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**Competitive Federalism, Individual Autonomy,
and Citizen Sovereignty**

Viktor J. Vanberg

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Albert-Ludwigs-Universität Freiburg

Competitive Federalism, Individual Autonomy, and Citizen Sovereignty¹

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1. Introduction

Adam Smith's ([1776] 1981: 26f.) well-known phrase that "it is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest" was, contrary to popular interpretation, not meant to praise individuals' self-interest but to point to the virtues of *competition*. It is the competition for customers that guides the self-interest of butchers, brewers and bakers into the beneficial direction Smith describes. Absent the constraints of competition their self-interest could scarcely be counted on to take care of our needs. Since Adam Smith's *Inquiry* the notion that competition is the principal instrument for directing producers' interests into serving consumers' interests has been at the core of economists' theory of the market.

Given economists' success in explaining how competition works in ordinary markets, it is not surprising that they also sought to apply the Smithian argument to the political realm, analyzing the workings of competition in democratic politics, both, the internal competition of candidates for political office and the external competition between governments. As a special variant of the latter, the theory of competitive federalism looks at the rivalry between sub-units in a federal system of government, exploring whether such competition may work as a disciplining force in a manner like the ways market competition induces producers to serve their customers' interests.

Paying particular attention to F.A. Hayek's and J.M. Buchanan's outlooks at the subject, this paper examines more closely the *analogy between market competition and intergovernmental competition* on which the theory of competitive federalism is based, and the critical role the latter assigns to viable *exit-option* as the essential operating force in both arenas. Its main argument is that, by exclusively focusing on exit in its *territorial dimension*, the theory of

¹ Prepared for Symposium in commemoration of awarding honorary doctoral degrees to F. A. v. Hayek and James M. Buchanan in 1982 at the Justus-Liebig-University, Giessen, October 21-22, 2022.

competitive federalism obfuscates the fact that “exit” can mean two critically different things in politics. It can mean *exiting from the territory* over which a government exercises its assigned authority, and it can mean exiting from a polity in the sense of *giving up one’s membership status* in the respective community.

The following sections discuss the nature, the significance, and the implications of the difference between these two kinds of exit and the underlying distinction between governments’ dual capacity, as territorial enterprises and as club-enterprises.

2. Governments’ Dual Capacity and Two Kinds of Exit

A democratic polity can be characterized as a *citizens’ cooperative* or, in John Rawls’ (1971: 84) words, as a “cooperative venture for mutual advantage.” It is a system of self-government, an association in which the decision-making authority of public officials derives its legitimacy from the mandate granted by its members, the citizens. Citizens are the *principals* or ultimate sovereigns. The organization “government” is the executive organ of the citizens’ cooperative, and government officials act as citizens’ *agents*.

Of particular significance in the present context is the fact that the services democratic governments provide can analytically be divided into two categories. On the one hand, they act as *territorial enterprises*. In this capacity they define and enforce the “law of the land” in the sense of the rules that apply to all persons living or operating within their respective territories. And they provide certain services, referred to as *territorial goods*, that can be made use of by anybody who resides and/or operates within their territorial domain. On the other hand, they serve as *club-enterprises*. In this capacity they define and enforce the “laws of the citizenry” in the sense of the rules that apply to its *citizens only*, i.e., to the *members of the respective polity*. And they provide certain services, referred to as *club goods*, to which only their citizens-members have access.

The distinction between the two roles or functions of governments corresponds to the distinction between two capacities in which individuals are subject to governmental authority. In their *private capacity* they are, as *jurisdiction-users*, subject to the authority of governments in whose territorial domain they reside and/or operate, whether this is their home-jurisdiction or not. In their capacity as *citizens-members* they are subject to whatever

rules their home-government defines and enforces for its citizens, rules that apply to them whether they reside in their home-jurisdiction or not.²

From the above arguments on governments' two functions and individuals' dual capacity as jurisdiction-users and as citizens-members it follows that an analogous distinction must be drawn for the exit-options a federal system offers. The exit options individuals enjoy in their private capacities as jurisdiction-users are different in character from those they may exercise in their capacity as citizens-members. As jurisdiction-users they can split up their private activities in multiple ways and degrees and they can distribute these activities – as residents, employees, consumers, investors, etc. – across any number of jurisdictions. Accordingly, they can adapt the various parts of their private engagements independently from each other to the relative attractiveness of the conditions potential alternative jurisdictions provide for the respective engagements. In contrast, membership in a polity comes with an inclusive bundle of rights and duties that cannot be unbundled in components that might be separately chosen. Choices can only be made between such inclusive bundles. Furthermore, one can only choose among polities to which one may be admitted as new member, and the options to gain such admittance are typically rather limited compared to the ease with which most jurisdictions allow entry for individuals as jurisdiction-users.

In an increasingly mobile world individuals can and do use other jurisdictions than their home-polity for their private activities. They may seek employment, take residence, place investments, etc. in other jurisdictions or may even, in the extreme, take all their private business elsewhere while maintaining membership status in their home-polity. Reversely, persons may in principle keep all their private activities within their received home-jurisdiction while choosing to give up their membership in the polity in favor of joining some other citizens-cooperative. In other words, individuals may respond separately to how governments, as territorial enterprises and as club-enterprises, affect their interests as jurisdiction-users and as citizens-members.

With regard to the role that *competition among jurisdictions* may play in aligning the interests of government officials with the interests of those whom they are supposed to serve one must surely distinguish between the disciplining force that may be expected from one or the other of the *two kinds of exit*, the exit of persons as *jurisdiction-users* from a government's territorial domain and the exit of persons as *citizens-members* from the polity to which they

² Whether, and the extent to which, governments are willing and able to enforce these rules outside of their territorial domain is a factual matter.

belong. With their focus on geographical exit and *locational choice*, contributions to the theory of competitive federalism tend to obfuscate this distinction.

3. The Theory of Competitive Federalism

The citizens of a democratic community, just as the members of any private cooperative enterprise, have two conflicting concerns. On the one hand they need to empower the executive organ, the government, to act as producer of the hoped-for mutual benefits. On the other hand, they want to be protected against the risk that governments employ the delegated authority in ways that harm their interests. The art of constitutional design is about finding a workable balance between the two concerns, between empowering and constraining governmental authority.

In their classic contribution to constitutional economics, *The Calculus of Consent – Logical Foundations of Constitutional Democracy*, J.M. Buchanan and G. Tullock ([1962] 1999) have addressed this issue, posing the question of whether the basic logic of Smith’s outlook at markets cannot be similarly applied to the general problem of democratic politics, namely, how to align politicians’ self-interest with the interests of those on whose behalf they exercise political authority. As Buchanan and Tullock put it:

Adam Smith and those associated with the movement he represented were partially successful in convincing the public at large that, within the limits of certain general rules of action, the self-seeking activities of the merchant and the moneylender tend to further the general interests of everyone in the community. An acceptable theory of collective choice can perhaps do something similar in pointing the way toward those rules for collective choice-making, the constitution, under which the activities of political tradesmen can be similarly reconciled with the interests of all members of the social group (ibid.: 22).

