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**GLOBALIZATION, DEMOCRACY AND  
CITIZENS' SOVEREIGNTY: CAN  
COMPETITION AMONG GOVERNMENTS  
ENHANCE DEMOCRACY?**

**VIKTOR J. VANBERG**

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# Globalization, Democracy, and Citizens' Sovereignty: Can Competition Among Governments Enhance Democracy?

**Abstract.** This paper examines the claim that the forces of globalization and of the ensuing competition among jurisdictions subvert the ability of democratic governments to act in the interest of their citizens. Against this claim it is argued that competition among jurisdictions can, on the contrary, enhance the capacity of democratic governments to serve the *common interests* of their constituents by limiting the scope for rent-seeking and by functioning as a discovery process.

**JEL classification:** D72, F01, F20, H73, K2.

## 1. Introduction

The expansion of markets known as globalization creates new options, new avenues for trade in goods and services, as well as new opportunities for capital investment and the allocation of mobile resources. It is a common, and uncontested, claim that globalization and the resulting competition among jurisdictions imposes restrictions on the freedom of action of national governments.<sup>1</sup> Competition is always a matter of accessibility of alternative options, and, to the same degree that the globalization of markets creates additional options for citizens and for those whom one may call *jurisdiction-users*,<sup>2</sup> competition among jurisdictions restricts the power governments

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<sup>1</sup> H.-W. Sinn (1994: 96) speaks of the “ability of taxed goods and factors to migrate across the borders and the constraints on government behavior imposed thereby.” – Sinn (1997b: 248): “Countries will compete for mobile factors of production and tax bases and face strong pressures to reform their fiscal and regulatory systems.”

<sup>2</sup> The term “jurisdiction-users” refers to persons who, be it as citizens or as non-citizens, allocate mobile resources in a jurisdiction, in the form of financial capital, investment capital, human capital or other.

can exercise over them. Governments cannot with impunity ignore the greater scope for choice that globalization offers to their citizens and to jurisdiction-users.

The point at issue is how this restriction of the power of governments should be evaluated. The argument that competition among jurisdictions can serve common interests of citizens, and is from their standpoint a welcome development, is stressed by authors like Geoffrey Brennan and James M. Buchanan (1988: 212ff.), who see the vulnerability to privilege-seeking or rent-seeking as a fundamental weakness of the political decision-making process. In their view competition between governments can provide a potential remedy by limiting governments' scope for granting privileges, thereby reducing the incentives for rent-seeking. The counter argument, that competition among jurisdictions obstructs or can even prevent the realization of the collective interests of citizens, is stressed by authors like Fritz W. Scharpf (1998) or Hans-Werner Sinn (1994; 1996). They emphasize potential negative incentive effects of competition among jurisdictions, and the danger that it can lead to "ruinous competition between states" (Sinn 1995: 241), with undesirable consequences for all parties involved.<sup>3</sup>

The focus of the present article is on an argument frequently heard in this context, namely that the developments referred to as *globalization* represent a threat to *democracy*, and that there is a systematic conflict between the market forces of competition among jurisdictions and the principles of democratic politics.<sup>4</sup> To examine this argument, it is first necessary to clarify what is to be regarded as the defining principle of a democratic polity, and which performance criterion should, accordingly, be used to assess democratic politics. This question must be clarified before one can proceed to a meaningful discussion of how the effects of competition among jurisdictions on politics are to be evaluated in terms of the postulated criterion.

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<sup>3</sup> Sinn (1997b: 248): "Since governments have stepped in where markets have failed, it can hardly be expected that a reintroduction of a market through the backdoor of systems competition will work. It is likely to bring about the same kind of market failure that justified government intervention in the first place."

<sup>4</sup> One of the most articulated proponents of this argument is B. R. Barber (1996).

## **2. State, „ Jurisdiction enterprises,“ and Democracy**

What are the “entities” that compete with one another in competition among jurisdictions (Vanberg and Kerber 1994)? In the current debate on globalization, nation states are generally, explicitly or implicitly, understood to be the competing units. The term “jurisdiction” can, however, also be interpreted in a broader sense to include other kinds of political communities, at the sub-national as well as at the supra-national level, to the extent that they command power to set and enforce rules and regulations governing people living or working in their respective territories. If we think in terms of nation states, we tend to imagine that the world is divided into political entities, each exercising exclusive state power over a certain area. If we think in categories of jurisdictions in the more general sense, a considerably more complex image of diversely overlapping jurisdictions emerges, comprising, in addition to nation states, political entities at the sub-national and supra-national level, among which authority is divided and each of which is in control only over a certain domain of issues. At the sub-national level, these are communities or Länder within federal states, and at the supra-national level these are entities such as the European Union. Even if nation states indisputably enjoy a special status within this framework, when we speak of „competition between jurisdictions“ it is important to take into account that the authority for shaping the characteristics of a territorially defined unit by political means can be divided up among various jurisdictions. For the sake of simplicity, one may read the arguments that follow as if they refer to nation states as the units involved in the “competition among jurisdictions”. They are meant, though, to apply, appropriately adjusted, to jurisdictions in general, i.e. to sub- or supra-national political jurisdictions as well.

For the present purpose it is useful to think of states (or jurisdictions) as “territorial enterprises” in the sense that they are viewed with respect to their role as organizations, that provide packages of jurisdiction services and characteristics for the inhabitants and users of their respective territorial domains, packages that include such things as infrastructure, legal security, social legislation, environmental standards, tax regulations, etc., i.e. all the properties of a jurisdiction that are a potential subject of political choice. Just as enterprises compete for customers by offering their respective

price-benefit packages, states or jurisdictions as “territorial enterprises” find themselves competing with their tax-benefit packages for “jurisdiction customers”, i.e. inhabitants and jurisdiction users.

If we view states as territorial enterprises in the noted sense, we can characterize *democratic* states as *cooperatives*, that is as “territorial enterprises” which are owned by their members, their citizens. The defining characteristic of democratic polities is that their members or citizens are the principals or ultimate sovereigns. And just as it is, in general, the purpose of *cooperatives* or *member-owned* organizations to promote the interests of their members, we can say that democratic polities, as associations of citizens, should serve the common interests of their members, the citizens. Accordingly, their performance or efficiency ought to be measured by how well they enable their citizens to realize mutual gains. The criterion for the efficiency of democratic polities in this sense may be defined as *citizen sovereignty*, in analogy to *consumer sovereignty* as a criterion for the efficiency of markets.

*Consumer sovereignty* means that the economic process should be organized – or be framed by rules – in such a way that producers are made most responsive to consumer wants. In other words, consumer sovereignty describes the ideal of an economic process in which consumer wants are the principal controlling variable. By comparison, *citizen sovereignty* means that the political process should be organized – or be framed by rules – such that the “producers of politics” are made most responsive zu citizens’ wants. In other words, citizen sovereignty describes the ideal of a political process in which citizens’ wants are the principal controlling variable. Consumer sovereignty is a purely procedural criterion. It does not apply directly to the outcomes of market processes but to the procedures through which they come about. In the same sense, citizen sovereignty is a purely procedural criterion. It does not apply to the outcomes of political processes per se, but to the nature of the processes that generate them. Ensuring citizen sovereignty means to organize a democratic polity, or to provide it with a constitution, such that the government is, on the one hand, equipped to implement schemes which benefit all citizens, while it is, on the other hand,

prevented, as far as possible, from acting against the interests of some or even all of its citizens.<sup>5</sup>

Whether competition among jurisdictions poses a “threat to democracy” obviously depends on what we consider the relevant performance-criterion for democratic polities. If we assume all that what a majority of elected officials approves to be desirable expression of “democracy”, the obvious and easy conclusion is that competition among jurisdictions must be “detrimental to democracy” to the extent that it prevents or restricts governments from carrying out measures that can command such majority approval. By contrast, if we measure the efficiency of democracy in terms of the noted criterion of citizen sovereignty, then we cannot simply draw such conclusion. Instead, we must first examine whether the restrictions imposed by competition among jurisdictions do, in fact, impede governments in their task to promote the common interests of their citizens.

The extent to which democratic polities genuinely satisfy the criterion of citizen sovereignty depends on how well their organizational structure or constitutional provisions help to solve two problems. They should, on the one hand, enable the organized citizenry or its executive organ, the government, to carry out projects that serve the interests of all citizens (“enabling constitution”). On the other hand, they should restrict the decisionmaking powers conferred on the polity so that they cannot be used against the interest of some or all citizens (“limiting constitution”). In short, the function of democratic political constitutions is to make the citizenry, on the one

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<sup>5</sup> In his "A Theory of Justice," John Rawls characterizes a democratic society "as a cooperative venture for mutual advantage" (1971: 84). The idea that the democratic state is an enterprise for the common gain of all citizens was the basic leitidea of Knut Wicksell's work "A New Principle of Just Taxation" (Wicksell 1896: 76-164; 1967), in which he speaks out against the fiscal principle of "taxation according to the ability-to-pay", and for the principle of "taxation according to benefit" (ebenda: 74). This principle should, so he says, assure "that taxes .... would come to be regarded as what they really should be, namely as means to procure for the community as a whole and for each of its classes particular benefits which could not be obtained in other ways". - Söderström (1986: 94) defines Wicksell's approach as follows: "According to Wicksell, the government should be a beneficial organ for all its subjects. This cannot be the case unless the interests of all persons are fully respected when fiscal policy is determined. ... otherwise taxation is a tool for theft and waste." Wicksell maintained, so Söderström claims (ebenda: 91), "that the interests of everyone should be respected. This, he thought, would be most favorable for all parties in the long run". - Richard Wagner (1988: 163) comments: "Wicksell's theoretical interest was to articulate general constitutional principles to which government must adhere if it is meaningfully

hand, capable of acting collectively to realize common benefits, and on the other, to provide protection against exploitation. The „constitutional calculus“ weighing up these two problems is, of course, what James M. Buchanan and Gordon Tullock (1962) have described as the “logical basis of constitutional democracy”, in one of the best-known Public-Choice classics.

