Government Competition

THINK GLOBALLY, ACT LOCALLY.
—popular bumper sticker on cars in Berkeley, California

IN HIS magisterial book A Theory of Justice, John Rawls asserts that a just state gains support from citizens when placed in competition with other states. Similarly, an efficient state gains support from citizens when placed in competition with other states. Competition among governments comes from people moving to governments and governments moving to people. This chapter canvasses theories of intergovernmental competition, including mobility, choice of private laws, and contracting for public goods. I will explore the global consequences of local government actions and address such questions as:

Example 1: By lavish spending on its state school, a suburb attracts rich, intellectual families. This school has its own computer network, whereas another state school in a poor city neighborhood struggles to afford books. Does residential mobility increase the efficiency of local government by clustering people together who have similar tastes, such as intellectuals? Or does mobility merely exacerbate inequality by clustering people together with similar incomes, such as the rich?

Example 2: An ethnic minority occupies a neighborhood in a large city. The neighborhood council enacts an ordinance requiring neighborhood signs to use only the minority’s language. A court must decide whether the ordinance violates the constitutional rights of advertisers. Will a decision in favor of the neighborhood council increase or diminish diversity among neighborhoods?

Example 3: The European Union issues directives requiring the European nations to harmonize their laws. Under what circumstances does harmonization reduce competition among governments and make them less responsive to citizens?

Example 4: In Switzerland, 50,000 signatures by citizens create a referendum on any law enacted by the federal legislature. Is this requirement a good way to filter good proposals and separate them from bad proposals? Or is this requirement a waste of resources?

Instead of benefiting citizens, political competition sometimes harms them. In extreme cases, competition among governments spills over into conflict.

1 See Rawls 1971, p. 177, 496–503.
The detritus of territorial wars litters the history of states. In addition to wars, even mild competition sometimes harms the public. In a celebrated example, Albert Hirschman observed that monopoly power by a Nigerian railroad forced aggrieved buyers to “voice” their complaints through politics. The development of competition from trucks, however, permitted buyers to “exit,” which caused railway services to deteriorate (Hirschman 1970). Applied to legal regimes, Hirschman’s theory predicts that political voices are sometimes more efficient than market choices. Similarly, decline in racial discrimination has allegedly caused talented African Americans to exit poor neighborhoods, thus causing deterioration in ghetto institutions (Wilson 1987). Using another example, lawyers sometimes argue that different regulations in different jurisdictions provoke a “race to laxity.” For example, decentralized environmental law can cause jurisdictions to compete for business by allowing more pollution.

The complexity of history falsifies most universal statements about social life, including the proposition that citizens always benefit from more competition in politics. Lacking universals, social science must rely on generalizations. A theme of this book is that democracy achieves superiority over other forms of government by harnessing political competition. The superiority of democracy over other forms of government rests on the generalization that competition is better than monopoly in government. Facilitating competition carries the promise of greater satisfaction of citizens with government, whereas abandoning competition in favor of monopoly serves the interests of political cartels.

In markets, greater efficiency automatically results in more customers, but in politics better government does not automatically result in wider jurisdiction. To repeat an illustration, if German federalism outperforms French centralism, few French citizens become German citizens, nor does the border separating these nations automatically move west. Centuries of territorial warfare testify that politicians crave the power that comes from expanded jurisdiction. If this motive were harnessed for creation rather than destruction, people could benefit dramatically. To create pressures for improvement, good governments must automatically expand and bad governments must automatically shrink.

Under current conditions, some people and firms move to successful governments or opt to come under their laws. Competition among governments, however, stops far short of automatic flux in response to performance. Most democratic constitutions amplify competition among candidates and mute competition among governments. To illustrate, most democracies strictly regulate the entry of immigrants, and many nations have legal impediments to internal mobility, such as immobile pensions or housing benefits. Furthermore, many countries have no laws on how to create special governments or contract with them. Transferring powers from one government to another can violate constitutional provisions on sovereignty. Finally, many national courts resist enforcing the terms in a contract that designate a foreign court to resolve disputes.

State officials often enrich themselves at the expense of citizens and suffocate enterprise under a blanket of bureaucracy. Sometimes direct democracy can correct failures of indirect democracy. In unusual cases such as Switzerland
and California, the constitution facilitates ballot initiatives enabling citizens to hold a referendum. Ballot initiatives compete with governments to make laws. Most democratic constitutions, however, inhibit referenda by imposing costly procedures for ballot initiatives or making no provision for them.

Increasing political competition carries the hope of improving alignment between the interests of politicians and the preferences of citizens. With good organization, competition among governments can produce a race to quality and efficiency. Realizing that hope requires improving the legal framework for competition among governments. I will analyze that framework as applied to mobility, choice of private laws, public goods, and direct democracy.

**Mobility**

Different people have different preferences with respect to public goods. For example, one person may value parks more than safe streets, and another person may value safe streets more than parks. Since local public goods are supplied to everyone in a jurisdiction, efficiency requires clustering together people with similar preferences. The people who especially prefer parks should live in a locality that devotes its resources especially to parks, and the people who especially prefer safe streets should live in a locality that devotes its resources especially to safe streets. In other words, sorting diverse populations into groups with relatively homogeneous tastes can give each of them their preferred public goods. The optimal number of jurisdictions thus increases with population diversity (Alesina and Spolaore 1997).

**Clusters and Tiebout**

People with similar tastes voluntarily cluster together in order to enjoy their preferred combination of local public goods. Consequently, mobility contributes to efficiency in local public goods. To refine thinking about clustering, I will extend the concepts of equilibrium and efficiency to mobility. Define *location equilibrium* as a situation in which no one prefers to move from one jurisdiction to another.