While *The Calculus* focuses on “the rules for collective choice-making” as instruments for aligning the interests of the “political tradesmen” with those of “all members of the group,” the authors note in passing that the “decentralization of collective activity” can help to utilize the forces of competition in politics, not unlike their role “in the operating of competitive markets” (ibid.: 115), referring to Charles M. Tiebout’s “A Pure Theory of Local Expenditures” (1956), the classical contribution to the theory of competitive federalism.

In his essay, Tiebout had characterized interjurisdictional competition in a federal system as a regime in which “consumer-voters” are free to choose among multiple local governments offering different combinations of public goods and tax burdens. In such a regime, Tiebout

argued, competition can work in similar ways as competition does in markets, aligning the interests of producers with the interests of those who demand their products.³ As he put it:

The act of moving or failing to move is crucial. ... Just as the consumer may be visualized as walking to a private marketplace to buy his goods, the prices of which are set, we place him in the position of walking to a community where the prices (taxes) of community services are set. Both trips take the consumer to market. ... Spatial mobility provides the local public-goods counterpart to the private shopping trip (Tiebout 1956: 420, 422).

Competition among local governments can thus, Tiebout posits, provide a market-type solution to a problem that the political mechanism can only solve in a less satisfactory manner by combining “expenditure wants of a ‘typical voter’ with an ability-to pay-principle on the revenue side” (ibid.: 416).

Tiebout’s contribution stimulated a voluminous literature reflecting, as Oates and Schwab (1988: 333) note, two sharply contrasting assessments, one viewing “interjurisdictional competition as a beneficent force that, similar to its role in the private sector, compels public agents to make efficient decisions” (ibid.), the other contending “that interjurisdictional competition is a source of distortion in public choices,” keeping “tax rates below levels needed to finance efficient levels of public services” (ibid.: 334). As exemplar of the first view Oates and Schwab point to G. Brennan’s and J.M. Buchanan’s *The Power to Tax*, to Oates’ (e.g. 1972) own work they refer as exemplar of the second.

Buchanan and Brennan focus with their discussion on “the prospects of using *federalization* of the political structure as an indirect means of imposing constraints on the potential fiscal exploitation of Leviathan” (1980: 174), constraints that are due to the “predicted intergovernmental competition for fiscal resources and the predicted mobility response of persons and resources to the exercise of governmental fiscal authority” (ibid.: 184).

In other writings on the subject Buchanan has more generally discussed the working properties of competitive federalism, stressing that “[f]ederalism offers a means of introducing essential features of the market into politics” ([1995/96] 2001:82). As he elaborates:

³ Buchanan and Goetz ([1972] 2001: 45): “Tiebout tried to demonstrate that so long as governmental units are appropriately assigned the task of providing certain public goods and services and so long as individuals retain freedom of personal migration among jurisdictions, there are efficiency-generating processes at work, despite the ‘publicness’ of the goods provided. His analysis was presented in partial but positive response to the negative proposition advanced by Samuelson that with nonexcludable public goods there exists no means of using market-like decentralization to attain tolerably efficient results.”

The principle of federalism emerges directly from the market analogy. The politicized sphere of activity, in itself, may be arranged or organized so as to allow for the workings of competition, which is the flip side of the availability of exit, to become operative ([1995] 2001:69).⁴

The operating principle of which he describes as follows:

A central government authority should be constitutionally restricted to the enforcement of openness of the whole nexus of economic interaction. ... Other political collective activities should be carried out, if at all, by separate state-provincial units that exist side-by-side, as competitors of sorts, in the inclusive polity ([1995/96] 2001: 86).

Under such a federal structure, Buchanan argues,

persons, singly and/or in groups, would be guaranteed the liberties of trade, investment, and migration across the inclusive area of the economy. Analogous to the market, persons retain an exit option ... Again, analogous to the market, the separate producing units (in this case, the separate state governments) would be forced to compete, one with another, in their offers of publicly provided services ([1995] 2001: 70)

And as the predictable effect of such competition he notes, that 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 ([1979] 2000: 264).

In his early contribution on the subject, entitled “The Economic Conditions of Interstate Federalism,” Hayek notes “as one of the great advantages of interstate federation that it would do away with the impediments as to the movement of men, goods, and capital between the states” ([1939] 1948: 255), thereby creating “one single market” (ibid.: 258), limiting “to a great extent the scope of the economic policy of the individual states” (ibid.). In such a federal regime, Hayek argues, the central government “will have to possess the negative power of preventing individual states from interfering with economic activity in certain ways” (ibid.: 267), while “the greater mobility” between them would force the individual states “to avoid all sorts of taxation which would drive capital or labor elsewhere” (ibid.: 260), providing a “salutary check” (ibid.: 268) on their activities.⁵

⁴ Buchanan [1995/96] 2001: 81: “By its nature, however, politics is coercive; all members of a political unit must be subjected to the same decisions. The prospect of exit, which is so important in imposing discipline in market relationships, is absent from politics unless it is deliberately built in by the constitution of a federalized structure.”

⁵ In *The Road to Serfdom* Hayek ([1944] 2007: 232) notes on the subject: “The form of international government under which certain strictly defined powers are transferred to an international authority, while in all other respects the individual countries remain responsible for their internal affairs, is, of course, that of federation. ... [T]he principle of federation is the only form of association of different peoples which will create an international order without putting an undue strain on their legitimate desire for independence.”

In later publications Hayek repeatedly discusses the effects of intergovernmental competition. Drawing a parallel between the “permanent control” that may be exercised in private estate developments and “the exercise of such control by public authority” (1960: 352) he notes that the private estate “will be restrained in the exercise of its powers by the necessity of competing with other similar units” (ibid.) and adds that “competition between municipalities or other political subdivisions will have a similar restraining effect” (ibid.). Such competition would result, he argues, in

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 potential citizens (Hayek 1979: 146).

[T]he regional and local governments, limited by the same uniform laws with regard to the manner in which they could make their individual inhabitants contribute to their revenue, would develop into business-like corporations competing with each other for citizens who would vote with their feet for that corporation which offered them the highest benefits compared with the price charged ([1976] 1978: 162).

As a more elaborated version of F.A. Hayek’s early arguments on “interstate federalism,” Barry R. Weingast (1993; 1995; 2008) has coined the concept of a “market-preserving federalism” by which he describes a regime in which “*economic regulatory authority*” (1993: 291) is vested with the lower-level governments while the central or federal government, itself deprived from such authority, prevents the sub-national governments from using their regulatory powers to erect barriers to trade (1995: 4; 2008: 155), thus securing a common market within the federal union. The “competition among lower units in the federal structure” will assure, so Weingast (1995: 5) concludes, “that public policy will be disciplined by the ability of resources to move between jurisdictions,” and that only those policies will survive “that citizens are willing to pay for” (ibid.). As he puts it:

