

ARTICLES

DECENTRALIZATION AND SUBSIDIARITY: TOWARD A THEORETICAL RECONCILIATION[†]

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1. INTRODUCTION

First introduced in the discussions concerning European integration in the 1975 *Report on European Union* submitted to the Council of Ministers by the European Commission,¹ the principle of subsidiarity² made its first official appearance in the Single

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¹ See Bull. Eur. Communities Comm'n Supp. 5/75, at 10-11. For a brief history of the principle of subsidiarity in modern European discussions, see A.G. Toth, *The Principle of Subsidiarity in the Maastricht Treaty*, 29 COMMON MKT. L. REV. 1079, 1088-89 (1992), and Deborah Z. Cass, *The Word That Saves Maastricht? The Principle of Subsidiarity and the Division of Powers Within the European Community*, 29 COMMON MKT. L. REV. 1107, 1112-16 (1992).

² Subsidiarity is an old concept. The ideas of federalism and subsidiarity were first brought together in *Fifteen Federalists* by the Franciscan Johannes Eberlin in 1521. See Ludger Kühnhardt, *Federalism and Subsidiarity*, TELOS, Spring 1992, at 77, 80. The name of Johannes Althusius is also associated with early discussions of subsidiarity and rightly so, even though Althusius does not appear to have made use of the word itself. Althusius conceived of the body

European Act signed in 1986 and implemented on July 1, 1987,³ to acquire definitive official status in the Maastricht Treaty which came into effect on November 1, 1993. Article 3b of that Treaty defines the principle in the following way:⁴

The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein. In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. Any action

politic as made up of five groupings: two private (the family and the collegium) and three public (the city, the province, and the commonwealth). See generally JOHANNES ALTHUSIUS, *POLITICA METHODICE DIGESTA ET EXEMPLIS SACRIS ET PROFANIS ILLUSTRATA* (1603). Because he assigned responsibilities to each grouping on the basis of what he believed were the capacities of each body to discharge them, he is considered an early contributor to an understanding of the concept. See generally Daniel J. Elazar, *The Multi-Faceted Covenant: The Biblical Approach to the Problem of Organizations, Constitutions, and Liberty as Reflected in the Thought of Johannes Althusius*, 2 CONST. POL. ECON. 187 (1991) (describing the form of civil society in the Althusian view). The modern conception of subsidiarity stems from Catholic social doctrine and is elaborated in the papal encyclicals. See, e.g., POPE PIUS XI, *QUADRAGESIMO ANNO* (1931), reprinted in *THE PAPAL ENCYCLICALS, 1903-1939*, at 415 (Claudia Carlen ed. & trans., 1981).

³ See Single European Act, 1987 O.J. (L 169) 1, [1987] 2 C.M.L.R. 741 (1987) (amending TREATY ESTABLISHING EUROPEAN ECONOMIC COMMUNITY, Mar. 25, 1957, 298 U.N.T.S. 11) [hereinafter SEA]. In reality, the principle of subsidiarity made a nominal appearance in 1984 when, pressed by Altiero Spinelli (one of the main proponents of European federalism), the European Parliament adopted a Draft Treaty establishing the European Union. See Draft Treaty Establishing the European Union, art. 12(2), 1984 O.J. (C 77) 33, 38. In paragraph nine of the Preamble of this Draft Treaty, subsidiarity was mentioned by name for the first time. See *id.* pmb., para. 9. The first direct application of the principle to a specific area, namely to environmental protection, was made in Article 130r of the Single European Act. See SEA, art. 130r (4) (stating that "[t]he Community shall take action relating to the environment to the extent to which [its] objectives can be attained better at [the] Community level than at the level of the individual states").

⁴ See Toth, *supra* note 1, at 1086 ("[T]here are at least three other references to subsidiarity in the Maastricht Treaty, one in the preamble and two in Title I containing 'Common Provisions.'").

by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.⁵

This definition makes clear that the principle of subsidiarity relates to the question of the assignment of powers to governing bodies located at different jurisdictional tiers in governmental systems, though the Treaty itself does not assign any powers.⁶ This is the only thing that the definition makes clear. Expressions such as “if . . . the proposed action cannot be sufficiently achieved by Member States” and “the scale or effects of the proposed action” in the above definition are open to many interpretations.⁷ Moreover, as Kees van Kersbergen and Bertjan Verbeek have noted, from the mid 1970s until the late 1980s, the principle was used “to justify *the enlargement of the competences* of the European Commission,”⁸ and only in the 1990s did “subsidiarity evolve[] into a principle for *curbing* the potential expansion of power of the European Commission.”⁹ Article 3b of the Maastricht Treaty is at present generally interpreted as expressing a principle that calls for decentralization. Even if that is granted—Article 3b can easily be read as supporting some centralization—it is not clear how the principle of subsidiarity is to play that role. The question that begs for an answer is the following: in what specific way does the principle of subsidiarity relate to the assignment of powers and how can it affect the assignment and reassignment of these powers?

The basic assumption of this Article is that the principle of subsidiarity and the answer to the above question belong to a theory of the decentralization (or of centralization) of powers in

⁵ TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Feb. 7, 1992, art. 3b, O.J. (C 224) 1 (1992), [1992] 1 C.M.L.R. 573 (1992).

⁶ See generally *id.* We use the expression “governmental systems” to refer to the apparatus of state in its entirety, including central, provincial or state and municipal governments. We also include special authorities (termed *syndicats* in France, *consorzi* in Italy, and *special districts* in the United States) that may be responsible for schools, fire protection, police, public transportation, water, sewerage, libraries, hospitals, and cemeteries. Governmental systems, therefore, include confederal, federal, and unitary states as well as structures, like the European Union, which are neither confederal, federal, nor unitary.

⁷ EC TREATY art. 3b.

⁸ Kees van Kersbergen & Bertjan Verbeek, *The Politics of Subsidiarity in the European Union*, 32 J. COMMON MKT. STUD. 215, 216 (1994).

⁹ *Id.*

governmental systems.¹⁰ The assumption is a natural one to make if one accepts that subsidiarity pertains to the assignment of powers.¹¹ Though natural, the assumption has strength only if a theory of decentralization is available. As this Article proceeds, the emergence of a theory of decentralization will become evident. Enough of it is currently available to allow us to ascribe an important strategic role to the principle of subsidiarity. Before doing this, this Article asks whether subsidiarity can be given a role in two currently accepted models of decentralization of governmental systems.

This Article begins with a review of the conventional public economics explanation of the reasons why governmental systems are or should be decentralized. Section 2 reviews the "Decentralization Theorem" which has been and remains central to that analysis. Section 3 examines a decentralization model derived from an application of the theory of incomplete contracts to governmental systems. Section 4 considers a model of decentralization based on the assumption that politics and intergovernmental relations are competitive. Section 5 situates the principle of subsidiarity in its historical context to understand the meaning currently given to it, and suggests a role for the principle in the

¹⁰ Assignments pertain to powers, that is to the authority to design and implement policies in particular domains of activity. They do not relate to policies, unless a power is capable of housing no more than a single policy. If a senior government appoints an agent at a junior level (for example, an administrative body) to implement one or more policies it itself designs, that is *not* an assignment. Assignments may or may not be entrenched in a constitutional document. Although such entrenchments or their absence will affect how assignment mechanisms, *see infra* Section 4.1., operate, they are irrelevant to the question of how to define and analyze assignments.

