governments'.

or *location* goods that he can thus register.<sup>18</sup> The choice between ‘locations’ does, however, not provide a mechanism by which individuals could register, as citizens–members of a polity, their preferences for *club goods* that different governments might offer in their capacity as *club enterprises*. Accordingly, Tiebout’s claim that in the competitive regime he describes expenditures for community services ‘approximate the proper level’ (ibid.) applies to territorial or location goods only, not to club goods that a government provides exclusively for their citizens–members.

Nearly, two decades before Tiebout’s contribution F.A. Hayek had published a paper on ‘The Economic Conditions of Interstate Federalism’ (1948 [1939]) in which he looked at competitive federalism as an institutional device to limit the power of government. In Hayek’s account, as in Tiebout’s, the competing sub-units in a federal system are exclusively considered in their capacity as *territorial enterprises*. In the regime Hayek envisaged, the federal government’s principal task is to assure free mobility between the states of the federation by doing ‘away with impediments as to the movement of men, goods, and capital’ (ibid.: 255), thus creating ‘one single market’ (ibid.: 258). The resulting competition for mobile labor and capital would lead, as Hayek put it in a later contribution, to

the transformation of local and even regional governments into quasi-commercial corporations competing for citizens. They would have to offer a combination of advantages and costs which made life within their territory at least as attractive as elsewhere within the reach of its potential citizens (1979: 146).<sup>19</sup>

Though Hayek speaks of competition for ‘citizens’, the competition he describes is in fact not between governments as *club enterprises* for *citizens–members* but only between governments as *territorial enterprises* for *jurisdiction users*.

The exclusive focus on governments’ role as territorial enterprises that Hayek’s and Tiebout’s contributions share is indeed a quite common feature in theories of competitive federalism. Explicitly endorsing Hayek’s account, Weingast advocates a ‘market-preserving federalism’ in which sub-national governments have primary regulatory control over their economies while the federal government’s task is to secure a common market by preventing sub-units from using their regulatory power to erect trade barriers (2008: 155). The ‘induced competition among lower units in the federal structure’, Weingast

<sup>18</sup> As examples of what consumer-voters consider in their ‘choice of municipality’ Tiebout (1956: 418) lists ‘schools . . . municipal golf course . . . beaches, parks, police protection, roads, and parking facilities’.

<sup>19</sup> See also Hayek (1978: 162): ‘Regional and local governments . . . would develop into business-like corporations competing with each other for citizens who could vote with their feet for that corporation which offered them the highest benefits compared with the price they charged’.



(1995: 5) concludes, implies ‘that policy choices will be disciplined by the ability of resources to move between jurisdictions’ and that only those policies will survive ‘that citizens are willing to pay for’ (ibid.). As he puts it:

(P)olitical competition implies that jurisdictions must compete for capital, labor and economic activity by offering public policies (e.g. levels of taxation, security of private rights, social amenities, and public goods). Economic actors make location decisions based in part on those menus (ibid.).

Again, though Weingast speaks of ‘citizens’, the competition he describes does not permit citizens to register what kinds of *club goods* they may wish government to provide and for which they are ‘willing to pay’. It only allows individuals to register with their ‘location decisions’ their preferences for location goods.

In his approach to public finance, James Buchanan has put particular emphasis on the role of competition among governments as a supplement to constitutional constraints, which, as he argues, ‘may not offer sufficient protection against the exploitation of citizens through the agencies of government’ (2001 [1995]: 69).<sup>20</sup> Like Hayek and Weingast, Buchanan suggests a federal structure in which the central government – though severely ‘restricted in its own domain of action’ (2001 [1995/96]: 70) – is sufficiently strong ‘to enforce economic freedom and openness over the whole of the territory’ (ibid.), while the ‘remaining political power is residually assigned to the several “state” units’ (ibid.). Under such a federal structure, Buchanan (2000 [1979]: 264) supposes, the ‘right of citizens to migrate freely, to vote with their feet or with their mobile resources, will limit the extent to which their demands for governmentally provided goods and services can be ignored by governmental units’. In emphasizing the ‘prospects for exit . . . as constraint on political control over the individual’, he notes, the ‘theory of competitive federalism is congenial to economists in particular because it is simply an extension of the principles of the market economy to the organization of the political structure’ (2001 [1995/96]: 80).<sup>21</sup>

