



**Competitive Federalism, Government's
Dual Role, and the Power to Tax**

Viktor J. Vanberg

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Albert-Ludwigs-Universität Freiburg

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Viktor J. Vanberg

Walter Eucken Institut

Abstract: Theories of competitive federalism generally focus on *exit* as the principal mechanism for making governments responsive to the interests of those who are subject to their powers. This paper draws attention to the necessity to specify more clearly the meaning of “exit” in light of the fact that democratic governments act in two distinguishable roles, namely as what I propose to call “territorial enterprises” and “clubs enterprises”. As *territorial enterprises*, governments define and enforce the rules and conditions under which private law subjects, citizens and non-citizens alike, may pursue their private purposes within the territory of the respective jurisdiction. As *club enterprises*, governments define and enforce the rules and conditions of membership in the respective political community. Accordingly, individuals are subject to government's power in two capacities. As *private law subjects* they can choose, like customers, among competing territorial enterprises according to their respective relative attractiveness, separately for the various purposes they pursue. As *citizens*, they share, as members of a polity, in the inclusive bundle of benefits and costs that come with the membership status. The focus of this paper is on the implications of the fact that “exit” means something different when one looks at citizens as customers of territorial enterprises (exit = leaving the territory) as opposed to their role as citizens-members (exit = giving up one's membership-status/citizenship).

1. Introduction

In terms of Albert O. Hirshman's (1970) useful distinction, persons can respond to the tax-burden imposed on them in two ways, by voice and by exit. They can seek to assert their interests via the political process, by voting and by lobbying. And they can “vote with their feet,” leaving a jurisdiction that offers them less attractive terms than they can find elsewhere. At least since Charles Tiebout's (1956) seminal essay “A Pure Theory of Local Expenditures” economists have paid considerable attention to the fact that in a world in which people are free to move – and to relocate their resources – between jurisdictions the exit-mechanism can help to align the interests of tax-payers with the services governments provide in their respective jurisdictions.

The present paper addresses the same issue, yet it focuses on an aspect that has found little attention in the public finance literature, an issue that the founder of the German public

finance journal *Finanzarchiv*, Georg Schanz,¹ raised more than one hundred years ago in an article entitled “On the issue of tax liability”. In this article Schanz argued that, due to the mobility of persons and economic activities – primarily between local communities but more and more also across national boundaries –, polities increasingly harbor people who are not their citizens while at the same time many of their own citizens do business in other jurisdictions (Schanz 1892: 6). This fact, so Schanz (*ibid.*: 8) concluded, should be taken into account in the manner taxes are levied if a correspondence between taxpayers and beneficiaries of public services is to be maintained.²

The purpose of the present paper is to take a closer look at the fact that, as suggested by Schanz, in a mobile world a distinction must be drawn between two different roles in which states act and between two different capacities in which individuals are subject to taxation. States act, on the one hand, as *territorial enterprises*, i.e. as the organizations that define and enforce the terms under which persons may pursue their private purposes within their respective jurisdiction. And they act, on the other hand, as *club enterprises*, i.e. as the organizations that define and enforce the terms of membership in the polity. An analogous distinction must be drawn between two capacities in which individuals are subject to taxation, namely as *citizens-members* and as what I shall call *jurisdiction-users*. The focus of the argument to be developed below will be on the implications that follow from the fact that “exit” has a different meaning when individuals act in their capacity as citizens-members as opposed to their capacity as jurisdiction-users. That the exit-option, i.e. the mobility of persons and resources between jurisdictions works as a constraint on government’s taxing power has often been recognized.³ The emphasis here is on the difference that, in this regard, exists between the state’s power to tax its own citizens in their capacity as citizens and its power to tax jurisdiction-users, including its own citizens in their capacity as jurisdiction-users.

¹ The *Finanzarchiv*, the world’s oldest and still existing scholarly Public Finance journal, is published since 1884.

² As he put it: “As long as taxes are a general payment for expenditures of the community it will not be compatible with the nature of taxes if the community does not tax a number of people who benefit from its expenditures while taxing others who do not benefit” (Schanz 1892: 8; my translation, V.V.).

³ For the history of thought on how the exit-option serves as a constraint on government see R. Vaubel 2008. – While the focus of this paper is on the exit-mechanism it should be noted that what is called “yardstick –“ or “laboratory federalism” (W. Oates 1999: 1131ff.) plays a supplementary role in aligning government policies with citizens’ preferences by its explorative potential and by providing comparative information about the service-packages offered in different jurisdictions. – It is worth quoting what Supreme Court judge Louis Brandeis said on this subject in a 1932 judgment: “It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country” (*New State Ice Co. v. Lieberman*, 285 U.S. 262,311).

2. The Democratic State as Citizen Cooperative

In a free and democratic society a clear distinction can be drawn between *state* and *private law society*. The state is the *organization* in which individuals, in their capacity as citizens, meet as members, whose rights and duties are defined by the state's organizational rules, the constitution. By contrast, the private-law society is, in Hayek's terms,⁴ a *spontaneous order*, an arena in which individuals, as private-law subjects, are free to enter into contractual relations with each other, within the confines defined by the private law system and public regulations. Correspondingly, one can distinguish between the rights individuals as members of the polity exercise *collectively* through the political process⁵ and the rights they exercise independently and separately as *private-law subjects*.

A society qualifies as *free* to the extent that its individual members possess an "assured free sphere" (Hayek 1960: 155), a protected domain in which, "limited only by some abstract rules that apply equally to all" (ibid.: 155), they can exercise their *private autonomy*. A society qualifies as *democratic*, as opposed to an authoritarian society, to the extent that the citizens-members effectively control the government as the executive organ of the state.

When John Rawls' (1971: 84) speaks of a democratic society as "a cooperative venture for mutual advantage"⁶ it is important to keep in mind that in such a society individuals deal with each other in both arenas, as private law subjects in the private law society (and its twin, the market economy)⁷ and as citizens in the political domain. With his formula "a cooperative venture for mutual advantage" Rawls defines in effect a normative benchmark against which the "rules of the game" in both domains can be judged, namely the extent to which they enable the individuals involved to realize mutual benefits. For the rules of the private law system, supplemented by the public regulations constraining private conduct, this means: they, and the mode of their enforcement, should ideally exclude fraud and coercion as means of enrichment, providing for an arena of voluntary cooperation in

⁴ See F.A. Hayek's (1973: 36ff.) comments on the contrast between "spontaneous order" and "organization" as "two kinds of order."

⁵ As J.M. Buchanan (2001 [1995/96]: 81) put it, "all members of a political unit must be subjected to the same decisions."

⁶ Rawls (1999: 31): "(W)e see a political conception of justice for a democratic society, viewed as a system of fair cooperation among free and equal citizens who willingly accept, as politically autonomous, the publicly recognized principles of justice determining the fair terms of that cooperation."