In light of the two noted risks, the risk of political measures not being undertaken that would, in fact, serve the common interests of all citizens, and the risk of political measures being undertaken that run against the interests of part or all of the citizenry, the principle of citizen sovereignty implies that all constitutional provisions – or other constraints – should be unequivocally welcome that reduce one risk without increasing the other, or that bring the two risks in a more favorable balance, as judged by the citizens themselves. In other words, the principle of citizen sovereignty can be defined as the ideal that the political process should be constrained by constitutional rules or other provision such that the two risks are brought into what the citizens themselves consider to be the most favorable balance.

In a democratic system in which no one is entitled to a privileged vote (apart from the special decisionmaking powers of delegates specifically appointed by citizens or principals), the risk of undesirable decisions would obviously be most effectively reduced by a unanimity rule, which would give each member a right of veto on all issues. The downside of this rule is, of course, that while guarding against the risk of undesirable decisions, it dramatically reduces the chance of *any* decision being taken, including ones which would actually benefit all members.<sup>6</sup> This danger would, in turn, be minimized by a rule that grants any single member the right to make binding decisions for the polity. Yet, since the democratic requirement of equal decisionmaking rights for all citizens would mean that this right applies to all citizens equally, such a decision rule would, from the perspective of every single member, maximize the risk of decisions being made that run against his interest. In order to escape from this calamity, it is in the interests of all citizens to agree on constitutions for their polities,

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to reflect the consent of the governed.” - Wicksell’s work was known to be the inspiration for James Buchanan’s draft of a “constitutional political economy” (Buchanan 1990).

<sup>6</sup> Decisionmaking costs, strategic behavior, and other reasons might prevent decisions from finding unanimous approval even if, indeed, they would serve the common interests of all involved.

which allow for majority decisions and the delegation of decisionmaking powers, even if this inevitably implies the possibility of measures being taken that will violate their interests. This does not mean at all abandoning the reference norm that, as citizens' associations, democratic polities should serve *the common interests of all members*. It simply means to take account of the trade-off between the two noted and of the costs that complete protection against any violation of one's interests would entail. The criterion of promoting the interests of all is -- so to speak -- moved to a higher or more general level: Since it is not practical, namely subject to too many disadvantages, at the level of particular political decisions, it is applied at the constitutional level where *decision-rules* are chosen. At this level the crucial question is: Among the feasible alternatives, which *constitutional arrangement or decision rules* serve the common interests of all best, even if they must be expected to allow for decisions which are not in the interests of all.<sup>7</sup>

In relation to the issue of "competition among jurisdictions and democracy," this implies that we must examine how the constraints that competition among jurisdictions imposes on governments affect the risks outlined - the risk of undesirable decisions being made and the risk of decisions which would benefit all not being made. In examining this issue, we must bear in mind that the reducing of either risks not only involves interest-related problems, but also serious *knowledge* problems. There is not only the problem that the realization of the common interests of all citizens might be impeded or prevented because political agents use the decisionmaking powers vested in them to pursue personal interests at the expense of citizens' interests, or because parts of the citizenry use the political process to achieve unilateral gains at the expense of others. Rather, there is the additional problem that it is not always apparent where the common interests of citizens lie, or how to serve them in the most efficient and

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<sup>7</sup> In the language of game metaphors, this can be expressed as follows: „The issue is not that every individual *toy* benefits all involved, but that the *game* - i.e. the system of rules - is more advantageous for all than potential alternative games or systems of rules. With regard to Knut Wicksell's theories on the role of unanimity as a fiscal principle of legitimization, Wagner (1988: 160) notes: "In assessing the practical nature of Wicksell's work, it is essential to distinguish between a general principle of consensual governance and specific methods or institutional formats through which such a principle might be implemented." - On the question of unanimity, Wicksell (1967: 90) wrote: "In the final analysis, unanimity and fully voluntary consent in the making of decisions proves the only certain and palpable guarantee against injustice in tax

cost-effective manner.<sup>8</sup> Any assessment of the effects of competition among jurisdiction must take both the knowledge problem and the interest problem into account.<sup>9</sup> Since the discovery of common citizen interests and the best methods of advancing them depends on the initiative of political entrepreneurs and the ability of citizens to assess relevant alternatives, competition among jurisdictions can -- apart from its motivating force -- play a useful role in generating information to help political entrepreneurs solve problems, and to facilitate citizens' evaluation of political performances by providing them with standards of comparison.<sup>10</sup>

### 3. Citizens and Jurisdiction-users

In discussion on the effects of competition among jurisdictions, the focus is often on the distinction between mobile and immobile factors, with the stress on the fact that competition among jurisdictions favors mobile factors above immobile factors, or, more generally speaking, that factors are favored in proportion to their degree of mobility.<sup>11</sup> The intensifying of the competition among jurisdictions witnessed in recent years has to do with the fact that technological, political and institutional changes have made economic options beyond national boundaries increasingly accessible. It is obvious that factors can avail of this options to the degree of their own mobility, with corresponding consequences for their relative bargaining powers. This means, of

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distribution. The whole discussion on tax justice remains suspended in mid-air so long as these conditions are not satisfied at least approximately.”

<sup>8</sup> J. St. Mill (1977: 435 ff.) refers to the two problems of democratic constitutions addressed here, in his work “Considerations on Representative Government”, when he writes: “The defect of any form of government may be either negative or positive. It is negatively defective if it does not concentrate in the hands of the authorities power sufficient to fulfill the necessary offices of a government . ... The *positive* evils and dangers of the representative, as of every form of government, may be reduced to two heads; first, .... insufficient mental qualifications in the controlling body; secondly, the danger of its being under the influence of interests not identical with the general welfare of the community.”

<sup>9</sup> The significance of the knowledge problem and the role of competition among jurisdictions as a “discovery procedure” (Hayek) is discussed by Kerber (1998: 200f.).

<sup>10</sup> The significance of the competitive dynamics in federal systems for generating knowledge on how governments can serve the interests of their citizens better is noted by Hayek (1944: 235; 1948: 255-69; 1960: 184f., 263f.).

<sup>11</sup> Sinn (1994: 98) says that “a tax on a mobile factor of production cannot survive in a process of institutional competition. Only taxes on the immobile factors of production will be chosen.”

course, that -- as the skeptics claim -- competition among jurisdictions does not equally favor mobile and immobile factors. However, it does not imply -- as is sometimes suggested -- that the less mobile factors would be better off if competition among jurisdictions would not have intensified, or that they could be made better off if they used the political process to obstruct more mobile factors from using the options created by competition among jurisdictions. Whether this is the case or not, cannot be established without further examination.

As relevant as it surely is for other purposes, the distinction between mobile and immobile resources is *per se* not relevant for the present issue, i.e. the relation between competition among jurisdictions and democracy. If democratic polities are to be viewed as associations designed to advance the common interests of their members or citizens, the question of how competition among jurisdictions affects the interests of mobile and immobile factors is *per se* not relevant for this issue. It is not either of the latter interests, but the interests of the *citizens* which provide the relevant standard for evaluating the effects of competition among jurisdictions and for judging the desirability of potential political reactions. From this perspective, the relevant contrast is not between mobile and immobile factors, but between *citizens* and those *jurisdiction-users*, who as non-citizens, live or conduct business within a jurisdiction. Needless to say, the two distinctions are, as a matter of fact, not entirely independent of each other. In particular, one should expect the combinations “citizens / immobile factors” and “jurisdiction-users / mobile factors” to occur disproportionately often, a fact that has to be taken into consideration in analyzing the effects of competition among jurisdictions. Nevertheless, it has to be kept in mind that only the ability of governments to promote the common interests of their citizens provides the decisive criterion against which we can judge whether there is a conflict between competition among jurisdictions and democracy. The interests of non-members as jurisdiction-users are *per se* of no systematic relevance. Note, however, that this by no means implies that the interests of non-citizens as current or potential jurisdiction-users can be neglected without impunity. *They are irrelevant only insofar as the performance criterion for democratic associations is the promotion of members’ interests, not the promotion of the interests of non-members.* The latter’s interest certainly do play an *indirect* role, however, to the extent that the citizens or members of polities have, with

regard to their own interests, good reasons to take the interests of such non-members into account, in more or less the same way as the owner of a firm must – if he wants to run a successful business -- consider the wishes of his clients, suppliers, creditors and employees.

