

Abstract

Many organizations have characteristics that normally are associated with governments, but which are created by private contract. Neighborhood associations and condominium associations are examples. These organizations often provide public goods, have the power to tax their members, and are governed democratically. They tend to be created by an entrepreneur who creates a contractual government and then sells shares in the government along with property ownership, with the expectation that the contractual government increases the value of the associated property. Property value is enhanced because the entrepreneur produces constitutional rules, which allows subsequent purchasers to avoid the decision-making costs inherent in reaching agreement at the constitutional level.

GOVERNMENT BY CONTRACT

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The distinction between constitutional and postconstitutional decision making made by Buchanan and Tullock (1962) explains how optimal constitutional rules can lead to efficient postconstitutional decisions. Their model does not explain the process by which efficient constitutional rules can be produced, however. They suggest that constitutional rules be agreed to unanimously, but such consent on constitutional rules for anything but a small group would entail such high decision-making costs that drawing up an efficient constitution could be prohibitively costly.¹ This article explains how the cost of devising optimal constitutional rules can be lowered. In particular, it explains how entrepreneurs can draw up constitutional rules covering a tract of property and then sell shares in the constitution

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along with the property to produce a government by contract.² We then describe why constitutional rules drawn up in this way will tend to be efficient.

Under the current legal structure in the United States, many contractual governments are formed by restrictive covenants. The covenants apply to all property under the contractual government's jurisdiction. In these cases, property owners governed by the contractual government all have clear title to their individual property. Contractual governments are also formed to govern property owned in common, such as the land occupied by multiple-story condominiums. There is great diversity in the types of property governed by contractual governments, the activities that they engage in, and the rules under which they govern. But despite their diversity, one feature common to almost all contractual governments is that the rules of the contractual government are devised when the property is owned by one owner. The owner writes a constitution and establishes a contractual government to enhance the value of the property when it is subsequently subdivided and sold to several owners.

Good constitutional rules are costly to produce, so as with anything that is costly to produce, there is an incentive to economize on the production of constitutional rules. Contractual governments economize on the production of constitutional rules by making a single entrepreneur responsible for drawing up a constitution and then selling shares of the constitution along with other property. Because the constitutional rules are sold in the market, the entrepreneur has an incentive to produce as efficient a constitution as possible, and the market provides an indicator of the value of the rules.³

The resulting contractual governments have many of the characteristics of governments, but are created by private contracts. A typical contractual government has a well defined set of constitutional and operating rules, is overseen by a governing body, has democratic institutions that allow the citizens of the government to make collective decisions about the contractual government's activities and policies, and has the power to tax its citizens in order to finance its activities.⁴

The next section contains a brief description of a real-world contractual government. Then, a theory of contractual governments is

developed based on the theory of constitutions (Buchanan and Tullock, 1962) and the theory of clubs (Buchanan, 1965). Efficiency aspects of contractual governments are then analyzed within a Tiebout (1956) framework. Next, the concept of contractual governments is discussed within a contractarian framework. A concluding section follows. Our thesis is that contractual governments are formed by entrepreneurs who produce and sell constitutional rules, thus allowing subsequent purchasers to avoid the decision-making costs inherent in drawing up and reaching agreement at the constitutional level.

AN EXAMPLE

Fallsmead is a subdivision in Rockville, Maryland, just outside Washington, D.C. Before its construction, which began in the late 1960s, Fallsmead was a farm owned by a single developer who subdivided the farm into lots upon which he built and sold houses. Near the center of the subdivision is a common area containing a swimming pool, tennis courts, a pond, other recreational facilities, and woods. This area is jointly owned by all homeowners in the subdivision. Its operation is governed by a board elected by the residents, and it is financed by mandatory payments from the homeowners. Fallsmead levies taxes and provides public goods for its residents.

Several other regulations apply to the residents of Fallsmead. One regulation states that homeowners may not alter the exterior color of their houses without approval, another limits the types and locations of fences that can be erected, and another bans residents from parking commercial vehicles outside their homes. Fallsmead is a contractual government, and all of its rules were imposed by restrictive covenants put on the property by the developer before any houses in the subdivision were sold.