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

As should be apparent from the above summaries, in Tiebout’s as well as in Buchanan’s, Hayek’s and Weingast’s accounts the competing sub-units in federal systems are considered only in their capacity as *territorial enterprises*. The “exit” figuring in these accounts as the essential disciplining force on governmental authority is about *geographical or spatial mobility*, the ability of persons and resources to move across jurisdictional boundaries. In other words, individuals are viewed exclusively as jurisdiction-users whose “location

decisions” are the driving force in federal competition. Even though reference is made to “consumer-voters” (Tiebout), to “citizens’ willingness to pay” (Weingast), to the “right of citizens” (Buchanan), and to local governments competing for “potential citizens” (Hayek), in fact individuals are accounted for *only in their capacity as jurisdiction-users*. They are not considered in their *capacity as citizens* who may expect their governments to provide, as club-enterprises, *club goods*, beyond the location goods they provide as territorial enterprises. In other words, these accounts ignore the categorical difference between the two roles or functions of government and the corresponding difference between exit in the sense of individuals choosing among alternative jurisdictions for their various private activities (location choices) and exit in the sense of individuals giving up their membership status in one jurisdiction in order to join an alternative political community (citizenship choices).⁶

4. Competitive Federalism, Residents and Citizens

If, as the standard theory of competitive federalism suggests, individuals’ *location decisions* are the principal force aligning the policies of *federal sub-units* with their interests, the essential *democratic* means of making governments responsive to citizens’ interests – *voice* as opposed to *exit*⁷ – would seem to be, *at that level*, of little significance. From such theoretical perspective, as far as the sub-units are concerned, individuals are considered only in their capacity as jurisdiction-users. Governments are reduced to their role as territorial enterprises and their relation to individuals becomes, indeed, analogous to the relation between customers and suppliers in ordinary markets. Accordingly, it would seem, the governmental function in the federal sub-units might just as well be performed by private business enterprises rather than by democratically elected representatives – just as Hayek posits when, as quoted above, he speaks of the “transformation of local and even regional governments into quasi commercial corporations competing for citizens.” Yet, when we deal with federalism as an organizing principle of a *democratic* polity, the federal sub-units must surely be organized as self-governing, democratic communities. Accordingly, the participation of individuals as

⁶ This difference is implicitly hinted at by Oates’ (1972: 17) who notes that in a federal government “choices made at each level concerning the provision of public services are determined largely by the demands for these services of the residents of (and perhaps others who carry on activities in) the respective jurisdiction.” Oates adds that the public services provided by a particular jurisdiction should “reflect to a substantial extent the interests of the constituencies of that jurisdiction,” yet he does not explicitly recognize the potential relevance of the difference between, on the one side, “residents” and those “who carry on activities in the jurisdiction,” and, on the other side, “the constituencies,” i.e. the citizens-members of the federal sub-units.

⁷ Hirschman 1970.

citizens-members in the political decision-making process within these sub-units (voice) must take on a character different from their roles as “customers” of local or regional governments as “quasi commercial corporations.” This difference is glossed over when, e.g., George Stigler speaks of competition “between firms (and in analogy, cities) for the patronage of customers” (1972: 91) as if it were the same as “the competition of local governments for citizens” (ibid.: 93), and as if there were no difference between “municipal choices” (ibid.: 94) individuals face in their capacity as jurisdiction-users and the policy choices they face as citizens-participants in self-government.⁸

That a distinction must be drawn between individuals in their capacity as *residents* who choose locations for their various private activities and individuals in their capacity as *citizens* who participate in local self-government is explicitly recognized by Buchanan. While emphasizing that the “efficacy of competitive federalism depends directly on the operative strength of the exit option” ([1995/96] 2001: 82) he notes in reference to Albert Hirschman’s “exit-and-voice” distinction: “But the exercise of voice is also important, especially in politics, and this feature lends independent support for federal structures” (ibid.). Speaking of “the engagement-participation of the individual in politics” (ibid.: 80) he contrasts the emphasis on “the prospects for exit” (ibid.) with an emphasis on “the prospects for the exercise of voice” (ibid.).

Citizens-members of a democratic polity can, as Buchanan emphasizes, surely be assumed to have an interest in limiting the powers the collective enterprise may command.⁹ Yet, in the first place, they surely have an interest in empowering the citizen cooperative with the ability to produce the benefits they want it to generate. While his above-quoted remarks focus on the first aspect, Buchanan addresses the second when he notes:

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

⁸ The same ambiguity is, e.g., present when W. Kerber (2000: S224) states: “If jurisdictions are seen as territorial multi-product clubs, including club membership linked with rights and duties, then the choices of individuals and firms between jurisdictions can also be understood as exit and entry decisions, and the competition processes as competition among clubs.”

⁹ Buchanan ([1994] 2001: 133): “A competitive federalism can prove to be efficacious in limiting domestic political intrusiveness in ways that no formal constitution can approach. The exit option offered by the widened market is overwhelmingly more important than the voice option offered by participation in democratic politics. And we should note here that the exit option need be exercised by only a few marginal resource owners in order to yield spillover benefits to all citizens.”

When Buchanan speaks of the competing federal sub-units' "capacities to meet the demands of the citizens for collectively provided services" ([1995] 2001: 71) he indicates the need to distinguish such "capacities" from the issue of whether the "availability of the exit option, guaranteed by the central government, would effectively place limits on the ability of the state-provincial governments to exploit citizens" ([1995/96] 2001:81). What is at stake here is the distinction between, on the one side, the *private autonomy* that individuals exercise as jurisdiction-users when deciding where to allocate their various activities and, on the other side, the *co-determination rights* they exercise when they participate in political decision-making processes.

Buchanan has made this distinction the main subject of a paper which he titled "Federalism and Individual Sovereignty", choosing the term *individual sovereignty*, as he emphasizes explicitly in contrast to the term *individual liberty* ((1995/96) 2001: 88). Individual sovereignty, in Buchanan's usage, is meant to include both, individual liberty in the sense of private autonomy as well as the collectively exercised self-government in democratically organized political communities. Respecting individuals as the ultimate sovereigns in social matters, this is Buchanan's point, requires respecting their right of self-determination in both capacities, as private-law subjects interacting and cooperating with others as participants in the private law society, and as citizens-members of democratic polities who engage, jointly with their fellow-citizens, in self-government. With a critical eye on libertarians who exclusively focus on individual sovereignty as private autonomy Buchanan states:

What is the ultimate maximand when the individual considers the organization of the political structure? ... [This] maximand cannot be summarized as the maximization of the (equal) individual liberty from political-collective action ... A more meaningful maximand is summarized as the maximization of (equal) individual sovereignty. This objective allows for the establishment of political collective institutions, but implies that these institutions be organized so as to minimize political coercion of the individual ([1995/96] 2001: 88f.).

It is a federal structure as described above, that, as Buchanan argues, recommends itself, "if the overriding objective is the protection of individual sovereignty" (ibid.: 86), in both its dimensions, as individual autonomy and as citizen sovereignty. A major reason is that a federal organization allows political authority to be distributed across smaller units in contrast to the necessarily more extended jurisdiction under a centralized regime. As Buchanan elaborates, smallness enhances the power of *exit*, and thus *individual autonomy*, as well as *voice*, and thus *individual sovereignty*.

The basic logic is straightforward. If the concern is for the protection and maintenance of individual sovereignty against the potential coercion that may be imposed by political or collective action, the size of the political unit, measured by the number of members becomes a relevant variable, quite apart from the presence or absence of an exit opportunity. ... If persons are, for any reason, either unable or unwilling to exercise the exit option, actually or potentially, they may be able to exercise voice, defined here as activity that is participatory in determining political choices. And voice is more effective in small than in large political units. One vote is more likely to be decisive in electorate of hundred than in an electorate of 1,000 or 1 million. ...