¹¹ Many authors assume, as we do, that subsidiarity pertains to the assignment problem. *See, e.g.*, CENTRE FOR ECONOMIC POLICY RESEARCH, MAKING SENSE OF SUBSIDIARITY: HOW MUCH CENTRALIZATION FOR EUROPE? (1993) [hereinafter MAKING SENSE OF SUBSIDIARITY]; Jacques Crémer et al., *The Decentralization of Public Services: Lessons from the Theory of the Firm*, in DECENTRALIZING INFRASTRUCTURE: ADVANTAGES AND LIMITATIONS (Antonio Estache ed., World Bank Discussion Paper No. 290, 1995); George A. Bermann, *Taking Subsidiarity Seriously: Federalism in the European Community and the United States*, 94 COLUM. L. REV. 331 (1994); Cass, *supra* note 1; Kühnhardt, *supra* note 2; Paul Seabright, *Accountability and Decentralization in Government: An Incomplete Contracts Model*, 40 EURO. ECON. REV. 61 (1996); Hans-Werner Sinn, *How Much Europe? Subsidiarity, Centralization and Fiscal Competition*, 41 SCOT. J. POL. ECON. 85 (1994); Toth, *supra* note 1, at 1090-91.

competition model of decentralization. Section 6 concludes the paper.

2. THE CONVENTIONAL ANALYSIS

Among the hodgepodge of propositions which constitute the conventional public economics explanation of why we should observe decentralization of governmental systems, there is one, which Wallace Oates has labeled the “decentralization theorem,” that occupies a special place in the literature of fiscal federalism.¹² After first reviewing that theorem, this Article will examine the assumptions on which it rests before looking at what the conventional analysis reveals about the principle of subsidiarity.

2.1. *The Theorem*

At the outset, the decentralization theorem accepts the Musgravian assumption that an analysis of decentralization requires that governments be decomposed into three branches: the allocation, the redistribution, and the stabilization branches.¹³ In the canonical version, there are no benefits to the decentralization of the redistribution and stabilization branches. To put it more precisely, the disadvantages of decentralization so greatly exceed the advantages, that whoever or whatever assigns powers would always assign redistribution and stabilization to the central authorities.¹⁴

To “prove” the theorem that there are benefits to the decentralization of some fraction of the allocation branch, four assumptions are needed. First, it is assumed that central governments are “obliged”¹⁵ to provide *uniformly* the goods and services they actu-

¹² See WALLACE E. OATES, FISCAL FEDERALISM 35-37 (William J. Baumol ed., 1972).

¹³ See RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY 5-6 (1959).

¹⁴ See generally RICHARD A. MUSGRAVE, FISCAL SYSTEMS (1969); OATES, *supra* note 12. Some writers have argued that redistribution need not be completely centralized. See, e.g., Mark V. Pauly, *Income Redistribution as a Local Public Good*, 2 J. PUB. ECON. 35, 36 (1973). Others have recognized a role to sub-central governments in stabilization. See, e.g., Edward M. Gramlich, *Federalism and Federal Deficit Reduction*, 40 NAT'L TAX J. 299 (1987). To account for these exceptions, we refer to a canonical version of the theorem.

¹⁵ The word “obliged” is from Tocqueville. See OATES, *supra* note 12, at 31. In the original, the term is “le législateur est obligé.” ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA: TOME I 194 (1835/1850). In his translation, George Lawrence renders Tocqueville’s sentence as “the lawgiver is

ally supply across their entire jurisdictions. Second, it is assumed that there is an inverse monotone relationship between the degree of homogeneity of preferences within jurisdictions and the size of jurisdictions.¹⁶ Third, it is assumed that there are no interjurisdictional spillovers. Finally, it is assumed that the goods and services supplied by senior and junior governments are produced at constant costs and provided to citizens at identical tax prices.

Given these four assumptions, it is easy to see the virtues of decentralization. The example of snow removal will illustrate. The central government in Rome is "obliged" to provide the service uniformly. Consequently, it removes snow from the streets of Turin which are blanketed with snow virtually every winter, as well as from the streets of Catania which seldom, if ever, see any snow.¹⁷ Decentralization allows for snow removal in Turin where the population has a preference for its removal and for no snow removal in Catania, where the population cannot want it to be removed. Preferences are therefore better satisfied with decentralization, and welfare is consequently greater.

2.2. *A Critical Assessment*

The fourth assumption, which pertains to equal cost of supply, is innocuous. Indeed, allowing differences in supply costs will not affect the theorem. Therefore, this Article examines only the first three assumptions concerning uniformity of supply, homogeneity of preferences, and interjurisdictional spillovers. Such an examination reveals the true worth of the theorem. It also helps an appreciation of the value of other theories of decentralization which make use of these assumptions, either together or singularly.

bound" which has the same meaning as "is obliged" and "est obligé." ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 161 (George Lawrence trans. & Anchor Books ed., 1969). Oates could also have quoted Tocqueville's assertion that "every central government worships uniformity." *Id.* at 673. In the original, that statement reads "tout gouvernement central adore l'uniformité." ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA: TOME II* 333 (1840/1850).

¹⁶ See *infra* Section 2.2.2. (discussing two factors that make for a greater homogeneity of preferences at junior rather than at senior levels of government).

¹⁷ We are aware that snow cannot be removed from where it has not fallen, but that snowplows pushing air will be driven through the streets of Catania is precisely what the concept of uniformity entails.

2.2.1. *Uniformity*

According to Oates, the uniformity assumption is satisfied as a matter of definition.¹⁸ He argues that if the central government can replicate the supply of goods and services undertaken by junior governments, then “in terms of [his] *economic definition* of federalism, . . . this is equivalent to the operation of a federal system with a decision-making unit for each jurisdiction.”¹⁹ Thus, Oates “associate[s] centralized decision-making with a uniform level of consumption of public goods across all jurisdictions.”²⁰ This is far from satisfactory.

In more recent literature, the uniformity assumption continues to play a fundamental role in discussions of decentralization, and is apparently taken to reflect the real world. Alan Hamlin, who diagnoses weaknesses²¹ in the conventional analysis of decentralization, nevertheless accepts that central governments are “constrained to adopt policies that apply uniformly across the entire population.”²² Others take the assumption to mean that “the central government is assumed to be institutionally compelled to adopt a uniformity constraint in service delivery”—a constraint that signals “government failure.”²³ Paul Seabright rejects the strong formulation of the assumption as “empirically false.”²⁴ Instead, he claims value for a weaker version which states “that centralized political systems do tend to implement policies that are regionally more uniform than decentralized ones.”²⁵

¹⁸ See OATES, *FISCAL FEDERALISM*, *supra* note 12, at 35-38 (defining the assumptions underlying his decentralization theorem); see also CLIFF WALSH, *FISCAL FEDERALISM: AN OVERVIEW OF ISSUES AND A DISCUSSION OF THEIR RELEVANCE TO THE EUROPEAN COMMUNITY* 5 (1992) (recognizing that, in OATES, *FISCAL FEDERALISM*, *supra* note 12, uniform supply by central governments is definitional).

¹⁹ OATES, *FISCAL FEDERALISM*, *supra* note 12, at 37 n.9 (emphasis added).

²⁰ *Id.*

²¹ See discussion *infra*.

²² Alan P. Hamlin, *Decentralization, Competition and the Efficiency of Federalism*, *ECON. REC.*, Sept. 1991, at 193, 194.

²³ Crémer et al., *supra* note 11, at 99.

²⁴ Seabright, *supra* note 11, at 63.

²⁵ *Id.* It is not clear whether the uniformity assumption is supposed to apply only to central governments or whether it also reflects what provincial, state, or even local governments do. We will see later that the way this question is addressed is not without consequences. See *infra* Section 2.2.2.