Although restrictive covenants limiting the use of property are relatively common,⁵ Fallsmead goes well beyond these restrictions by providing public goods for its residents, taxing them to pay for these goods, and providing a democratic government to oversee and administer the process. The fact that the developer lives elsewhere is evidence that he believes that these regulations and public goods, along

with the contractual government, enhance the aggregate value of the property when sold in individual lots.

Other neighborhoods (but not Fallsmead) provide security guards, bus services, and other amenities in the same way. Clearly, these organizations have many of the characteristics of municipal governments.

Contractual governments are not governments in a legal sense, however, and as a result they do not necessarily provide residents with some rights that would be constitutionally guaranteed in the United States if they were legally considered to be governments. Most notably, although they are usually democratically run, few contractual governments operate on the principle of one person-one vote. It is more usual for each unit of ownership to get one vote, so that there is only one vote per household. In some contractual governments, the number of votes is determined by the size of property holdings so that, for example, a four-bedroom house entitles its owner to more votes than the owner of a three-bedroom house.

The great variation among contractual governments prevents a more specific description of their characteristics, but from the above discussion the reader can see that contractual governments (1) have both constitutional and postconstitutional rules, (2) provide public goods, and (3) have the power to tax those in their jurisdiction. Although contractual governments appear similar to municipal governments, they are not governments in a legal sense and so do not necessarily provide the same rights to their citizens that are guaranteed by the U.S. Constitution.

THEORETICAL FOUNDATION

Why are contractual governments formed? The single owner of the property who establishes the contractual government's constitution by imposing restrictive covenants on the property must believe that the contractual government will enhance the value of the property when it is subdivided and sold. More focus can be brought to this answer if the eventual citizens in the contractual government's jurisdiction are thought to be members of a club in the sense described in Buchanan

(1965). Buchanan's model determines the optimal number of individuals in a sharing group and the optimal amount of collective goods produced by examining the trade-off between congestion of the facilities and the costs that are shared among the members.

According to Buchanan and Tullock (1962, ch. 6), one of the costs of any collective organization is the decision-making cost of arriving at collective decisions. Their framework deals with postconstitutional decisions, but the decision-making costs of postconstitutional decisions are directly relevant to constitutional decision making as well. That is, just as there are positive costs borne by individuals engaged in making and agreeing to collective choices at the postconstitutional level, there are similar costs that affect individuals engaged in constitutional decision making. If some approximation to the rule of unanimity is adhered to for constitutional decisions, these decision-making costs will be especially significant.⁶

In the Buchanan and Tullock framework, if a rule of unanimity is used there are no external costs because decisions contrary to the interest of a member of the group cannot be made. The decision-making costs, however, are very high under a rule of unanimity. Even with a less than unanimous decision rule, decision-making costs are likely to be substantial in the setting where individuals are trying to agree on the characteristics of a "club." Thus, from a constitutional standpoint, there may be many possible club arrangements that would benefit the residents of a particular area, but the clubs cannot be formed because the decision-making costs involved in reaching the necessary initial constitutional agreement among the whole group regarding the activities and governance structure of the club are prohibitively high. Profit-seeking developers can reduce these constitutional decision-making costs in the course of developing a viable governance structure for the club.

When contractual governments are formed, a single owner draws up the constitution and then gives potential residents the opportunity to live under that constitution. Approval or disapproval of the contractual government is expressed by exit rather than by voice, to use Hirschman's (1970) distinction. In this way, the constitution is the product of a profit-seeking entrepreneurial act. The entrepreneurial

writer of the constitution avoids all decision-making costs involved in developing and securing unanimous consent to the constitution, thus making collective activity less costly.

As an empirical observation, contractual governments are rarely formed by the residents of an area getting together and drawing up a constitution for collective action.⁷ However, when such constitutions are drawn up ahead of time—typically by a person who is not a member of the collective—residents are observed to demand the outputs of contractual governments. One important role of the developer of a contractual government, then, is to eliminate the decision-making costs of developing constitutional rules, thereby making it less costly overall to create and maintain optimal sharing arrangements. The developer takes a portion of the lower cost as a return for forming the government. As with producers in any market, the successful developer is likely to have a comparative advantage in producing efficient constitutional rules.

In short, contractual government entrepreneurs draw up a constitution before they have any citizens in their jurisdictions and then allow citizens to buy into the government's jurisdiction. The citizens avoid the decision-making costs involved in drawing up a constitution. This reduction in cost then lowers the overall cost of delivering collective goods and services, which may be prohibitively costly to provide otherwise.