But voice is more than a vote in some precise mathematical formula for measuring potential influence over political outcomes. Neither the set of alternatives among which political choices are made nor the preferences of citizens-voters are exogenous to the processes of political discussion. And it is self-evident that the influence of any person in a discussion process varies inversely with the size of the group (ibid.: 82f.).

5. Consumership and Citizenship

In Hayek's and Buchanan's as well as in Weingast's outlook at competitive federalism the creation of "one single market" (Hayek [1939] 1948: 258), is seen as its main beneficial consequence. The rationale behind this assessment is, as Adam Smith had famously argued,¹⁰ that we produce in order to consume and that, therefore, our common interest as consumers rather than our partial (and conflicting) *protectionist interests* as producers should be the dominant criterion when we choose the legal-institutional framework within which we live. While such logic provides prudential reasons for a citizenry to agree on an open market regime, in the ordinary political process such regime is under constant threat by rent-seeking efforts on the part of producers who seek protectionist privileges for their special trade. And it is as a safeguard against such rent-seeking that the federal organization which Weingast calls "market-preserving federalism" promises to provide a remedy. In such a regime, as Weingast (1995: 5) posits, only those menus of public services and taxes will survive that "citizens are willing to pay for." Yet, while this is surely true as far as citizens' interests as *jurisdiction-users*, i.e., as *consumers* of local services, are concerned, the question remains whether such a regime allows local governments to be equally responsive to interests individuals may harbor in their capacity as citizens-members.¹¹

¹⁰ A. Smith ([1776] 1981: 660): "Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident that it would be absurd to attempt to prove it."

¹¹ On this issue see also Vanberg 1997.

John Kincaid, a foremost authority in the study of American federalism, has since long pointed to the tension that exists between these two kinds of interests or, in his terminology, between “*consumership*” and “*citizenship*.” As he puts it:

Consumership refers to the empowerment derived from the 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 provided by the constituent political jurisdictions, while the requisites of citizenship can diminish the consumership opportunities provided by a common market (Kincaid 1994: 37).

Kincaid draws attention to an issue that poses a serious challenge to the theory of competitive federalism, namely, how the goal of creating a common market and the goal of allowing the competing federal subunits to freely choose the policy menus they offer are supposed to be squared with each other. There is, as Kincaid suggests, an irreconcilable conflict between having, on the one side, the central government enforce “openness of the whole nexus of economic interaction” (Buchanan [1995/96] 2001: 86) by preventing the local governments from using their regulatory powers to erect barriers to trade (Weingast 2008: 155) and, on the other side, allowing the latter to be free to decide on their local matters. Weingast ignores this conflict when he characterizes his “market-preserving federalism” by the simultaneous requirement “that subnational governments have substantial regulatory control over their economies” and “that a common market exists, including the federal government’s ability to prevent subnational governments from raising internal trade barriers” (2005: 155). Similarly, Buchanan fails to recognize the existence of such a conflict when he describes a competitive federalism as follows:

Within each separate state of the federal system, both the dividing line between privately and publicly organized production-distribution activity and the allocational-distributional mix among the items within the publicly organized sector remain to be determined by the interworking of the preferences of the citizenry and the internal political process. ... The separate states are free to do “as they please,” constrained by the participation of their own citizens in the decision processes ([1995/96] 2001: 71f.).

Obviously, though, in competitive federal systems local jurisdictions are “free to do ‘as they please’” only within the limits set by the central government’s mandate to secure a common market. They are explicitly prohibited from responding to citizens’ demands that would result in barriers to trade. Such restrictions on the scope for local self-government may, to be sure, considered legitimized if they reflect, as argued above, the constituents’ common interests *as consumers* in preventing the granting of protectionist privileges to special producer-interests. Yet, such limitations on jurisdictional sovereignty may also prohibit local governments from

responding to demands for measures that, while also resulting in barriers to trade, reflect interests citizens share in their capacity as citizens.¹² As an example of the latter consider, for instance, citizens' interest in preventing an international fast-food chain from opening a restaurant at their city's central square, because they want to preserve its traditional local character.

It is the latter kind of conflict that J. Kincaid addresses in contrasting *consumership* and *citizenship*, a contrast that has a social-structural as well as an intra-personal dimension. The structural dimension concerns the trade-off between the degree of integration into a wider market and the scope for local self-government. The intra-personal dimension concerns the conflict between two interests that individuals simultaneously hold, their interest as consumers in having access to the widest scope of market choice, and their interest as citizens in being able to control, jointly with their fellow-citizens, relevant aspects of their living environment.¹³ In both its dimensions this conflict has been intensified with the progress of globalization. In Kincaid's words:

[A]ccess to the global marketplace produces tensions between citizenship and consumership. As consumers, citizens desire unfettered access to the global marketplace, but as citizens, consumers desire local, regional, and national autonomy and self-government. Yet, a robust global economy operating under free-trade rules requires localities, regions, and nations to give up significant degrees of self-governing autonomy.

Indeed, now that free-trade rules under the World Trade Organization extend to non-tariff trade barriers, international trade rules will, over the long term, encroach significantly on the self-governing domestic powers of regional and local governments within federations because those governments ordinarily exercise powers that can be deemed to erect non-tariff trade barriers. ... There is, therefore, an inverse relationship between citizenship and consumership: the higher the level of consumership demand, the lower the level of citizenship autonomy; in turn, the higher the level of citizenship autonomy, the lower the level of global economic performance due to the greater number of trade barriers erected by autonomous communities. This is a classic dilemma for federations, now spreading worldwide (2001: 87).¹⁴

¹² There is no mention of individuals' dual interests when Kerber (2000:S226) states with reference to "locational competition": "The basic problem is how to ensure that competition processes are working in a manner such that the results of interjurisdictional competition are really fulfilling the individuals' preferences".

¹³ As Kincaid notes, "most people want both" (1993: 34), they "are pulled in two directions at once" (ibid.: 45), they "wish to be citizens of an identifiable place, ... but they also desire the means and freedom to consume the goods and services available on the world market" (ibid.: 32).

¹⁴ Kincaid's long-standing theme is echoed in Dani Rodrik's assessment of what he calls "the fundamental political trilemma of the world economy":

[W]e cannot simultaneously pursue democracy, national determination, and economic globalization. If we want to push globalization further, we have to give up either the nation state or democratic politics. If we want to maintain and deepen democracy, we have to choose between the nation state and international economic integration. And if we want to keep the nation-state and self-determination, we

6. Local Governments as Club-Enterprises: The Case of Redistribution

Kincaid's arguments challenge the theory of competitive federalism by pointing to the trade-off between local autonomy and market integration that arises in the case of policy measures that, while also erecting trade barriers, cannot be classified as protectionist privileges for special producer interests, but reflect genuine citizens interests. This challenge may be translated into the charge that, with their focus on spatial mobility, the advocates of a competitive federalism fail to pay attention to the distorting effects that such competitive regime may have on the capacity of federal sub-units to serve their citizens as *club-enterprises*.