Again, even though Buchanan speaks of ‘citizens’ and their ‘demands for governmentally provided goods and services’ he looks in effect, like Hayek and Weingast, at individuals only as *jurisdiction users* who, if they do ‘not like the

20 Brennan and Buchanan (1980: 184) speak of a ‘substitutability between intergovernmental competition for fiscal resources and explicit constitutional constraints on governmental taxing power’.

21 Buchanan (2001 [1995/96]: 81): ‘Federalism offers a means of introducing the essential features of the market into politics. . . . The availability of the exit option, guaranteed by the central government, would effectively place limits on the ability of state-provincial governments to exploit citizens . . . Localized politicians and coalitions would be unable to depart from overall efficiency standards in their taxing, spending, and regulatory politics’.



results of state or local political action, may move to another area or another location' (Buchanan and Flowers, 1987; Dercks, 1996: 385).<sup>22</sup>

#### 4. Federalism and two kinds of exit

As the above summaries of Tiebout's, Hayek's, Weingast's and Buchanan's accounts of federal competition illustrate, with their exclusive focus on *territorial* mobility they ignore the fact that democratic governments serve in the two noted roles and that, accordingly, we must distinguish between two different meanings of 'exit'. Exit may mean, on the one hand, that individuals, in their capacity as jurisdiction users, leave a government's territorial domain, and it may mean, on the other hand, that they give up membership in their citizens co-operative and seek citizenship in some other polity.

Exiting as private law subject from a jurisdiction is about 'location decisions' (Weingast, 1995: 5), exiting as citizen from a polity is about 'membership decisions'. As private law subjects individuals can split up their various activities – where to take residence, where to invest, where to work, etc. – between different 'territorial enterprises' according to how attractive they are with regard to their respective purposes. They do not give up their status as citizens–members, however, when they exit from their home polity's territory in one or more of these dimensions. In the extreme, they may take all their private activities elsewhere while maintaining their membership status in the polity. Reversely, they may exit as citizens–members from a polity while remaining with some – or even all – of their private engagements within its territorial boundaries.

The calculus of advantage on which individuals base their exit decisions will be characteristically different for location choices as opposed to membership choices. As jurisdiction users individuals can, as noted, distribute their various private activities across different (accessible) sovereign territories. They can decide separately for each type of activity which location to choose. By contrast, membership in a polity comes with an inclusive bundle of rights and duties, and the relevant comparison is between the inclusive bundles that different (accessible) citizens co-operatives offer. The flexibility and easy reversibility that individuals enjoy as jurisdiction users in their location decisions is typically absent in their choice of citizenship–membership in a citizens co-operative.

In the Tiebout–Hayek–Weingast–Buchanan approaches to competitive federalism, the distinction between the two kinds of 'exit' is simply ignored. When these authors speak of 'consumer-voters', 'taxpayers' or 'citizens' they refer in fact only to individuals in their capacity as customers of territorial enterprises, moving in a 'spatial economy' between jurisdictions. The issue of

<sup>22</sup> Buchanan and Flowers (1987: 385): 'To a limited extent, freedom of migration allows individuals to choose among different combinations of public services in the same way they can choose among private goods and services'.

how individuals may register the preferences they harbor in their capacity as citizens–members of a polity remains undiscussed. To be sure, the failure to distinguish between individuals as *jurisdiction users* and individuals as *citizens–members* of a polity is not limited to the cited authors.<sup>23</sup> It appears to be indeed a quite common feature in the literature on competitive federalism.<sup>24</sup> The likely reason for such one-sided focus on government’s role as *territorial enterprise* is that authors writing on the subject tacitly take a federal system like that of the United States as the *standard model* of a competitive federalism.