⁷ The concept of the market economy as a twin of the private law society I adopt from the jurist Franz Böhm, one of the founders of the so-called Freiburg School (see Vanberg 1998), who has emphasized, "that the functioning of the free market system presupposes the existence of the private law society" (Böhm 1989 [1966]: 54). "The exchange agreement and its fulfillment is the characteristic mode of cooperation between independent traders with equal rights. In this respect, therefore, the private law system is very decisively involved in controlling free market processes" (ibid.: 53).

which all interpersonal dealings are based on voluntary agreement, thus reflecting that all parties expect to benefit.⁸ For the rules of the organization state it means: they, and the mode of their enforcement, should ideally be such that the political process works to the benefit of all members of the polity and that citizens are protected against being exploited by fellow citizens or public officials.⁹

A theory of taxation must have as its conceptual basis a theory of the state. How the state is conceived provides the criterion against which potential alternative theories of taxation are to be judged. The democratic state, in the spirit of Rawls's formula I propose to call a *citizen cooperative* in order to underscore two things. Firstly, that the democratic polity is, like any ordinary business-cooperative, a *member-governed organization*, i.e. an organization in which decision-making authority resides ultimately with its members. Secondly, that, again like in any ordinary business-cooperative, individuals voluntarily participate only if they expect to benefit by their membership in the joint enterprise.¹⁰ This very view of the democratic state as a cooperative enterprise is at the core of James M. Buchanan's public finance theory. Buchanan's starting point is the contrast between two "opposing theories of the state" (1960 [1949]: 8), an "'organismic' theory" in which the state is "conceived as a single organic unit" and an "individualistic theory" in which "the state is represented as the sum of its members acting in a collective capacity" (ibid.).¹¹ According to the individualistic assumptions, which he considers "the only appropriate ones for democratically organizes societies" (ibid.: 4), the "fiscal process represents a quid pro quo transaction between the government and all individuals collectively considered" (ibid.: 12).¹²

⁸ This is what Hayek's (1976: 115ff.) formula of the market as the "game of catallaxy" is meant to describe.

⁹ Buchanan 2001 [1995/96]: 81): 81): "Normatively, the political structures should complement the market in the sense that the objective for its operation is the generation of results that are valued by citizens."

¹⁰ An early advocate of such an *individualist view* of the democratic state in ancient Greece was Lycophon (see Popper 1966, vol. 1, 114ff.), one of the younger sophists. Lycophon argued "that the state is not different from other human associations: one participates not to make sacrifices or to be harmed but to mutually benefit and assist each other, in order to be of mutual advantage where the power of the individual is not sufficient. ... In the state, not different from a commercial partnership, one supports each other, but only on the condition of reciprocity such that there is a balance between what one contributes and what one receives" (W. Gerloff 1928: 142; my translation, V.V.).

¹¹ Like Buchanan, Wilhelm Gerloff, a German public finance economist and editor of the "Handbuch der Finanzwissenschaft" (1926-1929, 2nd ed. 1952), has contrasted an individualistic and a social-organic approach as the "two opposing views that pervade the history of the state and of legal philosophy and, in their application to taxes and duties, also the history of public finance. ... The struggle between these two views of the nature of taxation and of the liability to pay taxes runs through the ages" (Gerloff 1928: 142; my translation, V.V.).

¹² Buchanan (1960 [1949]: 11): "The state has no ends other than those of its individual members and is not a separate decision-making unit. State decisions are, in the final analysis, the collective decisions of individuals. ... Ideally, the fiscal process represents a quid pro quo transaction between the government and all individuals collectively considered." – Buchanan (1977 [1976]: 269): Finally, the differences in approach to tax and fiscal institutions are important for the promulgation of attitudes of citizens as ultimate voters, taxpayers, and

The view of the fiscal process as exchange Buchanan found paradigmatically developed in Knut Wicksell's (1967 [1896])¹³ work as well as in contributions of the Italian public finance school.¹⁴ Their arguments were a major inspiration for the voluntary-exchange theory of government and taxation that he developed.¹⁵ According to the individualistic-democratic concept of the state, so Buchanan (1984: 103) argues, "taxation can be viewed as the cost side of an inclusive fiscal exchange process, with taxes being treated as 'prices' that persons pay for the benefits provided by collectively financed goods and services made available to them by the government."¹⁶ From such perspective, Buchanan (ibid.) adds, "the limits to taxation are those determined by the preferences of the citizens themselves for collectively provided goods."

In a democratic polity as a citizen cooperative, the authority to decide and act on behalf of the organized citizenry is delegated to an executive organ, the government. For analytical purposes the functions that democratic governments carry out, as agents, on behalf of the citizens as the principals can be classified along various dimensions. Buchanan (1975: 68ff.) has coined the useful distinction between the "*protective state*" and the "*productive*

beneficiaries of public outlays. The exchange framework tends to promote a constructive attitude toward governmental process, an attitude that accentuates the cooperative aspects, that underlines the prospects for mutuality of gain for all citizens."

¹³ Buchanan (1977 [1976]: 269): "In my view, one that I think was shared by Wicksell, the exchange-contractarian paradigm is the only one that is wholly consistent with what we may legitimately call "democracy" or with a social order that embodies 'democratic values.' ... (T)he normative evaluation that emerges from the exchange-contractarian paradigm applies to *process* instead of results. ... What does matter is whether or not the tax structure, along with the budgetary outlays, is generated through a decision-making process that reflects, even if imperfectly, individual values in a regime where all persons are given roughly equal weights." – E. Lindahl (1919: 138f., fn.) quotes from a 1919 report by K. Wicksell: "At least the degree of justice that is achieved in free exchange or free contract – namely that nobody is forced to conclude a transaction from which he, in his own judgment, does not benefit – should under all circumstances also be achieved in taxation" (my translation, V.V.).

¹⁴ According to De Viti De Marco (1936 [1928]: 43), a prominent representative of the Italian school, "we may regard the democratic State as that which resembles the economic pattern of the co-operative." As he argues: The "law of taxation in modern States is based on the assumption of an exchange relationship: that is, the exchange of a payment to the State for the provision of public services by the State. ... To sum up: The tax is the price which each citizen pays the State to cover the share of the cost of the general public services which he will consume." – About De Viti De Marco's contrast between the "cooperative" and the "monopolistic" state Buchanan (1960: 34f.) notes: "The first alternative involves the fundamental premise of democratic choice to the effect that *all* members of the social group participate conceptually in the reaching of collective decisions. This alternative may be called the 'cooperative,' the 'democratic', or the 'individualistic,' and it stems from the contractual conception of the state itself. ... The voluntary aspects of fiscal action are stressed, and the tax is considered as a price in the broadest philosophical sense. ... De Viti De Marco is essentially the source of this approach, and his cooperative state model is his standard construct."

¹⁵ Buchanan (1999 [1990]: 384): "If an exchange rather than a maximizing paradigm is taken to be descriptive of the inclusive research program for the discipline, then *economics* involves inquiry into *cooperative* arrangements for human interaction, extending from the simplest two-person, two-good trading processes through the most complex quasi-constitutional arrangements for multi-national organization."

¹⁶ In an essay "*Theory of Taxation*," submitted to the Swiss canton of Waadt in 1860, J.-P. Proudhon has argued: "According to the principles of modern law, the general tendency of ideas and institutions taxation is an expression of an exchange relationship between every citizen and a special kind of producer, called 'State'; it is the price the former pay the latter for its services" (Proudhon 2012 [1861]: 66; my translation, V.V.).

state.”¹⁷ The “protective state” serves as the “*guardian of the private-law society*. In this role, the state defines and enforces – within constitutional limits – the private-law system and the public regulations under which the private-law society functions. The “productive state,” in turn, serves as the enterprise through which the citizenry organizes the production of those goods and services that it judges, via the political process, to be inadequately provided for by the market.