If relocating people cannot increase anyone's satisfaction without decreasing someone else's satisfaction, then the location equilibrium is *Pareto efficient*. Scholars have extensively studied the question, "What conditions make a location equilibrium Pareto efficient?" I reduce their answers to two unrealistic conditions:

1. Publicly provided goods and services are produced with a congestable technology
2. There is a perfectly elastic supply of jurisdictions, each capable of replicating all attractive economic features of its competitors
3. Mobility of households among jurisdictions is costless
4. Households are fully informed about the fiscal attributes of each jurisdiction
5. There are no interjurisdictional externalities

Also see Stiglitz 1982.
conditions, whose logical purity helps explain clustering. First, people must enjoy "free mobility," which means no legal or economic obstacles to moving. Legal obstacles include residence permits or exclusionary zoning, and economic obstacles include the cost of moving from one place to another. Second, jurisdictions must be sufficiently numerous to accommodate differences in taste among different types of people. To be precise, the highest order of efficiency requires as many jurisdictions as types of people. Given free mobility and many jurisdictions, people with similar tastes will voluntarily cluster together to obtain the highest order of efficiency in the supply of local public goods.

In reality, however, mobility is costly and jurisdictions are limited in number. Like transaction costs, mobility costs obstruct movements toward efficiency. Like uniformity in mass production, too few jurisdictions cause too much similarity in jurisdictions relative to differences in people. With costly mobility and few jurisdictions, people with similar tastes still cluster together to obtain more of their preferred combination of local public goods, but the result falls short of the highest order of efficiency.

The contribution of free mobility to the efficient supply of local public goods provides an economic justification for guaranteeing mobility as an individual right in a federal system. For example, the European Union guarantees the right of workers to compete for jobs throughout Europe. To implement this right, the European Union now tries to dismantle the economic obstacles to mobility, notably the incompatibility of housing, health, and pension benefits in different localities and nations. As obstacles diminish, the economic model predicts that people with similar preferences for local public goods will cluster together more in the future than they did in the past.

Notice that this prediction of clustering by tastes contradicts the conventional prediction that mobility homogenizes culture. To illustrate, the historical district in many cities attracts people who especially value culture, whereas many suburbs attract families who want to raise children in safety and convenience. Mobility can accentuate the difference between childless families in the historical district and families with children in the suburbs. Similarly, a university town draws together an international population united by their love for learning. Mobility can also facilitate the clustering of ethnic or religious groups who prefer proximity to each other.

Restrictions

Now I turn to the paradox that restraint can increase freedom. As explained, free mobility contributes to clustering and efficiency. Restrictions on freedom within jurisdictions, however, can increase choice among jurisdictions. To see why, consider architectural regulations. Restricting neighborhood architecture to a uniform style appeals to residents who like architectural purity. To be concrete, some residents of London prefer a neighborhood consisting purely of Georgian houses. Private mechanisms such as restrictive covenants usually fall short of
producing uniform architecture. In practice, keeping buildings purely in one style requires the state to prohibit building in another style.

This proposition generalizes beyond architecture to other choices of local government. A community of people who cluster together in a neighborhood to perpetuate a culture may want to exclude other practices and people. To illustrate, when given the choice, some religious communities will forbid commerce on the Sabbath and require schools to display religious symbols, some family neighborhoods will prohibit the sale of pornography, and some ethnic groups will impose restrictions on using foreign languages. Given enough jurisdictions and free mobility, imposing restrictions on the activities of individuals in some jurisdictions does not harm anyone. People who prefer diversity will cluster in mixed neighborhoods that develop in unrestricted jurisdictions and people who prefer similarity will cluster in pure neighborhoods that develop in restricted jurisdictions. For example, permitting restrictions on where to buy pornography creates the option to live where it is not sold.

Some urban areas approximate the assumptions of free mobility and many jurisdictions. In most places, however, costly moving and scarce jurisdictions create a trade-off between uniformity and diversity. Local restrictions can produce some neighborhoods without Sabbath commerce, pornography, or signs in foreign languages, whereas the absence of local restrictions will often result in commerce on the Sabbath, the sale of pornography, and the mixing of languages.

Local restrictions bring nonconforming individuals into legal conflict with their neighbors. For example, a fashionable person tries to build a postmodern house in a Georgian neighborhood, an agnostic opens his store on the Sabbath, a magazine store sells pornography in a family neighborhood, or an Anglphone operates a school in Quebec. In these circumstances, the individual may allege that the local restrictions violate his individual rights, whereas the neighbors may claim that enforcing community values preserves the distinctiveness of neighborhoods.

Government must respond to this trade-off, especially when courts adjudicate individual rights. Central governments can require, forbid, or permit local governments to enforce community values. By requiring local governments to enforce community values, central governments induce many pure neighborhoods. By forbidding local governments to enforce community values, central governments induce many mixed neighborhoods. By permitting neighborhoods to enforce certain community values, central governments typically induce some mixed and some pure neighborhoods. Insofar as the social goal is diversity among neighborhoods, central governments should permit local governments to enforce community values. Insofar as the social goal is diversity within each neighborhood, central governments should forbid local governments to enforce community values.

Notice that the costs of mobility determine the severity of the trade-off between individual rights and community values. Local restrictions are not
oppressive when nonconforming individuals can easily move to unrestricted communities. Low relocation costs are a reason to allow local communities to develop different interpretations of individual rights. Conversely, local restrictions are oppressive when costs preclude nonconforming individuals from moving. High relocation costs are a reason for imposing the same respect for individual rights on different local governments. The strength of the right to be different should depend partly on the cost of leaving a community. In general, parochial rights fit mobile societies and universal rights fit immobile societies.

If local governments have power over these decisions, how will they use it? In practice, particular institutions and facts of history determine the answer. A simple theory, however, provides a useful benchmark for analysis. Property owners often care intensely about property values. As a jurisdiction becomes more popular, people bid up the value of its land. Assume that residents induce local governments to adjust taxes and local public goods in order to maximize the value of land (Brueckner 1983; Scotchmer 1994). Under this assumption, local governments compete with each other to maximize land values.

To increase demand by mobile citizens, some jurisdictions will impose restrictions, such as requiring uniform architecture. These restrictions appeal to people who prefer similarity rather than diversity within a neighborhood. Other jurisdictions, however, will retain individual freedom, such as allowing mixed architecture, thus appealing to people who prefer diversity within a neighborhood. Local governments that maximize land values will adjust the mixture of restricted and free neighborhoods to respond to the preferences of citizens.