In the federal system of the United States, the primary citizenship is in the Union. US citizens acquire membership status in local communities and states by virtue of taking residence in the respective territories.<sup>25</sup> This means that only the federal government can exercise effective authority over who obtains citizenship status.<sup>26</sup> Given the provision that US citizens can freely choose their place of residence within the territory of the US, local communities and states can only passively register but not actively control who acquires membership status in the polity. The US rules for assigning citizenship – locating primary citizenship at the federal level while citizenship in sub-units is a matter of individuals’ residential choice – are, to be sure, a quite common feature in other federal systems, such as e.g. in Germany. They are, however, neither a necessary nor a universal feature. They are a matter of *constitutional choice*. A counterexample is, for instance, Switzerland where the primary citizenship is at the level of local communes and cantons, while citizenship in the Swiss nation derives therefrom.<sup>27</sup> Another, more significant counterexample is the European Union to which I shall return below.<sup>28</sup>

23 Knight (1982 [1947]: 465), for example, ignores the distinction when he notes: ‘In common usage political groups are defined by territorial sovereignty; leaving one group means physical removal to another and is limited by material cost, by cultural differences, and by the laws governing departure and especially entry into other political units, which practically cover the earth’.

24 In his *American Federalism: Competition Among Governments*, Dye (1990) speaks of ‘consumers-taxpayers’, of governments’ responsibility ‘for the welfare of their citizens’, and of governments who ‘tax their citizens’ (ibid.: 190f.), yet his arguments pertain only to governments’ competition for jurisdiction users. In ‘Towards a Theory of Competitive Federalism’, to cite just one other example, Breton (1987: 297) describes the task of governments as meeting ‘the preferences of citizens who happen to be in the provinces or in the country they have been elected to govern’, reducing ‘citizens’ thereby in effect to jurisdiction users.

25 Schönberger (2007: 66): ‘In ... the United States since 1868, federal citizenship is primary and state citizenship depends on national citizenship plus residency’.

26 The federal government exercises this authority within the general proviso that children born within the US and in territories under US jurisdiction, or who are born to US citizens elsewhere in the World acquire automatically US citizenship.

27 Schönberger (2007: 62): ‘Swiss citizenship (*Schweizer Bürgerrecht*) is acquired and lost as a consequence of the acquisition or loss of the citizenship of a canton (*Kantonsbürgerrecht*) which is again linked to the citizenship of a municipality’.

28 For a comparison of the citizenship rules in the federal systems of the United States, Switzerland, Germany and the European Union see Schönberger (2005, 2007).

What I want to draw attention to is the fact that the constitutions of federal systems – how competencies are assigned to the respective levels of government, and how the rules of citizenship are defined – can be differently designed, and that the differences they exhibit may have a significant effect on how the competitive dynamics among sub-units unfold. A general theory of competitive federalism must account for this fact. If a US-type federal system is, expressly or tacitly, taken as the standard model, it follows naturally that the focus is exclusively on territorial mobility as the principal driving force in competitive federalism, while the role of federal sub-units as club enterprises is lost sight of. Where membership in federal sub-units can be acquired simply by individuals' unilateral residential choice, the ensuing competition among these sub-units will critically affect what kinds of public services they will be able to provide. It will in effect reduce them to their role as *territorial enterprises*,<sup>29</sup> incapacitating them in their role as *club enterprises*. Given their inability to control admission to and exit from the 'club', they will not be able to provide sustainably genuine club goods because such goods will be subject to adverse selection.<sup>30</sup> This is in particular so for the good 'redistribution as social insurance' that will be the subject of the next section.

## 5. Competitive federalism and redistribution

It is quite common to assert that redistributive policies are subject to adverse selection when governments have to compete for a mobile tax base.<sup>31</sup> R.A. Musgrave, to cite a particularly prominent source, has put it in these terms:

Redistribution policy, I believe, should be essentially a central function. Interstate differentials in redistribution policies, if substantial, will be a distorting factor in location, and by inducing population movement (with the rich leaving and the poor entering the more egalitarian states) will prove self-defeating (Musgrave, 1969: 530).