In addition to the above-mentioned indirect consideration, which we will return to later, the interests of the members of other jurisdictions can, of course, also gain direct importance, especially in cases concerning potential agreements (on rules) between states or jurisdictions. In order to assess the desirability of such international or inter-jurisdictional agreements, it is obviously not only the interests of the citizens of any single jurisdiction that are stake, but the interests of the citizens of *all* participating jurisdictions. This fact will be discussed below in more detail in connection with the issue of the „rules of competition“ for competition among jurisdictions.

Before examining the effects of ‘competition among jurisdictions’, a few remarks are in place to clarify the concept itself, since it is used in a variety of contexts. It is sometimes used, for example, to refer to the fact that through their infra-structural resources and institutional frameworks, jurisdictions influence the costs of the domestic production of tradable goods and services, and, consequently, the competitiveness of domestic producers on the global market. In this sense, jurisdictions compete with their characteristics indirectly, insofar as these affect the chances of domestic producers in international trade. As it is used most often, however, the concept of competition among jurisdictions does not refer to this “indirect” form of competition, but to the direct competition for people and mobile resources.

Jurisdictions compete with one another in terms of their natural attributes (climate, geographical properties, location, etc.) that are not subject to willfull change, and in terms of attributes that are subject to political choice, such as infrastructure (roads, education, etc.), or institutional framework conditions (legal security, economic constitution, etc.). Since the citizens are the principals or “owners” of democratic jurisdictions, one may say that they, represented by their governments, compete for mobile resources that they would like to attract to, and retain in, their respective jurisdictions. The interests that citizens assert in this context may very well be in conflict, not only among persons but also intra-personally, since citizens can be

affected in different capacities by the impact of competition among jurisdictions: as inhabitants of a jurisdiction, as suppliers of labor and human capital, as holders of mobile financial capital or of less mobile invested capital, as consumers, or in other respects.

The willingness of jurisdiction-users to remain, and to use their mobile resources, in a jurisdiction will depend on what may be called their *jurisdiction rent*, i.e. the difference between the return they get from investing their resources in a given jurisdiction and the return that they could realize by changing to the most attractive alternative jurisdiction open to them. Since the most favorable alternative return represents the opportunity costs of the investment of resources in any given jurisdiction, by implication the jurisdiction rent is positive as long as the opportunity costs are less than the return earned in that jurisdiction, and they are negative if the opportunity costs exceed this return. If the jurisdiction rent is nil, a jurisdiction user will be indifferent between remaining in the given jurisdiction or moving his mobile resources to the most attractive alternative jurisdiction. If the jurisdiction rent is negative, he will withdraw the resources in question from the jurisdiction.

The effects of the changes that the term globalization describes can, in terms of the above terminology, also be rephrased to suggest that a greater range and easier access of attractive alternative jurisdictions has generally increased the opportunity costs of the use of mobile resources in any specific jurisdiction. Even if, over a period of time, the “absolute” attractiveness of a jurisdiction should not have changed at all, the jurisdiction rents may be reduced by the mere fact that new attractive alternatives have become accessible, with the effect of increasing jurisdiction-users’ opportunity costs of remaining in the jurisdiction. This, of course, is even more the case if its politically modifiable attributes have become less attractive in absolute terms to mobile resources.

#### **4. Competition Among Jurisdictions and Common Interests**

Competition always imposes restrictions on the competitors. In this sense, as already noted, competition among jurisdictions imposes, quite obviously, restrictions on

governments which make it costly or even impossible for them to implement or sustain certain policies or regulations. If one supposes a substantive *a priori* list of activities that democratic governments have to pursue, one may quite easily arrive at the conclusion that competition among jurisdictions impedes governments from fulfilling some or all items on such a predefined “democratic agenda”. If, instead, one adopts a procedural understanding of democracy, as implied in the criterion of citizen sovereignty described above, one cannot arrive at any judgement without looking more closely at the issue of what kinds of policies can be expected to be encouraged or discouraged by competition among jurisdictions. In other words, one needs to examine whether the fact that citizens and jurisdiction-users may take advantage of the opportunities offered by competition among jurisdictions can, indeed, be said to prevent governments from serving common interests of their citizens.

The argument that competition among jurisdictions is in conflict with common interests of citizens, ultimately implies the claim that such competition creates a (prisoners) dilemma for the citizens involved, be it an *intra*-jurisdictional or an *inter*-jurisdictional (prisoners) dilemma, or both. In other words, to assert that a systematic conflict exists between competition among jurisdictions and democracy would mean to make one or the other (or both) of the following claims:

That the citizens of a jurisdiction, through their individual and separate use of the options offered to them by competition among jurisdictions, collectively put themselves in a situation, which is less attractive for all than the situation they would be in if these options were not available,

or

that the citizens of various jurisdictions inflict mutual damage and create a situation undesirable for all, either by using separately, as individual persons, the options offered by competition among jurisdictions or by adapting separately, as a single constituency or jurisdiction, to the conditions imposed by the competition among jurisdictions.

The first case would involve an *intra*-jurisdictional, the second an *inter*-jurisdictional (prisoners) dilemma.

In the case of an *intra*-jurisdictional (prisoners) dilemma, competition among jurisdictions could be said to offer the citizens of a jurisdiction “perverse” incentives

which would cause them, in the pursuit of their separate individual interests, to choose strategies that, in their aggregate effects, result in collective self-damage. An example might be if citizens, acting on individual, separate profit motives, favor capital investment abroad instead of at home, causing negative aggregate effects on living conditions in their home jurisdictions that, in their own assessment, outweigh the extra gains derived from such foreign -- as opposed to domestic -- investments.

In the case of an *inter*-jurisdictional (prisoners) dilemma, competition among jurisdictions would offer the respective citizenries, or their governments, “perverse” incentives in the sense of causing them to make decisions which, in the separate calculations of each individual jurisdiction seem advantageous, which, however, in their overall effect are disadvantageous for all involved.<sup>12</sup>

In what follows I want to examine more closely what potential reasons there might be to believe that such dilemmas exist.

## **5. Consumer-interests, Producer-interests, and Citizens-interests**

With respect to the possible reasons for (prisoners) dilemmas caused by competition among jurisdictions, it is useful to distinguish between various interests, in which the citizens of a state might be affected by competition among jurisdictions. In this respect, one can separate their interests as consumers from interests they have as producers -- be it as investors, employees, or in some other capacity, and from these two kinds of interests one may, in turn, distinguish interests they may hold as “citizens” in a more narrow sense, namely interests in jurisdiction-characteristics, which they cherish as citizens of jurisdictions, separate from their capacity as consumers or producers. In terms of this distinction, the argument that competition among jurisdictions creates intra- or inter-national (prisoners) dilemmas can be restated as follows: by using -- be it as consumers, as producers, or as owners of mobile resources -- the options available under competition among jurisdictions, citizens, in separate and individually rational pursuit of their interests, generate overall outcomes that damage their common *citizen*

interests to an extent that outweighs, in their own assessment, the benefits gained from the use of these options.

In order to locate more precisely the common citizen interests which could potentially be obstructed by competition among jurisdictions, it may be useful to start from the standard free trade argument and its implied criterion of consumer sovereignty.<sup>13</sup> According to Adam Smith's classical argument, the expansion and globalization of markets should clearly be welcomed as a source of welfare gains. By widening the extent of the market, i.e. by enlarging the set of exchange opportunities, it promotes division of labor and specialization, thereby enhancing the productivity of labor as the principal source of increases in wealth: Goods and services can be made available at lesser costs than otherwise would be the case. Competition among jurisdictions results precisely because the economic options created by globalization provide benefits to those who -- either as consumers and buyers or as holders of mobile resources -- have an incentive to use them. To be sure, this does not imply that the immediate effects of such competition must be of unanimous advantage for all citizens or members of a jurisdiction, since those who lose customers or trading partners due to the attractiveness of such options will consider themselves disadvantaged in comparison to the status quo.<sup>14</sup> And, since as a rule, each citizen does not experience the effects of competition among jurisdictions *solely* as a consumer, or as a holder of mobile resources, or as a producer, but embodies all or some of these interests, the various effects must be weighed up against one another, when it comes to judging the overall impact of competition among jurisdictions.

The normative principle of consumer sovereignty would surely be an extremely questionable ideal, if it was about dogmatically giving priority to consumer interests, without considering potential other human interests, that extend beyond the consumer role. If its implied constitutional recommendation, i.e. to organize "the economy" so

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<sup>12</sup> The existence of such an *inter-jurisdictional* dilemma is alleged, for instance, by Sinn (1997a: 39) and Scharpf (1998: 47).

<sup>13</sup> For a detailed discussion see R. Sally (1998, in particular pp. 35ff.).