3. Government as Territorial Enterprise and as Club-Enterprise

The distinction between governmental functions that I want to draw attention to is similar to Buchanan’s, but has as somewhat different focus. My focus is on the difference between government’s role as what I propose to call a *territorial enterprise* and its role as *club enterprise*. In its role as a territorial enterprise government acts as the sovereign power that defines and enforces the “rules of the game” to which everybody who lives or conducts business within its territorial boundaries is subject, citizens and non-citizens alike.¹⁸ In its role as club enterprise the government defines and enforces the rules to which only its citizens-members are subject. Accordingly, individuals can be subject to a government’s authority in two separate capacities. As private-law subjects and as what I propose to call “*jurisdiction-users*” they are subject to government’s authority as a territorial enterprise. In their capacity as citizens-members of a polity they are subject to the authority of the respective government as a club enterprise. As I shall argue below, there is a critical difference between the power to tax that the state can exercise with regard to its *citizens in their capacity as members of the polity* and with regard to *jurisdiction-users*.

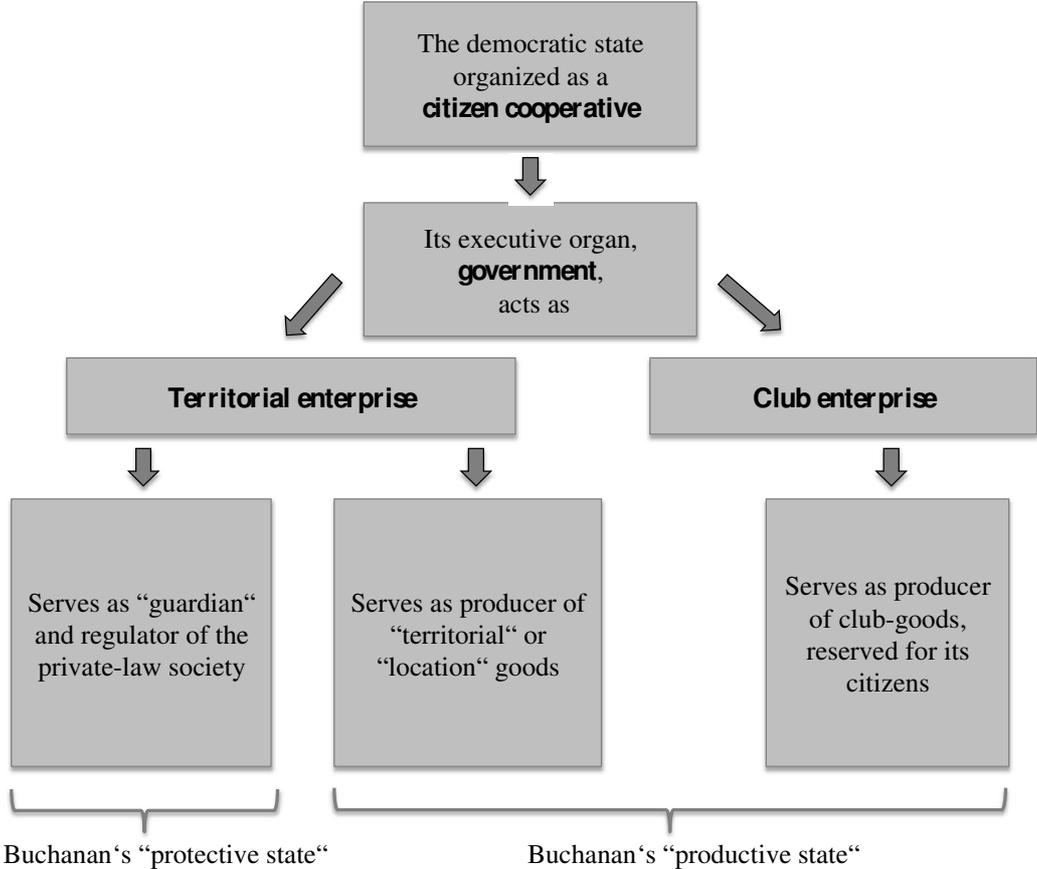
As the executive organ of a citizen cooperative a democratic government acts in both its roles as the agent of the citizenry, its mandate is to serve the interests of its citizens. The difference lies in the nature of the goods it provides in either role, namely, on the one hand, what I propose to contrast as “*territorial goods*” and, on the other hand, “*club goods*.” Under

¹⁷ Hayek (1973: 48) has drawn a similar distinction between the “two distinct functions of government,” “the protective functions in which government enforces rules of conduct, and its service function in which it needs merely administer the resources placed at its disposal.” – Hayek (ibid.) explicitly notes that he uses the term “government” rather than the term “state” because, as he puts it, the latter is “metaphysically charged” by its “Hegelian” connotations. Hayek’s warning against Hegelian connotations is surely justified. Nevertheless, one can meaningfully distinguish between the terms “state” and “government,” the former serving as label for the organized collective that includes the citizens as its members, and the latter serving as label for the executive body through which the organized citizenry carries out its activities. – As the German constitutional lawyer Hugo Preuss (1964 [1889]: 215) has put it: “the government is an organ but not the organization of the people, the latter being the state” (my translation, V.V.).

¹⁸ Preuss (1964 [1889]: 265) speaks of “territorial sovereignty” as the authority to “regulate the right of residence and to set standards for the acquisition and exercise of all rights” (my translation, V.V.).

the rubric “*territorial goods*” fall goods and services that can be taken advantage of by anybody, citizens and non-citizens alike, who reside or do business within the territorial boundaries of the respective state. In other words, they can be made use of by all jurisdiction-users. By contrast, the rubric “*club goods*” comprises goods and services that a government provides exclusively for its own citizens. Access to these goods and services is reserved for members of the respective citizen cooperative.

The figure below specifies the relation between Buchanan’s distinction and the distinction that I propose. It shows that the services provided by Buchanan’s *protective state* fall in the “territorial” category, because the rules the protective state enforces apply to anyone who resides or does business within the state’s boundaries. In this sense, government as a “*territorial enterprise*” comprises not only the *productive state* as producer of “*territorial goods*” but also the *protective state*. Government as a “*club enterprise*” includes Buchanan’s *productive state* insofar as it produces “club goods” exclusively for its citizens-members.



The figure helps to clarify further the nature of the relations between individuals in their different capacities, as *citizens-members* and as *jurisdiction-users*, to the democratic state and government as its executive organ. *Jurisdiction-users* are subject to the rules of a state as

private law subjects and by virtue of their presence (personally or with their resources) within its territory. Accordingly, they can escape the respective government's authority simply by leaving the territory. Citizens are subject to their government's authority in a *dual capacity*, as *citizens-members of the polity* and as *private law subjects*. In the latter capacity, they are free to decide whether they wish to use their home-state's territory for their private purposes or whether they prefer to pursue certain purposes, e.g. residence, employment, financial investment or business activities, in foreign jurisdictions. In other words, in their relation to their home state as a territorial enterprise citizens are, as private law subjects, essentially in the same position as other jurisdiction-users who, as non-citizens, use the state's territory for their private purposes. Not different from non-citizens, as jurisdiction-users they can evade their home-state's authority by taking their private business elsewhere. By contrast, in their capacity as *citizens-members* they are subject to the rules that define the conditions of membership in their respective polity as long as they maintain their citizenship, independently of whether they reside or do business inside or outside of the state's territory. They can (legally) evade the authority of their home-government as the enforcer of these rules only by terminating their membership in the citizen cooperative.¹⁹

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

4. Competitive Federalism and the Two Roles of Government

In his classic contribution to the theory of competitive federalism Charles Tiebout took issue with the received Musgrave-Samuelson doctrine "that no 'market-type' solution exists to determine the level of expenditures on public goods" (1956: 416).²⁰ The core problem, so Tiebout argues, concerns "the mechanism by which consumer-voters register their preferences for public goods" (ibid.). If such a mechanism existed, he notes, "the appropriate benefit tax could be determined" (ibid.). Finding the current method of solving the problem through the political mechanism – namely, combining "expenditure wants of a 'typical voter' with an

¹⁹ Whether and to what extent governments are willing and capable to enforce the terms of membership on citizens-members outside of their own territory is, of course, an empirical matter. – On this issue Schanz (1892: 1f.) comments: "A polity's domain of power is, in the first instance, limited to its own territory. ... Beyond the borders of its territory the common will is extremely reduced in its effectiveness; it can make itself effective only with citizens who, even though they live outside of the jurisdiction, want to maintain their citizenship, by threatening that, in case of non-compliance, they will be deprived of their citizenship" (my translation, V.V.).