Summarizing his reading of the literature on the subject, he states:

The proposition that voting with the feet generates an efficient outcome is intriguing, but a voluminous literature has pointed to serious limitations. . . . The conclusion remains that distributional concerns, including social insurance

<sup>29</sup> Kerber (2000: 248) points to this effect when he notes that, due to inter-jurisdictional competition, polities 'change into mere "locations"'. – As I argue here, inter-jurisdictional competition has this effect only where polities lack the authority to control who acquires membership status.

<sup>30</sup> When Brennan and Buchanan (1980: 178) assume 'that subordinate units of government may, without undue cost, effectively exclude non-citizens from enjoying the public-goods benefits from localized provision', they refer to *location goods* but not to *club goods*.

<sup>31</sup> Kerber (2000: 227f.): 'It has been contended that tax competition under certain conditions might lead to an under-provision of public goods and/or too low a degree of redistribution. . . . Free migration can lead to problems for the competing jurisdictions' redistribution policies through effects of adverse selection'.

and progressive taxation, must be met largely, if not entirely, at the central level. . . . There thus exists a linkage between the two issues: centralization permits progressive taxation and redistribution, whereas decentralization interferes with them (Musgrave, 1999: 158, 161).

Like many others writing on the subject, Musgrave apparently regards as an unquestionable fact that redistribution is a task of government, a task furthermore that cannot be carried out at the level of competing federal sub-units, but must be assigned to the central government. Yet, a theory that conceives of a democratic polity as a ‘cooperative venture for mutual advantage’ cannot treat these matters as unquestionable facts. It must provide arguments for why redistribution may qualify as a good in which the members of a citizens co-operative share a common interest. Furthermore, it must provide arguments for why citizens in a federal system may share a common interest in assigning the redistribution task to a particular level in the federal hierarchy.

There are, in fact, two kinds of arguments for why the members of a citizens co-operative may want their government to engage in redistributive policies. On the one hand, citizens may share a common interest in avoiding potential negative effects of great inequality in their home jurisdiction. Redistribution that is so motivated takes on properties of a ‘territorial good’. To the extent that it helps to make the jurisdiction a more attractive place for private purposes, jurisdiction users can be made to co-finance its production.

On the other hand, citizens may share a common interest in redistribution as a mutual insurance arrangement, covering the members of the citizens co-operative in case of need. It is the second variety that I shall focus on here.<sup>32</sup> That uncertainties about one’s own – and one’s children<sup>33</sup> – future income-earning prospects can provide prudential reasons for citizens to agree to a regime of redistributive insurance has often been observed.<sup>34</sup> As e.g. Sinn (1997: 258) has put it:

32 In his discussion of the redistribution issue, Dye (1990: 188f.) focuses on the first when he states: ‘The most serious challenge to the competitive federalism model arises in redistributional policy. Can multiple competing governments undertake redistributive policies without creating unbearable free-rider problems for themselves? . . . Few of us want to see poverty, hunger, homelessness, ill health, or deprivation in our society . . . States or communities that aggravate these hardships would hardly look attractive to families or businesses seeking places to locate’.

33 The fate of one’s children can be included in the insurance calculus where, according to the respective citizenship rules, the offspring of citizens are automatically and unconditionally granted membership status in the citizens co-operative.

34 Hayek (1960: 101): ‘There are good reasons why we should endeavor to use whatever political organization we have at our disposal to make provisions for the weak or infirm or for the victims of unforeseeable disaster. It may well be true that the most effective method of providing against certain risks common to all citizens of a state is to give every citizen protection against those risks’. – Buchanan (1977 [1976]: 267): ‘Uncertainty about income and wealth positions in future periods can produce general contractual agreement on a set of fiscal institutions, a fiscal constitution, that may incorporate protection against poverty and which may seem, when viewed in a short-term perspective, to produce pure transfer among individuals and groups’. – Buchanan (2001 [1985]: 249: ‘In a contractarian and rule-oriented

Redistribution and insurance are two sides of the same coin, their difference lies primarily in the point of time at which they are evaluated. Ex post, every insurance contract involves redistribution. Ex ante, before the dice of destiny are cast, much of the foreseen redistribution can be seen as insurance against the risk of income variations.