The effect of this cost reduction on the collective organization is illustrated within Buchanan's club framework in Figures 1, 2, and 3. In Figure 1, the optimal number in the sharing group is determined for a given quantity of collective good. Curves B and C show the benefit and cost in the absence of a contractual government. The contractual government that lowers the cost of the good lowers the C curve to C'. Two items should be noted. First, it may be that under some circumstances C would exceed B for all N, but C' would be lower than B for at least some N, making a contractual government feasible when other forms of collective organization are prohibitively costly. Second, if the reduction in costs made possible by the contractual government is a reduction in fixed costs, the downward shift in C is parallel and the optimal number in the group remains at N*. If the marginal cost of

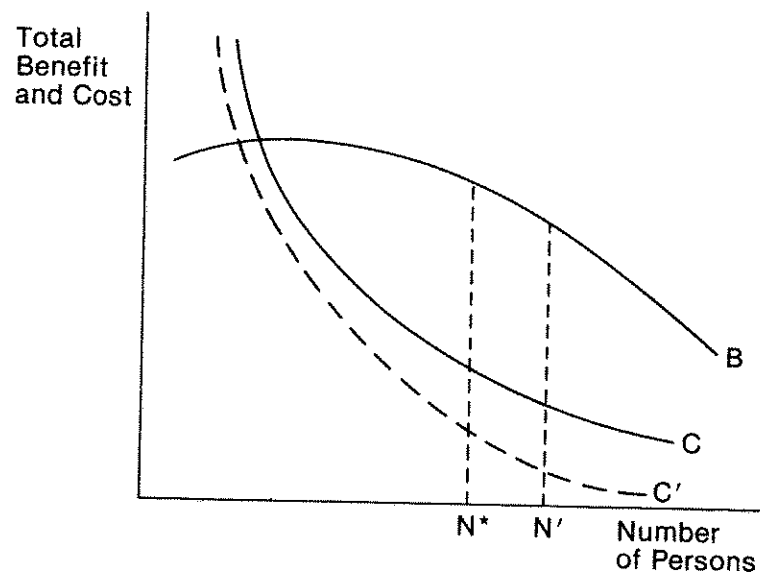


Figure 1

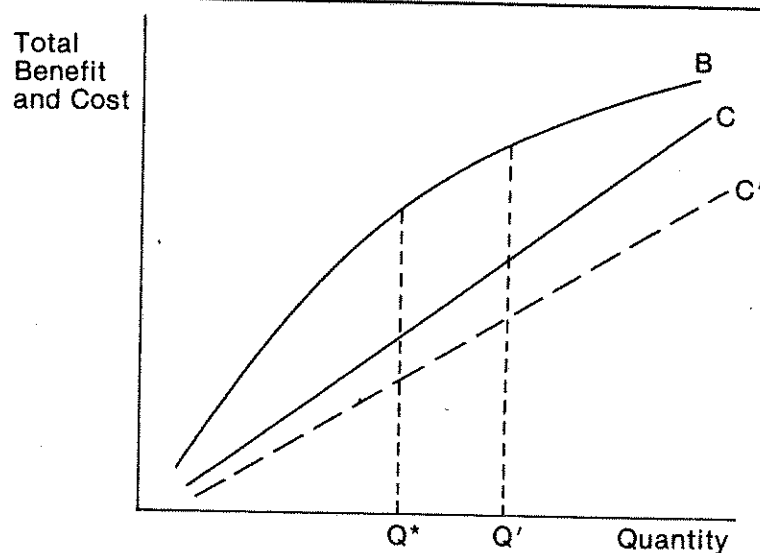


Figure 2

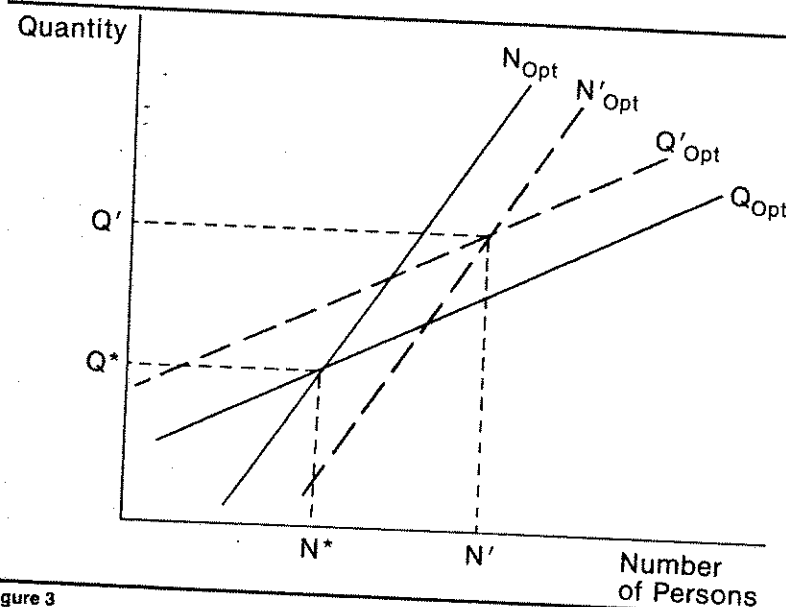


Figure 3

adding members is lowered, however, C drops to C' as shown in Figure 1, and the optimal number in the group increases. Factors affecting the nature of this shift are discussed later in this article.

Figure 2 reproduces Buchanan's analysis of the optimal quantity of goods for a sharing group of given size, and the same general conclusions apply. Lower costs, C' , make the production of a good feasible when it would be more costly or perhaps infeasible with another collective arrangement. Because contractual governments lower the constitutional decision-making costs, contractual governments lower the C curve in Figure 2. If the marginal cost of adding units of the good is reduced, the optimal level of output for a given sharing group increases.

Following Buchanan, the quantity of the good is varied in Figure 1 to trace an N_{Opt} curve, shown in Figure 3, and the number of individuals is varied in Figure 2 to generate a Q_{Opt} curve, also shown in Figure 3. If the costs of collective action are prohibitive, the curves in Figure 3 would not exist, in which case the lower costs of selecting and implementing constitutional rules could make the collective activity feasible. If the marginal cost of providing the good is lowered, the N'_{Opt}

and Q'_{opt} curves in Figure 3 are generated using the C' cost curves in Figures 1 and 2, showing that the result is a larger optimal group size producing more of the collective good.