These statements notwithstanding, it is difficult to know what the assumption really means. In considering a single-tier unitary governmental system, it makes little sense to assume that the unique government of that system is "obliged," "compelled," or "constrained" to remove snow where none actually falls. Only Seabright's formulation of the uniformity assumption makes sense in such a context. In focusing on multi-tier governmental systems,²⁶ even Seabright's weaker formulation of the assumption will not do. Some uniformity in these systems does not prove that more uniformity is provided than the citizens require and/or desire. For example, in Canada, the federal government has the power to decide on capital punishment,²⁷ and it has elected to uniformly proscribe capital punishment across the whole country.²⁸ However, in the United States, the state governments hold that power, with "oversight" by the Supreme Court. As a consequence, states vary considerably in the incidence of executions and in the manner of these executions. Still, one cannot assume—but must demonstrate—that Canadians are "obliged" or "compelled" to uniformity in this matter. In a fundamental sense, the American treatment of capital punishment was, and remains, available to Canadians, but so far they have not adopted it.²⁹

Samuelsonian public goods must be provided uniformly.³⁰ These public goods include international diplomacy, national defense (as deterrence), and exchange rate policies.³¹ The observation of uniformity regarding these services does not demonstrate that central governments are "obliged" or "constrained" to supply

²⁶ With the exception of the seven larger conurbations in England (Birmingham, Leeds, Liverpool, London, Manchester, Newcastle, and Sheffield), Northern Ireland, and, since April 1996, Scotland and Wales, all multi-tier governmental systems of democratic societies have more than two levels. Most have four or more, even if we count as tiers only those whose politicians are popularly elected, which is a very restrictive conception of tiers.

²⁷ See Constitution Act of 1867, 30 & 31 Vict. ch. 3, § 91 (27) (Eng.).

²⁸ See Act of 1976, 1974-1975-1976 S.C. 105 (Can.); see also PETER W. HOGG, CONSTITUTIONAL LAW IN CANADA 1137 (3d ed. 1992).

²⁹ In Canada, under the power it has to regulate the fisheries, the federal government not only implements different policies for different fish stocks, but also pursues different policy objectives on the Atlantic and Pacific coasts. See Coastal Fisheries Protection Act, R.S.C., ch. C-33 (1985) (Can.); Atlantic Fisheries Restructuring Act, R.S.C., ch. A-14 (1985) (Can.).

³⁰ See Paul Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387, 387 (1954).

³¹ See *id.*

goods and services uniformly. The unit costs of producing some goods and services fall when they are produced uniformly and in large volume. Tax collection is an example. The observation of uniformity in these cases cannot establish that central governments are “compelled” to adopt uniform provisions. Finally, governments uniformly provide goods and services which are neither public nor produced under conditions of decreasing unit cost because citizens want uniform provision. These include the right to a passport and the right to privacy. Each of these rights could easily be decentralized. Therefore, to argue that the powers which regulate these rights should be decentralized and diversified is to argue that citizens can never have a preference for uniformity.³²

Three institutions of governmental systems shed light on the question of uniform supply: *concurrency*, *standards*, and *field administration*. We first look at concurrency. Concurrency means that governments share powers to achieve a degree of uniformity consistent with technical requirements, such as publicness and scale economies, and the preferences of citizens, while sacrificing a minimum of diversity. To understand the meaning of this institution, one must recognize that governments assign powers, not policies, to jurisdictional tiers.³³ The assignment of a power grants the authority to design and implement policies *in a particular domain*. Assigning power over agriculture or education, for example, grants the authority to legislate in matters pertaining to these policy domains. It is because *powers*, not *policies*, are assigned that there can be concurrency. In other words, it is possible for a part of the authority to legislate in regards to agriculture and education to be centralized and at the same time for another part of that authority to be decentralized.

Concurrency sheds light on uniformity in another way. Suppose that a central government provides policies uniformly under the part of the authority it has been assigned and that the provinces or states do the same under their allotted part of authority. As long as the degree of concurrency is adjusted to reflect changes

³² Uniformity of certain variables can also be found in the marketplace. A notorious case is the fixed uniform sales commissions that govern residential real estate transactions between sellers and brokers in Canada and the United States. See Saul Levmore, *Commissions and Conflict in Agency Arrangements: Lawyers, Real Estate Brokers, Underwriters, and Other Agents' Rewards*, 36 J.L. & ECON. 503-39 (1993) (explaining this uniformity without assuming collusion).

³³ See *supra* note 10.

in the relevant circumstances, it is still impossible to argue that the central government was "compelled" to uniformity. The prevalence of concurrent powers therefore provides *prima facie* evidence that central governments are not "constrained" or "obliged" to provide goods and services uniformly.

We now turn our attention to standards. A central government can apply uniform minimum or maximum standards across its entire jurisdiction with respect to certain policy dimensions while allowing diversity in others. For example, in Canada, provincial governments have power over health, with the exception of responsibility over military hospitals and health in the northern territories. Under that power, the provinces severally have provided their citizens with public health programs. At the national level, however, the Canadian Parliament passed the Canada Health Act, which "forces" some uniformity on provincial programs.³⁴ The federal government was not "compelled" to pass and implement that Act, except in the sense that if it had not done so, it would have risked defeat at the ballot box. The Act, which calls for some uniform minimum standards in some areas, respects diversity in others. The presence of standards, like the use of concurrency, does not demonstrate that a uniformity constraint binds central governments. Rather, it shows that central governments have freedom in the matter.³⁵

Finally, there is field administration, or field service. Often central governments assert control over the financing and the overall design of a policy, but give discretionary authority to an administrator in the field (such as a prefect) who then implements the policy in a way that respects local conditions. As a consequence, the policy, though formally uniform, is varied in its application. This institution also shows that central governments are not "compelled" to uniformity.

2.2.2. *Homogeneity*

Two factors can, but need not, produce a greater homogeneity of preferences at junior rather than senior levels of government. The first is a total absence of mobility among isolated communi-

³⁴ See Canada Health Act, R.S.C., ch. C-6 (1985).

³⁵ This is equivalent to supposing that the decisions of central governments are *not* determined by the median voter, because if these decisions were made by that voter, the supply of goods and services would be uniform. We are grateful to Isidoro Mazza of the University of Catania for this point.

ties. Assume that over time, propinquity within local communities generates uniform preferences and that the absence of interaction among the communities results in different preferences. Formation of a higher level jurisdiction over these communities creates a two-tier governmental system. The result is an inverse monotone relationship between the homogeneity of preferences within communities at the lower level and jurisdictional size when moving from lower to higher levels. The inverse relationship will continue to hold when moving from a two- to a three- or four-tier system. In the case of an immobile population apportioned among isolated communities, one can assume the existence of an inverse relationship between the size of jurisdictions and intra-community homogeneity of preferences. However, this situation does not appear to be widespread in contemporary societies.

The second factor that can produce an inverse relationship between homogeneity and size is unfettered fiscal or Tiebout mobility.³⁶ At the lowest tier of governmental systems, fiscal mobility can sort the population by preferences and homogenize communities at that tier; however, this is inherently impossible at higher tiers.³⁷ When moving from two-tier to three-tier systems, the inverse relationship becomes impossible because effective fiscal mobility is no longer possible. For example, if one wants to live in Milan, one *must* live in Lombardy and in Italy.³⁸ Four or more tiers worsens matters. The pervasiveness of multi-tier governmental systems robs Tiebout mobility of the capacity to generate the inverse relationship between homogeneity and size needed by the decentralization theorem.

Any heterogeneity of preferences at the local level means that, in supplying goods and services, local governments must resolve the same problems that confront central governments. If the as-

³⁶ See Charles M. Tiebout, *A Pure Theory of Local Expenditure*, 64 J. POL. ECON. 416 (1957) (advancing the theory that mobility between communities is a mechanism through which citizens reveal their preferences for local public goods).

³⁷ Central, provincial or state, or metropolitan governments can use Tiebout mobility as a preference revelation mechanism. In other words, any one of these governments can diversify its policies and allow the population to sort itself by policy types. However, in three- or higher-tier systems, only one government—the central *or* the state *or* the metropolitan—can avail itself of this mechanism.

