

# Democracy by Competition: Referenda and Federalism in Switzerland

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*Competition is not only a prerequisite for the successful working of economics but also of political coordination systems. We argue that popular referenda and federalism are the key factors in maintaining competition in the political arena. Competitive economic or political markets require free entry and exit and the absence of regulations that prevent suppliers from being successful with the best product—be it goods or services in the form of policies—and prevent citizens from choosing freely.*

The democratic process<sup>1</sup> is based on the same criterion as the market process, namely, that only the individual person's preferences are to count. It is not a benevolent dictator, nor an expert, nor a politician who should decide what is good or bad, but the citizens themselves. Thus, assuming that citizens are the principals and politicians are their agents, the extent to which shirking occurs and, in particular, how far legislators pursue their own goals instead of following their electors' preferences, is an important question. Also assuming that the economists' normative base—methodological individualism—remains valid when leaving the marketplace and entering the political sphere, then competition must be the answer to the question of how people's wishes can best and most effectively be represented and coordinated in the public sphere.

However, neither for the economy nor the polity does it make sense to analyze an unreachable ideal,<sup>2</sup> namely, a fully competitive market without any externalities, information asymmetries, or monopolies. What counts is the relative efficiency of a decisionmaking system—in this case, of a direct democracy compared to a representative system and of federal decisionmaking compared to centralism.

Even though this article builds on the "Swiss experience" with referenda and

<sup>1</sup>Democracy is not concerned with end states but is a process by which rules are developed and decisions are taken: Norman P. Barry, "The Invisible Hand in Economics and Politics," *Hobart Paper*, no. 111 (London: Institute of Economic Affairs, 1988).

<sup>2</sup>Harold Demsetz, *Efficiency, Competition and Policy* (Oxford: Blackwell, 1989).

federalism, it suggests that the observations made for Switzerland are of great importance for all democracies.<sup>3</sup> Referenda as a means of breaking the cartel of the *classe politique* (political class) are discussed in the first section. The arguments against referenda put forward by many political scientists are taken into account. The section following provides an overview of the implications of federalism for policymaking in Switzerland and stresses the close link between the two institutions. Without different subunits competing, referenda tend to degenerate into simple plebiscites, which are initiated by the politicians in power only if they are advantageous to them.

### REFERENDA

Popular referenda have proven to be very successful in Switzerland for fighting restraints on competition in the political market. We will elaborate on two possible market failures: monopolies (or cartels) and information problems. Externalities are not discussed here because they do not depend on the directness of a democracy, but will be examined in the next section.

#### *Referenda Against Politicians' Cartels*

Building on rent-seeking theory, it is argued that representatives have a common interest in forming a cartel to protect and possibly extend political rents.<sup>4</sup> Referenda and initiatives are means to break the politicians' coalition against the voters. Initiatives require a certain number of signatures and force a referendum on a given issue. They are a particularly important institution because they take the agenda-setting monopoly away from the politicians and enable outsiders to propose issues for democratic decision, including those that many elected officials might have preferred to exclude from the agenda. As has been shown in public choice theory,<sup>5</sup> the group determining which propositions are voted on and in what order has a considerable advantage, because it decides to a large extent which issues will be discussed when, and which ones will be left out.

Referenda, obligatory or optional, enable the voters to state their preferences to the politicians more effectively than in a representative democracy. In a representative system, deviating preferences can only be expressed by informal protests, which are difficult to organize and make politically relevant. If no immediate action is taken, voters have to wait until election time, when they will still find it difficult to express specific demands on substantive issues. In a direct democracy, however, citizens may regularly participate in political decisions. In Switzerland, for example, over the past 150 years, there were 147 obligatory referenda (on constitutional issues) and 103 optional referenda (on laws); over the past 100 years (the

<sup>3</sup>See also Andre Eschet-Schwarz, "The Role of Semi-Direct Democracy in Shaping Swiss Federalism," *Publius: The Journal of Federalism* 19 (Winter 1989): 79-106.