The argument that, in a competitive federalism, local governments are prevented from providing certain goods and services that their citizens may well desire has been made early on in response to Tiebout's original contribution, in general and specifically regarding the issue of redistribution. As noted above, Oates and Schwab (1988) point out that the views of interjurisdictional competition "as a beneficent force," represented by the approaches reviewed in section three, stand in contrast to views contending that it is, on the contrary, "a source of distortion in public policy." In terms of the above-discussed conflicting concerns motivating citizens' demands, the contrast between the different outlooks at interjurisdictional competition can be briefly characterized as follows: while the view of competition as a "beneficent force" reflects the concern for limiting government's power to harm their constituents' interests, the view of competition as a "source of distortion" reflects the concern that governments may be prevented from implementing policies that promise mutual benefits for the citizenry.

In Hayek's, Buchanan's and Weingast's accounts of competitive federalism the emphasis is clearly on competition as a *constraint* on governmental power. In this sense Hayek speaks of federalism as "in a very definite sense limited government" (1960: 185) and notes that the possibilities of the individual states to interfere with economic life "would be severely limited" ([1939] 1948: 260). Buchanan ([1995/96] 2001: 82) stresses the "efficacy of competitive federalism" as an instrument that "would effectively place limits on the ability of state-provincial governments to exploit citizens" (ibid.: 81).¹⁵ And the focus of Weingast's

have to choose between deepening democracy and deepening globalization. Our troubles have their roots in our reluctance to face up to these ineluctable choices (Rodric 2012: xviiiif.).

¹⁵ Brennan and Buchanan (1980: 184) speak of a "substitutability between intergovernmental competition for fiscal resources and explicit constitutional constraints on governmental taxing power."

“market-preserving federalism” is unambiguously on the limits competition between federal sub-units imposes on their “political discretion with respect to the economy” (1995: 2).

Authors who view interjurisdictional competition as a “source of distortion” typically focus, in contrast, on its effects in depriving governments of powers they might otherwise be able to use to the benefit of their citizens. In this context redistribution is most prominently referred to as a task that governments cannot perform under the constraints of federal competition, even though it might be in citizens’ interest if they could. R.A. Musgrave (1999: 158), for instance, has argued that the

proposition that voting with the feet generates efficient outcomes is intriguing, but a voluminous literature has pointed to serious limitations (1999:158).

Inter-state differences 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 (1969: 530).

Among the voices from the “voluminous literature” about which Musgrave speaks is, e.g., W.E. Oates who notes

that the threat of mobility of both low- and high-income households will result in decentralized policies that provide too little assistance to the poor (sometimes described as a ‘race to the bottom’) (1999: 1131).

Likewise, H.-W. Sinn argues that fiscal competition will “create problems for public redistribution” (1997: 259), because in “an open economy ... where people have the right to change their residence” (2003: 77) the “power to enforce the necessary transfer of resources from the successful to the unsuccessful ... vanishes” (ibid.).

There are two aspects of “redistribution policies” that need to be distinguished here, only to the second of which the above-quoted concerns apply. On the one hand, such policies may well produce *territorial goods* in the form of effects that make the jurisdiction a more attractive location for jurisdiction-users, e.g., by reducing the risk of social unrest. To the extent that they are accompanied by such effects, redistribution policies are not impeded by competition because jurisdiction-users can be charged for the right to take advantage of the benefits so generated, such as, e.g., a more hospitable environment for investments.¹⁶ On the other hand, redistribution can serve as a *mutual insurance arrangement* that citizens might

¹⁶ Since corporations, by their very nature as legal entities, can only be taxed as *jurisdiction-users*, competition for *corporate* taxes can hardly be held responsible, as Zodrow (2003: 653) suggests, for an “under-provision of public services” that only benefit citizens, like distribution.

want governments to provide,¹⁷ and it is in this regard that authors like Sinn view interjurisdictional competition as a detrimental force.

The insurance motive, so Sinn (2004: 30) argues, is probably the most important among “the reasons for governmental redistribution”, a motive that may lead “wise constitutional fathers” to agree “on the social welfare state to cover the life and career risks of their children.”¹⁸ Yet, so Sinn adds, even though such a redistribution system can be “a useful government activity,”¹⁹ it cannot be expected to “survive in systems competition,” because the

migration of the successful and the unsuccessful is a choice that takes place *ex post*, that is after the veil of ignorance has already been lifted. Since the successful net payers do not participate, the social welfare state cannot survive (*ibid.*: 31).²⁰

If redistribution as an *insurance scheme* qualifies as a paradigm case of a “club-type public good” (Musgrave 1999: 1159) that, due to adverse selection, governments cannot provide in a competitive environment, the claim that the forces of competition compel “the separate states of a federal system ... to offer tolerably ‘efficient’ mixes of publicly provided goods and services” (Buchanan [1995] 2001: 72) must obviously be qualified. Apparently, there are components in the mix of “publicly provided goods and services” that a competitive federalism systematically prevents lower-level governments from producing. The distinction between governments as territorial enterprises providing location goods and governments as club-enterprises providing club goods does offer a criterion for classifying components of this mix into those that can be “efficiently” provided under the constraints of competition and those that cannot.

¹⁷ Buchanan (1977: 267): “Uncertainty about income and wealth positions in future periods can produce a 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 transfers among individuals and groups.” – Hayek (1976: 87): “There is no reason why in a free society government should not assure to all protection against severe deprivation in the form of an assured minimum income, of a floor below which nobody needs to descend. To enter into such an insurance against extreme misfortune may well be in the interest of all”.

¹⁸ Sinn (2003: 66): “Redistribution and insurance are two sides of the same coin. *Ex post*, every insurance contract implies a redistribution from the lucky to the unlucky, and *ex ante*, before the ‘veil of ignorance’ has been lifted, most of the redistributive activities of the state can be interpreted as insurance.”

¹⁹ Sinn (1994: 99): “(W)hat we call redistribution can often be seen as insurance from an *ex ante* perspective. Redistribution can therefore be a useful government activity that generates benefits similar to those provided by the insurance industry.”

²⁰ Sinn (1990: 10): “The problem with voting with one’s feet is that ... (the ability) to decide freely on where one wants to live ... leads to ... adverse selection ... 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.”

By reducing them to *territorial enterprises* competitive federalism forces lower-level governments to limit their competitive ambitions to the production of *territorial goods*.²¹ It deprives them of their capability to produce club goods, such as redistribution as insurance, even though that may be in the common interest of their citizens-members.²² It is telling that George Stigler in an early contribution on the “functions of local governments” asserts that interjurisdictional competition “offers not obstacles but opportunities to various communities to choose the types and scales of governmental functions they wish” (1957: 216), yet then poses the question: “Why could not each city be a private corporation, supplying at a price the services its dwellers demanded?” (ibid.).²³ In answering this question Stigler points to two “basic deficiencies” or “basic weaknesses” of such “private enterprise organization of social life.” The first being that it would allow “excessive freedom of the individual” (ibid.), a point that is elaborated by Stigler in a rather ad hoc fashion and can be left aside here.²⁴ The second being that the “local government ... does not have the ability to redistribute income” (ibid.).²⁵ The forces of competition, so he argues, would “make it impossible for a local government to obtain money from the rich to pay for the education of the poor, except to the extent the rich voluntarily assumed this burden” (ibid.: 217).