²⁰ Tiebout (1956: 417): A "public good is one which should be produced, but for which there is no feasible method of charging the consumer." – Tiebout does not specify the normative criterion that the "should" is meant to imply.

ability-to-pay principle on the revenue side” (ibid.)²¹ – “unsatisfactory,” Tiebout posed the question whether a set of social institutions might be determined that would “force the voter to reveal his preferences” (ibid.) and allow “to tax him accordingly” (ibid.: 418). As solution he suggested a regime of competitive federalism in which “consumer-voters” are free to choose among multiple local governments offering different combinations of public goods and tax burdens. The working principles of such a regime he described as follows.

The act of moving or failing to move is crucial. Moving or failing to move replaces the usual market test of willingness to buy a good and reveal the consumer-voter’s demand for public goods. Thus each locality has a revenue and expenditure pattern that reflects the desires of its residents. ... Just as the consumer may be visualized as walking to a private market place to buy his goods, the prices of which are set, we place him in the position of walking to a community where the prices (taxes) of community services²² are set. Both trips take the consumer to market. There is no way in which the consumer can avoid revealing his preferences in a spatial economy. Spatial mobility provides the local public-goods counterpart to the private market’s shopping trip (ibid.: 420, 422).

The fact I want to draw attention to is that in Tiebout’s account local governments²³ are considered exclusively in their role as territorial enterprises, as “localities” in a “spatial economy.” They play no role as club-enterprises. When the “consumer-voter” is said to move “to that community whose local government best satisfies his set of preferences” (ibid.: 418), it is actually only his preferences for *territorial* or *location*-goods that he can thus register.²⁴ The choice between “locations” does not provide them with an opportunity to register, as citizens-members of a polity, their preferences for club-goods that different governments might offer in their capacity as club-enterprises. Accordingly, Tiebout’s claim that in the competitive regime he describes expenditures for community services “approximate the proper level” (ibid.) applies only to location-goods, not to club-goods governments may provide exclusively for their citizens-members.

Nearly two decades before Tiebout’s contribution F.A. Hayek had published a paper on “The Economic Conditions of Interstate Federalism” (1948 [1939]) in which he looked at

²¹ E. Lindahl (1919: 5) relates the conflict between the benefit and the ability-to-pay principle to the conflict between an individualist and an organic theory of the state: “The contrast between the theory of ‘taxation according to interest’ ... and a theory of ‘taxation according to the ability-to-pay still persists. Basically, the supporters of an individualist theory of the state subscribe to the principle of an equivalence in exchange while the supporters of an organic concept of the state adhere to the ability-to-pay principle” (my translation, V.V.). – See Vanberg (2011, sect. 4) for a more detailed discussion of the contrast between the two principles of taxation.

²² In order to avoid definitional quibbles that the concept “public good” may provoke I shall use here, as Tiebout does, the terms “local public goods” and “community services” interchangeably.

²³ In a footnote Tiebout (1956: 418, fn. 9) adds that his analysis “also applies, with less force, to state governments.”

²⁴ As examples of what consumer-voters consider in their “choice of municipality” Tiebout (1956: 418) lists “schools ... municipal golf course ... beaches, parks, police protection, roads, and parking facilities.”

competitive federalism as an institutional device to limit the power of government. In Hayek's account, as in Tiebout's, the competing sub-units in a federal system are exclusively considered in their capacity as *territorial* enterprises. In the regime Hayek envisaged the federal government's principal task is to assure free mobility between the states of the federation by doing "away with impediments as to the movement of men, goods, and capital" (ibid.: 255), thus creating "one single market" (ibid.: 258). The resulting competition for mobile labor and capital, as Hayek was to put it in a later contribution,

would be the transformation of local and even regional governments into quasi-commercial corporations competing for citizens. They would have to offer a combination of advantages and costs which made life within their territory at least as attractive as elsewhere within the reach of its potential citizens (1979: 146).²⁵

Though Hayek speaks of "citizens," the competition he describes is not between governments as club-enterprises for citizens-members but only between governments as territorial enterprises for residents and other jurisdiction-users.

The exclusive focus on governments' role as territorial enterprises that Hayek's and Tiebout's contributions share appears to be, in fact, a quite common feature in theories of competitive federalism. Explicitly endorsing Hayek's account, Barry R. Weingast advocates a "market-preserving federalism" in which sub-national governments have primary regulatory control over their economies while the federal government's task is to secure a common market by preventing them from using their regulatory power to erect trade barriers (2008: 155). The "induced competition among lower units in the federal structure," Weingast (1995: 5) concludes, implies "that policy choices will be disciplined by the ability of resources to move between jurisdictions" and that only those policies will survive "that citizens are willing to pay for" (ibid.).²⁶ As he (ibid.) puts it:

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

Again, though Weingast speaks of "citizens," the competition he describes does not permit citizens to register what kinds of club-goods they are "willing to pay for." It only allows individuals to register with their "location decisions" their preferences for location-goods.

²⁵ See also Hayek (1978: 162): "Regional and local governments ... would develop into business-like corporations competing with each other for citizens who could vote with their feet for that corporation which offered them the highest benefits compared with the price they charged."

²⁶ Weingast (1995: 5):

In his approach to public finance, James Buchanan has put particular emphasis on the role of competition among governments as a supplement to constitutional constraints, which, as he argues, “may not offer sufficient protection against the exploitation of citizens through the agencies of government” (2001 [1995]: 69).²⁷ Like Hayek and Weingast, Buchanan suggests a federal structure in which the central government – though severely “restricted in its own domain of action” (2001 [1995/96] 70) – is sufficiently strong “to enforce economic freedom and openness over the whole of the territory” (ibid.), while the “remaining political power is residually assigned to the several ‘state’ units” (ibid.). Under such a federal structure, Buchanan (2000 [1979]: 264) supposes, the “right of citizens to migrate freely, to vote with their feet or with their mobile resources, will limit the extent to which their demands for governmentally provided goods and services can be ignored by governmental units.”²⁸ In emphasizing the “prospects for exit ... as constraint on political control over the individual,” he notes, the “theory of competitive federalism is congenial to economists in particular because it is simply an extension of the principles of the market economy to the organization of the political structure” (2001 [1995/96]: 80).²⁹

Again, even though Buchanan speaks of “citizens” and their “demands for governmentally provided goods and services” he looks in effect, not different from Hayek and Weingast, at individuals only as *jurisdiction-users* who, if they do “not like the results of state or local political action, may move to another area or another location” (Buchanan and Flowers 1980: 385).³⁰

5. Federalism and Two Kinds of Exit

As the above summaries of Tiebout’s, Hayek’s, Weingast’s and Buchanan’s accounts of federal competition illustrate, with their exclusive focus on *territorial* mobility they fail to account for the fact that democratic governments serve in the two noted roles and that, accordingly, we must distinguish between two different meanings of “exit.” Exit may mean, on the one hand, that individuals leave, in their capacity as private law subjects, a

²⁷ Brennan and Buchanan (1980: 184) speak of a “substitutability between intergovernmental competition for fiscal resources and explicit constitutional constraints on governmental taxing power.”