Exclusion

Do tastes for local public goods predict the actual way that people sort themselves into jurisdictions? Examples confirming the prediction easily come to mind. Connoisseurs cluster near restaurants, critics live near theaters, equestrians move to the green belt, religious enclaves try to exclude the world, and ethnic communities use local ordinances to sustain their traditions.

Besides clustering by taste, however, people also cluster by income. Neighborhoods often sort by class because the rich exclude the middle class and the middle class excludes the lower class. The logic of taxation partly explains why relatively rich people try to exclude relatively poor people. Everyone in a jurisdiction receives the same local public goods, but not everyone has the same ability to pay taxes. When local taxes finance local public goods, attracting people with high income enables the residents of a particular jurisdiction to enjoy a high level of local public goods with a low rate of taxation. Conversely, a concentration of poor people requires a high rate of taxation to finance a modest level of local public goods. If local taxation finances local public goods, relatively rich neighborhoods will seek legal devices to exclude relatively poor people.

Within countries where citizens can move freely, local governments especially rely on zoning to keep out poor people (Ellickson 1977; Fischel 1985).
Zoning controls the size of lots, the height of buildings, and the types of economic activities. To illustrate, exclusionary zoning in U.S. suburbs typically confines poor people to the cities, where the poorest people remain homeless and cause baffling social problems (Ellickson 1996). Reversing this pattern, historical preservation and other laws keep downtown Paris expensive and confine relatively poor Parisians to the suburbs.

Economics provide a theoretical basis for distinguishing restrictive zoning, which clusters people with similar tastes, and exclusionary zoning, which excludes relatively poor people. Zoning is exclusionary if it keeps people out of a neighborhood who share the residents' tastes in local public goods but not their income.

Some courts have taken dramatic measures to address inequalities caused by exclusionary zoning. For example, some state courts in the United States have required affluent suburbs to rezone in order to allow public housing for poor people. In another example, California courts ordered the reorganization of school finance. Public schools in California were traditionally financed by local property taxes, which caused rich neighborhoods to spend more money on public schools than poor neighborhoods could. The courts required California to equalize school expenditures in different localities by replacing local property taxes with statewide taxes (Inman and Rubinfeld 1979). The result is more equality in public schools and more flight to private schools. Instead of clustering in localities with excellent public schools, Californians who want to spend more than the state average on educating their children increasingly turn to private schools.

Whereas exclusionary zoning keeps poor people out, social welfare programs draw them in. Given mobile poverty, a government with relatively generous welfare programs draws the poor from jurisdictions with relatively grudging welfare programs. Localities might respond to this fact by reducing welfare programs in order to discourage poor immigrants, thus producing a race to the bottom. A strong effect in this direction could justify the federal government's imposing a minimum welfare standard on local governments.

Alternatively, the concentration of poor people in a locality increases the block of voters who favor generous welfare programs. Poor migrants attracted to high welfare jurisdictions could tip the electoral balance in favor of still higher welfare payments, thus increasing the gap between high and low welfare jurisdictions. Proof that states "race apart" would presumably undermine the case for the federal government's imposing a minimum welfare standard on local governments. Given the controversial politics of welfare, empirical studies inevitably disagree about the extent to which high welfare jurisdictions attract poor migrants and the extent to which migration causes a race to the bottom or a race apart.4


4 Brinig and Buckley 1997 find that high welfare states in the United States attract welfare migrants, and the presence of welfare migrants creates a political lobby that tends to increase
During the last decade, mobility of labor and capital has increased, while state welfare programs have retrenched or declined in many nations. Some proponents of redistribution despair for its future. Eighteenth-century legal scholar Blackstone said, "[M]ankind will not be reasoned out of the feelings of humanity." 5 Instead of giving up on redistribution, perhaps more mobility requires people to pursue income redistribution with less coercion. Instead of thinking in terms of a welfare state, perhaps people should think in terms of a welfare society. 6

Immigration

Vast migrations of people through history created the different peoples of the world (Cavalli-Sforza 1995; Cavalli-Sforza and Cavalli-Sforza 1995). Over centuries, territories became nations and nations enacted laws to restrict the movements of foreigners. In recent years, falling transportation costs and large differences in wages between countries have intensified pressures for migration (Hollifield 1994). According to a recent survey, "There are about 100 million persons living and often working outside their countries of citizenship, making this 'nation of migrants' equivalent in size to the world's tenth most populous country." 7

Relatively rich countries attempt to control immigration by imposing quotas of various kinds. For example, the U.S. quota system admits a relatively high proportion of poor, uneducated immigrants, who begin at the bottom of the socioeconomic scale and often work their way up. In contrast, Canada's point system restricts immigrants by wealth and education, so many immigrants enter Canada at the middle of the socioeconomic scale or higher (Buckley 1995). Unlike the United States and Canada, Japan allows almost no immigration.

Economic theory evaluates quotas for immigrants much as it evaluates quotas for goods (Chang 1996). Quotas on immigrants obstruct the exchange of labor, just as quotas on imports obstruct the exchange of goods. Conversely, free mobility of labor has the same advantages in terms of economic efficiency as free trade in goods. So economic efficiency requires free trade and free immigration.

Immigration, however, impacts many issues other than economic efficiency, such as distribution, culture, religion, and the environment. Passionate feelings

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5 Blackstone 1765 [1992], p. 238.
of people on these issues guarantees the persistence of immigration quotas in relatively rich countries.

What are the consequences of immigration quotas? Just as restriction of trade creates a black market, the persistence of quotas creates illegal immigration. To understand this phenomenon, consider an economic parable that focuses narrowly on wages. High wages provide an incentive to migrate from one country to another. Migration away from the low-wage country bids up its wages, and immigration into the high-wage country bids down its wages, thus reducing the difference in wages between the two countries. As the cost of mobility approaches zero, the location equilibrium requires equal wages everywhere. In brief, wage differences between nations create a disequilibrium that migration corrects.

In this parable, “wages” should be interpreted as “relative net wages.” Thus, relatively high wages attract illegal immigrants from Bangladesh to India, even though both countries suffer from low absolute wages. Net wage equals pay for work minus essential costs, such as the cost of housing and medical care. For illegal immigrants, essential costs include the costs of exclusion from social insurance, fear of arrest and deportation, and legal costs.