The conclusion at which Stigler arrives is that “redistribution is intrinsically a national policy” (ibid.), and he elaborates:

It happens ... that one function of paramount importance must be conducted on a very large scale: the collection of revenues designed to redistribute income. Much centralization, in fact probably most centralization, has been the consequence of this situation (ibid.: 219).

²¹ It is significant that when Tiebout (1956: 418) speaks of “local public goods” that consumer-voters consider in their “choice of municipality” the examples he refers to are typical location goods such as “schools, ... municipal golf courses, ... beaches, police protection, roads, and parking facilities.”

²² The issue of interest in the present context, namely the ability of lower-level governments to provide club goods, must be distinguished from such issues as the ability of local governments to set “standards for environmental quality,” an issue to which Oates and Schwab (1988: 334) refer. The problem in this case arises from territorial externalities not, as in the in the case of club goods, from adverse selection.

²³ Stigler (1957: 216): “With many, many such corporations, competition would prevent monopolistic pricing, and schooling and police and fire protection would be sold at a price including a fair rate of return on investment.”

²⁴ Stigler (1957: 216): “It would allow parents to horsewhip children, and it would create communities populated chiefly with drunkards and drug addicts – although thieves would presumably prefer to live among honest men (even with their policemen) than only with other thieves.”

²⁵ As one might expect from a hard-nosed Chicago economist, Stigler adds in parenthesis that what he classifies as a weakness of competitive federalism “some will call it a strength” (1957: 216).

The conclusion that, due to the adverse-selection effects of competition, federal sub-units cannot engage in redistributive policies is in fact generally drawn in the literature on competitive federalism. Musgrave, for instance, notes:

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 (1999: 161).²⁶

Oates (1999: 1134) likewise stresses that “the central government ... takes the lead in redistributive measures for support of the poor.”

On the general issue of how policy tasks may be assigned between the central government and federal sub-units Stigler (1957: 217) notes that “the local communities could still be allowed to perform any function that they were competent to perform efficiently”, and Oates (1999: 1134) comments that policy areas of decentralized levels of governments are “limited primarily to their own constituencies.” Yet, neither Stigler nor Oates specify a general criterion according to which one may distinguish the policies that local governments are “competent to perform” and that are limited “to their own constituencies” from those that, such as redistribution, do not meet these requirements. The lacking clarity in these matters is a quite common lacuna in the literature on competitive federalism. It results, as I posit, from the failure to clearly separate the above-noted *two kinds of exit* from each other and to account for the crucial role that the *assignment of citizenship* plays in a federal system.

7. Competitive Federalism and the Assignment of Citizenship

The terms competitive federalism and interjurisdictional competition are often used as if they were interchangeable. Yet, they are different insofar as the latter is the more general term, applicable to competition between governments of any kind, while competitive federalism is specifically about the competitive regime that exists between sub-units in a federal system. The difference is significant because of the role the assignment of *primary citizenship* plays in the working of intergovernmental competition.

In a federal system, individuals hold multiple citizenships. They are citizens of the inclusive federal union as well as of the various sub-units to which they belong, states, provinces, local communities, and others. Yet, in every federal system *primary citizenship* can be assigned

²⁶ Musgrave (1969: 530): “Redistribution policy, I believe, should be essentially a central function.”

only to one level, while the citizenships held at the remaining levels derive therefrom. In the literature on competitive federalism the US-type federal structure appears to be tacitly taken as the general rule, i.e. a structure in which primary citizenship is located at the level of the central government, while citizenship in the federal states and in local communities is assigned as a derivative of the national citizenship. Yet, while the US citizenship rules are indeed a quite common feature of federal systems, they are neither a necessary nor a universal feature. In Switzerland, for instance, primary citizenship is held at the level of the municipality, while the citizenship in the Cantons and in the Swiss Confederation is derived therefrom. The assignment of primary citizenship in a federal system is a matter of *constitutional choice*.

An important implication of a US-type federalism is that citizens of the federation acquire citizenship in the federal sub-units simply by *taking residence* in the respective jurisdiction. In other words, citizenship in the sub-units is a matter of individuals' unilateral residence-choice, without any involvement of the polity in whose jurisdiction they choose to take residence. Governments in these jurisdictions can only *passively register* but cannot *actively control* who acquires membership rights in their domain. An unavoidable consequence of their inability to control exit and entry into the citizens cooperative has an important consequence. It makes it impossible for them to sustainably provide goods which are subject to adverse selection, which is typically the case for club goods such as redistribution/insurance.²⁷ In other words, it is their lack of control of who gains membership rights that reduces lower-level governments to their function as territorial enterprises, stripping them of any role they might play as club-enterprises. In such a federal regime lower-level governments can only be expected to respond to the preferences of their citizens as *jurisdiction-users*, not to their potential preferences for club goods that are subject to adverse selection.

It is lower-level governments' inability to control who acquires membership rights in their respective jurisdictions that explains why in US-type federal systems redistribution is shifted upwards to the central government, and not, as is often imputed, the size of their jurisdictions *per se*.²⁸ This is not to deny that size matters in the sense that larger jurisdictions are favored

²⁷ The focus on location choice, that is a quite common feature in the literature on interjurisdictional competition, is the reason for the general tendency to view such competition as inimical to redistribution. See e.g. H. Kleven et al. (2020) who focus their literature survey on the question "whether people choose locations in response to ... tax differentials, thus reducing the ability of local and national governments to redistribute income and provide public goods."

²⁸ See e.g. Oates (1972: 8): "The scope for redistributive programs is thus limited to some extent by the potential mobility of residents, which tends to be greater the smaller the jurisdiction under consideration. This suggests,

in this regard, due to mobility-costs and because of the role the number of insured persons plays in risk-pooling. But the principal reason for the centralization of redistribution in US-type federal systems is that the assignment of primary citizenship to the union deprives the lower-level governments of any ability to implement redistributive policies. They could in principle, notwithstanding the smaller size of their jurisdictions, carry out such policies if they were the locus of primary citizenship and thereby be enabled to control membership in the citizens' cooperative. In fact, as Buchanan ([1995/96] 2001: 83f., 85) suggests, there are reasons that speak for decentralization in these matters:

(E)ven if productive welfare state functions could, in some ideal sense, be best carried out by the central government, there are offsetting grounds, based on what we may call 'political efficiency', for partitioning political choice ... It is surely easier and more natural to feel sympathy for and to care about others who are members of the same small community, than it is to care for members of a large polity. I suggest ... that a major factor in generating the breakdown of the welfare state was the shift of transfer activities to the central government and away from local communities in which political action might well embody a greater sense of interdependence.²⁹

To be sure, in an increasingly mobile world there are pragmatic reasons that speak for centralization and that must be weighed against the argument Buchanan points to. These reasons surely play a central role in the historic trend towards centralization of redistributive policies that had been formerly – in the case of Switzerland until quite recently³⁰ – been the responsibility of local governments.³¹ Hayek points to such reasons when he notes:

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 (1960: 285).

As important as the pragmatic reasons for centralizing of redistributive policies surely are, they must be distinguished from the principal reason that prevents local governments from

that, since mobility across national boundaries is generally much less than that within a nation, a policy of income redistribution has a much greater promise of success if carried out on the national level."