<sup>14</sup> Hayek (1976: 121) notes on this issue: "Any discovery of more favourable opportunities for satisfying their needs by some will thus be a disadvantage to those on whose services they would

that consumer preferences are the ultimate controlling variable of the process of production, is to make sense, it cannot be meant to ignore the fact that individuals are involved in the economic process as producers too -- be it as investors, as entrepreneurs or as employees, and must be expected to have corresponding producer interests as well.<sup>15</sup> In its ultimate rationale the principle of consumer sovereignty entails the claim that, as a regulating ideal for the economic process, it is in the common interest of all citizens -- and, indeed, with regard to their various interests, not only as consumers or investors, but also as producers. More precisely, the principle must ultimately be interpreted as the conjecture, that an economic constitution based on consumer interests, exhibits more desirable working properties for all citizens, with all their diverse interests, than an economic constitution that responds to their *protectionist* producer interests (Vanberg 1997a: 720ff.). This conjecture derives from the diagnosis that the interests in competitive openness, which people have as consumers or buyers, are consensual interests, not, however, the protectionist interests that they hold as producers.

Whatever special category of goods or services the primary interest of particular groups of buyers may aim at, openness to competition as a general principle is compatible with all such interests. In this sense, we can say that openness to competition is in the unanimous interest of consumers, as well as in the unanimous interest of producers, as far as they are affected *in their role as buyers*. To be sure, as mentioned before, in their role as *suppliers* producers may well be negatively affected by competition among jurisdictions, and may, therefore, be inclined to seek protectionist legislation, which would impede their customers' access to more attractive alternatives. In contrast to consumer or buyer interests in openness to

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otherwise have relied. ... Of course, those who as a result will be deprived of their former customers will incur a loss which it would be in their interest to prevent."

<sup>15</sup> In reference to the negative effects of competition on those who lose their former customers and transaction partners to more attractive alternatives (Hayek 1976: 120), Hayek (ibid.: 121) asks the rhetorical question: "Does this mean that something is disregarded that ought to be taken into account in the formation of a desirable order?" His answer is that these disadvantages are outweighed for everybody involved by the benefits provided by an order, "the advantage of which is that it continually adapts the use of resources to conditions unforeseen and unknown to most people. ... The effects of new and more favourable opportunities for exchanging which appear for particular individuals are for society as a whole as beneficial as the discovery of new or hitherto unknown material resources" (ibid.: 121f.). He adds: "And though in the short run the

competition, such protectionist producer interests are not, however, in mutual agreement. They offer no basis for a consensual economic constitution, but are in fact interests in *privileges* in the sense that the protectionist legislation is not sought for all producers equally but only for specific (narrowly defined) branches or industries.<sup>16</sup> Benefits are only to be had from protection granted to one's own specialty, not from protection granted to others. In fact, protection granted to others may well directly conflict with one's own interests, especially if granted to those whose goods or services one is in need of. Clearly, the most attractive situation is to enjoy sole protection while all others are subjected to competition. The greater the group of "beneficiaries" of protectionist legislation, the more unfavorable the balance between the benefits derived from one's own protectionist privilege, and the disadvantageous effects of the protection granted to others. In other words, while it is attractive to be the beneficiary of protectionist regulations, if one were presented with the choice between a thoroughly protectionist system and a totally non-protectionist, competitive regime, there would be every reason to choose the latter.<sup>17</sup>

Another way of describing the matter is to say that citizens are faced with a (prisoners) dilemma when it comes to their protectionist producer interests. Their dominant strategy is to seek protection for their own respective economic activity. In doing so, however, they tend to bring about a situation of endemic protectionism, which is less desirable for all than a completely non-protectionist arrangement. In the normal political process, they are not confronted by the choice between a thoroughly protectionist system and a system open to competition, but by the choice to seek, or to refrain from seeking, protectionist privileges for themselves. As a rule, they have no reason to assume that their own unilateral willingness to refrain from privilege-seeking will decide whether they will live under the one or the other system. Accordingly, as

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unfavourable effects may out-balance the sum of the indirect beneficial effects, in the long run the sum of all those particular effects ... are likely to improve the chances of all" (ibd.: 122).

<sup>16</sup> The term "privileges" is used here for regulations that "secure benefits to some at the expense of others, in a manner which cannot be justified by principles capable of general application" (Hayek 1976: 129).

<sup>17</sup> In this sense, mutually accepting a binding rule prohibiting any granting of protectionist privileges should be in the interest of all. – As Hayek (1976: 122) notes on this issue: "It should be obvious that we will achieve the best results if we abide by a rule which, if consistently applied, is likely to increase everybody's chances." – See also Buchanan (1989).

much as they may prefer to live in an open competitive system, this preference by itself cannot provide any motivation for unilateral restraint.

The protectionism dilemma resulting from this structure of incentives has been diagnosed as a major problem of the political process by both the Freiburg School of Law and Economics (Vanberg 1998) and the Public-Choice School.<sup>18</sup> A possible solution to this dilemma could be constitutional provisions which impose suitable constraints on governments and legislators; in the past, though, constitutional constraints that were meant to serve that purpose have provided limited remedy only.<sup>19</sup> Competition among jurisdictions might prove to be an effective force to support the in itself apparently somewhat limited disciplinary power of constitutional constraints.

As far as the relationship between consumer and producer interests is concerned, it is safe to say that competition among jurisdictions does not *create* a prisoners dilemma, but is in fact suited to *overcome* an intra-jurisdictional prisoners dilemma, namely the noted protectionism dilemma. By providing exit opportunities it restricts the power of governments to burden citizens (and jurisdiction-users) with the costs of protection privileges granted to others. The overall effects of such competition can be beneficial even for those whom it deprives of their privileges, if, by overcoming the protectionism dilemma, it leads to a simultaneous abolition of all – or, at least, a sufficiently large portion of all - protection privileges and, thereby, to a more desirable “game” for everybody involved. In this regard, competition among jurisdictions clearly appears to enhance rather than to impede democracy.

To be sure, all this does not answer yet the question raised earlier, whether competition among jurisdictions creates a dilemma with respect to the relationship between consumer and/or producer interests on the one hand, and citizen interests on

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<sup>18</sup> Hayek (1976: 122) notes on this issue: “The known and concentrated harm to those who lose part or all of the customary source of income must ... not be allowed to count against the diffused ... benefits to many. We shall see that the universal tendency of politics is to give preferential consideration to few strong and therefore conspicuous effects over the numerous small and therefore neglected ones, and therefore to grant special privileges to groups threatened with the loss of positions they have achieved.”

<sup>19</sup> On the constitutional ideal of liberalism Hayek (1944: ixf.) notes: “The essence of the liberal position, however, is the denial of all privilege, if privilege is understood in its proper and

the other. It could very well be that, besides the interests in protectionist *privileges*, something resembling “general protectionist interests” exist, for instance in the sense that the citizens of a jurisdiction have shared “protectionist” interests -- distinct from the discussed producer-interests -- in maintaining certain jurisdiction-characteristics, which they feel threatened by the forces of competition. By contrast to interests in protectionist privileges, with such “general protectionist interests” it is conceivable that the citizens of a jurisdiction would be better-off if they restricted their freedom to avail of certain options created by competition among jurisdictions.

It is undeniable that, as John Kincaid (1992) puts it, a conflict can arise between *consumership* and *citizenship*.<sup>20</sup> Yet, the mere insinuation that such a dilemma might arise is insufficient justification for the claim that competition among jurisdictions poses a threat to democracy, and that, therefore, restrictions on, or elimination of, such competition is advised. In order to arrive at such conclusion, one would need to show specifically which common interests of citizens might be enhanced by restrictions on competition, and for which regulatory restrictions on competition we can actually expect the advantages to outweigh the potential disadvantages. Even if a restriction of competition among jurisdictions may respond to certain citizen interests, this does not imply that implementing it is in fact desirable for citizens, when *all* its effects are considered. For instance, one might well argue that the majority of people do seem to share – quite apart from any interests in protectionist *privileges* -- a general interest in the stability of social and economic conditions in their own environment. The traditional and widespread resentments against competitive systems have probably fed to some degree of this desire, right up to the present-day communitarian criticism of liberal society. Yet, the undeniable fact that human beings hold such kinds of interests by no means implies that they seek to realize them at all cost, and that they are prepared to pay the price they would have to pay for living in a system which would consistently accommodate such interests. The past and current choices revealed in the actual behavior of people seem to provide clear evidence to the contrary. For most of them sacrificing the advantages to be enjoyed under open competitive systems appear

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original meaning of the state granting and protecting rights to some which are not available on equal terms to others.”

<sup>20</sup> On this see Vanberg (1997b).

to be too high a price for the consistent fulfillment of their interests in stability. After all, communities such as the Amish in Pennsylvania that are thoroughly committed to traditional life styles, are famous just because of their rarity.