²⁸ Buchanan and Flowers (1980: 385): “The individual who does not like the results of state or local political action may move to another area.”

²⁹ Buchanan (2001 [1995/96]: 81): “Federalism offers a means of introducing the essential features of the market into politics. ... The availability of the exit option, guaranteed by the central government, would effectively place limits on the ability of state-provincial governments to exploit citizens ... Localized politicians and coalitions would be unable to depart from overall efficiency standards in their taxing, spending, and regulatory politics.”

³⁰ Buchanan and Flowers (1980: 385): “To a limited extent, freedom of migration allows individuals to choose among different combinations of public services in the same way they can choose among private goods and services.”

government's territorial domain, and it may mean, on the other hand, that they leave, as citizens, the polity of which they were members, in order to join some other citizen-cooperative.

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

The calculus of advantage on which individuals base their exit decisions are fundamentally different in the case of location- as opposed to membership-choices. As jurisdiction-users individuals can, as noted, distribute their various private activities across different (accessible) sovereign territories. By contrast, membership in a polity comes with an inclusive bundle of rights and duties, and the relevant comparison between different (accessible) citizen-cooperatives must be in terms of the inclusive bundles they offer. The flexibility and easy reversibility that individuals typically enjoy as jurisdiction-users in their location decisions is, as a rule, absent in their choice of citizenship-membership in a citizen-cooperative.

What I want to draw attention to is that in the Tiebout-Hayek-Weingast-Buchanan approaches to competitive federalism the distinction between the two kinds of "exit" is not taken into account.³¹ When these authors speak of "consumer-voters," "tax-payers" or "citizens" they refer in fact not to individuals in their capacity as citizens-members of a polity but only in their role as customers of territorial enterprises, moving in a "spatial economy" between jurisdictions. To be sure, the failure to distinguish between individuals as jurisdiction-users, choosing among locations according to their suitability for their various private purposes, and individuals as citizens-members of a polity who choose whether to shift their alliance as members to some other citizen-cooperative is not limited to the cited authors.

³¹ The failure to account for this distinction is, of course, not limited to these authors. To cite just one other example, F. Knight (1982 [1947]: 465) ignores the distinction when he notes: "In common usage political groups are defined by territorial sovereignty; leaving one group means physical removal to another and is limited by material cost, by cultural differences, and by the laws governing departure and especially entry into other political units, which practically cover the earth."

It is indeed a quite common feature in the literature on competitive federalism,³² a fact that provokes the question whether there is not a systematic reason for such one-sided focus on government's role as territorial enterprise. The reason, I suppose, is that authors writing on the subject tacitly tend to take a federal system like that of the United States as the *standard model* of a competitive federalism.

In the federal system of the United States, the primary citizenship is in the Union. US citizens become members of local communities and states by virtue of taking residence in the respective territory.³³ This means that only the federal government can exercise effective authority over whom it grants citizenship status.³⁴ By contrast, given the provision that US citizens can freely choose their place of residence within the territory of the US, local communities and states can only passively register but not actively control who joins them as citizen-member. If, however, membership in federal sub-units can be acquired simply by individuals' unilateral residential choice, the ensuing competition among these sub-units will critically affect what kinds of public services they will be able to sustain. It will in effect reduce them to their role as territorial enterprises,³⁵ incapacitating them in their role as club-enterprises. They will not be able to provide sustainably genuine club-goods in the sense of goods that, in the absence of adequate membership-rules, are subject to adverse selection.³⁶ This is in particular so for the good "redistribution as social insurance" that will be the subject of the next section.

If a US-type federal system is, expressly or tacitly, taken as the standard model, it follows naturally that the focus is exclusively on territorial mobility as the principal driving force in competitive federalism, while the role of federal sub-units as club-enterprises is lost sight of. To be sure, the US-rules for assigning citizenship – locating primary citizenship at the federal level while citizenship in sub-units is a matter of individuals' residential choice –

³² In his *American Federalism: Competition Among Governments*, Th. R. Dye (1990) speaks of "consumers-taxpayers," of governments' responsibility "for the welfare of their citizens," and of governments who "tax their citizens (ibid.: 190f.), yet his arguments pertain only to governments' competition for jurisdiction-users. In "Towards a Theory of Competitive Federalism," to cite just one other example, Albert Breton (1987: 297) describes the task of governments as meeting "the preferences of citizens who happen to be in the provinces or in the country they have been elected to govern," reducing "citizens" thereby in effect to jurisdiction-users.

³³ Schönberger (2007: 66): "In ... the United States since 1868, federal citizenship is primary and state citizenship depends on national citizenship plus residency."

³⁴ The federal government exercises this authority within the general proviso that children born within the US and in territories under US jurisdiction, or who are born to US citizens elsewhere in the World acquire automatically US citizenship.

³⁵ W. Kerber (2000: 248) points to this effect when he notes that, due to inter-jurisdictional competition, states "change into mere 'locations'." – It should be added that competition has this effect only where "states" lack the authority to control who acquires membership status.

³⁶ When Brennan and Buchanan (1980: 178) assume "that subordinate units of government may, without undue cost, effectively exclude noncitizens from enjoying the public goods benefits from localized provision," they refer to *location-goods* but not to *club-goods*.

are a quite common feature in federal systems, such as e.g. in Germany, They are, however, neither a necessary nor a universal feature. They are a matter of constitutional choice. A counter-example is, for instance, Switzerland where the primary citizenship is at the level of local communes and cantons, while citizenship in the Swiss nation derives therefrom.³⁷ To another, significant counter-example, the European Union, I shall return below.³⁸

In other words, the constitutions of federal systems – how competencies are assigned to the respective levels of government, and how the rules of citizenship are defined – can be differently designed, and the differences they exhibit may have a significant effect on how the competitive dynamics among sub-units unfold. A general theory of competitive federalism must account for this fact, and it must recognize that in a democratic polity as a citizen-cooperative the citizens-members are the ultimate judges in matters of constitutional choice.³⁹

6. Responsive Government and the Power to Tax

The federal structure that Hayek, Weingast and Buchanan advocate has been charged by critics (Gill 2002; Harmes 2006; 2007) with a “neoliberal policy bias” (Harmes 2006: 737). The authors’ recipe for multilevel government, the critics argue, aims at “locking-in inter-jurisdictional competition” (ibid.: 727) in order “to ‘lock-in’ neoliberal policies and thus insulate them from democratic influence” (ibid.).⁴⁰ In their view, the purpose behind the advocated “centralization of ‘market-enabling’ policy competencies ... (and) decentralization of ‘market-inhibiting’ policy competencies” (ibid.) is to limit “democratic control over central elements of economic policy and regulation” (Gill 2002: 47) in favor of protecting individual liberty “from government interference” (ibid.: 55).