<sup>4</sup>The literature on rent-seeking was developed by Gordon Tullock, "The Welfare Costs of Tariff, Monopolies and Theft," *Western Economic Journal* 5 (June 1967): 224-232; James M. Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Towards a Theory of the Rent-Seeking Society* (College Station: Texas A&M University Press, 1980); and surveyed by Robert D. Tollison, "Rent-Seeking: A Survey," *Kyklos* 35 (1982): 575-602.

<sup>5</sup>Arthur T. Denzau, "Constitutional Change and Agenda Control," *Public Choice, Carnegie Papers on Political Economy* 47 (1985): 183-217.

initiative was instituted in 1891), there were 104 initiatives. These figures refer to the federal arena only<sup>6</sup>; in the cantonal and communal arenas, there have been thousands more.

A recent referendum made it clear that the political elite's interests do not always correspond with voters' preferences. In September 1992, the citizens of Switzerland turned down two proposals seeking to increase substantially the salaries and the staff of Swiss members of Parliament. Both issues would have become law without Swiss voters taking the optional referendum, and both issues would clearly have been to the benefit of the elected officials.

It seems obvious that while politicians may try to secure benefits for themselves, taxpayers are not always ready to pay for such expenses. Privileges, however, do not always appear in the form of direct income for the representatives, but may also result in higher status or prestige.<sup>7</sup> Many more telling pieces from democratic history in Switzerland could be adduced here.<sup>8</sup> Interesting examples are two referenda on Switzerland joining international organizations or agreements: the United Nations in 1986 and the European Economic Area in 1992.

Both proposals were rejected by the citizens, even though the political elite strongly supported them. These referenda were universally supported by all major political parties; all pressure groups, including both employers and trade unions; a huge majority of the members of Parliament; and the executive branch. However, the popular referendum on Switzerland joining the United Nations resulted in a rejection by 76 percent of the voters; on 6 December 1992, 50.3 percent of the population and a majority of the cantons (sixteen out of twenty-three) voted against Switzerland becoming part of the European Economic Area. This clear rejection by the federal units induced a broad public discussion of the merits of the federal system in Switzerland where not only the majority of the population but also of the cantons is required to adopt a proposal.

These two examples of the citizens voting differently than the public officials in power are not exceptions: In 39 percent of the 250 referenda held in Switzerland between 1948 and 1990, the will of the majority of the voters differed from the opinion of the Parliament. Thus, in a representative system, the decision by the Parliament would have deviated from the people's preferences in 39 percent of all cases where referenda were held.

Econometric cross-section studies for Switzerland,<sup>9</sup> moreover, reveal that politi-

<sup>6</sup>Bundesamt für Statistik (Federal Office for Statistics), ed., *Statistisches Jahrbuch der Schweiz* (Statistical Yearbook on Switzerland) (Zürich: NZZ-Verlag, 1992), p. 354.

<sup>7</sup>Empirical evidence for the extent of rent appropriations by the German politicians is provided by Hans H. von Arnim, *Die Partei, der Abgeordnete und das Geld* (The Party, the Representative, and Money) (Mainz, Germany: v. Hase & Koehler, 1991).

<sup>8</sup>For more examples see Charles B. Blankart, "A Public Choice View of Swiss Liberty," pp. 83-95.