³⁸ It is, of course, always possible to salvage Tiebout mobility. All one has to do is assume that Milans exist everywhere so that if one wanted to live in Milan but also in Arkansas, one could do so.

sumption of uniform provision applies to central governments only, then local governments could diversify supply to satisfy idiosyncratic preferences. But then, any argument that local governments can diversify will apply to central governments as well, and the case for decentralization will simply vanish. If the uniformity assumption applies to all governments, then decentralization will not be able, in the presence of heterogeneous preferences at the local level, to diversify supply. In this case also, the advantages of decentralization disappear.

2.2.3. *Spillovers*

The assumption that there are no interjurisdictional spillovers gives power or relief to the decentralization theorem, but it is dispensable. Allowing spillovers, however, requires the introduction of coordination and coordination costs to the analysis, concepts which have played no role in the conventional analysis.³⁹ And for good reason. As is now recognized, if coordination costs are given the absolutely essential role that Albert Breton and Anthony Scott argued a theory of decentralization recognizing the pervasiveness of spillovers had to give these costs,⁴⁰ the theory must also include other "organizational" or "transactional" costs.⁴¹ The analysis of decentralization based on this "theorem" then becomes not only outmoded, but misleading.

2.3. *Subsidiarity in the Conventional Model*

The authors of this Article do not believe that the conventional analysis supports the argument that decentralization is beneficial. To the contrary, the assumptions of the conventional approach of uniformity in central government supply as well as the assumption of a negative relation between intrajurisdiction homogeneity and jurisdictional size, are too much at variance

³⁹ In Musgrave's discussion of decentralization, spillovers play a major role and the necessity of coordination, which he calls "cooperation," is recognized, but plays no analytical role. See MUSGRAVE, *FISCAL SYSTEMS*, *supra* note 14, at 299-304.

⁴⁰ See generally ALBERT BRETON & ANTHONY SCOTT, *THE ECONOMIC CONSTITUTION OF FEDERAL STATES* (1978) [hereinafter BRETON & SCOTT, *ECONOMIC CONSTITUTION*].

⁴¹ See, e.g., Robert P. Inman & Daniel L. Rubinfeld, *The Political Economy of Federalism*, in *PERSPECTIVES ON PUBLIC CHOICE* 73, 76-80 (Dennis C. Mueller ed., 1997) (explaining that coordination and other organizational costs must be an integral part of the analysis of decentralization).

with what we observe in the world. Consequently, the conventional analysis cannot provide a foundation for a theory of decentralization of governmental systems that permits an appraisal of the virtues of decentralization. Furthermore, because it requires something like fiscal or Tiebout mobility to generate the necessary intrajurisdiction homogeneity, and because of the inherent impossibility of Tiebout mobility in governmental systems of three or more tiers, the conventional model fosters a tendency to think of governmental systems as two-tier systems. This tendency often leads analysts to overlook some genuine virtues of decentralization.

If efficiency can be improved by assigning some powers to senior governments and others to junior governments, someone or something must undertake the task of implementing the assignments. The earlier literature assumed that, once specified, assignments would somehow implement themselves.⁴² Consequently, that literature did not discuss the question of who or what implemented them. When Breton and Scott first recognized the problem, it was "solved" by the creation of a "constituent assembly" that was presumed capable of executing assignments by minimizing organizational costs. These costs were defined as those incurred by citizens to signal their preferences and to move from community to community, plus the costs of public administration and of intergovernmental coordination associated with alternative assignments.⁴³ The absence of ongoing, cost-minimizing constituent assemblies in the real world robbed that solution of much of its value.⁴⁴

Alan Hamlin accepts an augmented version of the conventional decentralization theorem, which he calls the "decentralization thesis," as "idealized federalism."⁴⁵ In particular, he refers to the "idealized federal outcome" as the outcome that a

⁴² See, e.g., OATES, FISCAL FEDERALISM, *supra* note 12; Albert Breton, *A Theory of Government Grants*, 31 CAN. J. ECON. & POL. SCI. 175, 178 (1965) [hereinafter Breton, *Government Grants*] (assuming that the division of powers followed automatically from the presumed hierarchy of public goods).

⁴³ See generally BRETON & SCOTT, ECONOMIC CONSTITUTION, *supra* note 40.

⁴⁴ For development of this point, see ALBERT BRETON & ANTHONY SCOTT, THE DESIGN OF FEDERATIONS (1980) [hereinafter BRETON & SCOTT, DESIGN OF FEDERATIONS].

⁴⁵ Alan P. Hamlin, *Decentralization, Competition and the Efficiency of Federalism*, ECON. REC., Sept. 1991, at 193, 194.

“procedural mechanism” should implement,⁴⁶ somewhat as perfectly competitive markets implement the idealized outcomes of the First and Second Theorems of Welfare Economics.⁴⁷ Hamlin’s discussion of procedural mechanisms does not, however, address the assignment problem. Hamlin analyzes mechanisms, based on one sort of mobility or the other, that match heterogeneous groupings of persons with supply sources of impure public goods.⁴⁸ This is a partitioning, not an assignment, problem. In the absence of an assignment mechanism, it is not possible to find a habitat and a role for the principle of subsidiarity.⁴⁹ This Article later discusses procedural mechanisms, or assignment mechanisms, to address the assignment problem.

3. THE CONTRACTUAL ANALYSIS

The theory of decentralization of governmental systems proposed by a 1993 Report of the London-based Centre for Economic Policy Research derives from the theory of incomplete contracts.⁵⁰ This Section will first outline the model proposed in that Report and in subsequent studies, then offer some criticisms, and finally will inquire into what the contractual model has to say about subsidiarity.

3.1. *The Model*

The framework in which the problem is formulated is familiar to students of contract theory. Citizens, as the principals in a

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ These include, for example, local, regional, and national goods. *Id.* at 196-204.

⁴⁹ See OATES, FISCAL FEDERALISM, *supra* note 12; Wallace E. Oates, *Federalism and Government Finance*, in MODERN PUBLIC FINANCE 126 (John M. Quigly & Eugene Smolensky eds., 1994). In his more recent survey of studies on fiscal federalism, Oates appears to be even less aware of the necessity of an assignment mechanism than he was in his earlier work. Compare Oates, *Federalism and Government Finance*, *supra*, with OATES, FISCAL FEDERALISM, *supra* note 12, at 221-41. Although the early work does not propose an assignment mechanism, it offers an insightful discussion of some of the forces that would impact on such a mechanism. It is noteworthy that in the recent survey neither the work of BRETON & SCOTT, ECONOMIC CONSTITUTION, *supra* note 40, nor that of Hamlin, *supra* note 45, are mentioned.

⁵⁰ See MAKING SENSE OF SUBSIDIARITY, *supra* note 11, at 9 (citing the impossibility of contracting for every contingency as an important difficulty in allocating control rights).

principal-agent relationship, need politicians and bureaucrats or governments as agents to provide them with some of the goods and services they desire. They can hire senior or junior governments. Two assumptions are basic to the decisions of principals. First, although central governments have the means to garner as much or more information about the preferences of citizens as have junior governments, they have only a weak incentive to collect that information.⁵¹ Second, although central governments can replicate, even exactly, the provision of goods and services undertaken by junior governments, they lack the incentive to do so.

The absence of incentive has, in both cases, a common root: the incompleteness of implicit (informal) or explicit (formal) contracts that citizens and governments must sign with each other if desired goods and services are to be forthcoming. Incompleteness means that some information which is possibly observable by the principals and the agents, is not verifiable by third parties and, as a consequence, cannot usefully be specified in the contract. One implication of this incompleteness is that even if citizens know that they have been made worse off by, for example, an overly uniform provision of a service by a senior government, it is not possible for them to appeal to the courts for redress. This is because the courts cannot conclude that citizens have been made worse off when the information is unverifiable. As a consequence, the provision of the service that made citizens worse off may "be subject to electoral review but not to judicial review."⁵²

Electoral review is available because the model assumes that it is possible—certainly easier—for residents of junior jurisdictions to control their local governments through the ballot box than for them to control their central government through the same device, thus making junior governments more accountable. To put the matter differently, citizens at the local level⁵³ can defeat

⁵¹ See Jacques Crémer et al., *The Decentralization of Public Services: Lessons from the Theory of the Firm*, in *DECENTRALIZATION INFRASTRUCTURE: ADVANTAGES AND LIMITATIONS* 107 (Antonio Estache ed., 1995) (arguing that central governments have the means to collect more information about preference than local governments can collect).