My interest here is not in examining the critics’ charges on their own merits. Of interest in the present context is that the issue they raise – namely, whether a competitive federalism privileges individuals’ interests as private law subjects in limiting government’s power to encroach on their private autonomy (ibid.: 52) at the expense of their interests in

³⁷ Schönberger (2007: 62): „Swiss citizenship (*Schweizer Bürgerrecht*) is acquired and lost as a consequence of the acquisition or loss of the citizenship of a canton (*Kantonsbürgerrecht*) which is again linked to the citizenship of a municipality.“

³⁸ For a comparison of the citizenship rules in the federal systems of the United States, Switzerland, Germany and the European Union see Ch. Schönberger 2005, 2007.

³⁹ When Brennan and Buchanan (1980: 181) speak of a “normative theory of the ‘optimal’ federal structure” they surely do not mean to imply that what is “optimal” can be determined on “scientific” grounds, independently of what the citizens who are to live under the regime consider desirable. The “normative theory” of which they speak can claim no more than to provide information about the predictable working properties of different constitutional regimes, and to offer suggestions on which regimes may be more likely to serve the presumed common interests of the citizenry under consideration.

⁴⁰ Harmes (2007: 418): “(T)he broader neoliberal approach to federalism ... seeks to use institutional reforms to lock in more market-oriented public policies.”

exercising their democratic rights as citizens-members of a polity – is of obvious significance for the central theme of this paper.⁴¹ As much as their concern for a protected private domain will make individuals interested in *limiting* the power of government, this interest is surely not the only concern that motivates persons’ participation in a citizen cooperative. Certainly, they can be presumed to also have an interest in *enabling* government to carry out, as territorial and as club-enterprise, projects they share a common interest in. In other words, they can be presumed to share an interest in a government that is not only *limited* but also *responsive* to their common interests as members of the citizen cooperative. The question to be asked therefore is how a competitive federalism affects the responsiveness of governments in both their capacities.

As I have argued above, a model of competitive federalism that focuses exclusively on territorial mobility can account for governments’ responsiveness to individuals’ interests as jurisdiction-users, but it is blind to the question of what secures their responsiveness to individuals’ interests in the services governments may provide as club-enterprises. An issue that I have not yet addressed is that individuals may have an interest in government’s activity as territorial enterprise not only in their capacity as jurisdiction-users, but also as citizens who may wish certain regulations to be enforced in their home-jurisdiction, and that these two kinds of interests need not always be in harmony. When John Kincaid, a foremost authority in the study of American federalism, speaks of “a tension between citizenship and consumership” (Kincaid 1992: 31)⁴² this can be described, in my terminology, as a tension between individuals’ interests as private-law subjects in open markets and their interests as citizens who value, and wish to retain, certain jurisdictional properties of their home-community. Consequentially, Kincaid notes, citizens face a trade-off in choosing the federal regime under which they wish to live.⁴³

In light of Kincaid’s argument the charge of critics like Gill and Harmes – namely, that “the need to compete for mobile citizens and firms” (Harmes 2006: 736) reduces governments’ regulatory powers and “the possibility for democratic accountability” (ibid.: 734) – can be answered in two parts. Firstly, in opting for a market-preserving federalism

⁴¹ According to Gill and Harmes, this “deficiency” can only be remedied by reversing the “neoliberal” in favor of a “social democratic” recipe, namely, “to limit the disciplinary effects of inter-jurisdictional competition” (Harmes 2006: 727) by assigning market-inhibiting policy competencies to higher levels of government.

⁴² Kincaid (1994: 37): “Consumership refers to the empowerment derived from access to the global marketplace for goods and services. Citizenship refers to the empowerment derived from participation in a self-governing political community having a distinct identity. ... The problem is that the requisites of consumership can diminish the citizenship opportunities by a common market.”

⁴³ Kincaid (1995: 261): “The more citizens pursue their consumership interests in the national marketplace by levelling jurisdictional boundaries, however, the more they reduce the effective scope of their local citizenship rights.”- See Vanberg 1997 for a more detailed discussion of this issue.

citizens sacrifice indeed part of their democratic rights to determine the regulatory framework in their home-jurisdiction.⁴⁴ Yet, whether or not they wish to commit to such a regime is itself a matter of democratic constitutional choice. It is a choice in which citizens must assess which of the alternatives they value higher. On the one side the “material benefits that would spring from the creation of so large an economic area” (Hayek 1948 [1939]: 255) and the curbing effects of inter-governmental competition on the possibilities for rent-seeking special interests to lobby for protectionist privileges. On the other side, the advantages they may expect from maintaining complete control over their community’s regulatory affairs. Secondly, with the limits set by the commitment to an open market – limits that are not always easy to draw – citizens remain free to choose the regulations they wish to adopt as long as they are willing to accept the costs – such as, e.g., a diminished ability of attracting investments to their jurisdiction – that they entail.

My main concern in this paper is, however, not with the issue of how a competitive federalism affects the responsiveness of governments as territorial enterprises to their citizens’ regulatory preferences. My principal interest here is, as indicated above, in the issue of governments’ responsiveness to their citizens’ preferences for club-goods, specifically for redistribution as social insurance. In the literature on the subject it is often treated as an unquestionable fact that redistribution is a task of government, a task furthermore that can only be carried out by the central government. A theory that conceives of a democratic polity as a “cooperative venture for mutual advantage” cannot treat these matters as unquestionable facts. It must provide arguments for why redistribution may qualify as a club-good in which the members of a citizen-cooperative share a common interest. And it must provide arguments for why citizens in a federal system may share a common interest in assigning the redistribution-task to a particular level in the federal hierarchy.

One cannot simply take for granted that citizens should have a common interest, those who have to feed the system with their tax contributions as well as those at the receiving end. There are two kinds of arguments for why the former may be willing to agree to a system of redistributive taxes. On the one hand, citizens may have a common interest in avoiding potential negative effects of great inequality in their home jurisdiction. This would concern a “territorial good” that falls in the domain of government as a territorial enterprise, a good for which jurisdiction-users can also be charged to the extent that it makes the jurisdiction more

⁴⁴ Hayek (1948 [1939]: 260) acknowledges that under the regime of his “interstate federalism” the regulatory “possibilities open to the individual states would be severely limited,” and that “even such legislation of child labor or of working hours becomes difficult to carry out for individual states.”

attractive for their purposes. On the other hand, citizens may have a common interest in redistribution as a mutual insurance arrangement, covering the members of the citizen cooperative in case of need. It is the second variety that I shall focus on here.⁴⁵

That uncertainties about one's own – and one's children⁴⁶ – future income-earning prospects can provide prudential reasons for citizens to agree to a regime of redistributive insurance has been observed by a number of authors.⁴⁷ As H.-W. Sinn (1997: 258) has put it:

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

This is the reason, Sinn concludes, why redistribution “as insurance ... may be welcomed by all citizens before destiny has lifted its veil of ignorance” (ibid.: 259).⁴⁸ Yet, so he argues, despite the benefits that welfare state provisions can generate for citizens, governments may not be able to provide them because of the “increased difficulties of carrying out redistributive policies ... if the factors of production are internationally mobile” (Sinn 1994: 90).⁴⁹ If a “country's borders are opened and both capital and labor can freely migrate across them,” he posits (Sinn 1997: 262), this liberty “will affect insurance through redistributive taxes since the government loses its power to enforce the payment of taxes.” This is, according to Sinn

⁴⁵ In his discussion of the redistribution issue Th.R. Dye (1990: 188f.) focuses on the first when he states: “The most serious challenge to the competitive federalism model arises in redistributive policy. Can multiple competing governments undertake redistributive policies without creating unbearable free-rider problems for themselves? ... Few of us want to see poverty, hunger, homelessness, ill health, or deprivation in our society ... States or communities that aggravate these hardships would hardly look attractive to families or business seeking places to locate.”