One reason for this illustration is to show that the efficiency aspects of contractual governments can be modeled as an application of the theory of clubs. Within the Buchanan club framework, many clubs that would be profitable in a world of zero constitutional decision-making costs will not form when the costs of developing a constitution are considered. Thus, a role exists for an entrepreneur to draw up a constitution to form a club, and then sell shares in the club. This constitutional cost-reducing role is the fundamental reason why contractual governments are formed. The club framework also provides insight into why shares in contractual governments are so closely tied to a specific community with a predetermined size and with predetermined collective good characteristics. The model shows that there is both an optimal sharing group and an optimal quantity of the collective good. By determining both in advance, club members will not have to incur the costs of collectively determining these characteristics.

TIEBOUT ISSUES

The most prominent line of inquiry regarding the efficiency of local government is inspired by Tiebout (1956). Tiebout's insight is that because individuals can "vote with their feet" by choosing a local government that best suits their preferences, there is a competitive mechanism that tends to produce efficiency in local government. However, the efficiency properties of contractual governments go well beyond those in the Tiebout model. The limitations of Tiebout competition have been discussed by others,⁸ but even when compared to an ideal Tiebout setting, contractual governments have efficiency characteristics that make a comparison of municipal governments with contractual governments worthwhile.

The efficient sorting of individuals by preferences for government operates with contractual governments just as it does in the Tiebout model.⁹ However, even if a community were already sorted to contain the same people who would live under a contractual government, the

contractual government still aids in the development of an efficient constitution. Any set of constitutional rules will be the result of a bargaining process among those who will be covered by the constitution; a bargaining process whereby individuals agree to accept some rules they mildly dislike (but that others want) in exchange for rules that they favor more intensely. The bargaining costs involved in drawing up a set of rules that benefits everyone on net and that maximizes the value of the property under the jurisdiction of the contractual government are avoided by using a single entrepreneur to draw up the constitution. Rather than bargaining on each provision, residents make only one decision, which is whether to accept or reject the constitution. The entrepreneur has an incentive to produce the most efficient constitution possible in order to maximize the value of the property as it is sold. Any cost of inefficient rules is then borne by the entrepreneur in the form of lower revenues from property sales rather than by purchasers, who will pay only the market value of the combined property and constitutional rules.

