

Karol Zdybel: Direct Democracy versus Representative Democracy. Cost and Benefits for the Citizenry

The function of Liberalism in the past was that of putting a limit to the powers of kings.

The function of true Liberalism in the future will be that of putting a limit to the powers of parliaments

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0. SUMMARY

The assumption of the paper is that private property protection, contractual cooperation and legal stability are desirable social values which ought to be reinforced. Firstly, representative democracy is analyzed with respect to these values. It comes out that representation induces a serious principal-agent problem, which creates incentives for political class to engage in active competition in expropriation, redistribution and regulation. These services – despite being generally considered as “bads” by many economists and social scientists with normative setting similar to ours – have many “clients” in societies. Political parties are therefore presented as entities reducing organization costs of rent-seeking.

Direct democracies are capable of overcoming above mentioned disadvantages. However, they may only be functional in certain constitutional frameworks. Two crucial elements of those frameworks are: limitation of government prerogatives and decentralization of political powers. Both of them, fortunately, enforce the values we declared as valid.

1. INTRODUCTORY REMARKS

The following text attempts to give a short and simplified answer to the question, what is the cost-benefit balance of representative and direct democracies. But here a doubt arises immediately: what is exactly meant by cost or benefit of a given political regime? It is the very nature of these two economic concepts, that they are individual and subjective². Benefits are – other things equal – desirable states of affairs; costs are – other things equal – undesirable states of affairs. Obviously the same turn of events may constitute a benefit for

¹ H. Spencer, *The Man Versus The State* (Idaho: The Caxton Printers, 1960), p. 209.

² See L. von Mises, *Human Action. A Treatise on Economics* (Auburn: Ludwig von Mises Institute, 1998), pp. 41-44, 91-98.

one man and a cost for another. Hence, as long as political systems are considered, it is necessary to establish some normative criteria in order to assess what is „better” or „worse” for the whole citizenry. In the following paper we will not argue for the validity of the criteria themselves. Instead, we will base our argument on an assumption of their validity.

The normative point of view in this paper is as follows: protection of private property, effective contract enforcement and legal stability are generally desirable and constitute political values that ought to be preserved and reinforced. Property rights, interpreted as legitimate, exclusive control of scarce resources together with right to derive income from these resources and necessity to bear their full costs, are the root of personal liberty and a necessary condition of welfare enhancement³. As long as there is no distortion of property rights, no external party is able to endanger formation of increasingly longer and more complicated capital structures, which ultimately multiply physical productivity. But in order to fully secure proprietorship, not only physical objects must be safe from non-owner aggression, but also contractual transfers of property rights must be effectively executed and non-contractual transfers (expropriation) at most limited. In other words, contract enforcement is a vital part and a prolongation of property rights protection. Last but not least, there is yet another normative factor to be mentioned. Even when present property is protected, the legal framework may be changing each couple of months, making prospective property unsafe. Minimization of „regime uncertainty”⁴ thus comprises an advantage in representative versus direct democracy trade-off.

In following chapters certain features of direct and representative democracies will be considered with respect to those three interconnected criteria: the nature and consequences of competition in market and political sphere, principal-agent setting of political representation, chances of collective rent-seeking, organization costs of direct democracies and a few minor others.

2. ECONOMICS VERSUS POLITICS

Normally when economists discuss entities operating on the market, they usually appreciate well organized, efficiency-oriented subjects which satisfy customers’ wants. As

³ For a justification of these views see i.a.: H.-H. Hoppe, *A Theory of Socialism and Capitalism* (Auburn: Ludwig von Mises Institute, 2010), Ch. 7., pp. 147-168.; M. Rothbard, *The Ethics of Liberty* (London and New York: New York University Press, 1998), pp. 29-62.

⁴ For “regime uncertainty” discussion see for instance: R. Higgs, “Regime Uncertainty. Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War”, *The Independent Review*, Vol. I, No. 4, Spring 1997, pp. 561-590.

long as market conditions are considered, it is a common belief that producer “intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention”, namely “by pursuing his own interest he frequently promotes that of the society”, as Adam Smith emphasized⁵. Market actors seek profits which are granted to them only if consumers decide to buy their goods or services on voluntary basis. Since voluntary transactions are mutually beneficial, profit-seeking subjects act not only for their own behalf, but also – intentionally or not – for the benefit of the customers. Therefore cost optimization and informational efficiency of consumer-serving companies should be appreciated, since they provide for welfare boost. As for industrial organization, it is needless to say that market competition is very desirable among market entities, because – as neoclassical theory frequently admits – it results in transferring surplus from producers to consumers and in reducing so-called deadweight loss⁶.