<sup>9</sup>Werner W. Pommerehne, "Institutional Approaches to Public Expenditure: Empirical Evidence from Swiss Municipalities," *Journal of Public Economics* 9 (April 1978): 255-280; Werner W. Pommerehne, "The Empirical Relevance of Comparative Institutional Analysis," *European Economic Review* 34 (May 1990): 458-469; Gebhard Kirchgassner and Werner W. Pommerehne, "Evolution of Public Finance as a Function of Federal Structure: A Comparison Between Switzerland and the Federal Republic of Germany" (Paper presented at the 46th congress of the International Institute of Public Finance [IIPF], Brussels, Belgium, 1990); and Bernard Steunenberg, "Referendum, Initiative, and Veto Power: Budgetary Decision Making in Local Government," *Kyklos* 45 (1992): 501-529.

cal decisions with respect to publicly supplied goods correspond better with the voters' preferences when the institutions of direct political participation are more extensively developed. Because it is the individual taxpayers and not the elected officials per se who have to bear the costs of government activities, it is not surprising that public expenditures are *ceteris paribus* lower in communities where the taxpayers themselves can decide on such matters.

Taxpayers, however, do reward politicians' performance by a high tax morale if they are satisfied with policies in their community. This can be shown for Swiss cantons, which have differing institutional options for citizens' political participation.<sup>10</sup> In some cantons, referenda and initiatives can be taken on virtually all issues, whereas others grant these options only on special issues and under special conditions or rely completely on the institutions of representative democracy. It has been econometrically shown that the more direct democratic institutions are, the less tax cheating takes place. Compared to the mean of all cantons, almost 8 percent (that is, about Sfr. 1.600 per taxpayer per year) less income was concealed in cantons with a high degree of direct political influence. In contrast, in cantons with a low degree of direct participation possibilities and, therefore, low tax morale, the mean income undeclared exceeded the mean for all cantons by roughly Sfr. 1.500.

Rexford Santerre used the price of land as an indicator for individuals' demand to live in a certain community.<sup>11</sup> His findings support the hypothesis that the more developed the direct participation options in a jurisdiction, the more people are attracted to it (i.e., the higher the willingness to pay and thus the price of land).

Referenda do, however, not only serve to break up the politicians' coalitions by destroying their monopoly on agenda-setting, but they also induce more competition in yet another respect: They provide information and stimulate communication.

#### *Referenda Against Information Asymmetries*

In economic research on politics, the process which takes place before casting the vote has been almost completely neglected.<sup>12</sup> Economics is the science of choice, a choice between known alternatives. These alternatives, however, have been shaped and defined by a process of verbal exchange.<sup>13</sup> This discourse among the citizens puts new issues on individuals' agendas, raises their perception, and communicates the arguments in the media. It offers information free of charge—information that is not only relevant to the issue in question but also to an evaluation of the performance of politicians, parties, and interest groups.

In order to be able to judge the relevance of the outcome of a referendum for one's

<sup>10</sup>Werner W. Pommerehne and Bruno S. Frey, "The Effects of Tax Administration on Tax Morale" (Paper presented at the Conference on Tax Administration and Tax Evasion of the International Seminar in Public Economics [ISPE] at El Escorial, Spain, June 1992).

<sup>11</sup>Rexford E. Santerre, "Representative Versus Direct Democracy: A Tiebout Test of Relative Performance," *Public Choice* 48 (1986): 55-63.

<sup>12</sup>See, e.g., the survey by Dennis C. Mueller, *Public Choice II* (Cambridge, England: Cambridge University Press, 1989).

<sup>13</sup>For the relevance of communication in democracies, see John S. Dryzek, *Discursive Democracy: Politics, Policy, and Political Science* (Cambridge, England: Cambridge University Press, 1990).

own life as well as to evaluate decisionmakers' behavior, citizens need to know the working properties of alternative rules. As Victor Vanberg and James Buchanan put it: Individuals must have "constitutional theories."<sup>14</sup> "A person's constitutional theories are about matters of fact. They are his predictions (embodying assumptions and beliefs) about what the factual outcomes of alternative rules will be."<sup>15</sup>

Besides information, communication may also enhance people's willingness to accept the decisions made by a referendum. They feel more responsible for whatever the result of the referendum may be because the process and the rules made them part of the decision. In a representative system, however, it is not difficult to shift the responsibility onto the actual decisionmakers, the politicians. As was pointed out for the European Community (EC), the more removed the agents are from the principals, the easier it is to pass the buck to someone else.<sup>16</sup> Thus, the very indirect system of the EC makes it easy for national politicians to blame the commission for any decision that may endanger their reelection. (This commission created in 1957 by the Treaty of Rome, whose primary task is to initiate policies and implement those already agreed upon, is the supranational and bonding element composed of nine members appointed for renewable four-year terms by the national governments.) This means, however, that the EC can make even more decisions that do not represent the will of the people than is the case within the national arena.