⁵² Seabright, *supra* note 11, at 64.

⁵³ These citizens must have roughly the same preferences. See *id.* at 67 n.10 ("[T]he assumption that localities can be characterized by a single welfare function can be thought of as implying that mobility has already played a part in

their local government at the ballot box if that government has not performed satisfactorily. However, if the central government has not performed to their satisfaction, these same citizens will not be able to prevail if that government can rely on the support of citizens in other jurisdictions who feel happy with the central government's performance.

It is this phenomenon which is said to deprive central governments of the incentive to collect information from citizens about their preferences and to diversify the supply of goods and services to satisfy these preferences. Put differently, junior governments are more effective than senior governments at gathering from citizens the information needed to make "good" decisions. While senior governments cannot credibly commit not to later use the information collected from citizens to the disadvantage of those same citizens, junior governments can so commit.⁵⁴ The point is illustrated with the example of prosperous localities willing to reveal their large taxable capacity to junior governments. If these governments use that information to levy "unacceptably high" taxes from them, the citizens of the prosperous localities will simply defeat these governments at the next election.⁵⁵

Conversely, the senior governments, not susceptible to electoral defeat by a single locality, cannot credibly commit never to use the knowledge of the locality's taxable capacity to levy "unacceptably high" taxes in the future. Electoral review begets the accountability of junior governments and insures that these governments are more accountable than senior governments. Accountability being a virtue, it follows that the provision of goods and services by governments should be decentralized.

There is a trade-off, however. Decentralization, as recognized for over a quarter of a century,⁵⁶ produces interjurisdictional spillovers such as those associated with consumption externalities and unexploited economies of scale.⁵⁷ Older approaches to decentrali-

sorting the population so that a reasonable degree of homogeneity of preferences characterizes single localities.").

⁵⁴ See MAKING SENSE OF SUBSIDIARITY, *supra* note 11, at 7, 41-43, 84.

⁵⁵ See *id.* at 7, 42 (noting that "decentralization allows voters in a locality to decide collectively to replace their government if they are dissatisfied with its performance").

⁵⁶ See generally MUSGRAVE, FISCAL SYSTEMS, *supra* note 14; Gordon Tullock, *Federalism: Problems of Scale*, PUB. CHOICE, Spring 1969, at 19.

⁵⁷ See OATES, FISCAL FEDERALISM, *supra* note 12, at 46-47; Breton, *Government Grants*, *supra* note 42, at 175-87.

zation⁵⁸ would argue, at this juncture, that junior governments should deal with these spillovers, cost permitting, through coordination. As expected, the contractual approach visualizes the relationship between junior governments engaging in coordination as built on a contract which is, again as a matter of necessity, incomplete. As a consequence, little intergovernmental coordination can be expected. In the contractual approach to decentralization, coordination is achieved through the centralization of powers and, therefore, is bought at the price of diminished accountability.

3.2. *A Critical Assessment*

Notwithstanding the contribution it makes to our understanding of the decentralization of governmental systems, the contractual model is led to very restrictive notions of accountability and coordination because it neglects the competitive nature of politics and of intergovernmental relations.

3.2.1. *Accountability*

While recognizing that in practice competition in politics and intergovernmental relations is often less than perfect, it must also be acknowledged that it is seldom absent.⁵⁹ Given that the analysis of polar cases usually facilitates the appreciation of the effects of any particular force, this Article assumes that politics and intergovernmental relations are genuinely competitive. Having made the assumption, it is no longer possible to hold the view that the actions of a central government in a particular locality will remain the private information of that government and of the citizens of that locality. For example, the proposition that

⁵⁸ See, e.g., BRETON & SCOTT, ECONOMIC CONSTITUTION, *supra* note 40.

⁵⁹ For example, Wittman argues correctly, in our view, that a significant volume of information is transmitted to voters by competing political entrepreneurs seeking the support of these voters. See DONALD A. WITTMAN, THE MYTH OF DEMOCRATIC FAILURE 10 (1995). If we follow this view, we have to accept that entrepreneurship will be more limited under coalition governments. Still, as others have been able to document, voters recognize the differential contribution of coalition members to the supply of goods and services and vote accordingly. See Arthur Schram & Frans Van Winden, *Revealed Preferences for Public Goods: Applying a Model of Voter Behavior*, 60 PUB. CHOICE 259, 280 (1989) (finding that Dutch voters imputed responsibility to a particular government party even when the party was part of a coalition). Competition, though diminished, is not extinguished.

senior governments cannot credibly commit not to use information (on, for example, taxable capacity) against citizens at some future date rests on the assumption that the "misuse" of the information never becomes public or common knowledge. If, indeed, the misuse of the information by senior governments was to become public, these governments could be severely damaged by the revelation. This alone makes it possible for senior governments to credibly commit not to misuse information and, therefore, to collect it.

Many students of Public Choice assume that collective choices are made at the ballot box and only there—the authors of the Report of the Centre for Economic Policy Research make the same assumption.⁶⁰ Because of this, the commitment mechanism they have constructed is based exclusively on voting. They failed to find a place in their model for the on-going competition between opposition politicians located *at all jurisdictional levels* and other governments of a given system. Nor do they find a place for the competition that derives from parliamentary debates, commissions of inquiry, investigative journalism, standing committees of legislative assemblies, the "question period" of parliamentary governments, freedom of information legislation, or from the competition based on the capacity of citizens—helped by the political media, by academics, and by other observers of the political scene—to observe what is happening in other jurisdictions.

If they had, they would have had to accept the view that the unsatisfactory performance of a central government can become public knowledge.⁶¹ They would then have had to recognize that that knowledge would, in turn, negatively affect the probability that citizens—at the limit, all citizens of the senior jurisdiction—would grant their consent or their votes to the central government. If we assume that this government maximizes expected consent (or, expected votes), the transformation of private information about the unsatisfactory performance of a central government in a particular locality (and of any senior government, such as a provincial or state government) into public information through the force of competition, must be seen as making that central government accountable.

⁶⁰ See, e.g., MAKING SENSE OF SUBSIDIARITY, *supra* note 11, at 42.

⁶¹ This argument is further developed in Section 4.2.

That argument can be formalized. Suppose that for the governing party (a), expected consent at time t is EC_{at} defined as the sum over all citizens (j) ($= 1, \dots, J$) of the probability π_{jt}^a that j will grant his or her consent to party a, namely $EC_{at} = \sum_j \pi_{jt}^a$ ($1 \geq \pi_{jt}^a \geq 0$). If π is a function of "bad news" (N), then $\pi_{jt}^a = f(N)$ with f continuous and twice differentiable. If $f_N^a < 0$ (i. e. bad news reduces the probability that j will grant her or his consent to a) and if $f_N^b > 0$ (i.e. if bad news increases the probability that j will grant her or his consent to the opposition party b), then the public revelation of unsatisfactory performance will make that information politically verifiable. If we assume that expected votes are proportional to EC, the argument holds for a model in which politics is restricted to voting. It is competition that begets accountability. Additionally, competition makes all governments accountable, whatever tier they inhabit.