²⁹ Speaking about the possibility of redistributive policies at a local level Musgrave (1999:161f.) notes: "But this is hardly a realistic construct. ... It would be feasible only if accompanied by ... limited mobility." – It is noteworthy that Musgrave considers restrictions on *spatial mobility* as a potential remedy, but does not take the issue of citizenship and the "second kind of exit" into account.

³⁰ 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."

³¹ Oates (1972: 194): "(H)istory shows a trend toward the increasing centralization of explicitly redistributive programs; a trend that has greatly accelerated in recent decades. The care of the poor in the history of England, the United States, and a number of other countries, was originally envisioned as a local responsibility."

carrying out redistributive policies in US-type federal system, namely an assignment of primary citizenship that prevents them from controlling access to the benefits such policies are to provide. In other words, as Sinn (1994: 97) indicates, at what level redistributive policies can be carried out is dependent on the “constitutional framework under which government competition” takes place.

6. An Illustration: Citizenship and Freedom of Movement in the European Union

As a prominent instance of the conflict between interjurisdictional competition and redistribution Sinn (1994: 85) discusses the EU’s Single Market Program with its four liberties according to which “goods, services, capital, and labor can now migrate between the countries without major legal obstacles.” In such a free-movement regime in which governments “find themselves in an intense competition for tax-paying citizens, capital, and enterprises”, Sinn (ibid.: 96) concludes, redistribution policies will “not be able to survive” (ibid.: 99). Such a regime, he adds, “is like an insurance market where the customers can choose the company ex post, after the insurance period is over and everyone knows whether he has incurred a loss or not” (1994: 99).

Apparently, the critical component among the four liberties that, in Sinn’s assessment, undermines redistribution policies is the free movement of persons who, when “the veil of ignorance has already been lifted” (Sinn 1990: 10), are “able to decide freely where they want to live” (ibid.).³² Yet, as the name “Single Market Program” indicates, the free movement that is at stake here is the spatial movement of persons between *national markets* within the *common market*. In other words, it is about the exit from and the entry into the domain of governments *in their capacity as territorial enterprises*. It is, per se, not about exit from and entry into their domain as *club-enterprises* that provide club-goods to their citizens-members. Accordingly, one should assume that the free-movement principle requires national governments only to freely admit citizens of other EU member-states into their territory, their domestic *market*, yet, does not require them to grant citizens of other EU member-states access to the club goods they provide for their own citizens.

³² Sinn (2003: 65): “The problem is ... that opening the borders and allowing factors of production to move freely across them makes it more and more difficult to maintain the welfare state. ... It is difficult for the welfare state to survive undamaged in the systems competition that follows from the general freedom of movement.”

Primary citizenship in the EU resides with the member-states, EU citizenship, introduced by the Maastricht Treaty in 1992, is derived therefrom.³³ Persons become EU citizens by virtue of holding or acquiring a member state's citizenship, not the reverse. Accordingly, the member-states are in control over who acquires membership status in their citizens-cooperative and they should, if not prevented by other treaty provisions, be able to provide for their citizens club goods, including redistribution-insurance, without granting them on an equal basis to citizens of other member-states who, making use of the right to free movement, choose to take residence in their jurisdiction.

National redistribution policies, to which anyone would be entitled to who chooses to take residence in a member-state, would surely be rendered unsustainable in the common market. Yet, there is per se no reason why, as Sinn supposes, the requirement to grant citizens from other member-states free access to their domestic markets should prevent national governments from providing club-goods, such as redistribution, exclusively for their own citizens. In fact, Sinn argues as much when he advocates, what he calls, the *home country principle*. As he (2003: 79f.) notes:

[T]he home country principle states that the country in which a person was born remains responsible for the welfare aid this person receives and the redistributive taxes he or she pays. When the home country principle is applied there will be no tax flight and no artificial migration incentives, because no one can improve his or her net financial position by migrating to another country. There will be migration, but it will be driven by the genuine incentives of the market economy.³⁴

When, in the EU, member-states' governments do, in fact, face obstacles in reserving club-goods for their own citizens, there must be *other* reasons than the common market's free movement principles. Such reasons result, indeed, notably from ambiguous interpretations of what the *non-discrimination principle* enshrined in Article 18, TFEU (Treaty on the Functioning of the EU) implies.³⁵ The non-discrimination principle is surely an essential ingredient of the common market, since the right to freely move within it could be easily rendered ineffective if national governments were allowed to secure their own citizens privileges in the home-market by protectionist legislation. It would allow them to erect

³³ Article 20,1 TFEU says: "Every citizen holding the nationality of a Member State shall be a citizen of the Union. Citizenship of the Union shall be additional to and not replace national citizenship."

³⁴ L. Feld (2005: 434f.) comments on Sinn's proposal: "This proposal is reasonable in several respects because the incentives of migration in order to avoid the rules of income redistribution of the home country are reduced. If the nationality principle holds, the welfare state is not eroded by fiscal competition. In the U.S. and in Switzerland successful examples of elements of a nationality principle existed in the recent past."

³⁵ Article 18 TFEU says: "Within the scope of application of the Treatise ... any discrimination on grounds of nationality shall be prohibited."

barriers for market-participants from other member-states, shielding their citizens from foreign competition. Yet, while this principle is clearly meant to impose constraints on national governments in their capacity as *territorial enterprises*, there is per se no reason why it should apply to activities governments carry out in their capacity as club-enterprises.

It is a failure to carefully distinguish between the constraints the EU Single Market Program imposes on member-states in their capacity as *territorial enterprises* and the authority they should be allowed to exercise in their capacity as *club-enterprises* that has caused ambiguities in EU legal practice and jurisdiction. EU regulations and directives as well as rulings of the European Court of Justice (ECJ) have significantly curtailed member-states' ability to limit social benefits they provide, such as welfare payments or child benefits, to their own citizens.³⁶ By requiring member-states to grant, in these matters, equal treatment to citizens from other member-states who choose to take residence in their territory they extend the non-discrimination principle from its proper field of application, the authority member-states exercise in their capacity as territorial enterprises, to a domain where it per se does not apply, the authority they hold in their capacity as *club-enterprises*.³⁷

Such extension of the equal treatment requirement from its *original domain*, the *common market*, to the domain of national social policy has been primarily based, as already noted, on an extensive interpretation of what the right to free movement, as one of the common market's four freedoms, entails. Yet, in addition it is being argued for in terms of the rights that the *EU citizenship* is presumed to grant.³⁸ In particular, the right to free movement that, according to Article 21,1, TFEU,³⁹ EU citizenship grants independently of, and in addition to, the right to free movement as part of the common market's four freedoms, has been interpreted in support of the equal treatment requirement in *welfare matters*.

For the issues of present interest there is no need to review in detail the respective EU regulations and directives or rulings of the ECJ, as well as the changes both have undergone over time. Suffice it to note that by their extensive interpretation of what the non-

³⁶ This requirement is subject to certain qualification, the details of which are not of relevance for the general issue that this paper is concerned with.

³⁷ This issue is discussed in more detail in Vanberg 2016: 839ff.

³⁸ As D. Thym (2015: 130) notes: "Since its adoption in 1992 union citizenship presents a dilemma for EU-integration." In Thym's assessment, the treaty of Maastricht adopted with the term EU-citizenship a concept that "by itself cannot provide a foundation for citizenship in a normative significant sense" (ibid.).