If quotas restrict legal immigration, then the “marginal” migrant who makes the location equilibrium is an illegal immigrant. To illustrate, the equilibrium model predicts that illegal immigration from Mexico to Los Angeles will continue so long as the net wage of an illegal factory worker in Los Angeles exceeds the net wage of a legal factory worker in Mexico. Equivalently, the model predicts that illegal immigration from Guatemala to Mexico will continue so long as the net wage of an illegal worker on a coffee plantation in Mexico exceeds the net wage of a legal worker on a coffee plantation in Guatemala.

According to this model, reducing differences in net wages reduces the amount of immigration required for equilibrium. For example, illegal immigration will slow if free trade causes wages to grow faster in the relatively poor country.8 The model also predicts that illiberal or inhumane measures will retard illegal immigration, such as denying illegal aliens social services and the protection of law.

Questions

1. Explain the problem of clustering people of similar tastes when the types of people outnumber government jurisdictions.

2. How can restrictive zoning increase freedom?

3. Characterize the illegal migration equilibrium between Spain and Morocco.

4. In the United States, each state government can decide whether or not to provide the poor with “stamps” redeemable for food at grocery stores. A state that decides to have such a program, however, cannot exclude striking workers from receiving the stamps. Excluding striking workers is an “unconstitutional

8 For a review of data on wage conversion between rich and poor countries, see Bardhan 1996.
condition” for such programs. How does the doctrine of unconstitutional conditions affect the location equilibrium?

CHOICE OF PRIVATE LAWS

Having discussed the movement of people to jurisdictions, now I discuss the movement of jurisdictions to people. The place where goods are made, sold, or used determines jurisdiction over most disputes in private law. Sometimes, however, people can choose the jurisdiction to resolve a dispute. For example, if buyer and seller reside in different countries, their contract may specify which jurisdiction controls disputes. Similarly, many contracts stipulate the resolution of disputes through arbitration, thus replacing public courts with private courts. Finally, firms exert some control over jurisdiction of their disputes by choosing where to incorporate. I will discuss the mechanisms and conditions under which the choice of jurisdiction enables people to obtain the laws that they prefer.

Bargained Contracts

When is contracting for jurisdiction efficient? A full answer requires a theory of contract, which I cannot develop here. A brief answer uses the Coase Theorem, which reduces strategic behavior to transaction costs.

Information enables people to perceive their interests accurately, and bargaining enables people to advance their perceived interests. A contract, consequently, tends to advance the interests of the parties as fully as possible when they bargain together and they are informed. In general, bargained contracts between informed parties tend toward pair-wise Pareto efficiency. Absent “third-party effects,” which fall on noncontracting parties, bargained contracts between informed parties are socially efficient.

This proposition extends to contract terms stipulating how to resolve disputes or designating the court or arbitrator with jurisdiction over the dispute. Absent third-party effects, bargaining between informed parties results in socially efficient terms stipulating jurisdiction over disputes. To illustrate, if a bargained contract between informed parties stipulates adjudication according to Japanese law, then applying Japanese law to such a contract creates value. Similarly, if a bargained contract between informed parties stipulates adjudication by the International Chamber of Commerce (ICC), then applying ICC law creates value.

Facilitating Contracts for Jurisdiction

The preceding principle gives a reason why law should facilitate contracts for jurisdiction. Facilitation has two aspects. First, courts must enforce the terms of


contracts that stipulate jurisdiction. Uniform principles of enforceability increase
the confidence of the parties in the effectiveness of contract terms stipulating
jurisdiction. Second, courts must enforce judgments by other courts. If the
defendant’s assets are located in a different jurisdiction than the jurisdiction stipu-
lated for deciding disputes, then the dispute must be tried in one jurisdiction
and enforced in another. A domestic court must enforce the judgment of a for-
eign court. Enforcing the judgment of a foreign court requires an international
agreement or a practice of mutual recognition between courts.

To illustrate by arbitration clauses, many countries have enacted the United
Nations Commission on International Trade Law (UNCITRAL) model law of
international arbitration, which narrowly specifies the legal grounds for chal-
lenging contract terms stipulating the resolution of disputes by arbitration.11
Similarly, most nations have joined the New York Convention of 1958 requiring
national courts to enforce arbitration clauses in international contracts. Domestic
courts often enforce foreign arbitral judgments more readily than foreign court
judgments. This legal framework has created a vigorous competition among

Harmonizing Law

Competition causes more successful jurisdictions to innovate and less successful
jurisdictions to emulate. To illustrate, the trust, which is unknown in civil law,
developed into a flexible instrument for investing and transferring wealth in
Britain. This fact gave London an advantage over Paris in competing for funds
in the 1980s. France responded by adapting instruments of the civil law to
resemble the trust more closely (Hansmann and Mattei 1994). In this example,
innovation differentiated common law from civil law, and emulation harmonized
civil law with common law. When competition drives legal evolution, innovation
differentiates and emulation harmonizes.

In principle, competing jurisdictions can supply optimal innovation and har-
monization in contract law, just as competing firms can supply optimal inno-
vation and uniformity in the design of automobiles and computers. In practice,
many obstacles impede competition among jurisdictions. Model laws and restate-
ments can speed up the process of innovation and diffusion by focusing the best
legal minds on concrete problems and publicizing superior rules.

