

Consumer Sovereignty and Quasi-Market Failure

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ABSTRACT

This article explores the concept of quasi-market failure in order to develop a coherent and consistent critique of such quasi-market institutions as vouchers, contracting, and the Tiebout model. After discussing the use of consumer sovereignty as a criterion by which to assess failure, three sources of quasi-market failure are examined: failure in quasi-market formation, failure by preference error, and failure by preference substitution. Each is illustrated with examples from the empirical literature. The article concludes with a discussion of the implications of quasi-market failure both for quasi-markets and for justifying reliance on the more traditional progressive reform institutions of public-service provision and production.

The delivery of public goods and services by local government has been profoundly changed over the last twenty-five years by the substitution of quasi markets for the traditional institutions of progressive reform government. According to both critics (Haque 1996) and proponents (Eggers and O'Leary 1994), vouchers, contracting, and the Tiebout model have replaced the progressives' reliance on centralized bureaucratic production within metropolitan government as preferred mechanisms to produce goods and services. The success of quasi-market institutions is founded on their claim to bring market-like forces to bear on the production of goods and services, either directly by separating provision and production so that the latter is generated via a market (e.g., vouchers and contracting) or indirectly by arranging public production institutions so that they are subject to the market-like constraint of residents ever poised to vote with their feet (e.g., the Tiebout model). In comparison to the bureaucratic monopolies of traditional progressive reform institutions, quasi-

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markets are presumed to be both more efficient and more responsive to the diverse preferences of citizens/consumers.

Quasi-market institutions have not, of course, gone unchallenged. But while vouchers, contracting, and the Tiebout model have generated dozens of both theoretical and empirical critiques, little attention has been given to organizing these criticisms into a coherent assessment of the limits of quasi-markets per se. Given the growing prominence of quasi-market institutions, such a general critique might prove useful if we are to fully understand both their promise and their potential liabilities. This analysis provides such a general critique by using the concept of *quasi-market failure*. After briefly discussing the parallels of quasi-market failure with prior analyses of institutional failure, the criterion employed to assess quasi-market failure is considered in the first major section of the article. Three types of failure then are discussed and illustrated with examples from the empirical literature. The implications of quasi-market failure for both quasi markets and progressive reform institutions are discussed in the conclusion.

Examination of the sources of institutional failure has a notable pedigree (Williamson 1975). The notion of divergence of individual and social costs and benefits hinted at by Sidgwick (1883) and so forcefully developed by Pigou (1922) has provided a fruitful avenue for understanding both the power and the limitations of markets (Mishan 1971; Margolis and Vincent 1966; Burkhead and Miner 1971, 97-144). Moreover, it takes but a small step to extract from the idea of *market failure* the policy prescription that government can and even should serve as a corrective when externalities undermine the virtues of market exchanges. In short, both good science and clear policy guidance were generated via examination of market failure.

Similarly, public-choice theory is most fundamentally a theory about *nonmarket failure* (Buchanan 1972; Stigler 1965). Rejecting the Pigouvian assumption that market failure implies government success, a generation of scholars has now cataloged the many ways that democratic and bureaucratic institutions imperfectly aggregate, represent, and implement consumers' preferences (Buchanan and Tullock 1962; Downs 1957 and 1967; Buchanan and Tollison 1972; Niskanen 1971; Olson 1965). And like the analysis of market failure, the study of its nonmarket kin has produced its own policy prescriptions. The most important of these are quasi-market institutions of vouchers, contracting, and the Tiebout model, which are hypothesized to provide a superior solution to cases of market failure than do the progressive reform institutions of Pigouvians (V. Ostrom 1974; Savas 1987; E. Ostrom 1972; Parks and Oakerson 1989; Ostrom and Ostrom

1971). Again, the analysis of failure stimulated productive scholarship, which in turn generated an original and innovative menu of policy applications.