3.2.2. Coordination

There are many contractual agreements aimed at securing coordination that are plagued by free-riding, cheating, hold-ups, and other problems of that sort which, to abbreviate, this Article will call "shirking." This plague arises because shirkers can expect to benefit from coordination without having to pay their share of the costs. Consequently, these contractual agreements have to be monitored, with sanctions imposed on the miscreants. As monitoring is costly, some shirking will remain in equilibrium, which undermines the initial contractual agreement and the coordination it is supposed to deliver. In this way, shirking robs agreements of their credibility. Additionally, coordination may be made more difficult if policies have different distributional implications. Still, contractual agreements are more likely to develop when the number of parties to an agreement is small (which facilitates trust among the parties),⁶² when policies are more precisely defined,⁶³ and when interjurisdictional spillovers are small and can be measured easily.⁶⁴

It must be recognized that in addition to the above, competition will motivate coordination or, to put it differently, will lead to less shirking. Suppose that the relations between governments

⁶² See MAKING SENSE OF SUBSIDIARITY, *supra* note 11, at 39, 135-37.

⁶³ See *id.* at 138-39.

⁶⁴ See *id.* at 136.

are competitive and that all governments maximize expected consent. Assume further that expected consent depends on the costs (C) at which goods and services are provided in such a way that when costs are lower, the expectation of consent is higher and vice versa. That is, if we re-write $f(\cdot)$ above as $\pi_{jt}^a = f(N, C)$ we have $f_C^a < 0$ and $f_C^b > 0$. Under these circumstances, given that monitoring is costly, shirking by a government will lead to a reduction in its expected consent. That government, as well as all the others in the system, therefore has an incentive not to shirk. Indeed, if the expected consent function is very sensitive to changes in the costs of goods and services, shirking may be all but extinguished.

As *The Federalist Papers* so well understood, intergovernmental competition can only be beneficial and lead to stable outcomes if it is regulated by an "umpire."⁶⁵ *The Federalist Papers* assigned the responsibility to act as umpire to central governments.⁶⁶ In terms of the problem under discussion, the cost of monitoring will be less when central governments umpire intergovernmental competition. Then, there will be more coordination. Properly umpired competition can therefore reduce and possibly eliminate shirking. That is the reason why we observe so much coordination in governmental systems.

Others make no such observation.⁶⁷ Their perception, as is to be expected, is colored by what is happening in the European Union, a governmental system in which intergovernmental relations are only moderately competitive and in which there is no effective umpire. The consequent difficulties of coordination through contractual agreement lead proponents of the contractual approach to advocate coordination through centralization. Why? Because when a power is centralized in the European Union, it is in effect assigned to the Council of Ministers.⁶⁸ The Council is responsible for coordinating the interests of the governments that

⁶⁵ THE FEDERALIST NO. 4, at 35 (Alexander Hamilton) (Random House 1937)

⁶⁶ See *id.*; see also George J. Stigler, *The Tenable Range of Functions of Local Governments*, in SUBCOMMITTEE ON FISCAL POL'Y, JOINT ECON. COMM., FED. EXPENDITURE POL'Y FOR ECON. GROWTH & STABILITY 213 (1957).

⁶⁷ See generally MAKING SENSE OF SUBSIDIARITY, *supra* note 11; Crémer et al., *supra* note 11; Seabright, *supra* note 11.

⁶⁸ It is true that the Commission has the power to propose and that the Parliament possesses the power of disallowance. Nevertheless, decisions ultimately rest with the Council of Ministers.

appoint them and, ultimately, the interests of the citizens of their respective countries.

However, this is not what generally happens in governmental systems, especially federal states. There, the exercise of a centralized power is void of any element of coordination. An example will illustrate: the decision of the American central government to create and maintain a military capability aimed at providing the country with national defense is free of coordination involving the states. That decision is not the result of a failure of cooperation among the states, since they continue to maintain their own militias. If centralization was an instrument of coordination, the state militias would have some role in the provision of national defense. They have none.

In general, setting the European Union aside, it is best to keep centralization and coordination separate. In addition, again for the general case, centralization requires neither coordination nor cooperation. It is simply the exercise by the central government of the powers that have been assigned to it. That kind of centralization cannot happen in Europe as long as the European Parliament has only a power of disallowance.⁶⁹ Centralization requires that genuine powers be assigned.

3.3. *Subsidiarity in the Contractual Model*

The burden of the foregoing critique of the contractual model of decentralization of governmental systems is that decentralization need not beget more accountability than centralization. Also, it is generally inappropriate to suppose that the internalization of spillovers requires centralization. As a consequence, if our critique is correct, the contractual model's trade-off between accountability and centralization, if it exists, is not reliable. Moreover, as it now stands, the contractual model does not embody an assignment mechanism—that is, the model does not incorporate a set of forces that compels a society's political and legal institutions to change the degree of centralization with respect to one power or another.

The view of the Report of the Centre for Economic Policy Research is that “subsidiarity is the specific claim that the burden of proof in the process of making this trade-off [between the claims of decentralization and those of centralization] should lie

⁶⁹ See EC TREATY art. 189 (c).

in favour of decentralization,"⁷⁰ and "that when in doubt, decentralization should be preferred."⁷¹ This principle

can therefore be interpreted as the expression of an essentially political judgement that good government is more likely to be under threat from failures of accountability than from failures of cooperation, and moreover that the kinds of distortion induced by these failures in accountability are of the kind that decentralization can help to alleviate⁷²

In hands as capable as those of the authors of the Centre for Economic Policy Research report, that view generates provocative and interesting analysis and conclusions.⁷³ It does not, however, tell us where, in a theory of decentralization of governmental systems, the principle of subsidiarity should be housed and it leaves unstated how the principle can be expected to play the role that the Report implicitly expects it to play.

4. THE COMPETITION MODEL

In the competition model of decentralization of governmental systems and of the assignment of powers to jurisdictional tiers, the costs and benefits of decentralization are in effect the costs and benefits of competition. Put differently, decentralization begets competition and, therefore, will only be desirable if the advantages of competition exceed its disadvantages. This Section first examines the benefits of competition and therefore of decentralization, and then looks at a mechanism through which decentralization generates competition. Third, this Section will describe how well functioning governmental systems deal with the inevitable costs of competition and therefore of decentralization. The Section will conclude with a brief look at often-mentioned alternative advantages of decentralization.

⁷⁰ MAKING SENSE OF SUBSIDIARITY, *supra* note 11, at 35.

⁷¹ *Id.* at 47.

⁷² *Id.*

⁷³ See *id.* at 47-49.

4.1. *Benefits*

Broadly speaking, there are three fundamental advantages to the competition which decentralization begets. First, competition facilitates the control and regulation of the exercise of political power.⁷⁴ Put differently, competition insures that politicians pursue the interests and the welfare of citizens. That is, of course, the traditional case for competition. In the marketplace, it serves to dampen and possibly eliminate the exercise of market power. In bureaucratic organizations, it is a major contributing factor in ensuring that subordinates pursue the interests of their superiors. There can be no doubt that this advantage of competition is very important for those who view the prime object of political activity as the welfare of citizens.

Competition produces other benefits. A second advantage is that competition generates assignments of powers that correctly reflect the relative efficiency of governments inhabiting different jurisdictional tiers in providing the goods and services (including redistribution) that citizens desire. Competition, in other words, assigns supply responsibilities in such a way that the production, distribution, and other costs of providing goods and services are minimal. Furthermore, as Breton has shown, competition leads to an assignment of powers that minimizes organizational costs,⁷⁵ exactly as a Breton-Scott constituent assembly would do if one could be put in place.⁷⁶ The optimality character of that assignment is now recognized.⁷⁷ In sum, competition is an efficient "automatic" assignment mechanism.