Yet, however one may interpret the available evidence, the ultimate test for the “willingness to pay” must be seen in the willingness of people -- faced with viable alternatives -- to opt for such systems and remain loyal to them in the presence of exit possibilities.<sup>21</sup> If this is so, systems which would satisfy their citizens’ common interests in stability by introducing appropriate “protectionist constraints”, should be sustainable in a world in which competition among jurisdictions prevails at least to the extent that people can exercise free choice between alternative systems. This suggests that, if we wish to improve people’s chances of being able to live in systems which serve, to the largest extent possible, their common and compatible interests - including potential “general protectionist interests”, we should favor “meta-constitutions for constitutional choice” that enhance individuals’ possibilities of voluntarily choosing, individually and separately, among alternative regimes.<sup>22</sup> This issue, to which the theory of fiscal federalism has made important contributions,<sup>23</sup> is of obvious relevance in the evaluation of the effects of competition among jurisdictions on democracy.<sup>24</sup>

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<sup>21</sup> It was one of the core arguments of Tibout’s (1956) classical contribution to the theory of fiscal federalism that competition among jurisdictions not only induces local governments to be responsive to citizens’ preferences, but also requires citizens to reveal their “willingness to pay” and their “true preferences for public goods”.

<sup>22</sup> R. Nozick’s (1974: 297ff.) discussion on a “framework for utopia” centers around the idea of a “meta-constitution” that allows individuals to choose freely among communities which, in turn, are free to agree, internally, on all kinds of restrictions, as long as freedom of mobility is maintained. Under such conditions, communities are subject to the test of voluntary participation: “Each community must win and hold the voluntary adherence of its members” (ibid.: 316).

<sup>23</sup> At the beginning of the chapter on “The Prospects of International Order” in “The Road to Serfdom” Hayek (1944: 219) cites Lord Acton with the following quotation: “Of all checks on democracy, federation has been the most efficacious and the most congenial. ... It is the only method of curbing not only the majority but the power of the whole people.” Hayek comments: “Nineteenth-century liberals may not have been fully aware *how* essential a complement of their principles a federal organization of the different states formed” (ibid.: 234f.).

<sup>24</sup> J. Kincaid (1991: 98) notes on what he calls the principle of “federal democracy”: “At base, a emigrate is fundamental. However, because emigration is costly, citizens must have effective choices within the polity. Here, competition performs a dual function. It allows citizens to migrate from one group or jurisdiction to another in search of satisfaction, and it encourages public and private institutions to satisfy their constituents so that they stay put voluntarily.”

## 6. The „Race to the Bottom“ Argument

To the extent that problematic effects attributed to competition among jurisdictions can be traced back to intra-national (or intra-jurisdictional) dilemmas, the respective problems can be solved by unilateral, national (or jurisdictional) measures. This means that the real problem is not due to competition *per se*, but to deficiencies of the existing “jurisdiction constitution”, deficiencies which are *exposed* by, but not *caused* by competition. Admittedly, this result is of limited significance only, since the authors who stress the dangers of competition among jurisdictions, seem to identify the critical problem less in the occurrence of *intra*-jurisdictional (prisoners) dilemmas than in the fact that it may lead to *inter*-jurisdictional dilemmas. If we accept the above concept of states or jurisdictions as *territorial enterprises*, the supposition of such dilemmas implies the claim that competition forces governments to respond to the interests of mobile resources in ways that prevent them from maintaining regulations or taking measures that would be in the common interests of their respective constituencies. In other words, it implies that competition for mobile factors causes the competing jurisdictions -- or the respective governments -- to adopt measures that in their overall effect are disadvantageous for all citizens involved. A suspicion voices in this context is that, as far as regulation of economic activities or taxation of enterprises is concerned, competition will result in a “race to the bottom” to the detriment of all involved. Or fears are expressed that the provision of certain public goods and, in particular, distributional policies will become impossible (Sinn 1997a; 1997b).

As far as the issue of public goods is concerned, one needs to clarify first whether the advantages that are at stake solely benefit the citizens of the providing jurisdiction, or appreciably “radiate beyond” the jurisdiction’s boundaries. If the latter is the case, i.e. if there are significant external effects, the attractiveness of the “free-rider option” may well prevent governments from supplying such public goods under competitive conditions, even if this would be in the common interest of all their citizens. Yet, the root of the difficulty is not, once again, to be found in competition *per se*, but in the externality problem. This problem should be resolved, however, through appropriate international (inter-jurisdictional) agreements on rules directly addressing the externality issue, rather than by eliminating competition.

The „race to the bottom“ argument is controversial mainly where state measures, regulations or services are concerned, whose alleged advantages accrue mainly benefit the citizens of the jurisdiction concerned (Sinn 1997a: 12.) As regards possible negative effects of competition among jurisdictions on such regulations or services, the skeptics do not always distinguish clearly enough between the issues of “free-riding” on the one hand and “exit” on the other. A sharp distinction has to be drawn, however, between a) problems caused when mobile resources are allowed to profit from the services or characteristics of jurisdictions, without paying an appropriate price (problems of free-riding in the provision of public goods) and b) problems that result from the fact that mobile resources have the option of migrating from less attractive regimes to more attractive jurisdictions.

The free-rider problem would in fact prevent the provision of jurisdiction characteristics which, for the citizens and jurisdiction-users, have the character of public goods, as long as the option of non-contributory consumption exists. If mobile resources have the option of using the service and infrastructure of a jurisdiction without payment, they are likely to take advantage. However, it is not competition among jurisdictions that creates this option. Competition among jurisdictions is about the migration of mobile resources from one jurisdiction to another, and migration is something completely different from free-riding. It is about choice among alternative jurisdictions with their various *combinations* of services and required contributions. To be sure, by migrating from one jurisdiction to another, mobile resources can avoid required contributions at the exit-jurisdiction, but they can do so only by simultaneously foregoing the services of that jurisdiction. There is no evidence that -- regardless of possible differences in the quality of the services provided -- they will always favor the jurisdiction that demands the lowest taxes. In fact, it is far more likely that they will seek the most attractive cost-benefit package.

A „race to the bottom“ in tax competition is not likely, as long as the applied taxation rules prohibit free-riding -- i.e. the non-contributory use of jurisdiction services -- and the taxes imposed on enterprises correspond to their use of jurisdiction

services.<sup>25</sup> Where this is not guaranteed, competition among jurisdictions may well lead to a “race to the bottom”, but then the real problem is not with competition *per se*, but with deficiencies of the taxation system. Solving this problem is, however, primarily a matter of introducing appropriate reforms of taxation rules at the national level. “Ruinous competition” can be prevented, if international taxation competition takes the form of “Leistungswettbewerb” or “performance competition,” i.e. if national taxation systems burden jurisdiction users to the extent in which they use jurisdiction services or characteristics. Should international regulations or agreements be in conflict with such a “taxation according to benefit”, there is obviously a need for reform at this level. If, say, international tax agreements grant enterprises the option of deciding whether to pay taxes in a jurisdiction whose services they actually use, or in a jurisdiction in which they -- figuratively speaking -- merely have a P.O. box, a “race to the bottom” will be hard to avoid in enterprise taxation. But again, in such cases the problem is not with competition among jurisdictions, but with the inadequacy of the pertinent rules of the game.

To the extent that location characteristics or services provided by a jurisdiction have the properties of “local” public goods, in the sense that the citizens and jurisdiction-users are the main beneficiaries, competition among jurisdictions apparently does not stand in the way of “taxation according to benefit.” If, as Sinn appears to do, one sees in the restriction to “benefit taxes” an undesirable limitation of the power of government,<sup>26</sup> one ought to explicate on what grounds one considers it desirable and legitimate for governments to be allowed to burden citizens or jurisdiction-users with the costs of schemes from which they derive no advantage whatsoever.

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<sup>25</sup> To organize a tax system so as to accomplish this is, quite obviously, not an easy task. But here, as in other areas, competition may serve a useful function as a “discovery procedure” allowing governments and citizens to find out which schemes are more efficient in solving this problem than others. --On this issue see Ch.B. Blankart (1997; 1999).

<sup>26</sup> Sinn (1994: 98f.): “Competition will drive the tax rate on a mobile factor down to ... a mere benefit charge, ... no redistributive taxation is possible.” Sinn adds (ibid.: 101): “In the end, all countries will settle at an equilibrium where only benefit taxes are charged, and no redistribution policies are carried out.”

In his reflections on “A New Principle of Just Taxation” (Wicksell 1896: 73-164; 1967), Knut Wicksell more than one hundred years ago stated an argument still relevant today, on why the principle of “taxation according to benefit” (1967: 74) can be said to be a *just* principle. As he argued: “It would seem to be a blatant injustice if someone should be forced to contribute toward the costs of some activity which does not further his interests or may even be diametrically opposed to them” (ibid.: 89).<sup>27</sup> Competition among jurisdictions favors the principle of “taxation according to benefit”, it offers protection against what Wicksell saw as “the controversial part of fiscal policy” (Söderström 1986: 94), namely the possibility “(for) various groups to obtain advantages at the cost of others” (ibid.). Of course, it may also stand in the way of projects that are not motivated by an interest in privileges, but by well-intentioned concerns for the “general good”, to the extent that the ideas proposed by the advocates of such schemes do not coincide with the assessment of the citizens and jurisdiction users themselves. As Dennis Mueller (1998: 186) puts it:

Most objections to tax competition between governments on the grounds that it will lead to ‘social dumping’ and ‘a race to the bottom’ rest on an elitist view of government similar to that underlying the ‘merit want’ argument. The ‘impartial observer’ knows what the proper level of taxation for the country should be and how this money should be spent, and fears that any loss in tax revenue will harm these programs. Such fears are unfounded, *if governments provide the goods and services their citizens want, and use benefit taxes to finance them.*<sup>28</sup>

The principle of “taxation according to benefit” does not require a perfect proportionality between tax contributions and benefits received. It means that tax contributions are to be viewed as a price willingly paid for jurisdiction benefits which, in the judgement of the citizens or jurisdiction-users offset the costs, *in light of available alternative options*. Competition among jurisdictions in the sense of the availability of alternatives is essential for any meaningful weighing-up of costs and

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<sup>27</sup> On the relevance of the Wicksellian concept for the issue of competition among jurisdictions see also. Mueller (1998: 180f.). - Wicksell was an advocate of what R. A. Musgrave has termed “voluntary exchange theory of public economy”, a theory which Musgrave thought to be of no practical relevance (Wagner 1988: 162).