⁴⁶ The fate of one's children can be included in the insurance-calculus where, according to the respective citizenship rules, the offspring of citizens is automatically and unconditionally granted membership status in the citizen cooperative.

⁴⁷ Hayek (1960: 101): “There are good reasons why we should endeavor to use whatever political organization we have at our disposal to make provisions for the weak or infirm or for the victims of unforeseeable disaster. I may well be true that the most effective method of providing against certain risks common to all citizens of a state is to give every citizen protection against those risks.” – Buchanan (1977 [1976]: 267): “Uncertainty about income and wealth positions in future periods can produce general contractual agreement on a set of fiscal institutions, a fiscal constitution, that may incorporate protection against poverty and which may seem, when viewed in a short-term perspective, to produce pure transfer among individuals and groups.” – Buchanan (2001 [1985]: 249): “In a contractarian and rule-oriented perspective, therefore, it is possible that consensus on a set of institutional arrangements will emerge that will, in operation, embody interpersonal transfers that may loosely be described as redistributive.”

⁴⁸ Sinn (1994: 99): “Redistribution can therefore be a useful government activity that generates benefits similar to those provided by the insurance industry.” – As Sinn points out, the ability to function as a trans-generational insurance distinguishes the state from private insurance companies.

⁴⁹ Sinn (1997: 259, 263): “Fiscal competition will ... create severe problems for public redistribution ... The welfare state has no survival chance when unbridled tax competition is allowed.”

(ibid.: 264), so because the “good risks leave the insurance state,” creating an adverse-selection problem that destroys the viability of the insurance arrangement.

It is quite common to assert that redistributive policies are subject to adverse selection when governments have to compete for a mobile tax base.⁵⁰ R.A. Musgrave, to cite a particularly prominent source, has put it in these terms:

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

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

The proposition that voting with the feet generates an efficient outcome is intriguing, but a voluminous literature has pointed to serious limitations. ... The conclusion remains that distributional concerns, including social insurance and progressive taxation, must be met largely, if not entirely, at the central level. ... There thus exists a linkage between the two issues: centralization permits progressive taxation and redistribution, whereas decentralization interferes with them (Musgrave 1999: 158, 161).

As indicated before, claims about the effects of inter-governmental competition – e.g. on governments’ ability to provide such club-goods as social insurance – cannot be assessed in the absence of a clear distinction between governments’ roles as territorial and as club-enterprises. Governments’ power to tax in both their roles depends on their ability to make access to the services they provide contingent on the payment of required tax contributions.

As territorial enterprises, governments can charge the taxes to finance their services on a pay-as-you-go basis. For the permission to benefit from the advantages their jurisdiction offers they can charge ongoing payments. In a competitive environment, the taxes jurisdiction-users can be made to pay will tend to take on the character of prices or *user-charges*, graded according to the respective uses made (residents, investors, tourists, etc.). The situation is categorically different for governments’ services as club-enterprises. Club goods like social insurance cannot be provided, as territorial goods can be, on a pay-as-you-go basis. By contrast to user-charges, the taxes governments need to raise to finance their services as club-enterprises have the character of *membership-dues*.⁵¹ They are payments for the *option* to

⁵⁰ Kerber (2000: 227f.): “It has been contended that tax competition under certain conditions might lead to an under-provision of public goods and/or too low a degree of redistribution. ... Free migration can lead to problems for the competing jurisdictions’ redistribution policies through effects of adverse selection.”

⁵¹ The distinction between these two kinds seems to find rarely attention in the public finance literature. It is ignored, for instance, when Buchanan and Flowers (1980: 85) state: “The ‘public economy,’ the public sector

partake in the bundle of services that the club provides, not payments for their actual consumption. Membership-dues must be paid as long as one maintains one's membership status, independent of the extent to which one makes use of the options it offers, even if, as may well happen in the case of social insurance, the option never materializes.⁵²

In order for governments to be able to charge taxes – such as redistributive taxes – for their services as club-enterprises they must be able to control the conditions under which new members are admitted to the citizen cooperative. Nation states typically have this ability. They have the authority to decide whom they admit as citizen-member. The need to compete for a mobile tax base does not per se undermine, as authors like Sinn suppose, their ability to charge redistributive taxes. If they lack this ability competition can only be the proximate, not the ultimate reason. The principal reason most surely is their failure to distinguish adequately between the taxes they *can* charge as territorial enterprises and the taxes they *must* charge in order to function as club-enterprises. Since jurisdiction-users can avoid being taxed by a particular government simply by exiting the respective territory, they cannot be burdened with taxes that serve to finance services from which they derive no benefit. In this sense, Sinn (1994: 101) is right in saying that “mobile factors cannot be taxed for redistributive purposes,” because in their capacity as jurisdiction-users they do not benefit from the club-good “social insurance.”⁵³ If citizens too have the option to avoid paying taxes to finance government's services as club-enterprise simply by exiting their home-jurisdiction, but can enjoy the benefits of social insurance simply by re-entering, their government obviously fails to organize its taxation regime in ways required for its viability as producer of club-goods. Under such conditions the problem of adverse selection must inevitably arise.

In federal systems, the ability of lower-level governments to function as club-enterprises depends, as already noted, on the respective citizenship-rules. If, as in US-type federal systems, primary citizenship is at the union level while citizenship in states and local communities is a matter of individuals' residential choice, lower-level governments are in effect, as I have argued, reduced to their role as territorial enterprises. It is for *this* reason, not

involves government provision of goods and services to beneficiaries. These are financed through tax revenues collected from individuals coercively.”

⁵² De Viti de Marco (1936 [1928]: 115): “In short, it is possible to maintain that every taxpayer pays taxes today, not only in consideration of his present wants, but also in anticipation of future wants. ... (I)t transforms ... a series of different prices into a single ‘subscription’ price.”

⁵³ As noted above, jurisdiction-users can be charged for redistributive policies that make the jurisdiction more attractive for their purposes, e.g. as resident or investors.

because “redistribution is intrinsically a national policy” (Stigler 1965: 172),⁵⁴ that the power to collect redistributive taxes resides only with the central government. Note, that to say that redistribution is not “intrinsically” a central government’s task is not to deny that there may be *prudential* reasons for citizens in a federal system to choose such assignment. In fact, the historical trend towards a centralization of redistributive policies that used to be in the domain of local communities⁵⁵ has its apparent causes in the difficulties the local provision of social insurance faced in an increasingly mobile world.⁵⁶ Yet, specifying prudential reasons why citizens may want to centralize redistribution as social insurance is quite different from simply positing that redistribution requires “intrinsically” its centralization. To keep this difference in mind is important when one looks at a federal system such as the European Union.

7. The Case of the EU

It is in line with his above cited claims about the effects of inter-governmental competition when Sinn (1994: 97) charges that the EU’s Single Market Program with its four liberties (free movement of goods, services, labor and capital) must lead to “the breakdown of national redistribution schemes under institutional competition.”⁵⁷ He concludes that because of the “impossibility of redistribution policy” on part of the member-states tax rates will “have to be harmonized across countries or chosen by a central agency” (ibid.: 99).⁵⁸

What Sinn fails to take into account in his claims about the impossibility of national redistribution policies is that in assessing the effects of competition one needs to distinguish

⁵⁴ Stigler (1965: 172): “The purely competitive organization of local services would make it impossible for a local government to obtain money from the rich to pay for the education of the children of the poor, except to the extent that the rich voluntarily assumed this burden.”