Nonetheless, efficiency and competition should not be appreciated in every sort of human action. Only as far as markets are taken into consideration, seeking reduction of transaction, organization and information costs should be desirable. Politics is a very different case in this respect, since it constitutes an involuntary, coercion-based type of interpersonal relations. Politicians, in contrast to market participants, do not possess and manage wealth obtained through contractual exchange nor homesteading (original appropriation). They rather take possession and dispose of already existing wealth or income streams through practicing compulsion⁷. As a coercion-employing activity, politics does not allow for demonstration of preferences, since government “services” are not voluntarily bought by willing consumers, but imposed on citizens no matter they wish for it or not. In other words, while allocation of resources *via* market process is the very essence of both private property and contractual cooperation, political activity is just the opposite. Hence it is not necessarily true that efficiency and competition should be appreciated in the field of politics; quite the opposite: while they both are desirable in production of goods, they are harmful in production of “bads”⁸.

We do not claim, however, that taxation, regulation, subsidies, tariffs etc. do not represent “goods” in economic sense of this term. In fact it is difficult to refuse this status to

⁵ A. Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (Buffalo: Prometheus Books, 1991), p. 592.

⁶ See H. Varian, *Intermediate Microeconomics. A Modern Approach*, (New York: W. W. Norton & Company, 2010), pp. 252-269.

⁷ See F. Oppenheimer, *Der Staat. 3. ueberarbeitete Auflage von 1929* (no further information), http://www.geokey.de/literatur/doc/Der_Staat_-_Franz_Oppenheimer.pdf.

⁸ See. i.a. H.-H. Hoppe, “Why Bad Man Rule” (LewRockwell.com, November 2004), <https://www.lewrockwell.com/2004/11/hans-hermann-hoppe/how-the-worst-rise-to-the-top/>.

most of government services. Goods, just like costs and benefits, are subjective and depend on existence of individuals' needs as well as identified possibilities of meeting the needs⁹. It cannot be denied that there are certain people at least potentially interested in imposing taxes, receiving public aid, benefiting from regulations and coercive monopolies etc. As we could see in the former paragraph, demand for this kind of services does not signify willingness to engage in mutually beneficial exchanges and thereby to enhance welfare, but to repossess already existing wealth. Economic glossaries define above described sort of activities as rent-seeking¹⁰. We will argue that rent-seeking opportunities and incentives depend strongly on institutional framework of democracy. While representative democracy is a competitive and efficiency-oriented rent-seeking industry, direct democracy is not; on the other hand, the latter one entails formidable organization cost which may be omitted through electing representative houses.

3. THE ESSENCE OF POLITICAL COMPETITION

The entitlement to use political power in democratic systems is dependent on the number of votes. This entitlement may be executed directly by the citizenry *via* plebiscites or referenda or indirectly, by a class of elected professionals (deputies). Many arguments can be raised for maintaining a class of politicians trained for offices. One of them is that from division of labor. Effective politics, as every other profession, requires some degree of specialization. Consequently – one might argue – there needs to be a class of professionals earning their bread from it, and the rest of society should rely on their abilities to make politics as they regularly rely upon bakers or shoemakers in other fields. This argument should not be underestimated. Indeed, as we see in the later chapters, when constitutional setting of a given regime provides for widely-ranged politics and leaves little to the market process, the common and universal political participation may almost overshadow private business activity.

On the other hand, implementation of an intermediate level of decision-making in a form of representative houses rearranges incentives structure. In typical economic models which reject the hypothesis of benevolent government and employ some realistic assumptions

⁹ See C. Menger, *Principles of Economics* (Auburn: Ludwig von Mises Institute, 2004), pp. 51-55.

¹⁰ See to initial formulation of the problem: G. Tullock, "The Welfare Costs of Tariffs, Monopolies and Theft", *Western Economic Journal*, June 1967, <http://cameroneconomics.com/tullock%201967.pdf>.