Friedrich Hayek called the market a discovering mechanism.<sup>17</sup> The same could be said about discourse. By talking to one another, people discover the means of fulfilling their preferences. By relating to other people's positions, they find out where they stand. In economic terms, it could be said that communication changes the production function to fulfill individuals' preferences.<sup>18</sup>

The Swiss experience shows that people's demand for discussion varies, depending on the importance of the issue in question. Some referenda motivate intensive and far-reaching discussions that lead to a high rate of voter participation (e.g., the proposal to join the European Economic Area witnessed a participation rate of 79 percent, though the average turnout between 1985 and 1992 was only 42 percent). Referenda considered to be of little importance by the voters engender little discussion and low participation (as low as 25 percent). This variability in the intensity of discussion and participation overrides the much studied "paradox of voting."<sup>19</sup>

<sup>14</sup>Viktor Vanberg and James M. Buchanan, "Interests and Theories in Constitutional Choice," *Journal of Theoretical Politics* 1 (January 1989): 49-62.

<sup>15</sup>*Ibid.*, 52.

<sup>16</sup>Roland Vaubel, "A Public Choice Approach to International Organization," *Public Choice* 51 (1986): 39-57.

<sup>17</sup>Friedrich A. Hayek, "Competition as Discovery Procedure," *New Studies in Philosophy, Politics, Economics and the History of Ideas*, ed. Friedrich A. Hayek (London: Routledge & Kegan Paul, 1978).

<sup>18</sup>George J. Stigler and Gary S. Becker, "De Gustibus Non Est Disputandum" (Matters of Taste Are Not Debatable), *The American Economic Review* 67 (March 1977): 76-90.

<sup>19</sup>Gordon Tullock, *Towards a Mathematics of Politics* (Ann Arbor: University of Michigan Press, 1967) and William H. Riker and Peter C. Ordeshook, "A Theory of the Calculus of Voting," *American Political Science Review* 62 (March 1968): 25-42.

Even though a political decision is formally taken by a referendum, the issue in question does not disappear from public discourse after citizens have cast their vote. The referendum clearly reveals how the citizens feel and who and how large the minorities are. Groups dissenting from the majority are identified; their preferences become visible and part of the political process. A post-referendum adjustment process to please the losers is often observed.

Switzerland again provides a suitable example. In 1989, a popular initiative demanded that the Swiss army be completely dismantled. To many Swiss, this was considered an attack against one of the most essential, almost sacred institutions of the country. The *classe politique* was again solidly against the proposal, and the generals threatened to retire if the initiative was not overwhelmingly rejected. (They expected a share of no-votes close to 90 percent.)

The referendum outcome was surprising to almost everyone. One-third of the voters (and a majority among the young voters eligible for service) voted for the dissolution of the army. After a short period of shock, several parties suggested changes in the army to make this institution more acceptable among the population. These changes, which were considered impossible to achieve before the referendum, were put into effect within a short time. A major innovation—the introduction of a substitute to regular service in the army, which, by then, had been mandatory for all Swiss men—had been rejected in several referenda before, the last time in 1984 with a rejection rate of 64 percent. This change of individuals' preferences seems to have been induced by the discourse that accompanied the previously hotly discussed referendum on the dissolution of the army.