Some rules might be economically efficient but not a Pareto improvement, so for unanimous adoption, gainers would have to compensate losers. Arriving at the optimal rules and the optimal compensation is potentially very costly, especially because individuals have incentives to strategically misstate their preferences. In a contractual government where constitutional rules are sold with the property, the compensation issue is easily handled because the gainers will be willing to pay more for their property while the losers will pay less.¹⁰ By making all the decisions himself, the entrepreneur avoids the collective decision-making costs, and the market provides the incentive for entrepreneurs to draw up efficient rules. Competition among various contractual governments provides a feedback mechanism to signal future entrepreneurs about the characteristics of constitutions that residents find most valuable.¹¹

An important difference between contractual governments and Tiebout governments is that competition in the Tiebout model occurs only at the postconstitutional stage. Governments compete over tax rates, the scope of public services, and so forth. Missing from Tiebout's analysis is a competitive process for devising efficient constitutions, as opposed to an efficient mix of services. In the Tiebout

model, where moving is costless, constitutional rules are less important because a dissatisfied citizen can easily relocate. Constitutional rules are more important when individuals make investments in locational decisions because moving is costly. Therefore, contractual governments augment the efficiencies gained by Tiebout competition.

After property subject to a contractual government is subdivided and sold, the contractual government becomes similar to a municipal government in that the entrepreneurial incentive for efficient decision making at the constitutional level is attenuated. This diminution of incentive is why MacCallum (1970) argues that property such as shopping centers, industrial parks, and even hotels lease rather than sell their space and continue to be run by single entrepreneurs. Because an entrepreneur makes the rules in competition with other developers, the constitution can continue to evolve after the property is occupied, and the occupants have the assurance that the entrepreneur has the incentive to devise rules that maximize the value of the property to the tenants. MacCallum argues that this explains why shopping centers continue to thrive while downtown urban areas decay.

Although the same argument could apply to residential areas, the sale of residences to people who expect to be long-term residents is likely to add value to the property precisely because residents typically desire constitutional rules that are inflexible and difficult to change. But the desirability of stability in a residential neighborhood does not carry over to commercial property. If occupants of property desire stability in constitutional rules, individual ownership by the occupants will produce the inflexibility that produces stability. If occupants desire flexible constitutional rules that continue to maximize the value of the property, then occupants will prefer to lease rather than own.¹²

The model of contractual government goes beyond the Tiebout model because it describes the development of efficient constitutions rather than a mechanism producing efficient postconstitutional decisions. There is also an entrepreneurial incentive in contractual governments that is missing in the Tiebout model. In a Tiebout world where moving is costless, constitutional rules are less important than when people make sunk investments in locational decisions.

CONTRACTARIAN ISSUES

The analysis of contractual governments sheds some light on the social contract model of the state, especially as it has developed recently. In the Buchanan and Tullock (1962) framework, efficient constitutional rules can be guaranteed only by unanimous agreement, yet unanimous agreement would rarely be possible in the real world. This has led contractarians such as Rawls (1971) and Buchanan (1975) to develop models of conceptual agreement for the purpose of analyzing constitutional rules. One criticism levied against these models is that because there is not an actual agreement, the term "conceptual agreement" obscures the coercive nature of government.¹³ Without actual unanimity, the terms of an optimal constitution in the sense of Buchanan and Tullock (1962) must remain a matter of speculation.

Contractual governments are an interesting object of inquiry within the contractarian paradigm because they do originate by voluntary agreement. There is some similarity between contractual governments and the Rawlsian veil of ignorance, because the entrepreneur who creates the contractual government does not know the specific identities of the people who eventually will move into the government's jurisdiction. The entrepreneur has an incentive to create as valuable a piece of property as possible, which provides the incentive to produce efficient constitutional rules. The entrepreneur makes constitutional decisions about the contractual government under the same conditions as would the future citizens of the contractual government if they were behind a Rawlsian veil of ignorance. The establishment of a contractual government appears to be the closest thing to a real world social contract that can be found because it is created behind something analogous to a veil, and because everyone unanimously agrees to move into the contractual government's jurisdiction, so that the government is at no time imposed on anyone.