³⁹ Article 21,1 TFEU says: "Every citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in the Treaties". – Article 45,1, TFEU, in Title IV on "Free movement of persons, services and capital" says: "Freedom of movement for workers shall be secured within the Union."

discrimination principle is supposed to imply, and of the rights that are supposed to be granted by the EU-citizenship,⁴⁰ they tend to prevent national governments from exercising effective control over who gains access to the services they want to provide as club goods for their citizens-members. In other words, they take away from member-states' authority to serve their citizens as club-enterprises, an authority that, as the locus of *primary citizenship*, they should be able to exercise.

The concerns that a number of member-states increasingly have voiced about an immigration to their social benefit systems is presumably among the reasons why, compared to its earlier rulings, the ECJ has more recently adopted a significantly more restrictive interpretation of what the freedom of movement implies for the access to social benefits in the host state.⁴¹ As one author puts it:

While between the late 1990s and the early 2010s its judgments seemed to pave the way for a EU citizenship as 'social citizenship' ..., in recent cases the tide has turned. Against the background of debates on 'benefit tourism' ... the ECJ has validated national (particularly German) legislation that (increasingly) limits EU citizens' access to welfare and confirmed it does in fact not contradict EU legislation (Bouali 2018:168).

Contrary to voices that deplore this reorientation of the ECJ as a diminution of EU citizenship from a "social citizenship" to a "market citizenship,"⁴² in light of the principal tenet of the argument developed in this paper it should be welcomed as reflecting a growing recognition of the need to distinguish between the two roles the member-states serve in the European federal system, their functions as territorial enterprises and as club-enterprises.

9. Two Kinds of Exit and Two Kinds of Taxes

Georg Schanz, the founder and first editor of the world's oldest public finance journal *Finanzarchiv*,⁴³ published in 1892 in his journal an article entitled "Zur Frage der Steuerpflicht" (On the issue of the liability to pay tax).⁴⁴ In it he explored the question of how liability to pay tax should be determined in a world in which there is no longer a coincidence

⁴⁰ For a review of the controversy on this issue see S. Buckel (2011: 637-657). Buckel characterizes restrictive interpretations as "neoliberal" (637, 652) and extensive interpretations, which she favors, as "pro-europen-social-democratic" (657).

⁴¹ D. Thym (2015: 130) notes that the ECJ, after having interpreted the rights that come with EU-citizenship in an extensive way, returned in the late 2010s to the "traditional paradigm (Leitbild) of the economically active 'market citizen' (Marktbürger)."

⁴² On this issue see Clemens 2014; Thym 2015; Schreiber 201; Frings and Janda 2018; Buckel 2011.

⁴³ The journal was founded in 1884 and is published since 2000 as *Finanzarchiv – Public Finance Analysis*.

⁴⁴ Translation from Schanz's text are mine, V.V.

between a community's "legal" and the "factual" population, the less so the smaller it's size. As he (1892: 6) put it: "Every community hosts a number of persons who are not legally affiliated with it, just as many of its members stay in foreign communities." In such a world, so Schanz argues, the liability to pay tax can obviously not be limited to the "legal population".

The absent part of it is difficult to get hold of and to control, and for it the benefits that the home community provides are largely suspended and substituted by those of a foreign community, while matters are reversed for the non-legal part that is present, which is easy to get hold of and enjoys the benefits the community offers (1892: 6).

As the appropriate principle, Schanz suggests basing the liability to pay tax on a person's economic affiliation with the community, so as to create a harmonious relation between the benefits enjoyed and the tax paid.

When this principle is applied, the community's activities and the group of persons who benefit from them coincides most. Everyone who has economic ties with the community, i.e., everyone who benefits from the tasks the community performs, shares in the burden (ibid.: 8).

Anticipating the objection that this would mean a return to the often criticized *benefit principle*, Schanz notes:

In response to all this I want to stress that there is, as a matter of fact, no tax which does not embody a benefit relation of some kind. ... One can exit from any community, the nation-state included, one can assess whether a community's services, the advantages and inner happiness, outweigh the sacrifices it demands (ibid.: 10).

In terms of the benefit principle to which Schanz alludes, the distinction between the two functions of government would suggest classifying taxes into two principal categories. On the one hand, there are taxes governments in their capacity as club-enterprise levy on their citizens as payment for the club goods they provide. On the other hand, there are taxes governments in their capacity as territorial enterprise collect from jurisdiction-users for the right to take advantage of its territorial goods. Resident citizens were, in such a system, subject to taxation in their capacity as citizens as well as in their capacity as jurisdiction-users. Citizens residing abroad were charged as citizens by their home country and as jurisdiction-users by their host country.

If taxes were levied in the noted manner, there would be no reason to consider it problematic, as Sinn does, that with competition taxes "would lose their fiscal character and become pure benefit taxes, because this would mean forgoing redistribution and insurance protection" (2004: 32). To the extent that "redistribution and insurance protection" is a club good, the

benefits of which are limited to citizens, the burden of financing them would have to be shared by the latter, whether they reside in their home jurisdiction or abroad. While collecting taxes from citizens residing abroad is surely more difficult, it is by no means impossible. As Schanz (1892: 1f.) notes:

A polity's range of power is, in the first instance, limited to its own territory. ... Beyond the border of its territory ... 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.

There are, to be sure, as Schanz (1892: 4) notes, “multiple levels of intensity” in a person's economic affiliation with a community that taxation policy would need to account for. Accordingly, the noted classification into the two principal kinds of taxes would have to be sub-divided into multiple, more specific categories, depending on the kinds of services for which a burden-sharing were required. For instance, in the case of taxes they collect as territorial enterprises from jurisdiction-users, it would seem natural to distinguish between using a jurisdiction as permanent residence and using it for other purposes.

10. Conclusion

The principal aim of this paper is one of conceptual and theoretical clarification. Its purpose is to draw attention to the distinction between governments' functions as territorial enterprises and as club-enterprises, a distinction that tends to be ignored in contributions to the theory of competitive federalism even though it is of systematic relevance for the ways in which interjurisdictional competition unfolds. Adequately accounting, or failing to account, for the difference between the two functions, and the distinction between two kinds of exit, is bound to have significant consequences in practical politics. Yet, inquiring into its practical implications is only a secondary concern of the present paper. This issue is touched upon in the two preceding sections, about ambiguities in how the freedom-of-movement and non-discrimination principles are interpreted in EU-legislation and by the European Court of Justice, and on requirements for a consistent system of taxation. His essay on the latter subject Schanz (1892:70) concludes on the note that a principle of taxation should meet two requirements. It ought to assign the liability to pay tax in the most appropriate manner and it should be expedient for the practical purposes of tax collection. The taxation principle sketched above can be claimed to assign the liability to pay tax in a more systematic and coherent manner than the taxation schemes that are commonly practiced. If implemented, this

principle could surely not be undermined by interjurisdictional competition, yet, putting it into practice would pose the formidable challenge of orchestrating the transition from long-accustomed routines to yet to be discovered practices of tax collection that best approximate the systematic logic of the principle they are supposed to serve.

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