#### *Criticism of Referenda*

Democracy is not concerned with end states; solutions are not simply adopted, but developed. In the course of the direct democratic process, information is produced and preferences are shaped—in the sense that the voters are confronted with political issues they have not considered before, and which they learn to evaluate according to their basic values. Skeptics, however, worry about the intellectual capability of the citizens to cast votes on complicated, technical issues.<sup>20</sup> This task, they argue, should be left to an elite.<sup>21</sup>

Following the individualistic view and taking individuals' preferences as the normative base for evaluation, such a charge is unacceptable. Compatibility with the citizens' preferences is valued higher than any possible technocratic brilliance. The voters, moreover, need not have detailed knowledge on the issues, but rather on the main questions at stake. These, however, are not of a technical nature but involve basic decisions (i.e., value judgments), which a voter is as qualified to make as a politician. It has even been argued that politicians are a group particularly ill-

<sup>20</sup>Direct and representative democracies are compared by Thomas E. Cronin, *Direct Democracy: The Politics of Initiative, Referendum and Recall* (Cambridge, Mass.: Harvard University Press, 1989); and David B. Magleby, *Direct Legislation: Voting on Ballot Propositions in the United States* (Baltimore, Md.: Johns Hopkins University Press, 1984).

<sup>21</sup>For criticism of the Swiss system see Hans Peter Hertig, "Volksabstimmungen" (Referenda), *Handbuch des politischen Systems der Schweiz* (Handbook of Political Systems in Switzerland), ed. Ulrich Kloti (Bern, Switzerland: Haupt, 1984), 2:247-277.

equipped to make such decisions because, as professionals, they spent most of their life in sessions and commissions, and meetings and cocktail parties, and therefore know much less about reality than ordinary people.<sup>22</sup>

This argument only holds, of course, if voters are given the opportunity to make their choices seriously. As has been pointed out for California, this is not always the case: "Last November any Los Angelano voter was allotted ten minutes in the ballot booth to make over forty different electoral choices, varying from statewide propositions to local judgeships; in 1990 the total was over 100."<sup>23</sup>

Such obviously ineffective institutions, however, not only keep a direct democracy from functioning effectively but also prevent voters from making serious "electoral choices" and, thus, might even lead to worse outcomes in a representative democracy. It is, furthermore, not clear why the citizens are trusted to be able to choose between parties and politicians in elections but not between issues in referenda. If anything, the former choice seems to be more difficult because electors must form expectations about politicians' actions in the future.

It is not argued here that there is no room for a political elite, for a parliament, and a bureaucracy in a democracy. They are indispensable to provide information, work out the details, and assess the consequences of the various political issues at hand. This technical expertise of the representatives must be weighed against the human competence of the citizens—a process which seems to have led to a recent trend in Europe: Important political issues are referred to the population even in representative democracies. This can be witnessed by the popular referenda on entry into the European Community held in the Scandinavian countries and the United Kingdom, or on the Maastricht Treaty in Denmark, France, and Ireland.

Critics also point out that well organized interest groups might utilize direct democratic procedures for their own benefits. It cannot be denied that financially potent parties and pressure groups are better able to start initiatives and to engage in referendum propaganda than poor and nonorganized interests. Again, there is no sense in having the impossible aspiration creating a totally egalitarian democracy where every citizen is a citizen-legislator.<sup>24</sup> Of course, there remain disparities in individuals' and groups' capacities to influence the direction of government. It is always true that rich and well organized groups wield more power.

The important question, however, is not if there are any disparities, but under which institutional arrangements or rules, organizational and financial advantages play a more important role. We argue that lobbying is more successful, the less democratic a system is, because even with no elections, as in dictatorships, interest groups do have channels of influence.<sup>25</sup> For the European Community, it is argued

<sup>22</sup>Hans Magnus Enzensberger, "Erbarmen mit den Politikern" (To Have Mercy with Politicians), *Frankfurter Allgemeine Zeitung* (Frankfurt General Newspaper), 9 November 1992, p. 18.