The concept of quasi-market failure might, in the same vein, allow us to distinguish what is most fundamental in critiques of the various instruments of quasi-market production from that which is merely contextual to the instrument or case at hand. As such, an analysis of quasi-market failure should be a useful guide both to explaining outcomes in urban service delivery and to prescribing how they might be improved. And importantly, examining quasi markets from the perspective of institutional failure does not imply that quasi markets always or inevitably fail, only that they can fail, and for reasons that are systematic rather than idiosyncratic. In this, the analysis of quasi-market failure fully parallels prior analyses of both market (Samuels 1972, 93) and nonmarket failure (Buchanan 1972, 23; Ostrom and Ostrom 1971, 203-16).

INSTITUTIONAL FAILURE AND CONSUMER SOVEREIGNTY

Examining quasi-markets from the perspective of institutional failure requires a standard of evaluation. The standard we will use is the same as that used in conventional analyses of both market and nonmarket failure: idealized market outcomes. The outcomes of idealized markets can be characterized in any number of ways (Friedman and Friedman 1980, 9-27). However, the traits that are perhaps most important to advocates of market institutions are those associated with the concept of consumer sovereignty (Scitovsky 1962, 264). Jerome Rothenberg (1962, 269) has noted that "[c]onsumers' sovereignty was early used in two senses . . . [i]n its descriptive sense it simply signified that the consumer was in fact the ultimate king: production in a market economy is ultimately oriented toward meeting the wants of consumers." In an economy of many small producers, and when a variety of other familiar assumptions are satisfied, the tastes of consumers will guide what is produced and how it is distributed. The centrality of this descriptive use of the concept of consumer sovereignty inheres in how it subsumes or implies many other expected outcomes of market exchange. It is the constraint of consumer sovereignty, for example, that generates incentives to innovate and orchestrates coordination of supply and demand.

The concept of consumer sovereignty, however, has a second meaning that goes beyond simple description, a normative

meaning rooted in the utilitarian vision of the good life (Buchanan 1975). Thus, Rothenberg continues:

In its normative sense consumers' sovereignty asserted that the performance of an economy should be evaluated in terms of the degree to which it fulfills the wants of consumers. . . . The principle of consumers' sovereignty as presently employed is a value judgment which stipulates that we should take the degree of fulfillment of consumers' wants—or the degree to which performance accords with consumers' tastes—as a criterion for evaluating the social desirability of different social situations and, through these, the desirability of the various public policies or institutional structures which give rise to them (1962, 269-70).

This normative use of consumer sovereignty is central, of course, to the methodological individualism that underlies economic analysis of institutions (V. Ostrom 1974, 50-52; V. Ostrom 1977; Ostrom and Ostrom 1971, 205-06). Just as importantly, the extraction of policy recommendations from the use of consumer sovereignty as a description of market operations depends on its second normative use (Rothenberg 1962, 271). Under ideal conditions, then, markets both provide consumer sovereignty and are justified by it.

The normative use of consumer sovereignty can be critiqued any number of ways, especially from outside the economic paradigm in which public choice theory is embedded (e.g., Baker 1976; Golembiewski 1977; Furniss 1978; Wade 1979). As an internal critique of quasi markets, though, these will not be addressed here. Simply put, public choice theory takes a narrow view of the purposes of public goods provision (Kirlin 1996). As Ostrom and Ostrom (1971, 207) have noted, from a public-choice perspective "public agencies are viewed as means for allocating decision-making capabilities in order to provide public goods and services responsive to the preferences of individuals." From a public-choice perspective, insuring consumer sovereignty must be the central criterion meriting attention.

While this may seem to be excessively limiting, viewing public-sector performance in terms of consumer sovereignty entails use of the same standard employed in prior economics-grounded analyses of institutional failure. Theories of market and nonmarket failure constitute explications of the conditions under which institutions fail to satisfy consumers' preferences. Their policy recommendations prescribe how those institutions might be modified or replaced so as to more completely satisfy the requirements of consumer sovereignty. By extension, a theory of quasi-market failure should do the same for quasi-market institutions.