Unlike model rules or restatements, harmonization by treaty, convention,
or federal law typically binds governments to uniform laws. I refer to such
agreements as “obligatory harmonization.” Obligatory harmonization diminishes
jurisdictional competition and reduces the scope of bargaining over jurisdiction
between the parties to a contract. Do the gains from standardization exceed the
losses from blunting competition among jurisdictions? When treaty, convention,
or federal law binds several governments, innovation must proceed by agreement

11 Article 34 of the UNCITRAL model law of international arbitration specifies six conditions
under which a court can set aside an award of an arbitral tribunal (United Nations Commission on
among all of them. Revisions to treaties, conventions, or federal laws often lag behind changes in economy and society. I believe that jurisdictional competition is typically more efficient for contract law than is obligatory harmonization.\footnote{See Koetz 1996, who cautions against harmonization of European private law, including contracts, at least in the immediate future. Note that European directives that overlap national law can create complexity by adding new regulations without repealing old statutes. To illustrate using an example from Koetz 1997, the scope, process, and substance of the British Unfair Contract Terms Act of 1977 differ from the European Union’s directive on Unfair Terms in Consumer Contracts. To achieve consistency, the British need to repeal the 1977 act and replace it with a new statute. Instead of following this difficult and time-consuming process, the British government responded to the directive by adopting new regulations and leaving the 1977 act in place. The resulting combination of new regulations and old statute complicates and confuses contract law.}

\textit{Voluntary Transactions and Relationships}

I have explained that informed parties who bargain for jurisdiction can create competition among jurisdictions to supply efficient contract laws. Can competition among jurisdictions succeed when the parties to contracts remain uninformed or do not bargain over the terms that stipulate jurisdiction? Furthermore, can competition among jurisdictions succeed when the affected parties do not have a contract? I can only sketch an answer.

Standard form contracts, which offer a package of terms without possibility of modification ("take-it-or-leave-it"), preclude bargaining. Even so, these contracts do not necessarily indicate market failure or inefficiency (Koetz 1997). Instead, standard forms can lower transaction costs. Sellers compete by offering different contracts and different prices, not by bargaining over the terms in contracts. In these circumstances, standard forms facilitate competition, not indicate its absence.

Similarly, the purchaser of stock cannot ordinarily bargain with the issuer over jurisdiction for disputes, but competition among jurisdictions can increase the efficiency of corporate law. The states in the United States compete vigorously to supply corporate charters, with Delaware being the most successful. Some evidence indicates that competition among states contributes to improvements in corporate charters.\footnote{Romano 1987. See Bebchuk 1992 for an account of some limits of competition among jurisdictions in increasing the efficiency of corporate law.} Furthermore, legal protection influences the extent of stock financing by corporations in different countries (La Porta, Lopez-de-Silanes, and Shleifer 1997). Proposals exist to extend jurisdictional competition to securities laws.\footnote{Choi 1998 would allow issuers of securities to choose a regulatory regime and jurisdiction. Thus U.S. issuers could choose German securities law and German courts, or German courts could choose U.S. securities law and U.S. courts.}

I have explained that jurisdictional competition can sometimes work without bargains. In addition, jurisdictional competition can sometimes work with little information. To illustrate, a buyer who knows little about computers often takes price as a signal for quality. Price accurately signals quality in markets so long as informed buyers make the market. Similarly, contracts for jurisdiction
might work with many ignorant parties, provided that informed parties make the market. In general, competition for contracts with asymmetrical information can produce a variety of results, some efficient and some inefficient.\footnote{An early, influential paper on the topic is Schwartz and Wilde 1979. Recent papers include Emons 1996 and Emons 1998 or 1999.}

Now I consider third-party effects. In general, the advantages of jurisdictional competition do not extend to third-party effects. For example, assume that a borrower approaching bankruptcy promises to repay a new loan before compensating the victims of a past accident. The lender and the borrower are the first and second parties, and the accident victims are third parties. The loan agreement benefits the first and second parties at the expense of the third parties. Such a contract can be pair-wise Pareto efficient, but it is typically socially inefficient.

Visionary mechanisms could sweep third parties into contracts and extend jurisdictional competition in novel directions (Cooter 1989). I will describe briefly an example from the law of accidents. A right is \textit{contingent} if it matures when an uncertain event occurs. To illustrate, tort rights are contingent on an accident occurring. A contingent right offered for sale in a market is a \textit{contingent commodity}. To illustrate, a call option is a right to buy stock if the market price reaches the price stipulated in the contract. The mechanisms for extending contracts into accident law treat tort rights as contingent commodities. The basic idea is to buy and sell rights to recover damages before accidents occur, much like buying and selling options before the market reaches the strike price. In principle, competitive markets for liability rights can solve some perplexing problems that baffle tort reform, such as combining optimal insurance for victims and efficient deterrence of injurers.\footnote{Many potential accident victims have adequate private insurance to cover their losses. With the insurance market providing compensation, the remaining task for liability law is to deter accidents efficiently. One way to deter accidents efficiently is to extract the full value of the harm from the injurer at low transaction costs. Think of the injurer who pays a court judgment as acquiring the victim’s liability right. The transaction costs of transferring liability rights are much higher in courts than in markets. To get the right to recover damages out of court, allow the potential victim to sell the right at any time, including before an accident occurs. A description of how a market for unmatured tort rights might improve the efficiency of accident law is found in Cooter 1989.}

Contracts for unmatured tort claims could stipulate the jurisdiction to adjudicate disputes. By this means, jurisdictions would compete over these novel contracts just as jurisdictions currently compete over conventional contracts.

These possibilities, however, are visionary. So long as courts prohibit the sale of liability rights, markets cannot form. Besides these visionary mechanisms, social norms assigning responsibility for harm might evolve toward efficiency. If common-law courts enforce such norms, or if civil-law courts use such norms to interpret statutes, the law made by judges can evolve toward efficiency (see discussion in chapter 8). Whether competition among jurisdictions would enhance or retard the evolution of social norms toward efficiency remains unanalyzed by scholars.
CHAPTER SIX

COMPETITION TO SUPPLY PUBLIC GOODS

Now I turn from jurisdictional competition over private law to jurisdictional competition over public goods. Competition in supplying local public goods requires people to move to more efficient jurisdictions or more efficient jurisdictions to move to people. Having discussed mobile people, I now discuss mobile jurisdictions.

The Fifth Freedom

States often supply goods like education that have the basic characteristics of private goods. Competition in the supply of these goods merely requires some adjustments in the law. For example, with appropriate revision in the law, a citizen of France who resides in Alsace might attend a school across the border in Germany and pay using a voucher. This example concerns competition among states that produce goods. In addition to producing goods, states buy private inputs for public goods, such as rifles used by the military to defend the country. Designing new ways for the state to produce less and buy more is a frontier of privatization.

Unlike prices for private goods, however, taxes for public goods are compulsory. Years of research by economists have not produced a workable mechanism to overcome free-riding on the supply of most public goods. Since no way exists to replace compulsory taxes with voluntary prices, the supply of truly public goods must rest on collective choice, not individual choice. In a democracy, collective choice usually means voting.