<sup>23</sup>"Government in California: Buckling Under the Strain," *The Economist*, 13 February 1993, pp. 19-22.

<sup>24</sup>The argument for a unitary democracy is presented in Jane J. Mansbridge, *Beyond Adversary Democracy* (New York: Basic Books, 1980).

<sup>25</sup>Bruno S. Frey and Reiner Eichenberger, "The Political Economy of Stabilization Programmes in Developing Countries," *Technical Papers*, vol. 59 (Paris: OECD Development Centre, 1992).

that pressure groups are able to exert more power than in the former nation-states exactly because the EC is less democratic than its member states.<sup>26</sup> On the other hand, the experience of Switzerland shows that even if pressure groups and the political class are united, they cannot always have their way, particularly on important issues.

### FEDERALISM

Federalism is the other important institution that serves to establish competition within the political arena.<sup>27</sup> Federal competition provides for the third possible market failure in politics—political externalities. These are costs that develop for the general population if certain groups are able to appropriate the benefits of a publicly supplied good but do not have to pay the price for it. These groups may be the politicians and the bureaucrats who are seen as self-interested rent-seekers<sup>28</sup> or special interest groups that try to “capture”<sup>29</sup> the relevant decisionmakers. Although it is not argued here that politicians and bureaucrats always and exclusively seek to maximize their own utility to the extent of actively exploiting the citizens and taxpayers, taking governments to be completely responsive to the population’s wishes is not realistic either. Thus, federal competition serves as a safeguard against decisionmakers taking unfair advantage of their discretionary power.

Even though political externalities are stressed here, the authors are well aware that federal competition may lead to an increase in economic spillovers. Many economists, therefore, argue that centralized regulation must be introduced to correct market failures arising from economic externalities.<sup>30</sup> A vivid discussion about centralizing and harmonizing is going on in the European Community at the moment. With the creation of a single market and, therewith, the abolishment of barriers to trade, taxes may need to be harmonized and redistribution to be deferred to the Community.<sup>31</sup>

<sup>26</sup>Iris Bohnet, “Interessenvertretung in der EG: Die Landwirtschaft” (Interest Representation in the Economic Community: Agriculture) (Zürich: University of Zürich, 1991, Mimeo.); Svein S. Andersen and Kjell A. Eliassen, “European Community Lobbying,” *European Journal of Political Research* 20 (September 1991): 173-187; and William S. Peirce, “After 1992: The European Community and the Redistribution of Rents,” *Kyklos* 44 (1991): 521-536.

<sup>27</sup>See also Daphne A. Kenyon and John Kincaid, eds., *Competition among States and Local Governments: Efficiency and Equity in American Federalism* (Washington, D.C.: Urban Institute Press, 1991) and U.S. Advisory Commission on Intergovernmental Relations, *Interjurisdictional Competition: Good or Bad for the Federal System?* (Washington, D.C.: ACIR, 1991).

<sup>28</sup>See Buchanan, Tollison, and Tullock, *Rent Seeking*.

<sup>29</sup>See George J. Stigler, “The Theory of Economic Regulation,” *Bell Journal of Economics and Management Science* 2 (Spring 1971): 3-21; and the survey on the economic theory of regulation in Sam Peltzman, “The Growth of Government,” *The Journal of Law & Economics* 23 (October 1980): 209-287. This cooperation of the public sector with parts of the private sector is called “the power of distributional coalitions” by Mancur Olson, *The Rise and Decline of Nations* (New Haven, Conn.: Yale University Press, 1982).

<sup>30</sup>For the public-interest view of governments see Richard A. Musgrave, *The Theory of Public Finance* (New York: McGraw Hill, 1959).