But what do consumers prefer when they exercise sovereignty? This question is not unique to quasi-markets (Rothenberg 1962, 273), but it presents us with something of a special dilemma. On the one hand, quasi-markets have been associated with any number of worthy objectives. As Cullis and Jones (1992, 134) note, "Commentaries on privatization see it as a cure for everything from an economic cold to economic cancer plus a few political ailments." On the other hand, these claims all too often are poorly explicated. Indeed, public choice analyses of quasi-markets rarely discuss specific preferences in anything like an explicit manner (e.g., Chubb and Moe 1990; Savas 1987). Still, the literature touting quasi-markets typically characterizes preferences on two broad dimensions. First, it is assumed that preferences for public goods and services are heterogeneous. To satisfy the requirements of consumer sovereignty, local governments should provide—and perhaps produce—goods and services that are heterogeneous in an isomorphic manner. Second, it is assumed that consumers prefer that their tastes be satisfied in an efficient manner; all other things equal, high quality goods and services are preferred to low quality, and low cost is preferred to high cost. These two dimensions are distinct: homogenous services can be provided efficiently or heterogeneous services provided inefficiently.

A rather large empirical literature has developed that criticizes quasi-market institutions. While for the most part they are unconnected, many of these criticisms are similarly founded on one of three ways in which quasi-markets may not always satisfy the rigorous requirements of consumer sovereignty. The first, *failure in market formation*, closely parallels traditional analysis of market and nonmarket failure and has been duly recognized—if not intensively examined—in the quasi-market literature. The second, *failure by preference error*, also has been recognized to some degree in the literature, but some original wrinkles are added when this source of institutional failure is applied to quasi markets. The third, *failure by preference substitution*, is unique to quasi markets, given their distinctive separation of provision and production, and it has received little comment. The consequences of each source of failure for consumer sovereignty are examined along with an evaluation of the efficacy of possible remedies that might be available while working within a quasi-market regime.

Examples from the empirical literature on urban service production are discussed for each of the sources of failure, in the spirit of a reality check so as to anchor theoretical arguments about quasi-market failure in plausible empirical reality. Many institutional arrangements have been identified as quasi-markets

(Savas 1987, 58-92) or as having quasi-market characteristics (Stein 1993; Percy 1984). The examples I will discuss focus on four of the most prominent of these mechanisms applied to urban service delivery: contracting, vouchers, and the Tiebout model both as originally presented by Charles Tiebout (1956; Ostrom, Tiebout, and Warren 1961) and, to a lesser extent, as modified by Teske, Schneider, Mintrom, and Best (1993; Schneider and Teske 1993) to include a powerful role for both consumers and policy entrepreneurs.

FAILURE IN QUASI-MARKET FORMATION

The problems of monopoly and oligopoly, of course, were not unknown to Adam Smith (1937 [1776]). Classical theories of monopoly suggest that monopoly and oligopoly can develop due to any of three conditions: when marginal costs decline, when there are legal barriers to entry, or when a resource essential to production is cornered (Phelps 1985, 282-309). Monopolies strike at the heart of consumer sovereignty by eliminating competition. Lacking competition, or at least potential competition in the form of contestable markets (Baumol, Panzar, and Willig 1982), there is no incentive to be efficient.¹ Similarly, the problem of monopoly is a central element of the theory of nonmarket failure (Niskanen 1971; Chubb and Moe 1990). But while problems of monopoly have been recognized as applying fully to the workings of quasi markets (Savas 1987, 279; Stein 1993, 68-70; Donahue 1989, 147), with but one exception proponents have not examined failure of quasi-market formation in any depth or with any consistency. The exception is the legal barrier to entry posed by "cities without suburbs" (Rusk 1995), which precludes efforts to establish Tiebout (1956) quasi-markets. Elimination of such legal barriers to entry as consolidated governments and permissive annexation laws constitutes core policy recommendations offered by advocates of Tiebout quasi-markets (E. Ostrom 1972).