This is the reason, Sinn concludes, why redistribution ‘as insurance . . . may be welcomed by all citizens before destiny has lifted its veil of ignorance’ (ibid.: 259).<sup>35</sup> Yet, so he argues, despite the benefits that welfare state provisions can generate for citizens, governments may not be able to provide them because of the ‘increased difficulties of carrying out redistributive policies . . . if the factors of production are internationally mobile’ (Sinn, 1994: 90).<sup>36</sup> If a ‘country’s borders are opened and both capital and labor can freely migrate across them’, he posits (Sinn, 1997: 262), this liberty ‘will affect insurance through redistributive taxes since the government loses its power to enforce the payment of taxes’. This is, according to Sinn (ibid.: 264), so because the ‘good risks leave the insurance state’, creating an adverse-selection problem that destroys the viability of the insurance arrangement.

As noted before, claims about the effects of inter-governmental competition on governments’ ability to provide club goods such as social insurance cannot be assessed in the absence of a clear distinction between governments’ roles as territorial and as club enterprises. Governments’ power to tax in both their roles depends on their ability to make access to the services they provide contingent on the payment of required tax contributions. As territorial enterprises, governments can charge the taxes to finance their services as, in effect, *user charges*. They can make the permission to take advantage of the benefits their jurisdiction offers contingent on payments made by jurisdiction users. In a competitive environment, the taxes jurisdiction users can be made to pay will tend to take on the character of *prices*, differentiated according to the respective uses made (as residents, investors, tourists, etc.).

The situation is categorically different for the services governments provide in their capacity as club enterprises. Club goods like social insurance cannot be provided in the same manner as territorial goods. By contrast to user charges, the taxes governments need to raise to finance their services as club enterprises must be charged in the form of *membership dues*.<sup>37</sup> They are payments for

perspective, therefore, it is possible that consensus on a set of institutional arrangements will emerge that will, in operation, embody interpersonal transfers that may loosely be described as redistributive’.

35 Sinn (1994: 99): ‘Redistribution can therefore be a useful government activity that generates benefits similar to those provided by the insurance industry’. – As Sinn points out, the ability to function as a trans-generational insurance distinguishes the state from private insurance companies.

36 Sinn (1997: 259, 263): ‘Fiscal competition will . . . create severe problems for public redistribution . . . The welfare state has no survival chance when unbridled tax competition is allowed’.

37 The systematic distinction between these two kinds of taxes is mostly ignored in existing taxation systems. It has also found scarcely any attention in the public finance literature. It is ignored, for

the *option* to partake in the bundle of services that the club provides for its members, not payments charged separately according to the actual use made of the respective services. Membership dues must be paid as long as one maintains one's membership status, independent of the extent to which one makes use of the options it offers, even if, as may well happen in the case of social insurance, the option never materializes.<sup>38</sup>

In order for governments to be able to charge taxes – such as redistributive taxes – for their services as club enterprises they must be able to control the conditions under which new members are admitted to the citizens co-operative. Nation-states typically have this ability. They have the authority to decide whom they admit as citizen-member. Contrary to what authors like Sinn suggest, the need to compete for a mobile tax base does not *per se* undermine states' ability to charge redistributive taxes. Where states lack this ability competition can only be a proximate, not the ultimate reason. The ultimate reason most surely is their failure to distinguish adequately between the taxes they *can* charge as territorial enterprises, and the taxes they *must* charge in order to function as club enterprises. Accordingly, and in light of what has been said above about the two reasons for redistribution, Sinn's (1994: 101) argument that 'mobile factors cannot be taxed for redistributive purposes' needs to be specified. To the extent that redistributive policies make the jurisdiction a more attractive place for jurisdiction users, the latter can be made to co-finance its production. By exiting from the jurisdiction, they can avoid the respective tax, but must also forgo the corresponding advantages the jurisdiction offers. By contrast, to the extent that redistributive taxes serve to finance the club good 'social insurance', a good from which jurisdiction users as such do not benefit, the latter can avoid paying the tax by exiting the jurisdiction without corresponding sacrifice.<sup>39</sup> Redistributive taxes to finance the club good 'social insurance' must be collected as *membership dues* that can only be evaded by giving up one's membership status, thereby sacrificing one's claim to insurance coverage.<sup>40</sup>