In international commerce, the specializations dictated by comparative efficiency are often impeded by tariffs, quotas, and other barriers to trade. The same is true in governmental systems. There too, barriers of various sorts can be erected to block the emergence of beneficial assignments or reassignments for

⁷⁴ This notion played a central role in the debates of the founding fathers of the American Republic, dominating the thinking of the authors of *The Federalist Papers*. See, e.g., THE FEDERALIST NO. 4, *supra* note 65; see generally GEOFFREY BRENNAN & JAMES M. BUCHANAN, THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION (1980) (re-energizing the notion).

⁷⁵ See ALBERT BRETON, COMPETITIVE GOVERNMENTS: AN ECONOMIC THEORY OF POLITICS AND PUBLIC FINANCE 196-227 (1996) [hereinafter BRETON, COMPETITIVE GOVERNMENTS].

⁷⁶ See BRETON & SCOTT, ECONOMIC CONSTITUTION, *supra* note 40.

⁷⁷ See Inman & Rubinfeld, *supra* note 41, at 96-101.

which competition calls. This is an area that has barely been studied and which begs for scholarly attention.

A third benefit of decentralization and of the competition it provokes is that jurisdictional tiers or levels will develop whenever such creations can produce reductions in the costs of supplying goods and services; old tiers will be jettisoned when that leads to cost reductions. In a competitive governmental system, one therefore expects to find groupings of two, three, or more provinces or states whose purpose is the internalization of externalities and/or the exploitation of economies of scale. One also expects to find various types of "special authorities" created to deal with certain goods and services whose efficient provision requires special administrative arrangements. These tiers and "mini-tiers" are ubiquitous features of all governmental systems and are not the product of constitutional dictates or of legal necessity. Rather, they are the product of competition.

It may be noteworthy that even if one does encounter tiers of all sorts in other models of decentralization, they exist in these models, as Brennan and Buchanan have correctly indicated, in the absence of rationality.⁷⁸ The conventional and contractual models tell us that there are advantages to decentralization. However, they are silent on the number of tiers that exist and therefore silent on the extent to which governmental systems will or should be decentralized.

4.2. *Intergovernmental Competition*

At the outset, one must recall that competition in governmental systems organizes itself along two axes—horizontal and vertical. The first type of competition regulates the behavior of governments located at the same jurisdictional tier: national governments internationally, provincial or state governments nationally and internationally, and so on through the whole hierarchical structure. The second type controls the behavior of governments inhabiting different jurisdictional tiers.

Before addressing the question of what drives competition, we must consider the "objects" on which it focuses. Vertical competition, like horizontal competition, pertains to the supply of goods and services (including redistribution). In other words, governments compete among themselves to provide the quantity

⁷⁸ See BRENNAN & BUCHANAN, *supra* note 74, at 174-75.

and quality of goods and services desired by citizens at the lowest possible tax prices, namely tax prices that correctly reflect the marginal social costs of supply.

Given the near impossibility of Tiebout mobility in governmental systems in which there are three or more tiers and given the prevalence of such systems in reality, we assume, in order to simplify, that fiscal mobility does not exist.⁷⁹ It follows that competition cannot have its origin in mobility. However, Pierre Salmon has suggested an alternative mechanism which can motivate competition.⁸⁰ On strictly *a priori* grounds, it seems reasonable to hold to the view that even in two-tier governmental systems (which, again, are virtually non-existent) the mechanism proposed by Salmon is at least as, if not more, powerful than the Tiebout mechanism.

The Salmon mechanism is an application of the theory of rank-order tournaments in labor markets to intergovernmental relations.⁸¹ The basic idea underlying the theory is that if the costs to an employer of measuring the effort exerted by workers is high, if the costs of measuring the productivity of one worker relative to the productivity of another worker is low compared to the costs of measuring the absolute productivity of workers, and if productivity is a random variable, then by setting up a tournament, an employer makes it attractive for each worker to increase the probability of winning the larger prize by exerting more effort.

To be able to apply the theory to intergovernmental relations in a world in which mobility has been ruled out, Salmon postulated that citizens assess their government's performance by comparing it to that of governments in other jurisdictions.⁸² He was able to show that these assessments generate competition between governments for rank order on some ordinal scale or scales. Because of performance comparisons,

⁷⁹ This is a more restrictive assumption than necessary because even in three-tier governmental systems, capital, being fungible, is mobile. However, weakening the assumption simply reinforces the case for decentralization based on competition.

⁸⁰ See Pierre Salmon, *The Logic of Pressure Groups and the Structure of the Public Sector*, 3 EUR. J. POL. ECON. 55, 55-86 (1987).

⁸¹ See Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841, 841-64 (1981).

⁸² See Salmon, *supra* note 80, at 32.

[e]ach government has an incentive to do better than governments in other jurisdictions in terms of levels and qualities of services, of levels of taxes or of more general economic and social indicators. The strength of this incentive depends on the possibility and willingness of citizens to make assessments of comparative performance—and [on] the impact these assessments have on the well-being of politicians.⁸³

As is the case with labor market tournaments in intergovernmental tournaments, the relationship between the effort of public sector actors and their reward, although always stochastic, is stronger if random disturbances affect all participants in the contest.

The Salmon mechanism, in other words, reveals that if citizens use information about the goods and services supplied in other jurisdictions as a benchmark to evaluate the performance of their own governments, and if they decide to grant consent (or votes) to their governing politicians or to withhold it from them on the basis of that assessment, governments in different jurisdictions will compete with one another. That competition will persist as long as there is electoral competition within jurisdictions.

The Salmon mechanism, independently rediscovered and empirically tested for certain taxes by Timothy Besley and Anne Case,⁸⁴ was developed with horizontal competition in mind.⁸⁵ The above succinct summary of the mechanism carefully outlined it with the two broad types of competition in focus, for indeed, it motivates vertical as well as horizontal competition. In that particular application, the mechanism provides incentives for governments located at a given jurisdictional tier to occupy or be ready to occupy all or a part of the powers that are assigned to governments located at different tiers.

⁸³ See Pierre Salmon, *Decentralization as an Incentive Scheme*, 3 OXFORD REV. ECON. POL'Y 24, 32 (1987).

⁸⁴ See Timothy Besley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition*, 85 AM. ECON. REV. 25 (1995).

⁸⁵ See BRETON, *COMPETITIVE GOVERNMENTS*, *supra* note 75, at 235-37 (arguing that the Salmon mechanism also provides a rationale for the documented logistic curve that public policies trace, over time, as they diffuse from one junior jurisdiction to another).

It should be emphasized that the actual or potential occupation of the powers of another tier is not a prerogative of one particular level of government. All governments, whatever tier they inhabit, will move to occupy a power or part thereof if they believe they can do better for “their” citizens than can the current holder of the power. Put differently, governments will occupy a power or a part of a power if they believe that they can provide citizens with the same quantity and quality of a good or service at a lower tax price, or if they think that at the prevalent tax price they can better match the quantity and the quality of a good or service than that offered by the current holder.

As a result, in real world governmental systems there exists a volume of actual and potential “overlap” and “duplication” despite the incessant efforts to eliminate them. When competition is recognized as the only force available to discipline behavior in the public domain, deregulation will be introduced in politics as a consequence, much as it has in some markets over recent decades. Then, there will be a significant increase in actual and potential overlap and duplication, as there has been in markets which have been deregulated.

4.3. *Regulating Intergovernmental Competition*

To produce stable outcomes, intergovernmental competition—like competition in other contexts—must comply with certain rules. In the marketplace, the rules that regulate competition define property rights. These rights, in turn, are enforced through the courts. In intergovernmental competition, the rules are also in the nature of property rights. An Article concerned with the principle of subsidiarity need not spell them out.⁸⁶ What is significant, however, is the fact that in governmental systems, the central governments must monitor and enforce the rules. Consequently, at the same time that central governments compete with junior governments in the provision of goods and services, they are responsible for implementation of the rules that insure orderly competition.