⁵⁵ See A. Dercks (1996: 62ff.). Dercks quotes W. Oates’ (1972: 194) observation: “History shows a trend toward the increasing centralization of explicitly redistributive programs ... The care of the poor ... was originally envisioned as local responsibility.” – L. Feld (2005: 435): “In Switzerland, a citizenship principle existed until 1979 according to which the places of citizenship (i.e. communes and cantons, V.V.) were responsible for social welfare of their citizens.”

⁵⁶ Hayek (1960: 285): “In the Western world some provisions for those threatened by the extremes of indigence and starvation due to circumstances beyond their control has long been accepted as a duty of the communities. The local arrangements which first supplied this need became inadequate when the growth of large cities and the increased mobility of men dissolved the old neighborhood ties; and (if the responsibility of the local authority was not to produce obstacles to movement) these services had to be organized nationally.”

⁵⁷ Sinn (1990: 10): “The problem with voting with one’s feet is that real freedom of movement in Europe means that all people, even those for whom the veil of ignorance has already been lifted, must be able to decide freely on where they want to live. This freedom leads to ... adverse selection, where ... eventually welfare states must collapse. ... Competition in this case functions like competition in an insurance market without binding contracts and ex-post premium settlement. Such a market could also not survive.”

⁵⁸ Sinn (1990: 11): “A workable solution can only be found in the creation of a central state with corresponding redistribution objectives, or if it is impossible to form such a state, the individual redistribution systems must be harmonized with one another.”

between the member-states' two roles.⁵⁹ It is simply not the case that "(s)tates could establish redistribution schemes only when borders are closed, not when they are open" (Sinn 1990: 10). There is a categorical difference between "open borders" in the sense of allowing free migration of jurisdiction-users across national boundaries and "open borders" in the sense of free admission to the services, in particular redistribution as insurance, governments provide as club-enterprises for their citizens.⁶⁰ The EU's Single Market Program is about the first, not the second. The commitment to the common market's four liberties requires member states to admit all EU citizens *as jurisdiction-users* into their sovereign territory. It does not require them, however, to grant citizens from other EU member states free access to their services as club-enterprises. In the EU primary citizenship is with the member states, while the EU-citizenship derives therefrom.⁶¹ Different from the US-type federalism, EU citizens cannot acquire citizenship of a member state simply by taking residence therein. Accordingly, as providers of club-goods like social insurance member states are immune to adverse selection as long as they enforce an appropriate taxation regime. Interestingly, if only passingly, Sinn (1994: 100) acknowledges this fact when he notes that redistribution can work with free migration if "a strict nationality principle for redistributive taxation is applied."⁶²

Adverse selection undermining independent national redistribution policies within the EU it definitely not an inevitable consequence of free migration. It may be caused, though, by EU-rules that prevent national governments from exercising effective control over whom they admit to services they provide as club-enterprises for their citizens-members. A tendency for such rules to be adopted can indeed be observed in the EU, caused, as I suppose, by a failure to distinguish properly between the member states' two roles. The failure is particularly visible in interpretations of the non-discrimination principle that is at the core of the Single Market Program. The principle clearly requires national governments in their capacity as territorial enterprises to treat all jurisdiction-users, whether they are their own citizens or citizens of other member states, equally. There is, however, no intrinsic reason whatsoever to extend the non-discrimination principle to the services the individual states provide to their citizens in their capacity as members of the citizen-cooperative. Non-discrimination in the

⁵⁹ Implicitly Sinn (1994: 102) invokes the distinction when he argues that because of the four liberties "not only redistributive taxes have to be lifted to the community level ..., to some extent even benefit taxes for local public goods must be too." – See my above (pp. 15f.) comments on how competition affects governments as territorial enterprises providing "local public goods."

⁶⁰ On this distinction see W. Niskanen 2006; A. Nowrasteh and S. Cole 2013.

⁶¹ Schönberger (2007: 76): "(A)ccording to the EC Treaty, Union citizenship is predicated on Member States nationality (Article 17 para. 1 EC Treaty). It is acquired or lost as a consequence of the acquisition or loss of the nationality of one of the Member States."

⁶² On this see also Feld 2005: 434ff.

provision of territorial goods and excluding non-citizens from club-goods provided for citizens need not at all be in conflict with each other.

The *Treaty establishing a Constitution for Europe* (TCE) that was signed by all member states in 2004 explicitly included provisions that could pave the way for the above described extension of the non-discrimination principle to the member states' role as club-enterprises.⁶³ Because it has been rejected by French and Dutch voters, the TCE has not been ratified, yet the ambiguity about what the non-discrimination principle implies for member states' redistributive policies is nourished by certain EU-regulations⁶⁴ and -directives⁶⁵ as well as by rulings of the European Court of Justice. One of the ECJ's recent rulings may serve as an illustration.

In the Case C-333/13, the ECJ had to decide whether the Sozialgericht Leipzig, Germany, had justly denied benefits according to the German system of basic provision (Grundsicherung) to a Romanian mother and her son, who had taken residence with the mother's sister in Leipzig.⁶⁶ The "Judgment of the Court (Grand Chamber)" of November 11, 2014, covers 20 pages to answer a question that could have been answered in one sentence if the Court had been guided by the unambiguous understanding that the non-discrimination principle binds the member-states in their role as territorial enterprises but not in their activities as club-enterprises. If guided by such an understanding the Court could have simply stated that the right to take residence in any member-state does not imply the right to be admitted to the club-goods the respective state provides for its citizens.⁶⁷ Instead, the judgment draws repeatedly on the argument, incidental to the principal issue, that persons exercising their right to move and reside within the EU should not "become an unreasonable burden on the social assistance system of the host Member State." Pondering various directives and regulations pertinent to the issue the Court arrives at the conclusion that they

"must be interpreted as not precluding legislation of a Member State under which nationals of other Member States are excluded from entitlements to certain 'special

⁶³ Feld (2005: 435): "The proposals by the European Convention to establish a European citizenship (AR. I-8 of the Constitutional Draft) together with non-discrimination (Art. I-4) and the positive right of social protection (Art. II-34) impose strong restrictions on the introduction of a citizenship principle."

⁶⁴ E.g. by Reg. 883/2004 on the coordination of social security systems.

⁶⁵ E.g. by Directive 2004/38, Art. 24 on "Equal Treatment."

⁶⁶ For a more comprehensive discussion of ECJ judgments on the general issue at stake see Schönberger 2005: 344ff.

⁶⁷ Of relevance in this context is the distinction between national *social security systems*, which belong indeed in the domain of governments as territorial enterprises, and national *social assistance systems* belonging in their domain as club-enterprises.

non-contributory cash benefits' ..., although those benefits are granted to nationals of the host Member State who are in the same situation.”

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

8. Conclusion

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

In terms of what has been my main argument in this paper, a stricter separation between member-states two roles may well be the most promising instrument for simultaneously achieving the two goals Kerber lists. A European Union, just as any other federal system, that is to be responsive to the preferences of its citizens – their interests as jurisdiction-users as well as their interests as members of their respective citizen cooperatives – must adopt rules of competition that take adequate account of the different tasks that governments perform in their roles as territorial and as club-enterprises.

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