In federal systems, the ability of lower level governments to function as club enterprises depends, as already noted, on the respective citizenship rules. If, as in

instance, when Buchanan and Flowers (1987: 85) state: 'The "public economy", the public sector involves government provision of goods and services to beneficiaries. These are financed through tax revenues collected from individuals coercively'.

38 De Viti de Marco (1936 [1928]: 115): 'In short, it is possible to maintain that every taxpayer pays taxes today, not only in consideration of his present wants, but also in anticipation of future wants. . . . (I)t transforms . . . a series of different prices into a single "subscription" price'.

39 Other jurisdictional advantages may overcompensate the tax burden, preventing jurisdiction users from exiting.

40 Redistributive policies will likewise be undermined by inter-jurisdictional competition in the case of taxation systems that allow citizens to avoid paying taxes to finance such policies by exiting from their home jurisdiction, while maintaining the option to benefit from the insurance arrangement by re-entering. Such taxation systems simply fail to meet the requirements for a viable production of genuine club goods. In such systems, the problem of adverse selection must inevitably arise.

US-type federal systems, primary citizenship is at the union level while citizenship in states and local communities is a matter of individuals' unilateral residential choice, lower level governments are in effect, as I have argued, reduced to their role as territorial enterprises. It is for *this* reason, not because 'redistribution is intrinsically a national policy' (Stigler, 1965: 172),<sup>41</sup> that in such cases the power to collect redistributive taxes will be assigned to the central government.

Notice that to deny that redistribution is 'intrinsically' a central government's task is not meant to deny that there may well be *prudential reasons* for citizens in a federal system to choose to put the central government in charge of redistributive policies. In fact, the historical trend towards a centralization of redistributive policies that had formerly been the domain of local communities<sup>42</sup> has its apparent causes in the difficulties the local provision of social insurance faced in an increasingly mobile world.<sup>43</sup> Yet, specifying prudential reasons why citizens may want to centralize redistribution as social insurance is quite different from simply positing that redistribution requires 'intrinsically' its centralization. To keep this difference in mind is important when one looks at a federal system such as the European Union.

## 6. The case of the EU: governments' dual role and 'redistribution policy'

It is in line with his above-cited claims about the effects of inter-governmental competition when Sinn (1994: 97) charges that the EU's Single Market Program with its four liberties (free movement of goods, services, labor and capital) must lead to 'the breakdown of national redistribution schemes under institutional competition'.<sup>44</sup> He concludes that because of the 'impossibility of redistribution

41 Stigler (1965: 172): 'The purely competitive organization of local services would make it impossible for a local government to obtain money from the rich to pay for the education of the children of the poor, except to the extent that the rich voluntarily assumed this burden'.

42 See Dercks (1996: 62ff.). Dercks quotes Oates' (1972: 194) observation: 'History shows a trend toward the increasing centralization of explicitly redistributive programs . . . The care of the poor . . . was originally envisioned as local responsibility'. – Feld (2005: 435): 'In Switzerland, a citizenship principle existed until 1979 according to which the places of citizenship (i.e. communes and cantons, V.V.) were responsible for social welfare of their citizens'.

43 Hayek (1960: 285): 'In the Western world some provisions for those threatened by the extremes of indigence and starvation due to circumstances beyond their control has long been accepted as a duty of the communities. The local arrangements which first supplied this need became inadequate when the growth of large cities and the increased mobility of men dissolved the old neighborhood ties; and (if the responsibility of the local authority was not to produce obstacles to movement) these services had to be organized nationally'.