instead (“Politics without romance”¹¹) the goals of public officials are not identical with those of citizenry. Many motives may induce people to run for an office, but as far as democracy is concerned, the necessary condition of realizing own motives – whatever they are – is to be elected for the office. It even became a basis of an “expanded” neoclassical general equilibrium model to assume that additionally to consumers maximizing utility and firms maximizing profits there are parties maximizing votes. It is an often underestimated concept of Anthony Downs that parties or other parliamentary entities do not serve as a transmission belt from citizens to policies, passively “representing” citizens¹². Quite the opposite: they very actively seek opportunities to enlarge their own electoral base. Party or some other sort of political group in the office attempts to retain its position in upcoming elections; opposite parties aim at gaining voters’ popularity by trying to offer more popular proposition. In other words, there indeed are efficiency-oriented organizations competing for political powers in representative setting, just like market companies compete for clients. All parties and political pressure groups have incentives to declare rent-seeking agenda when it is expected to obtain massive support, and to be relatively more credible in accomplishment of this agenda than their competitors. Moreover, just like market companies advertise in order to convince consumers to their products, professional politicians are expected to produce some kind of propaganda generating additional sources of envy, sense of distributive injustice, conviction of harmfulness of international trade etc., and therefore enhance demand for their services.

To put in another way, seeking for popular support generates incentives to outdistance each other in property rights violation, income redistribution, regulations and tariffs etc., generally: production of “bads” and multiplication of deadweight loss. If only some additional percentage of voters may be bought off through redistribution from non-supporters to prospective supporters, party deciders do not hesitate to perform it. However, these only make sense if the target audience is correctly addressed and large enough. Rent-seeking activities must be backed with recognized group interest.

Normally, there are many “group interests” in Olsonian sense in the whole society. Their essence in a nutshell can be presented as follows: benefits resulting from delivering some sort of “collective” good are spread among the group indiscriminately, but the good itself can be produced only through joint effort. Since the benefits are received no matter one

¹¹ J. Buchanan., *The Limits of Liberty: Between Anarchy and Leviathan*, (Indianapolis: Liberty Fund 1999), <http://www.econlib.org/library/Buchanan/buchCv7.html>; J. Buchanan, G. Tullock, *The Calculus of Consent. Logical Foundations of Constitutional Democracy* (Indianapolis: Liberty Fund 1999).

¹² A. Downs, *An Economic Theory of Democracy*, (New York: Harper 1957); „An Economic Theory of Political Action in Democracy”, *The Journal of Political Economy*, Vol. 65, Issue 2.

has made a contribution or not, there is no individual incentive to engage in production, and when group is large enough, no possibility to identify and punish free riders exist. Moreover, due to high number of required participants and above-mentioned risk of unilateral breakout, an attempt to establish a formal agreement between potentially involved parties requires a ridiculously high organization and negotiation costs¹³. Hence, even if participants somehow succeed in securing such agreement, it will surely consume a cost that prevails over potential benefits they initially wanted to seize.

Such “group interests” are indeed very common. For instance, competitive industry producers would probably all be better-off if they together decided to set monopoly price, but economic force of competition – human action resulting from individual incentives – effectively prevent such group goals from achievement. Those common cases of groups potentially but never effectively united by some common interest will be called – after Olson himself – “latent groups”.

The above reasoning applies to all “latent groups” indifferently of the exact nature of their group interest, be it economic or political. Consequentially, in case of politics, when property rights are not a binding constrain since they can be easily overcome through taxation or regulation, emergence of “latent groups” is quite frequent. Many people are – at least in a narrow, materialistic sense of the word – potentially interested in living at the expense of the others. Low earners might be interested in taxing high earners; workers of industry competing with imports might be interested in introduction of tariffs; mothers in subsidizing motherhood, pensioners in raising pensions etc. There is a lot of configurations to imagine. This alluring lifestyle – “the great fiction”¹⁴, as Bastiat accurately described it –requires political power, which in turn, as long as democracy is considered, requires a group of supporters numerous enough and united in pursuit of common goal.

4. POLITICAL INTEREST GROUPS

Individual incentives to fight for “common goals” are weak among “latent groups” in democracies. Low earners, workers, mothers, pensioners and others lack individual incentives to develop common political agenda on their own and convince the rest of the society. However, as we pointed out in earlier chapters, recognition of special political interests of

¹³ See. M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge: Harvard University Press, 1965).

¹⁴ F. Bastiat, *The State*, (New York: The Foundation for Economic Education, 1995), <http://www.econlib.org/library/Bastiat/basEss5.html>.

different “latent groups” is a vital interest of parties competing for votes. It is the very essence of pluralistic representative democracy that different entities, while fighting for public support, offer agenda to large social subgroups. Instead of costly bottom-up procedures which are normally necessary to induce individuals to act for their group interests, parliamentary representatives actively work on providing certain political agenda to society in order to receive votes. Their motivation may be quite different from motivation that members of citizenry usually have when they organize together. Politicians’ goal is voters’ support, so they are keen on bearing the organization cost that normally is too high for each individual alone. What usually would end up with massive free riding and failure, might be successfully finished thanks to professional politicians. To put in a simple way, certain political outcomes are a “byproduct” of a struggle for votes. It is not the group interest itself, but the interest of professional politicians, that allows for omitting organization costs and free riding risk which are normally inevitable.