<sup>28</sup> Mueller (1998: 186) adds: “Citizens in the United States move into communities with high quality police forces, *not away* from them, and they are willing to pay the high property taxes that are needed to finance these high quality public services. They do move away from cities with high tax rates and *low* quality schools and other public services, however, like Washington, D.C.”

benefits.<sup>29</sup> Tax contributions which compensate for benefits to be gained in a jurisdiction are paid willingly. Competition among jurisdictions cannot jeopardize such kinds of tax systems.<sup>30</sup>

## **7. Competition Among Jurisdictions and Redistribution**

Under the noted conditions of “Leistungswettbewerb” or “performance competition” governments can only tax mobile factors if these are willing to pay the required tax as a price for the benefits they hope to reap from the use of the particular jurisdiction. Apparently, a main reason for authors like Hans-Werner Sinn to view a limitation to “benefit taxes” as an undesirable restriction of political power is the suspicion “that mobile factors cannot be taxed for redistributive purposes” (Sinn 1994: 101).<sup>31</sup> If this argument were merely meant to assert that competition among jurisdictions obstructs certain predefined redistribution aims, that are justified by reasons unrelated to “citizen sovereignty”, there is no need to discuss it in the present context. Suffice is to refer to the above comments on the incompatibility between a procedural concept of democracy and postulated state aims. The argument is of systematic interest in the present context only if it is meant as the claim that competition among jurisdictions endangers redistribution projects that serve common interest of all citizens.<sup>32</sup>

Where redistributive taxes are used to produce jurisdiction characteristics (such as the “social peace”, regularly invoked in the German debate) that make the jurisdiction more attractive for citizens and jurisdiction-users, such taxes can be seen as

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<sup>29</sup> Hayek (1978: 162) notes on the working properties of federal competition: “The 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 charged.”

<sup>30</sup> In reference to environmental regulation J. D. Wilson (1996: 394) notes on this issue: “A critical condition for efficiency is that each firm pays a tax equal to the costs that its operations impose on the jurisdictions. These costs can consist of the costs incurred in providing public goods and services to the firms plus environmental costs. Given that governments are able to use taxes as ‘user fees’ in this manner, considerations involving capital mobility do not enter into the benefit-cost rules governments use to choose environmental standards.”

<sup>31</sup> In reference to the competition among jurisdictions induced by the “four basic liberties” within the EU Sinn (1994: 101) suspects: “Eventually, not only redistributive taxes have to be lifted to the community level when the four liberties are to be granted, to some extent even benefit taxes for local public goods must be too.”

a price that may be demanded of mobile factors no less than of citizens for permission to take advantage of these particular jurisdiction characteristics. To the extent that the option of “free-riding” is excluded, mobile factors will be faced with the choice of paying the price demanded or foregoing the benefits of that jurisdiction. There are reasons conceivable why redistributive taxes could benefit all citizens of a jurisdiction, including those who have to pay them (Mueller 1998). There are also conceivable reasons why the same may be true for non-citizens as jurisdiction-users. Where redistributive taxes are not offset by any jurisdiction-services or -characteristics that offer benefits to mobile factors, the latter will obviously attempt to avoid such payments.<sup>33</sup> But on what grounds should a government then be allowed to recruit mobile factors for the financing of transfers, which generate no benefits for them whatsoever? If redistribution results in desirable jurisdiction characteristics, should not the beneficiaries of these characteristics also carry the costs? No doubt, the citizens of any particular jurisdiction may find the prospect attractive of having jurisdiction-users contribute to schemes that exclusively benefit them, the citizens. This, however, does not mean at all that the citizens of a single jurisdiction could realize common benefits from unilateral attempts to coerce jurisdiction-users into making such contributions, nor does it imply that the citizens of several jurisdictions -- such as the citizens of EU member states -- could jointly better their situation, if, in pursuit of such “exploitative interests,” they restricted jurisdictional competition among themselves. In fact, in regard to the fiscal exploitation of jurisdiction-users, the citizens of different jurisdiction are facing a “dilemma,” but it is a “dilemma” that serves their common interests. It prevents them from adopting (exploitative) strategies, which, from the standpoint of each individual jurisdiction may seem attractive, but which would make them collectively worse off than they are by mutually refraining from employing them.

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<sup>32</sup> Sinn (1994: 99): “Redistribution policy can potentially be interpreted as an efficiency enhancing activity of the state.”

<sup>33</sup> Mueller (1998: 179): “Just as diners are unlikely to frequent a restaurant that continually overcharges them, if they have other options, a citizen who is overtaxed for the goods and services she receives seeks to avoid these taxes. In an increasingly mobile world, ... communities are forced to rely on benefit taxation and to limit activities to those public goods and services that benefit all members of the community. In the limit, mobility acts like a silent unanimity rule and produces the same outcomes as we would expect under this voting rule in an immobile world.”

It is one question whether competition among jurisdictions prevents governments from taxing mobile factors or jurisdiction-users for redistributive purposes which would bring them no equivalent benefits. It is another question whether competition among jurisdictions prevents citizens from implementing redistribution schemes *among themselves*, which could be of benefit to all. That this is the case is argued by H.-W. Sinn, who focuses on redistribution as a form of insurance:<sup>34</sup> “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” (Sinn 1997b: 258).<sup>35</sup> Such an interpretation of redistribution as an insurance scheme in the common interest of all citizens makes no doubt sense. It does not dispense, however, with the question as to whether the existing redistribution arrangements actually pass the test that has to be passed by any “efficient” insurance scheme, namely that it is *ex ante* beneficial for all parties, and thus gives all parties *ex ante* good reasons to willingly participate in the arrangement. Nor does it dispense with the necessity to examine why insurance schemes that pass this test should be threatened by competition among jurisdictions.

If, in this light, we look at one of the main elements of the redistributive machinery of the welfare state, namely the subsidization of “threatened” industries, as an “insurance against the risk of income variations” (Sinn 1997b: 258), it seems very doubtful that this particular element qualifies as an *ex ante* beneficial insurance scheme for all citizens. This kind of insurance against market risks can only be granted as a privilege to selected groups. It clearly is not practicable as a general rule equally applicable to all. However understandable the desire for such a safeguard against market risks may be, it cannot be satisfied in a manner still desirable if extended to all parties in a non-discriminatory manner. As Hayek (1944: 123) once put it:

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<sup>34</sup> Sinn (1997b: 258): “Redistribution can have many reasons including charity, social and political stabilization, or ethics and justice. Arguably the most important reason is the insurance it provides in an uncertain world.”

<sup>35</sup> Sinn (1994: 99): “Contracts that *ex ante* can be interpreted as insurance, involve redistribution from an *ex post* perspective, and what we call redistribution can often be seen as insurance from an *ex*

That anyone should suffer a great diminution of his income ... undoubtedly offends our sense of justice. The demands of those who suffer in this way, for state interference on their behalf ..., are certain to receive popular sympathy and support. The general approval of these demands has had the effect that governments everywhere have taken action .. to shelter them from the vicissitudes of the market.

Certainty of a given income can, however, not be given to all ... . And, if it is provided for some, it becomes a privilege at the expense of others whose security is thereby necessarily diminished.<sup>36</sup>

On the other hand, the fact that an arrangement granting the “privilege of security” (ibid.: 128) only to some can scarcely be regarded as an insurance beneficial for *all*, by no means implies that the interest in social safeguards could not be accounted for in a manner that would, indeed, benefit all.<sup>37</sup> A redistributive regime that can genuinely claim to serve the interests of all citizens, would have to pass, though, the minimal test, that it is capable of extending equal treatment to all parties involved in a non-discriminating, privilege-free manner.<sup>38</sup> Even if redistribution schemes that grant privileges to some at the expense of others can, indeed, hardly be sustained under conditions of competition among jurisdictions, there is no reason why privilege-free schemes for social insurance could not be organized in ways that enable them to be viable under such conditions.

In his concern about the anti-redistribution effects of competition among jurisdictions, Sinn focuses, though, not on the above aspects of the “redistributional state” but on trans-generational “insurance aspects” of the welfare state, specifically the possibility created by the “redistributional state,” to obtain, not only for oneself but also for future descendants, insurance against “life-risks” such as, in particular,

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ante perspective. Redistribution can therefore be a useful government activity that generates benefits similar to those provided by the insurance industry.”