44 Sinn (1990: 10): 'The problem with voting with one's feet is that real freedom of movement in Europe means that all people, even those for whom the veil of ignorance has already been lifted, must be able to decide freely on where they want to live. This freedom leads to . . . adverse selection, where . . . eventually welfare states must collapse. . . . Competition in this case functions like competition in an insurance market without binding contracts and ex-post premium settlement. Such a market could also not survive'.



policy’ on part of the member states, tax rates will ‘have to be harmonized across countries or chosen by a central agency’ (ibid.: 99).<sup>45</sup>

In terms of what has been argued above, what Sinn fails to take into account in his ‘impossibility’ claim is that in assessing the effects of competition on redistributive policies one needs to distinguish between the member states’ two roles.<sup>46</sup> It is simply not the case that ‘(s)tates could establish redistribution schemes only when borders are closed, not when they are open’ (Sinn, 1990: 10). There is a categorical difference between ‘open borders’ in the sense of allowing free migration of jurisdiction users across national boundaries and ‘open borders’ in the sense of free admission to the services, in particular redistribution as insurance, governments provide as club enterprises for their citizens.<sup>47</sup> The EU’s Single Market Program is about the first, not the second. The commitment to the common market’s four liberties requires member states in their capacity as *territorial enterprises* to allow citizens of all EU member states to operate, as *jurisdiction users*, within their respective territories. Yet, this commitment does not require them in their capacity as *club enterprises* to grant citizens from other EU member states free access to the club goods they provide for their own citizens. In the EU primary citizenship is with the member states, while the EU citizenship derives therefrom.<sup>48</sup> Different from the US-type federalism, EU citizens cannot acquire citizenship of a member state simply by taking residence therein. Accordingly, as providers of club goods like social insurance member states can avoid problems of adverse selection as long as they enforce an appropriate taxation regime, a regime that carefully distinguishes between the state’s two roles. Interestingly, if only passingly, Sinn (1994: 100) acknowledges this fact when he notes that redistribution can work with free migration if ‘a strict nationality principle for redistributive taxation is applied’.<sup>49</sup>

Adverse selection undermining independent national redistribution policies within the EU is *not* a consequence of free migration *per se*. It may be a consequence, though, of EU rules that prevent national governments from exercising effective control over whom they admit to the services they want to provide as club enterprises for their citizens–members. A tendency to adopt such rules, and for existing rules to be so interpreted, can indeed be observed in the

45 Sinn (1990: 11): ‘A workable solution can only be found in the creation of a central state with corresponding redistribution objectives, or if it is impossible to form such a state, the individual redistribution systems must be harmonized with one another’.

46 Implicitly Sinn (1994: 102) invokes the distinction when he argues that because of the four liberties ‘not only redistributive taxes have to be lifted to the community level . . . , to some extent even benefit taxes for local public goods must be too’. – See my above comments on how competition affects governments as territorial enterprises providing ‘local public goods’.

47 On this distinction, see (Niskanen, 2006; Nowrasteh and Cole, 2013).

48 Schönberger (2007: 76): ‘(A)ccording to the EC Treaty, Union citizenship is predicated on Member States nationality (Article 17 para. 1 EC Treaty). It is acquired or lost as a consequence of the acquisition or loss of the nationality of one of the Member States’.

49 On this, see also Feld 2005: 434ff.

EU, caused, as I posit, by a failure to distinguish properly between the member states' two roles. The failure is particularly visible in some interpretations of the *non-discrimination principle* that is at the core of the Single Market Program. As noted before, the principle requires national governments in their capacity as *territorial enterprises* to treat citizens of all EU member states equally *in their capacity as jurisdiction users*, prohibiting them from granting privileges to their own citizens *in their capacity as jurisdiction users*.

As a defining characteristic of the common market, the non-discrimination principle does *per se* not apply to member states in their capacity as *club enterprises*, and there is no intrinsic reason why a principle that is constitutive of the common market should be extended to the club goods the individual member states provide for their citizens. Yet, ambiguities about what the non-discrimination principle implies for member states' redistributive policies have been created by certain EU regulations<sup>50</sup> and directives<sup>51</sup> as well as by rulings of the European Court of Justice.<sup>52</sup> One of the ECJ's recent rulings may serve as an illustration.