The Buchanan club framework that was employed earlier in this article describes some characteristics of an optimal club, but does not describe a decision-making process in which these characteristics could be produced. Likewise, the Buchanan and Tullock framework describes the characteristics of optimal constitutional decision rules

but does not describe a mechanism or institution that will produce optimal rules. Not all rules produced by real-world contractual governments would be optimal. Competition among various contractual governments, however, provides a market mechanism that leads contractual governments, as if by an invisible hand, toward the production of optimal rules. The contractual government is an institution that produces unanimous agreement in the real world that parallels the conceptual agreement postulated in the recent contractarian models.

In reality, most governments were not formed by contract, but theorists maintain an interest in analyzing the efficiency characteristics of the constitutional rules of real-world governments. Contractual governments provide unanimously agreed-upon constitutional rules for comparison. The social contract remains a hypothetical construction in analyses of typical governments, but the characteristics of contractual governments can lend some insight into the nature of a government that would emerge from a social contract.

For example, contractual governments tend to assign voting rights based upon ownership rather than the one person-one vote principle that is used in the United States. But the U.S. government originally extended franchise only to property owners, much as contractual governments typically do. The development of optimal voting rules at the constitutional level is discussed by Buchanan and Tullock (1962), and an analysis of the actual voting rules of contractual governments can provide additional insight. Because the contractual government's entrepreneur, as the residual claimant, has an incentive to establish the wealth-maximizing voting rule, there is evidence that the one person-one vote rule typically is not optimal. In fact, the franchise history of the United States shows the right to vote being extended continually. Not only were more groups of people enfranchised, but offices not originally subject to popular vote (the U.S. Senate) became so. In concert with the more limited franchise arrangements found in contractual governments, this suggests that broader franchise is not necessarily wealth-maximizing.¹⁴

The parallel between the formation of contractual governments and the conceptual agreement found in the social contract model of the state is of interest for two reasons. First, it provides an example of real-world institutions that produce unanimously agreed-upon consti-

tutional rules. Second, it provides a benchmark for evaluating real-world decision rules when they are not unanimously approved. The earlier discussion of franchise is an example of the direction that this type of analysis can take.

CONCLUSION

A contractual government has many of the characteristics of a typical government, but is created by private contract, often in the form of restrictive covenants on property. The motivation for forming contractual governments is illuminated by considering them within the framework of the Buchanan and Tullock (1962) theory of constitutions and Buchanan's (1965) theory of clubs. When the costs of developing a constitution for a new club are considered, there are many clubs that otherwise would be profitable but that might not form. Therefore, there is a role for an entrepreneur to form a club (complete with its own constitution) and sell shares, thus allowing the members to receive the benefits of an established club without having to incur the constitutional decision-making costs of forming one.

The purpose of this article has been to provide a theoretical perspective on the formation of contractual governments. Contractual governments are almost always formed when a single entrepreneur owns all of the property in the contractual government's jurisdiction. By forming the contractual government and then subdividing and selling the property, the decision-making costs involved in creating a constitution are avoided, thus lowering the cost of providing collective goods.

The entrepreneur, then, is in the business of producing and selling constitutional rules that are tied to the real property being sold. Efficient constitutional rules enhance the value of the property, which provides the entrepreneur with the incentive to produce an efficient constitution. The incentive to develop efficient constitutional rules exists with any group, but the typical contractual government differs from other collective organizations because a single entrepreneur develops the constitution and then sells shares in the group, eliminating the decision-making costs at the constitutional level. This arrange-

ment allows the profitable production of collective goods in cases where production might be unprofitable if the decision-making costs of writing and agreeing to a constitution had to be borne by the sharing group.

Although much has been written about efficiency in government production, the literature has focused on postconstitutional decisions rather than the development of efficient constitutional rules. The work on the theory of constitutions prompted by Buchanan and Tullock (1962) has described the characteristics of efficient constitutional rules, but it has not described institutions that can produce efficient constitutions. Contractual governments are built around an incentive structure that leads toward efficient constitutional rules, so although they are interesting in their own right, their study also illustrates how the economic theory of constitutions applies to real-world institutions.