<sup>36</sup> See also Hayek (1944: 128ff.). In an other context Hayek (1967: 173) notes on this issue: “More than by anything else the market order has been distorted by efforts to protect groups from a decline from their former position. ... In a market order the fact that a group of persons has achieved a certain relative position cannot give them a claim in justice to maintain it, because this cannot be defended by a rule which could be equally applied to all.”

<sup>37</sup> On this issue Hayek (1944: 132) notes: “There can be no question that adequate security against severe privation ... will have to be one of the main goals of policy.”

<sup>38</sup> That a discretionary politics that grants subsidies to particular groups may well produce more severe inequalities than those inherent in the distribution of earning powers in the market has

reductions in one's income-earning ability due to disabilities, illness, or accident.<sup>39</sup> Such trans-generational insurance schemes – for which, according to Sinn, there are no substitutes in the private law arena --<sup>40</sup> are, Sinn claims, *ex ante* beneficial for all,<sup>41</sup> but cannot be sustained under conditions of competition among jurisdictions. The reason, he says, is that under the conditions of such competition, the basic requirement of an efficient insurance cannot be guaranteed, namely that insured, who have not suffered damages, cannot *ex post* evade liability to pay.<sup>42</sup> With respect to the situation in the European Community, Sinn (1994: 99) states: “Even such beneficial redistribution would not be able to survive in a Europe where the single countries compete with one another. A Europe with free migration is like an insurance where the customers can choose the company *ex post*.”

If we assume for a moment that competition among jurisdictions actually does jeopardize the welfare state in its present form,<sup>43</sup> and leave aside the question whether there are, indeed, no private law substitutes conceivable that could serve the kind of insurance interests which Sinn has in mind, his argument raises two fundamental questions: the first question is whether the “breakdown of national redistribution schemes under institutional competition” (Sinn 1994: 97), which he fears, can justifiably be blamed on competition, or whether instead, it manifests functional

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been pointed out by M. Olson (1982: 175): “There is greater inequality ... in the opportunity to create distributional coalitions than there is in the inherent productive abilities of people.”

<sup>39</sup> Sinn (1997b: 259): “Consider the preferences of parents or parents to be. At or before the time of birth the parents do not know whether their child will be handicapped or healthy, gifted or untalented. They are therefore interested in obtaining insurance against the lifetime income variations resulting from these differences.”

<sup>40</sup> Sinn (1997b: 259): “The market cannot provide this insurance since this would imply that the parents sign a bondage contract for their children from which these children could not escape even if they wished to do so. ... There is little doubt that private markets cannot provide the type of career insurance which is the essence of income redistribution through the government budget.”

<sup>41</sup> Sinn (1997b: 259): “Redistribution through the government budget can be seen as insurance against being a bad risk and as such it may be welcomed by all citizens before destiny has lifted its veil of ignorance.”

<sup>42</sup> Sinn (1997b: 262 comments on the “implications of fiscal competition among redistributive tax systems”: “Suppose the country's borders are opened and both capital and labour can freely migrate accross them. This liberty ... will affect insurance through redistributive taxation since athe government loses its power to enforce the payment of taxes.”

<sup>43</sup> On the need to qualify this supposition see, for instance, Windisch (1999: 166f.); Feld, Kirchgässner und Savioz (1997); Straubhaar (1998: 261ff.).

deficiencies of the existing redistributive machinery of the welfare state. In other words, the question is whether the adequate response to the difficulties faced by the welfare state lies in restricting competition among jurisdictions, a measure which Sinn appears to favor,<sup>44</sup> or whether instead it lies in appropriate reforms of existing welfare institutions themselves, reforms that would enable these institutions to survive under competitive conditions. The second question is: if the trans-generational insurance scheme, that Sinn has in mind, should actually turn out not to be viable under competitive conditions, are the restrictions on competition – and thereby on individuals' freedom of choice – that are necessary to make the scheme viable not perhaps associated with disadvantages that outweigh the advantages of the hoped-for insurance protection?

As regards the first question, Sinn himself concedes that if existing welfare regulations run into difficulties, it may not least be due to internal structural deficiencies, and he even points out possibilities for appropriate reforms, such as the adoption of a “homeland principle in redistributive taxation.”<sup>45</sup> As regards the second question, it is not entirely clear from Sinn's argument, how we should, in the case of the insurance scheme in question, separate problems of free-riding from problems due to the insufficient attractiveness of the scheme. Needless to say, no insurance can be viable if „free-riding“ -- claiming services without sharing the costs -- is not excluded. Preventing free-riding is, however, something entirely different from preventing exit from, or forcing participation in, an insurance scheme. The free-rider seeks to enjoy benefits without payment. By contrast, if someone wants to exit, or refuses to join, he simply reveals that he considers the balance of advantages and disadvantages unfavorable. It is difficult to see what other ultimate test should exist to test the claim that a redistributive regime provides insurance beneficial to all parties, if not the willingness to join and remain within the scheme, in the presence of potential alternatives. If the exclusion of the exit option is declared a precondition for the welfare state's insurance arrangements to be viable, it is difficult to see how the claim

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<sup>44</sup> In reference to the fact that competition among jurisdictions favours “benefit taxes” and does not allow for “redistributive taxation” Sinn (1994: 99) notes: “To avoid this implication, the tax rates have to be harmonized across all countries or chosen by a centralized agency.”

of the advantageousness of such an arrangement for all involved can be put to the test. Yet, Sinn's argument does, indeed, seem to take such a turn by his failure to clearly distinguish between problems of exit and those of free-riding,<sup>46</sup> a failure that appears to be due to his particular notion of the transgenerational nature of such „welfare insurance.“

Sinn (1997a: 37) is surely right when he states that an insurance contract can only produce its beneficial effect if it is signed before the risks are played out and is faithfully executed afterwards. This is, unquestionably, also true for any viable welfare state insurance arrangement. Yet an arrangement of this kind must, undoubtedly, also be subjected to the test of being *ex ante* advantageous for all parties and of being, accordingly, able to count on voluntary participation. Considering Sinn's understanding of the requirements of a transgenerational welfare state insurance, the question has to be asked of who are to be the „sovereigns“ whose voluntary consent is to count as the relevant test of the preferability of this insurance.<sup>47</sup> To be sure, Sinn (1997a: 30) rightly argues that it is a matter of ex-ante versus ex-post perspective whether a redistributive scheme can be viewed as an insurance.<sup>48</sup> If, however, future generations and those who have not yet come of age are to be included in the insurance, does this mean that the appropriate ex-ante perspective can only be applied by the first “founder generation”, that only their assessment of costs and benefits is to count, and that all subsequent generations are de-franchised in this respect? If the “playing out of the risks” includes the strong or weak talents with which people are born, what does it mean to say that it cannot be permitted to allow those who know

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<sup>45</sup> See Sinn (1997a: 49; 1998). – On the issue of competition-compatible welfare-state provisions see also Kerber (1998: 214ff.).

<sup>46</sup> Sinn (1994: 99): “Even such beneficial redistribution would not be able to survive in a Europe where the single countries compete with one another. A Europe with free migration is like an insurance where the customers can choose the company ex post.”

<sup>47</sup> If, as Sinn (1997b: 264) argues, “a private solution is infeasible because private redistribution contracts cannot be written early enough,” the question has to be asked: What is “early enough” in the context of a “political solution”, given the fact that a political community consists of a continuous stream of overlapping generations?

<sup>48</sup> Sinn (1997b: 259): “Arguably, the main reason why the government can do better than private insurance markets is that it can introduce its insurance protection earlier, before the ‘good risks’ and the ‘bad risks’ have been sorted out.”

they have been lucky to opt out of the system (Sinn 1997a: 37)?<sup>49</sup> Does it ultimately mean that implementing the intended insurance arrangement requires eliminating the right to exit from the polity?<sup>50</sup>

There are presumably good reasons why -- as Sinn notes (with some regret?)<sup>51</sup> -- our legal system does not allow for private contracts binding one's personal offspring in the manner envisaged by his insurance scheme. The fact that the political process allows such commitments to be made and enforced, at least to a certain degree, does not mean that the reasons for abstinence under private law have no significance at this level. It certainly does not mean that the restrictions necessary for their enforcement may not entail disadvantages for the parties involved, which outweigh the anticipated benefits, whether these restrictions mean that the option to withdraw is taken away directly through an "exit ban", or indirectly, through "international harmonization." Giving up one's own exit right would no doubt be a considerable price, if a person had to pay it for the welfare state's protection of his life risks. The sacrifice of this right in the name of subsequent generations would not only be an even higher price, it would conflict with the fundamental principles of legitimacy of a democratic polity, which has to continually prove that it is, in the eyes of its current citizens, serving the common interests of all.

There is no doubt that individuals feel a need to insure themselves and their offspring against what Sinn terms "life risks", and there is no doubt that the state as an organization may also serve as a vehicle to cater for this need in a way beneficial to all. The benefit of such arrangements should, however, be demonstrated by the very fact

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<sup>49</sup> What are the implications if the functioning of a redistributive arrangement requires "that the parents sign a bondage contract for their children from which these children could not escape even if they wished to do so" (Sinn 1997b: 259)? Is *one* parent-generation entitled to commit all future generations?