In principle, a community could vote to contract with a government to supply a local public good. For example, the members of a small community could entertain bids from several larger governments or special districts to supply water or collect garbage. Almost everyone agrees that democratic states should provide citizens with a right of free mobility, thus allowing people to move to more efficient jurisdictions. In time almost everyone may agree that democratic states should provide local governments with a right of free contract with other governments, thus allowing jurisdictions to move to people.

Bruno Frey and Reiner Eichenberger propose that the European Union guarantee its citizens the right to replace all-purpose inclusive governments with governments formed for specific functions. This "fifth freedom" would ideally give European citizens choice over governments, not merely choice over candidates. Citizens and localities could choose from a menu of special governments.

\[17\] See Libecap 1989. George Stigler allegedly said that identifying a market failure and recommending government intervention is like awarding the prize in a music competition to the second contestant after listening to the first contestant. The second contestant may prove worse than the first, and state intervention may prove worse than the market failure.

\[18\] The old problem of "preference revelation" in public finance developed into the new problem of "mechanisms design" in mathematical economics. The basic problem is to avoid free-riding in paying for public goods. For some attempted solutions, see Wilson 1987 and Emons 1994.

\[19\] Frey and Eichenberger 1995 and Frey 1996. Also see Breton 1996.
each offering to provide public goods and collect taxes. This proposal would implement the strand in contractarian philosophy that advocates actual contracts for government, as opposed to hypothetical contracts (Simmons 1997).

In my earlier discussion of mobility, I explained that mobile people cluster together for efficiency and distribution. Similarly, laws regulating the formation of special districts must consider the politics of redistribution as well as the economics of efficiency. To illustrate, if rich people can separate themselves from poor people by forming a special district for public schools, the rich can lower their taxes and increase their expenditures per pupil on schools. Given the right legal framework, however, competition among special governments can increase the efficiency of public goods, not create enclaves for the rich.

**Secession**

In a democracy, individuals typically have the right to leave a jurisdiction, but groups seldom have the right to secede. Many constitutions make no provisions for secession, just as many marriages make no provisions for divorce. Sometimes secession occurs peacefully, as illustrated by Estonia and Czechoslovakia. Sometimes secession provokes bloody civil wars as in Bangladesh, Nigeria, and the United States. Uncertainty about the right of secession and the absence of accepted procedures presumably contributes to civil wars of secession. Conversely, stipulating procedures can provoke a group to threaten secession in order to gain an advantage in bargaining over distribution.²⁰

Unfortunately, systematic writing by social scientists about secession is rare (A. Buchanan 1991; Bolton and Roland 1997). I will briefly consider the economic logic of secession and its implications for constitutions. Among the many reasons for secession, efficiency and distribution are two on which economic theory focuses. I consider each in turn.

The cost of government often increases with diversity among citizens. To illustrate, empirical research shows that successful cooperatives reduce the transaction costs of making collective decisions by keeping membership homogeneous (Hansmann 1990; Hansmann 1998). When citizens perceive themselves as too different, they may prefer to separate and lower the cost of governance, as illustrated by the division of Czechoslovakia into a Czech nation and a Slovak nation. Reducing the transaction costs of shared governance can motivate secession, although the zealots who lead secessionist movements use more colorful language.²¹ Given mutual agreement to secede, constitutional provision for an orderly process can reduce costly uncertainties.

Sometimes, however, majoritarian politics enables a majority to exploit the minority. In these circumstances, secession concerns ending exploitation, not lowering transaction costs. Instead of mutual agreement, the majority may resist

²⁰ From this fact, some theorists conclude that secession is a moral right but not a legal right (Sunstein 1991).

²¹ Even economists would not go to the barricades under the banner, "Zero transaction costs or death!"
the minority’s attempts to secede. In these circumstances, constitutional provisions for secession strengthen the position of the exploited minority.

A secessionist group may also want to lay claim to national wealth. A compelling example comes from the Independent Nation of Papua New Guinea, where the small island of Bougainville contains one of the world’s richest copper and gold mines. If Bougainville’s attempted secession succeeds, a small group of islanders will divide the wealth that once supplied 44 percent of Papua New Guinea’s exports (Young 1997). In these circumstances, constitutional provisions for secession strengthen the position of the minority wanting to expropriate national wealth.

Transition costs of secession depend on entanglement of assets and intermingling of populations. When populations and assets are relatively separate as in the former Czechoslovakia, transition costs of secession are modest. Conversely, when populations get mixed together, separating them for purposes of secession can have tragic and inhumane consequences, as in the former Yugoslavia.

I discussed lowering transaction costs, ending majority exploitation, and expropriating wealth as economic motives for secession, which must be weighed against the transition costs. In reality, however, economic motives typically mix with atavistic nationalism. No easy solution exists for hostile passions. In a future world, however, competition among governments might raise problems of secession for economic reasons, as when a town secedes from a county. In anticipation of these cases, Frey and Eichenberger propose that special governments created in the future should contain explicit provisions on the general principles for dividing assets, possibly including a price paid for exit. Such a constitutional provision resembles a prenuptial agreement on the terms of a possible divorce. Declaring in advance general principles for dividing assets can avoid secession by reducing the incentive for the dominant group to exploit the subordinate group, or for one group to secede as a means of expropriating national wealth.

Questions

1. Explain the conditions under which efficiency requires enforcing contract terms that stipulate jurisdiction.

2. Discuss the case for standardizing civil procedure internationally.

3. Kaiser Permanente, a large corporation that sells comprehensive health care services to Americans, requires consumers to submit all disputes over medical malpractice to compulsory arbitration. Discuss whether public courts should recognize and enforce the contract term containing this requirement.

4. Discuss whether the seller of a consumer good should be able to choose German liability law for a product sold in Italy.