<sup>31</sup>Dominique Bureau and Paul Champsaur, “Fiscal Federalism and European Economic Unification,” *The American Economic Review, Papers and Proceedings* 82 (May 1992): 88-92; Damien J. Neven, “Regulatory Reform in the European Community,” *The American Economic Review, Papers and Proceedings* 82 (May 1992): 98-103; and Friedrich Schneider, “The Federal and Fiscal Structures of

An extensive analysis of the debate about the efficient degree of harmonization and centralization cannot be provided here; however, we stress that property rights theory<sup>32</sup> and constitutional economics<sup>33</sup> suggest that neither public goods nor income redistribution are sufficient reasons to justify harmonization and centralization as long as adequate property rights cannot be assigned and guaranteed.

Surprisingly enough, many European countries do not know the institution of federal competition at all; the most prominent examples are France, Great Britain, and Sweden. Others, such as Germany, Austria, and Switzerland, have introduced competition between autonomous local governments to a limited extent. However, the potential offered by federalism<sup>34</sup> to establish a vigorous competition between government units has so far not been rationally designed by any country. The principle of "fiscal equivalence"<sup>35</sup> seems to apply only to some extent (e.g., in the United States, Australia, and Switzerland).<sup>36</sup>

Fiscal equivalence means that the size of a political decisionmaking unit should depend on the spatial effects of the benefits and costs of a publicly supplied good. Each public function (e.g., education, police, fire protection, or, if not privately supplied, refuse collection) could be allocated to a particular political unit whose geographic extension varies according to the particular supply conditions. The Swiss Canton of Thurgau, for instance, uses this concept; hence, several hundreds of such multiple functional and overlapping jurisdictions exist, each with corresponding taxes.<sup>37</sup>

This decentralization of decisionmaking enables the citizens to "vote with their feet."<sup>38</sup> If they are dissatisfied with the publicly supplied good and the corresponding cost, they can leave the jurisdiction searching for a different jurisdiction where their preferences are better fulfilled. This possibility of "exit"<sup>39</sup> tends to undermine regional or functional cartels by politicians.

Representative and Direct Democracies as Models for a European Federal Union? Some Thoughts on the Public Choice Approach" (Linz, Austria: University of Linz, 1992, Mimeo.).

<sup>32</sup>For a recent survey see Yoram Barzel, *Economic Analysis of Property Rights* (Cambridge, England: Cambridge University Press, 1989).

<sup>33</sup>Geoffrey Brennan and James M. Buchanan, *The Reason of Rules: Constitutional Political Economy* (Cambridge, England: Cambridge University Press, 1985).

<sup>34</sup>Charles M. Tiebout, "A Pure Theory of Local Expenditure," *Journal of Political Economy* 64 (October 1956): 416-424 and Wallace E. Oates, *Studies in Fiscal Federalism* (Aldershot, England: Edward Elgar, 1992).

<sup>35</sup>Mancur Olson, Jr., "The Principle of 'Fiscal Equivalence': The Division of Responsibilities Among Different Levels of Government," *The American Economic Review, Papers and Proceedings* 59 (May 1969): 479-487 and Mancur Olson, "Toward a More General Theory of Governmental Structure," *The American Economic Review, Papers and Proceedings* 76 (May 1986): 120-125.

<sup>36</sup>For the Swiss experience with federalism, see Hansjörg Blochliger and Rene L. Frey, "Der Schweizerische Föderalismus: Ein Modell für den Institutionellen Aufbau der Europäischen Union?" (Swiss Federalism: A Model for Institutional Development in the European Union?), *Aussenwirtschaft* (Foreign Trade) 47 (1992): 515-548.

<sup>37</sup>Alessandra Casella and Bruno Frey, "Federalism and Clubs: Towards an Economic Theory of Overlapping Political Jurisdictions," *The European Economic Review* 36 (April 1992): 639-646.

<sup>38</sup>Tiebout, "A Pure Theory of Local Expenditure"; James M. Buchanan, "An Economic Theory of Clubs," *Economica* 32 (February 1965): 1-14; and Albert O. Hirschman, *Exit, Voice and Loyalty* (Cambridge, Mass.: Harvard University Press, 1970).