The problem of monopoly is simply applied to contracting and vouchers when these quasi-market tools rely on some form of institutional production—for example, through a firm or a school. For the consumer sovereignty advantages of competition to obtain, there must be a competitive quasi-market of institutional providers. Yet, in a careful study of contracting for substance abuse services in North Carolina, Smith and Smyth (1996, 286) observed that "it is striking how little formal competition there is for contracted substance abuse services in North Carolina. Few contracts are competitively bid, and once created a contract tends to be renewed routinely." Smith and Smyth attribute this failure to all three sources of monopoly. With insufficient demand in rural settings to support more than a single provider, the vendor

¹Supporters of contracting and vouchers are quick to cite contestable markets when reference is made to lack of overt competition over contracts; they do not realize that the argument applies as well to the presumed monopolists that are engaged in direct public production so long as contracting is at least on the table for consideration. Indeed, such active consideration, rather than contracting *per se*, may be all that is required to secure the efficiency advantages of quasi markets.

corners the market of all available consumers. But assuming ease of entry, even this problem should not be sufficient to prevent competition over time as contracts are rebid. So ultimately, they attribute the failure of quasi-market formation in both rural and urban settings to declining marginal costs (Smith and Smyth 1996, 293) and quasi-legal barriers to entry in the form of raw political clout and enduring relationships of trust that develop between monopoly producers and providing governments (Smith and Smyth 1996, 279-82; but see also Williamson 1975, 34-35). The former problem suggests that franchises or direct public production rather than contracting might be more appropriate, and the latter problems of political influence and/or relationships of trust are not inherent in the use of contracting per se, but arise from ineffective implementation. All too often, though, the public choice literature which so castigates public officials when discussing nonmarket failure (e.g., Savas 1987) assumes that Niskanen's (1971) bureaucrats are somehow transformed into responsive public servants once contracting is adopted.

Is this case typical or unusual? Werner Hirsch (1995a, 230; see also Haque 1996) has cautioned, on the basis of an extensive review of the contracting literature, that "markets for local public services are apt to be imperfectly competitive." But there are few broad-scale studies that address this issue. The one that perhaps comes closest to providing an answer is Stein's (1990) analysis of contracting for sixty functional responsibilities by more than eleven thousand cities. Stein (1990, 201) concluded his analysis by reporting, "I have not confirmed widespread efficiency gains from the use of service contracts, either joint or complete, for individual goods and services. To the contrary, the findings show limited evidence that contracting at the bureau level nets a significant reduction in spending." It remains unclear, however, *why* this is so.

With little evidence, Stein (1990, 201-02) blames bureau officials. But his null finding could be due *either* to a lack of quasi-market competition *or* to the effectiveness of contestable markets. Lack of competition within contracting quasi-markets could have resulted in Stein's (1990) comparing monopolistic public production with monopolistic private production. While their enthusiasm for controlling monopolies has varied over time (Stigler 1982), economists traditionally suggest that the appropriate remedies for such problems should include regulation, public production, or franchise agreements (privatization rather than quasi-market production) in the case of declining marginal costs. And government actions to dissolve monopolies are called for in cases of legal or quasi-legal barriers to entry and/or the cornering of resources vital for entry into a market. On the other

hand, the theory of contestable markets (Baumol, Panzar, and Willig 1982) suggests that actual competition may not be required if "many firms would quickly become available if the price paid by government exceeded the average cost incurred by contractors" (Thompson 1993, 580). One underexamined implication of this argument is that, given the extensive use of contracting observed by Stein (1990), even public production may operate in a fully contestable market. If so, then few efficiency differences would be observed between public and contract production. But in this case, it would be because the former cannot act as monopolists. To date, we have remarkably little systematic evidence supporting either of these radically different answers. If either is valid, the presumed efficiency advantages of contract production should evaporate.

Tiebout quasi-markets raise two issues of monopoly. First, little attention has been paid to how many independent communities are required for the benefits of quasi-market competition to succeed. Research assessing Peterson's *City Limits* (1981) version of the Tiebout model indicates that fragmented governmental institutions spend less, especially on redistribution (Schneider 1989). However, it is not clear that consumer satisfaction was thereby improved.² Even if so, proving that the savings found by Schneider (1989) result from efficiencies in the production of local public goods and services generated by competition is a more difficult task. Thus, based on an extensive review of the literature, Dowding, John, and Biggs (1994, 787) note that "[i]t is very difficult to test the proposition that the greater [the] number of jurisdictions, the greater the competition between them. There is virtually no worthwhile evidence to support this implication." But even admitting that the task is difficult, this research gap is still glaring in light of the oceans of academic blood shed over how many producers are needed for a market to be competitive for even a single private good, which is certainly no easier to determine empirically.