5. How does the technical character of public goods create an obstacle to allowing individuals to choose governments?
6. Discuss how competition among jurisdictions affects the following:

- workplace safety
- automobile safety standards (design or performance)
- standard weights and measurements
- licensing lawyers
- chartering corporations

DIRECT AND INDIRECT DEMOCRACY

Most democracies hold direct votes by citizens from time to time on major issues, such as whether Quebec should secede from Canada or whether Denmark should join the European currency union. In most countries, legal obstacles assure that referenda are rare. For example, Italian voters can organize an “abrogative referendum” (a referendum to repeal a statute), but not a “positive referendum” (a referendum to create a statute).

A few governments, however, routinely decide many issues by direct vote of the citizens. The Swiss hold direct votes on such issues as whether to increase the salaries of officials or whether to retain compulsory military service for adult males. In addition, most important legislation in Switzerland must survive a yes-or-no vote by the citizens to become law. Californians hold direct votes on everything of interest to them, from constructing prisons to affirmative action. Direct voting has created some of California’s most important laws, such as “Proposition Thirteen,” which capped property taxes and sparked a nationwide “revolt of the tax payers” in the 1970s (Wildermuth 1998). Over half of the state constitutions in the United States provide for some form of ballot initiative, and other states seem to be following California in using this process more frequently (Verhovek 1998).

In addition to the legal obstacles, costs limit the frequency of referenda. Gathering signatures from citizens is expensive and exhausting, and holding an election is costly for the state. In the future, however, technological developments such as electronic voting and collection of signatures over the Internet could dramatically lower the transactions cost of direct democracy. With costs falling, direct democracy could become a new frontier of decentralization. In this section I analyze the consequences of direct democracy, especially drawing on the experience of Switzerland and California.

Procedures and Effects

Procedures for direct democracy differ by place and issue. To illustrate, the collection of 50,000 signatures in Switzerland creates a referendum on any law enacted by the federal legislature. In a referendum, the legislation is accepted or rejected by a simple majority of votes. In contrast, the collection of 100,000
signatures in Switzerland creates a referendum to amend the federal constitution. To succeed, the referendum must win a majority of the votes in the nation and also a majority of votes in a majority of the cantons (Frey and Bohnet 1994).

Like Switzerland, California requires the accumulation of signatures to bring issues directly to the voters, but the organization of the process differs dramatically. In California, direct democracy is a big business. To illustrate the scope of activity, the seventeen initiatives on the ballot in 1996 lured $141.3 million in contributions, which exceeded the total of $105.7 million spent by several hundred candidates who ran for the California legislature that year (Howe 1998). California referenda resemble commercial products with a development cycle. Many observers wonder whether the state should facilitate or impede direct democracy. To answer this question, I first ask whether direct democracy produces different results from indirect democracy. In Switzerland, the results in 39 percent of recent referenda contradict the outcome that representative government would have produced. Tax rates are lower in Swiss jurisdictions where citizens directly decide on public goods (Pommerehne 1990). In referenda Swiss citizens seem to prefer lower taxes and lower government salaries than legislators prefer. Referenda undermine the exclusive power of elected officials to set the political agenda.

Most important, as Frey argues, direct democracy in Switzerland increases the morale of citizens and improves their intrinsic motivation to support government. The process of direct democracy is relatively transparent. Each side must appeal directly to the citizens, who understand more fully why the political process yields one result rather than another. The morale of citizens apparently improves because they feel informed and empowered. To support this argument, Frey offers evidence that direct democracy in Switzerland makes citizens more willing to pay taxes and inform themselves about politics.

Commentators sometimes assume that referenda slant outcomes toward the right or the left. However, a survey of California ballot initiatives does not indicate any bias in favor of liberal or conservative causes (Verhovek 1998). Instead favoring the left or the right, California ballot initiatives are all over the political spectrum. In California, ballot initiatives cost their supporters more than lobbying the legislature. Californians apparently pursue the more costly...

Note, however, that this comparison is potentially misleading. In direct democracy, all the money is spent on issues. In contrast, political expenditures in indirect democracy include money spent on electoral campaigns plus money spent on lobbying activities.


"In 39 percent of the 250 obligatory and optional referenda held in Switzerland between 1948 and 1990, the will of the majority of the voters differed from the opinion of Parliament" (Frey and Bohnet 1994 p. 153).

"Popular referenda have proven to be very successful in Switzerland for fighting restraints on competition in the political market .... Referenda and initiatives are means to break the politicians' coalition against the voters .... they take the agenda-setting monopoly away from the politicians and enable outsiders to propose issues for democratic decision, including those that many elected officials might have preferred to exclude from the agenda" (Frey and Bohnet 1994 p. 151.

alternative because they believe that ballot initiatives mostly create laws that the legislature would not enact. In the next section I explain why referenda and legislation yield different laws.

Factoring by Referenda, Splicing by Legislation

Most constitutions restrict referenda and initiatives to a yes-or-no vote on a single issue. To illustrate, Californians might be asked to vote "yes or no" on restricting abortions and "yes or no" on capital punishment, but the law precludes Californians from being asked to vote "yes or no" on restricting-abortion-and-restricting-capital-punishment. A practical reason compels restricting each ballot initiative to a single issue. Logrolling, which combines issues in a single vote, requires bargaining. Bargaining among different groups requires representation. Ballot initiatives bypass elected representatives. Thus a multiple-purpose ballot initiative invites bargaining without bargaining agents. With agents, bargaining among many people inevitably fails.

In legislatures the members often bargain, compromise, and draft a single bill that combines different issues. In contrast, rules restricting ballot initiatives to a single issue prevent logrolling, so different groups have little incentive to bargain or vote strategically. When citizens vote their preferences on a single dimension of choice, the median usually prevails. In general, direct democracy factors the issues, so the median voter should prevail. In contrast, members of legislatures bargain, compromise, and roll logs. If bargaining fails, legislatures must try to avoid an unstable redistributive contest by undemocratic means such as agenda control. In general, indirect democracy splices issues, which should result in bargains or cycles.

The contrast between splicing and factoring predicts some consequences of a shift from indirect to direct democracy. A change from indirect to direct democracy often replaces bargains among representatives with the preference of the median voter on each dimension of choice. Is this change better or worse? That depends on how well indirect democracy works. Given informed voters and competitive elections, indirect democracy produces effective representation of political interests. If representatives bargain successfully and cooperate with each other, then citizens get their way on their preferred issues. In these circumstances, indirect democracy satisfies the preferences of voters better than direct democracy.