Nonetheless, the strategy described above is optimal for every parliamentary narrow band interested in gaining voters’ support. This means that while one party would appeal to one group of voters interested in redistribution of wealth or income, the other ones would appeal to some other groups, always aiming at broadening the voter base. As a result, significantly popular concepts of expropriation and redistribution will all be present in the house. Sufficiently large “latent groups” are expected to be “served” by their representatives.

Although some similarities between political and market organizations once more come to light – in both cases there are organizations motivated by self-interest which respond to people’s wants – the crucial difference must be stressed again. Ordinary market subjects are limited by property rights which are transferred among people *via* voluntary, mutually beneficial exchanges. But political organizations permanently engage in coercive transfers of wealth and income. Hence, while the former ones produce goods appreciated by willing consumers, the latter ones deliver “bads” unwanted by afflicted citizenry which neither sought for them nor accepted them. In other words, as a result of political competition every individual must be permanently expropriated and deprived of liberty, or at least threatened with such treatment. Although everybody would be better-off if no representation of group political interest existed, the situation constitutes a special case of “tragedy of commons”. Not surprisingly many states with representative democracies have certain constitutional constraints to redistributive, regulatory and indebting activity of governments, which form an attempt to limit potentially disastrous effects of political competition. Even less surprisingly, most of those limitations are currently or were historically ignored.

Moreover, parties' activity damage not only present wealth and welfare, but also prospective ones. Regime uncertainty grows, as ruling groups frequently enter and leave offices. Subsequent cabinets must somehow change policies that existed prior to them, be it relatively better ones or worse ones. As long as votes are the primary interest, rule of law and legal stability will not be necessarily promoted. As a cabinet with different electoral base than the former one, every new cabinet will come with some packet of new agenda, and episodes of "legislation offensives" will tend to repeat with each tenure. The rate of taxation and regulatory framework for various households and businesses shall not be close to constant in representative democracy, but rather differ from one tenure to another. In a sense presented originally by Olson we may refer to parties as to "roving bandits"¹⁵, which come round for a period of intensive exploitation of certain groups of citizens and are rapidly substituted by other majorities exploiting slightly different groups etc.

5. IS NO REPRESENTATION BETTER?

Having considered above-mentioned disadvantages of political representation, direct democracy seems a self-evident solution. It is a characteristic feature of such system that, by definition¹⁶, it omits representation and arrives at political decisions directly through citizenry voting. Legislative questions are decided by the public in a plebiscites or referenda. As such, direct democracies do not contain competitive mechanisms and do not promote active pursuit to taxation and redistribution. It is rather the case that special interest coalitions within political "latent groups" must be formed at full organization costs mentioned a few pages above. As far as activity of professional politicians is ceded on the people, the rent-seekers in the citizenry would have a hard time, and periods of redistribution from and to different groups should not happen at a scope similar to that in representative democracies.

It is indeed true that those problems do not bother direct-democratic societies. However, these significant comparative advantages of direct democracies come at a price. In a nutshell, when delegation of decision-making powers is very limited or does not exist at all, plebiscitary voting is extremely costly as long as it is not encompassed in a very special constitutional framework. In other words, a few conditions must be fulfilled in order to make direct democracies a handful tool of managing the public sphere. Otherwise their comparative

¹⁵ M. Olson, "Dictatorship, Democracy, and Development", *The American Political Science Review*, Vol. 87, No. 3 (Sep., 1993), pp. 567-576.

¹⁶ For a representative constitutional setting of a direct democracy, see H. A. von Liechtenstein, *Der Staat im dritten Jahrtausend* (Triesen: van Eck Verlag, 2010).

advantages *versus* representative systems would be covered up by extremely large organization costs which can make direct democracies virtually dysfunctional.

First of all, the scope of political power available to the society ought to be limited to relatively small amount. These sort of limitations might be called “constitutional”: only a certain share of human activities may be subject to democratic decisions, while the rest must be left to the private sector. In oversized states the organization and negotiation costs of voting, as well as learning costs, would certainly outbalance benefits of having no competitive political industry.