<sup>39</sup>Hirschman, *Exit, Voice and Loyalty*.

Federalism, however, is not only an alternative to referenda but also a prerequisite for the effective working of a direct democracy. In small communities, the information costs of voters when deciding on issues or judging representatives' performance are much lower than in a large jurisdiction. The more fiscal equivalence is guaranteed, the better the benefits of publicly supplied goods can be acknowledged and the corresponding costs be attributed to the relevant political programs or actors. Thus, while federalism provides for cheaper information, referenda enable citizens to use this knowledge effectively in the political process.

The interdependence of federalism and referenda also works the other way around: Referenda improve the working of federalism. Besides the possibility of voting with their feet, citizens may also vote directly. This represents a double incentive for politicians to take their citizens' preferences into account; otherwise, they may lose their tax base to another jurisdiction or may be forced by referenda and initiatives to meet the demands of the voters.

### CONCLUSION

Direct democracy and federalism are effective mechanisms to provide competition in the political arena. At the same time, they produce incentives for politicians to take the citizens' preferences into account. We do not argue, however, that referenda and federalism are the only institutions to prevent politicians from pursuing their own goals at taxpayers' expense. All democracies have recognized the potential danger lying in cartels among politicians and have therefore created institutions to prevent their appearance. Many constitutions know the division of executive, legislative, and judicial powers; the establishment of two houses of parliament; and electoral competition between parties.

Further constitutional devices are rules prohibiting the excessive appropriation of rents by politicians, the most stringent ones being against corruption. Courts of accounts are supposed to control politicians' and administrators' behavior. It can be shown, however, that at least in some respects, these institutions tend to widen the gap between what the decisionmakers provide and what the population wishes.<sup>40</sup>

Instead of relying on direct democratic institutions, individuals may also express their dissatisfaction by other types of "voice."<sup>41</sup> Governments can be forced to respond to citizens' wishes by various forms of protest, ranging from complaints by individuals to violent uprisings by the masses. If taxpayers do not have any ability to exit to another jurisdiction (as in the former communist countries), or if this kind of exit is relatively more expensive, they may prefer an internal exit to the shadow economy. In both cases, the rulers lose part of their power because the tax base and the area in which their regulations are followed shrink accordingly.

<sup>40</sup>This argument is developed by Bruno S. Frey and Angel Serna, "Eine Politisch-Ökonomische Betrachtung des Rechnungshofes" (A Political-Economic View of the Public Accounting Office), *Finanzarchiv* (Financial Archive) 48 (1990): 244-270 and applied to the Italian Corte dei Conti by Bruno S. Frey, Angel Serna, and Ilda Ferro, "La Corte dei Conti: l'Aspetto Politico-Economico" (The Court of the Counts: The Political-Economic Aspect) (Zürich, Switzerland: University of Zürich, 1993, Mimeo.).

<sup>41</sup>Hirschman, *Exit, Voice and Loyalty*.

The “Swiss experience,” nevertheless, suggests that all these institutions do not provide a sufficient safeguard against politicians’ rent-seeking because they do not effectively fight political market failures. Initiatives and referenda, however, break the politicians’ coalition by destroying their monopoly on agenda-setting and decisionmaking. Furthermore, they induce a discussion on relevant issues and thus provide information for all citizens at a very low cost. The informational advantage of the *classe politique* shrinks.

By providing the exit option, federal competition undermines political externalities in the form of politicians’ or pressure groups’ rent-seeking. Fiscal federalism enables the citizens to judge the politicians’ performance and compare it with differing jurisdictions. The federal subunits of Switzerland, the cantons, represent a good example of the interdependent working of federalism and direct democracy.

Even though this article refers to the “Swiss case,” we suggest that the results are of general relevance. Referenda and federalism provide better means of fulfilling individual preferences than any other constitutional device designed for breaking up politicians’ cartels.