NOTES

1. Recognition of this fact has led theorists such as Rawls (1971), Nozick (1974), and Buchanan (1975) to develop models of conceptual agreement to analyze efficient constitutional rules. Gordon (1976) refers to this group as the New Contractarians.
2. These organizations have been given many names. For example, a front-page article in the *Washington Post*, June 14, 1987, referred to them as "shadow governments." We like that name, but in politics the term shadow government also refers to a group of people not currently in power who evaluate the current government's policies and, perhaps, provide voters with a clear-cut alternative government should the voters want to unseat the incumbents.
3. Friedman (1987) discusses this aspect of contractual governments.
4. No attempt will be made here to draw a line separating governments from private organizations, but Holcombe (1987) has argued that the power to tax is the identifying mark of government.
5. See the discussion by Siegan (1970) which explains how Houston uses restrictive covenants rather than zoning to dictate land use.
6. Constitutional decisions are often made without regard to a unanimity rule. For example, in some states, cities can annex adjacent areas without even receiving the approval of the individuals in the areas to be annexed. Unanimity rule does have the appeal, however, of ensuring that any decision made under it results in a Pareto improvement. The overall desirability of unanimity rules is a normative issue, but Wicksell's (1967) argument in favor has been developed by Buchanan and Tullock (1962) and Buchanan (1975). The contractarian framework of Rawls (1971) contains a similar argument favoring unanimous agreement for constitutional decisions.
7. An exception is provided by the residents of the Loch Lomond area of Miami Lakes, Florida, who voted to have a guardhouse erected at the single entrance to their neighborhood

and to have security guards patrol the neighborhood, paid for by a property tax. This decision, however, was made by majority rule and was not unanimously approved. Governments also might be formed by contract to subdivide a common area, as described by Umbeck (1977). During the California gold rush, miners formed contractual governments with constitutional rules for the purpose of subdividing the common resource into individual claims, showing that a contractual government need not be the result of a single individual's activity.

8. See, for example, Buchanan and Goetz (1972).
9. Ellickson (1982) mentions the role of Tiebout-type sorting that occurs with homeowners associations.
10. MacCallum (1970) discusses rules drawn up by property owners in exactly this context.
11. For evidence that such a competitive signalling mechanism works if given the opportunity, see Beito (forthcoming).
12. The commercial tenant benefits from an increase in the value of the occupied property because the value of the property is determined by its potential to generate commercial revenue. Residential tenants might not benefit from an increase in the value of the property they lease because the landlord is in a position to capture the increased value through higher rents. Too much improvement of the property could displace tenants in favor of individuals who can afford to pay more.
13. See Yeager (1985) for a development of this critique.
14. Ellickson (1982) suggests that the majoritarian origins of municipalities give them greater potential for redistributive activities, which is one possible reason why greater franchise would not be wealth-maximizing.

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Abstract

The partnership form of business has become increasingly popular in the United States and may account for a significant portion of new business formation in the future. In spite of the growth of partnerships, there has been little formal analysis of their formation or behavior. In this article, we consider the possibility that the level of partnership formation is inefficient and find conditions under which tax-subsidy schemes yield welfare-improving changes in the level of partnership formation. We also determine the effects of income taxation on partnership activity. Finally we examine the impact of government expenditure programs on partnership behavior. We find that some of these programs, for example those that are ostensibly designed to foster new business, may actually inhibit partnership formation and increase the likelihood of partnership failure.

AN ANALYSIS OF THE FORMATION AND BEHAVIOR OF PARTNERSHIPS

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The partnership form of business has become increasingly popular in the United States, and it may account for a significant portion of new business formation in the future. One reason for the burgeoning of partnerships is that this form of business offers many of the risk-sharing opportunities of the corporate form without the burden of corporate income taxation. Partnership income, unlike corporate income, is not taxed directly; the rewards of partnership activity, less expenses, are distributed among partners and are then subject to personal income taxation. This tax advantage has been magnified by the most recent round of tax law revisions, which has left the corporate tax rate higher than the highest personal income tax rate. In addition to risk-sharing and tax advantages, partnerships may also provide a mechanism for the pooling of skills that are necessary to undertake some productive activities. For example, suppose that a minimum skill level is critical to the success of some activity and that no one individual's skills approach the level required for success. Then, if individuals' skills are additive, a group of individuals may be