To put it another way, in properly functioning direct democracies interpersonal relations must be regulated through mutually recognized property rights and voluntary contracts, i.e. by economic, not political means. As long as political class pretend to represent citizenry interest, governmental responsibilities may be effectively handled by professional politicians no matter the actual scope. It is them who deal with numerous every-day political issues, while the rest of the society is exempted from this sort of responsibilities. On the other hand, when state prerogatives are distended in direct democracy regimes, “ordinary people” must neglect every day businesses in order to perform in politics. Since a significant share of income is distributed *via* political and not market channels, and political profession is widely open to everyone, it is relatively rewarding to devote resources to politics, where the direction of income is decided, and abandon market business, which actually generates the income to be later divided. In other words, instead of being *zoon politikon* who reasonably shares preoccupation between “public” and “private” spheres, one has an incentive to become *zoon despotikon* who devotes himself to redistribution, but not production of wealth. Society of producers would be therefore quickly replaced by society of rent-seekers.

Another crucial limitation to direct democracy is of territorial nature. Since every decision requires a certain amount of information to be collected, direct democracy can be functional only if citizens are somehow provided with information or perform self-reliant research. But since individual input to general outcome of referendum is negligible, no serious amount of research pays back. To put it in other way, a citizen normally has no incentive to gain any extra knowledge of matters he is entitled to decide, and this lack of incentive is a common thing within the whole society. Fortunately, if the country is decentralized enough, so the territorial range of autonomous political units does not exceed reasonable limits, local problems are *eo ipso* well-known among local communities. There is no need to invest additional valuable resources in gaining knowledge about issues subject to political decisions. Therefore it is certainly no coincidence that Swiss communities and

cantons, where local direct democracies are a core of social life, exhibit very low level of public debt; and even among those communities those ones where separate citizens' approval is required for any amount of public finance deficit are characterized by lower indebtedness than the remaining ones¹⁷.

6. BENEFICIAL BOUNDARIES

Above-mentioned conditions binding to direct democratic systems not only determine reasonable boundaries to democracy itself, but also happen to work for the benefits of citizens. Limitation of government's power which is necessary to prevent overpolitization clearly supports the institution of private property, personal responsibility and sound market order *per se*. Needless to say, when political means are excluded, people are free to act on their own behalf and do not need to worry about regime interferences.

Also territorial limitations, fortunately, indirectly support stable and predictable governments and punish for irresponsible, cruel and welfare-devastating policies. As Charles Tiebout pointed out long ago¹⁸, one of the crucial factors inducing policy changes are migration streams: people move to places with higher expected standard of living and flee from places where safety, welfare and property is insecure. It is an advantage of decentralized direct democracies that not only people with their human capital, but also their material wealth may be easily moved from one different destination to other autonomous units with various tax, legal and social systems, which are virtually in the neighborhood. Thus apart from the "voice" option – which comprises chances and costs of pursuing a change of internal policy in a given regime – there is also the "exit" option – which comprises opportunities and costs of leaving the country and move in elsewhere¹⁹. If the former one becomes more appealing, migration pattern will speak for itself. In short, the well-known "feet voting" effectively promotes good policies no less than all constitutional "checks and balances".

Last but not least, nonexistence of tenures – predefined periods between elections – is a matter of great importance. Since elections in most countries take place once a four or five years, each specific problem subject to political decision is decided by the representative assembly within this period. A voter, on the other hand, may elect a single representative or a

¹⁷ Frey, B. S. and Stutzer, A. and Neckermann, S., "Direct Democracy and the Constitution" (October 22, 2013), <https://ssrn.com/abstract=2343615>.

¹⁸ Ch. M. Tiebout, *A Pure Theory of Local Expenditures*, *The Journal of Political Economy*, Vol. 64, No. 5, (Oct., 1956), pp. 416-424.

¹⁹ See A. O. Hirschmann, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge: Harvard University Press, 1970).

list once a time, and the chosen one will proceed with further decisions in the house. As a result, apart from already presented problems with the structure of incentives, political competition and rent-seeking, electoral choice becomes a choice between “bundles” of policies. If, for instance, one supports denationalization of forests, low real estate taxes and decentralization of schooling system, he may be offered three different parties, each supporting two out of three policies he supports himself. The electoral question is then not to choose most preferred policies, but rather to elect people, who will probably support at least some of the policies convenient for the voter. In case of direct democracies, however, the situation is obviously different. Each matter subject to political decision can be treated in a separate way with no unnecessary bundling.

Ultimately, as long as certain restrictions upon direct democracy are respected, the representative systems seem less desirable from the normative point of view presented in the first words of this essay. However, necessity of introducing those restrictions to political powers as well as validity of the criteria are still convictions to be spread across nations.

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