Indirect democracy, however, can create a political cartel whose members conspire to blunt electoral competition. For example, the spectacular disclosure of corruption among leading Italian politicians in the 1990s suggests that citizens had little influence over deals struck by their representatives. An opaque political process and proportional representation made Italian electoral competition relatively ineffective. In these circumstances, a change to direct democracy can break the political cartel. In addition, indirect democracy can cause an unstable

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27 See California Constitution, art. 2 sec. 8d.
contest of redistribution among interest groups. Changing to direct democracy can increase stability, which should increase the satisfaction of citizens with politics.

I have explained that direct democracy causes the median voter to prevail on each dimension of choice, which is better than a cycle or a political cartel and worse than perfect bargaining by elected representatives. This proposition summarizes the main difference in theory between direct and indirect democracy. Besides this large difference, some small differences are sometimes important.

First, direct democracy gives more weight to those citizens who actually vote, whereas indirect democracy gives more weight to the number of citizens living in a district. To illustrate, assume that poor people, who vote at relatively low rates, live in poor districts. Indirect democracy apportions representatives by population, so the number of representatives from poor districts reflects the number of poor citizens, including those who do not vote. In contrast, direct democracy responds to the citizens who actually vote. Thus, in the preceding example where rich people vote at higher rates than poor people do, direct democracy gives more weight to the opinions of rich people. This phenomenon tilts California ballot initiatives in favor of older, conservative, white citizens.

Second, critics of direct democracy allege that the majority of citizens will vote to redistribute wealth from the few to the many. For example, if most citizens buy auto insurance, they will vote to cap its price. Or if most citizens rent houses, they will vote for rent control. More generally, critics of direct democracy allege that the majority of citizens will vote to undermine the rights of the minority.

This criticism, however, has a weak foundation in theory. From the viewpoint of theory, direct democracy factors voting, which does not necessarily harm minorities more than spliced voting. Spliced voting encourages citizens to coalesce into blocks to bargain with each other. A system of proportional representation can guarantee representation in political bargaining to every minority group. Two-party competition, however, contains no such guarantees. When groups coalesce, some minorities may suffer permanent exclusion from the ruling coalition.

In contrast, after factoring the issues, the minority on one dimension of choice is seldom the same group of people as the minority on another dimension of choice. Any single person with complicated political views wins on some dimensions of choice and loses on others. In general, factoring issues can dissolve large blocks of citizens and ensure that everyone wins some of the time. In addition, all the nonmedian voters participate in determining the median voter. Thus, everyone’s preferences have an effect on the voter equilibrium. Under these conditions, majorities do not exploit minorities more under direct democracy than they do under indirect democracy.

Any democratic system of politics, whether direct or indirect, requires protection of minorities, such as ethnic groups and wealthy people. Later I discuss various forms of protection, such as bicameralism and constitutional rights. For now, note that Bill of Rights in the U.S. Constitution constrains the states,
so a federal judge would nullify a California referendum that violates the U.S. Bill of Rights. This fact imposes an essential constraint on California’s referenda.

Notice that the comparison of direct and indirect democracy parallels the comparison between single-purpose and multipurpose governments in chapter 5. In indirect democracy the constitution can prescribe separate governments for separate purposes, or the constitution can prescribe multipurpose governments. Similarly, in direct democracy the constitution can limit each popular referendum to a single purpose, or the constitution can permit multipurpose referenda. Narrowing the scope of each government or election creates obstacles to bargaining across issues by political factions, so the median rule determines the outcome.

**Bonding Ballot Initiatives**

In addition to the legal obstacles, transaction costs currently limit the frequency of referenda. Specifically, the cost of gathering signatures currently limits the number of referenda placed on the ballot. In the future, however, technological developments such as collection of signatures over the Internet and electronic voting could dramatically lower the transactions cost of direct democracy. With lower costs, the pace of referenda could accelerate, thus forcing citizens to vote on a barrage of hopeless proposals and to decide close votes over and over again.

Is there a better means to ration referenda than collecting signatures? Bonding offers an attractive alternative. According to this approach, supporters could place a proposition on the ballot by posting money bond with the electoral commission. If the proposition performed well in the election, the bond would be returned. Conversely, if the proposition performed poorly in the election, the state would confiscate the bond. For example, in lieu of 100,000 signatures, supporters of an initiative might post $100,000, which they would forfeit unless the initiative won, say, at least 45 percent of the votes.

Compared to collecting signatures, bonding reduces the transaction costs of direct democracy. Compared to cheap collection of signatures over the Internet, bonding discourages frivolous or previously defeated initiatives. By bonding ballot initiatives, constitutional law could reduce the velocity of direct democracy without stopping it or imposing unnecessary costs. Note that some countries, notably New Zealand and the United Kingdom, already require candidates for Parliament to post bond, which they forfeit for poor performance in elections.

Also note that people accused of crimes in the United States must post bail to escape jail while awaiting trial. The person who appears for trial recovers the bail, whereas the person who fails to appear for trial forfeits the bail. In reality, most people borrow money for bail from a professional bail bondsman, who charges a rate based on his assessment of the risk. Similarly, with ballot initiatives a market should develop allowing supporters to borrow the bond.
Lenders would charge low rates for promising ballot initiatives that carry low risk and high rates for unpromising initiatives that carry high risk.

CONCLUSION

Why do democratic governments so often fail to satisfy the political preferences of citizens? Incomplete political competition partly explains the shortfall. Democratic constitutions organize competition among candidates for office and blunt competition among governments for jurisdiction over people and money. In this chapter I analyzed the legal framework for mobility, choice of private laws, contracting for public goods, and direct democracy.

Mobility promotes efficiency by clustering people with similar preferences for local public goods. Contracting for jurisdiction promotes efficiency by allowing people to choose the best jurisdiction to resolve future disputes. Visionary schemes might some day extend competition among jurisdictions to encompass liability for accidents and the supply of local public goods. Ballot initiatives allow citizens to substitute median rule for failed legislative bargains. In general, improving the legal framework for political competition carries the promise of greater satisfaction of citizens with government.