<sup>50</sup> What is implied, one has to ask, when Sinn (1997b: 264) argues: "In a closed economy, the government can remedy the situation because it can provide insurance through the tax law. It has the power to enforce the necessary resource transfer between the lucky and the unlucky without having to rely on voluntary private contracts. In an open economy, however, this power vanishes with the right to migrate across the borders. The good risks leave the insurance state just as they would leave the insurance company."

<sup>51</sup> Sinn (1997b: 259): "Whether the absence of bondage is a market failure or the result of a government intervention that requires another intervention to patch up the consequences can be left open here."

that they are capable of securing the loyalty of their clientele, in the face of potential alternatives. In this regard, competition among jurisdictions can not only generate incentives for “insurers” to be responsive to the needs of their “clients”, it can also serve an important function for insurers and insured as a process of discovery, helping them to find out how the insurance needs in question can be satisfied most effectively and economically. Before taking the severe step of accepting the restrictions of freedom entailed in the restrictions of competition among jurisdictions proposed by Sinn, one ought to check if not competition-compatible solutions exist for welfare-state matters.<sup>52</sup>

## **8. Competition among Jurisdictions and Rules of Competition**

To the extent that the problems diagnosed as consequences of competition among jurisdictions are to do with shortcomings in national regulations, which are merely exposed by, but not caused by competition among jurisdictions, adequate remedies are to be found in corrections of the respective national constitutional deficiencies, not in the restriction of competition. This applies, for instance, wherever alleged problems of competition among jurisdictions can be traced to inadequate provisions against free-riding at the national level, and can, consequently, be eliminated by taking adequate precautions. Problems of this kind can be remedied through unilateral national measures, without any need for international coordination. Many of the symptoms generally deplored as problems of competition among jurisdictions can be shown to fall into this category.

Problems of competition among jurisdictions which can be traced back to *intra*-national constitutional deficiencies can be remedied by national constitutional reforms. This is different with problems that may be described as “genuine problems of competition” in the sense that they result from deficiencies in the “rules of competition”, i.e. in the “rules of the game” according to which competition is carried out. Such “genuine problems of competition” cannot be effectively remedied through

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<sup>52</sup> The issue of how redistribution-insurance may be organized in a competition-compatible manner is also briefly addressed by Sinn (1994: 100; 1997a: 49).

unilateral national measures but only through international constitutional agreements. As all competition, competition among jurisdictions always takes place under some “rules of the game”, ranging from the “everything goes” of genuine anarchy to a perfect “harmonization” across jurisdictions that eliminates almost any competition. And as with all competition, the working properties of competition among jurisdictions depends on the nature of these “rules of the game” (Vanberg 1995).

Choosing rules of competition among jurisdictions means to choose rules of the game that apply to the inclusive constituency, i.e. to the citizenries of all participating jurisdictions. In a sense, a more inclusive jurisdiction is created, defined by the mutual recognition and implementation of the respective rules of the game. The appropriate criterion for the desirability of these rules is, accordingly, the common interests of all citizens within the inclusive jurisdiction. In other words, according to the democratic principle of citizen sovereignty the desirability of reforms in the rules for competition among jurisdictions should be measured by whether they generate benefits for all citizens involved, in comparison to the existing rules of competition.

An example of a type of competition among jurisdictions where adopting better rules of the game may, indeed, serve the common interests of all those involved, is the competition for mobile factors through the granting of special privileges in the form of subsidies, tax benefits or other preferential treatment, which are granted in a discretionary and discriminating manner to selected persons or groups, but not to others. Just as the citizens of any single jurisdiction become domestically embroiled in a rent-seeking dilemma under a regime of privilege-granting, and can all benefit from constitutional provision that effectively restrict the ability of the government and legislature to grant privileges, the citizens of several jurisdictions find themselves in an inter-jurisdictional rent-seeking dilemma, if their governments conduct the competition for mobile factors through the granting of privileges, and can they can all benefit from effectively restricting the possibilities of privilege-granting through appropriate rules of competition.<sup>53</sup>

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<sup>53</sup> The perversities of such competition by granting privileges are instructively illustrated by D.I. Barlett and J.B. Steele (1988) in their documentation on “Corporate Welfare.”

Clearly, one option in the agreement on rules for competition among jurisdictions would be for the jurisdictions involved to harmonize contested regulations, thereby eliminating competition among themselves with regard to the respective provisions. An example would be setting standard rates of taxation for enterprises or standard forms of welfare state provisions (Sinn 1997a: 49). However, before one jumps from diagnosing undesirable effects of competition among jurisdictions to recommending harmonization, one should examine whether the diagnosed negative effects can not be averted by subjecting competition to more appropriate rules of the game instead of eliminating it altogether.<sup>54</sup> The relevant alternatives are clearly not exhausted by “unbridled tax competition”<sup>55</sup> or “unbridled competitive confrontation” (Sinn 1994: 97) on the one hand and harmonization on the other.<sup>56</sup> Without having explored the possibility of competition under *appropriate rules* more carefully, it would certainly be premature to recommend centralist reforms as a remedy against deficiencies of competition among jurisdictions. This should be kept in mind when, in reference to the European situation, Sinn (1994: 97) advocates “centralized actions” as a fairly sure strategy to prevent inefficiencies in institutional competition, while dismissing the option of improving the rules of competition: „An alternative, but at this stage, highly speculative, remedy would be the search for a constitutional framework under which government competition can be expected to work“ (ibid.).<sup>57</sup>

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<sup>54</sup> The general issue of appropriate “rules for competition among jurisdictions” is discussed by W. Kerber (1998).

<sup>55</sup> Sinn (1997b: 263): “The welfare state has no survival chance when unbridled tax competition is allowed.”

<sup>56</sup> On the problems with harmonization Mueller (1998: 187) comments: “The most attractive response for many European governments will be to reduce the options of its citizens by pressing for tax and regulation harmonization, and thereby avoid the politically costly steps of having to take away the subsidies and privileges to which the politically most powerful groups have become accustomed. ... Although uniform taxes on capital would stop the movement of capital from high tax countries like Germany into low tax countries like Ireland, they would not deter the flow of capital *outside* the EU, indeed they would stimulate it. ... The danger Europe faces, if it responds to the pressure from increasing mobility and globalization by tax harmonization, is that it retains its system of high redistributive taxes and regulations, preserves the resulting inefficiencies, and becomes therefore an increasingly unattractive place for businesses to locate, people to work, and eventually for people to live.”

## 9. Conclusion

The theme of this paper has been the relationship between democratic political processes and competition among jurisdictions. If we look at democratic polities as cooperatives or joint enterprises for the common benefit of their citizens, and if we measure the performance of democratic systems against the criterion of citizen sovereignty, then we must examine the effects of competition among jurisdictions with respect to the two key tasks that democratic constitutions have to accomplish: First of all, to enable governments to implement measures that do in fact reflect the common interests of all citizens, and secondly, to prevent governments from carrying out projects that conflict with the interests of some or all of its citizens.

As far as the second task is concerned, the arguments discussed in this paper clearly imply that competition among jurisdictions can make a valuable contribution to “the improvement of democracy” by making it more difficult for governments to implement political schemes that benefit some citizens at the expense of others. To the extent of their own mobility and the mobility of their resources, competition among jurisdictions offers citizens and jurisdiction-users effective protection against exploitation, be it in favor of privileged groups or of those who hold the reins of political decisionmaking power.

As regards the ability of governments to act in the common interests of all citizens, competition among jurisdictions can be expected to assist, in its role as a *discovery procedure*, governments and citizens in solving the by no means trivial problem of ascertaining precisely which jurisdiction characteristics and services best serve the common interests of citizens, and how these jurisdiction characteristics and services can be provided most efficiently. In this respect too, competition among jurisdictions can help to improve democracy. On the other hand, as my discussion of the resentment against competition among jurisdictions was meant to show, there are no obvious indications that this competition would impede or prevent governments from implementing schemes that can truly be claimed to benefit all citizens. If, in this respect, detrimental effects of competition appear to exist, one should first examine

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<sup>57</sup> A more sceptical view is voiced, however, in Sinn (1997a: 48).

whether such effects can actually be blamed on competition itself, or whether they are instead a result of constitutional deficiencies at the national or the international level. Constitutional deficiencies at the national level can arise from the failure to prevent problems of free-riding, due to incentives for mobile resources to extract benefits from jurisdiction-services without paying for them. Free-rider problems of this kind should be strictly distinguished from the issue that is at the heart of competition of jurisdictions, namely mobility and exit, an issue concerned with whether mobile factors are ready to pay the price demanded for jurisdiction-services, or prefer to forego these services in favor of alternative options. Constitutional deficiencies at the international level can be due to the failure to frame competition among jurisdictions by appropriate rules of the game. Until the possibilities for eliminating constitutional deficiencies at this level are explored, it is inappropriate to recommend centralist solutions.

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