Federal governmental systems have resolved this inherent conflict of interest by designing central governments so as to represent the interests and preoccupations of junior governments and jurisdictions *qua* governments and jurisdictions in the institu-

⁸⁶ See *id.* (discussing these rules).

tional fabric of central governments. Whenever central governments are not designed to guarantee this kind of representation, competition can generate unstable outcomes. Because of this, the advantages of decentralization can be less than they otherwise could be.

4.4. *A Digression*

This Article has not yet addressed those alleged consequences of decentralization that the fiscal federalism literature treats as important virtues. Among them are an alleged greater responsiveness of junior (compared to senior) governments to the preferences of citizens, an alleged superiority of junior governments in collecting information about the preferences and other relevant circumstances of citizens, and an alleged greater propensity of junior governments to innovate. This Article agrees that these consequences, if they exist, are virtues of decentralization.

Earlier, this Article argued that the proposition that junior governments are superior in collecting information was tenable only upon the assumption that politics and intergovernmental relations were not competitive. The same is true of the other two propositions listed in the last paragraph. While numerous examples illustrate that junior governments are more responsive to the preferences of citizens than senior governments, other, equally viable examples show the opposite.⁸⁷

It is difficult, however, to dismiss the view that responsiveness is bred by competition. In politics, as in the marketplace, "the best of all monopoly profits is a quiet life."⁸⁸ If, for any reason, vertical competition is weak while horizontal competition is strong, junior governments should be more responsive than senior governments to the preferences of citizens. If vertical and horizontal competition are both vigorous, governments at all levels will be equally responsive.

⁸⁷ Senior governments are often more responsive than junior governments to citizen preferences because senior governments are large enough to take into account spillovers that citizens wish the government to deal with and, due to economies of scale in production, to reduce production costs. Additionally, politicians at the senior level have greater incentives to respond to citizen preferences, as the costs of electoral defeat are often larger for such politicians.

⁸⁸ J.R. Hicks, *Annual Survey of Economic Theory: The Theory of Monopoly*, in READINGS IN PRICE THEORY 361, 369 (George J. Stigler & Kenneth E. Boulding eds., 1952).

Note that the intuition behind the assertions found in the fiscal federalism literature is, at least to a degree, correct. Indeed, given that competition derives from decentralization, it is fair to adhere to the view that decentralization begets responsiveness. However, in the absence of competition, there is nothing that would induce governments located at lower tiers of the hierarchy of governmental systems to be responsive. The same kind of reasoning can be applied, *mutatis mutandis*, to the alleged greater propensity of junior governments to innovate.

5. THE PRINCIPLE OF SUBSIDIARITY

To properly understand the principle of subsidiarity, one must appreciate the institutional context in which the principle has officially been inserted in the historical development of the governmental system of Europe. In the background, there was and still is the interpretation by the European Court of Justice, accepted by the courts of all Member States, that in cases of conflict between European law and national laws, the former would have predominance over the latter, making the former a powerful centralizing force.⁸⁹ In addition, and of key importance, there are the rules governing the decisions of the Council of Ministers introduced in the Single European Act of 1987.⁹⁰ By replacing unanimity in a whole range of issues, these new decisionmaking rules are conducive to centralization, a tendency that in all likelihood will be exacerbated when and as new members join the Union. Finally, by declaring that the European Union should accord a place to what it calls the second and third pillars, the Treaty of Maastricht itself opened the door to further centralization.⁹¹

The second pillar concerns a common foreign and security policy. According to *Epoque*, the documentary database of the European Parliament, the policy “will include all questions related to the security of the Union, including the eventual framing of a common defence policy—which might in time lead to a

⁸⁹ See Case 106/77, *Amministrazione Delle Fianze Dello Stato v. Simmenthal*, 3 C.M.L.R. 263 (E.C.J. 1978) (holding that European Community law invalidates conflicting national laws of member states).

⁹⁰ See Single European Act, tit. II, 1987 O.J. (L 169) 1, [1987] 2 C.M.L.R. 741 (1987)

⁹¹ See TREATY ON EUROPEAN UNION, Feb. 7, 1992, tits. V, VI, O.J. (C 224) 1 (1992), [1992] 1 C.M.L.R. 719 (1992).

common defence.”⁹² This, the document adds, will require “systematic cooperation between Member States.”⁹³ The third pillar is no less impressive. It pertains to justice and home affairs and is defined by *Epoque* to cover “border-related issues such as a policy on asylum, immigration, conditions of entry and movement, residence, illegal immigration and work” as well as “cross-border criminal issues such as drugs, terrorism, fraud, and legal cooperation on civil law, criminal law and customs.”⁹⁴

In addition, one must keep in mind that the European Union, as a governmental system, remains an incomplete democratic system and that, as a consequence, competition operating within its confines does not always dictate efficient assignments. The “democratic deficit” which is on every European’s lips is rooted in the weakness of the European Parliament—in the fact that that Parliament has a power of disallowance but no genuine constitutional powers, in the sense of authority to legislate autonomously in domains like foreign affairs, defense, and immigration. This lack of powers most likely leads to more centralization or harmonization than if the government in Strasbourg had more powers. The paradox of Europe is that the refusal of Member States to assign more powers to the European Parliament—Europe’s potential central government—means that the system is more centralized than it would be otherwise.

Since the signing of the Treaties of Paris and Rome, much centralization of powers has taken place in Europe, and a genuine European governmental system has been created. In such a context, the principle of subsidiarity, as formulated in the Treaty of Maastricht, must be seen as an efficient response by the governments of Member States to unshackle and redirect the forces of competition as they impinge on the assignment of powers.

In other words, the principle of subsidiarity must be understood to be a part of the political-legal-constitutional machinery which implements the assignments and reassignments called for by the competition that drives assignment mechanisms. In that capacity, the principle has already begun to be used as an instrument to attack and eventually bring down the barriers that cur-

⁹² *The European Union and the Viewpoint of the European Parliament* (visited Jan. 28, 1998) < <http://dylec.keel.econ.ship.edu/intntl/intfin/epsheets.htm> >.

⁹³ *Id.*

⁹⁴ *Id.*

rently prevent some efficient reassignment of powers. The principle has empowered junior governments in their competitive struggle with senior governments by getting political-legal-constitutional institutions to acknowledge the greater relative efficiency of junior governments in certain domains and to implement the decentralization mandated by this relatively greater supply efficiency.

Local governments within Member States are currently using the principle of subsidiarity to deal directly with the European Union in seeking the decentralization, to local jurisdictions, of powers or of parts of powers that are currently assigned to Brussels.⁹⁵ These same local governments are also beginning to use subsidiarity to obtain more devolution within Member States.⁹⁶ Additionally, subsidiarity has affected assignments between Member States and the Council of Ministers. Over time, one must expect the "real" constitution of Europe to reflect the influence of this decentralizing principle in a marked way.

6. CONCLUSION

This Article has surveyed a number of approaches to the decentralization of governmental systems, while trying at all times to identify two things: first, the benefits of decentralization, and second, an appropriate niche for the principle of subsidiarity, a niche that would provide it with a useful meaning and a significant role in a coherent theory of decentralization.

This Article has been critical of the conventional approach to decentralization, arguing that it provides no ground for thinking that decentralization is beneficial. This Article has also argued that the more recent contractual approach, because it is constructed on a much too restrictive conception of politics, is also wanting. Finally, this Article has argued that an approach which equates the virtues of decentralization with those of competition permits an appreciation of the true benefits of decentralization while at the same time providing a natural habitat for the principle of subsidiarity.

⁹⁵ See Rodney A.W. Rhodes, *THE EUROPEANISATION OF SUB-CENTRAL GOVERNMENT: THE CASE OF THE UK*, in *STAATSWISSENSCHAFTEN UND STAATSPRAXIS* 272-86 (Vol. 2, No. 3. Jahrgang, 1992).

⁹⁶ See *id.*

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