In the Case C-333/13, the ECJ had to decide whether the Sozialgericht Leipzig, Germany, had justly denied benefits according to the German system of basic provision (Grundsicherung) to a Romanian mother and her son, who had taken residence with the mother's sister in Leipzig.<sup>53</sup> The 'Judgment of the Court (Grand Chamber)' of November 11, 2014, covers 20 pages to answer a question that could have been answered in one sentence if the Court had been guided by the unambiguous understanding that the non-discrimination principle binds the member states in their role as *territorial enterprises* but not in their activities as *club enterprises*. If guided by such an understanding the Court could have simply stated that the right to take residence in any member state does not imply the right to be admitted to the club goods the respective state provides for its citizens.<sup>54</sup> Instead, the judgment draws repeatedly on the argument, incidental to the principal issue, that persons exercising their right to move and reside within the EU should not 'become an unreasonable burden on the social assistance

50 E.g. by Reg. 883/2004 on the coordination of social security systems.

51 E.g. by Directive 2004/38, Art. 24 on 'Equal Treatment'.

52 The *Treaty establishing a Constitution for Europe* (TCE), signed by all member states in 2004 (but not ratified because the French and Dutch voters rejected it), explicitly included provisions that tacitly extended the non-discrimination principle to the member states' role as club enterprises. – As Feld (2005: 435) notes: 'The proposals by the European Convention to establish a European citizenship (AR. I-8 of the Constitutional Draft) together with non-discrimination (Art. I-4) and the positive right of social protection (Art. II-34) impose strong restrictions on the introduction of a citizenship principle'.

53 For a more comprehensive discussion of ECJ judgments on the general issue at stake, see Schönberger (2005: 344ff).

54 Of relevance in this context is the distinction between national *social security systems*, which belong indeed in the domain of governments as territorial enterprises, and national *social assistance systems* belonging in their domain as club enterprises.

system of the host Member State'. Pondering various directives and regulations pertinent to the issue the Court arrives at the conclusion that they

'must be interpreted as not precluding legislation of a Member State under which nationals of other Member States are excluded from entitlements to certain "special non-contributory cash benefits" . . . , although those benefits are granted to nationals of the host Member State who are in the same situation'.

I should emphasize that by insisting on a clear distinction between the EU member states' roles as territorial and as club enterprises I do not mean to rule out that citizens in Europe, through their representatives, may choose, if they wish, to extend the non-discrimination principle to such matters as redistributive policies. The point I want to make rather is that such extension should be the subject of explicit and well-considered constitutional choice. It should not creep in tacitly, due to a mistaken interpretation of what the common market's non-discrimination principle requires.

## 7. Conclusion

Kerber (2000: 217), among others, has observed some time ago that a tension exists 'between the additional shifting of competencies for economic policies . . . to the European Community level, and increasing desires of the EU population for decentralization and preservation of regional diversity'. If anything this tension has grown in recent years and it gives indeed, as Kerber concludes, reason to ask, 'how can the institutional structures of the EU be reformed in a way that both the Community's central aim of an internal market, and decentralization and diversity within the EC, are simultaneously achieved' (ibid.).

A suggestion for how the two goals Kerber lists may be simultaneously achieved is implied in the main argument developed in this paper. There should be a stricter separation between the member states' two roles, their role as territorial enterprises, which are bound by the common market's non-discrimination principle, and their role as club enterprises, which may provide different bundles of club goods to their citizens–members. A European Union, just as any other federal system, that is responsive to the preferences of its citizens, to their interests as *jurisdiction users* as well as to their interests as *citizens–members* of their respective polities, must adopt rules of competition that take adequate account of the different tasks that governments perform in their roles as *territorial* and as *club enterprises*.

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<sup>55</sup> The year of original publication in rectangular brackets.

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