To create a rough sketch of the magnitude of this problem, we might first assume that there must be at least twice as many independent jurisdictions as there are goods and services provided by local government, even if preferences are limited to simply favoring or not favoring provision. Only then could a Tiebout quasi-market present consumers with a full set of market baskets representing the heterogeneity of their preferences for simply providing or not providing each good. Savas (1987, 119-230) lists more than a dozen goods and services commonly provided by local government, while Stein (1990, 133-35) examines more than sixty. But even using Savas's lower estimate, establishing only twenty-four jurisdictions is not alone sufficient to

²Some research suggests that satisfaction is positively associated with both the number and the quality of local public goods and services (DeHoog, Lowery, and Lyons 1990).

satisfy heterogeneous tastes. All plausible combinations of these twelve goods and services must be represented among the choices presented to consumers: 10^{12} or 4,096 cities.

To this point, we have satisfied only the requirement of offering market baskets that match consumers' heterogeneous tastes for or against provision. Since each market basket constitutes a monopoly of the particular combination of goods and services provided therein, there can as yet be little competition over efficiency in their production. How much competition over efficiency is sufficient? Teske and his colleagues (1993) assess variations in inputs in the provision of local education services with a three-item index indicating above average, about average, and below average spending. For competition to occur on outputs as well, at least three levels of quality at any given spending level might be necessary. In combination, then, we potentially have nine levels of efficiency that represent variations in the ratio of outputs to inputs for even one level of provision of even one good or service. Without such variation, competition among locations will occur only on the heterogeneous tastes dimension of consumer preferences, not on the dimension of production efficiency. When we multiply this by the possible combinations of provided goods or services we quickly arrive at large numbers.

In short, satisfying heterogeneous tastes—and doing so in a manner that encourages productive efficiency—*may* require a very large number of municipal jurisdictions. *May* is used deliberately because we simply do not know. Tiebout exiters may be attentive to only one or a few services in making location decisions, or their preferences may be arrayed neatly by income. Also, consumer preferences might be arrayed so as to be encompassed by only a few broad combinations of goods and services, as suggested by Schneider's (1989) research on redistributive, allocational, and developmental spending in suburbs. Overlapping jurisdictions of different sizes that offer a more limited range of choice on some services also might reduce the amount of variation that is required to efficiently satisfy diverse preferences. But claims for the Tiebout model are not restricted to only a few services, and it is not touted as an institutional remedy for non-market failure applicable only in large metropolitan areas (Bish and V. Ostrom 1973; E. Ostrom 1972). The quick calculations noted above suggest that such proponents should be expected to demonstrate precisely how number of jurisdictions is related to satisfying diverse tastes and doing so in a manner that enhances production efficiency.

Failure also occurs in Tiebout quasi-market formation in another way. In this case, quasi-legal barriers to entry and

cornering a vital resource are the culprits. But here there are distinct and rather serious distributive implications, since failure is only partial. This claim starts with the observation that establishment of an independent municipality requires a minimally viable tax base. Many critics of the Tiebout model suggest that low income and minority consumers are excluded systematically from the assumed benefits of Tiebout quasi-markets because of limited access to minimally viable tax bases.

At least part of this argument is not about failure in quasi-market formation per se and is more appropriately characterized as a negative externality that arises from use of Tiebout quasi markets. That is, critics suggest that Tiebout quasi-markets create local monopolies over land use regulations, which can be used by current residents to corner the resource of space so as to exclude low income and black movers from existing Tiebout enclaves (Hill 1974; Neiman 1976). This is a negative externality in that consumption by one set of consumers, through control of land use regulations created by the establishment of the quasi market, impose unrecompensed costs on others. While the proportion of suburban blacks has increased in recent decades, high levels of segregation have not declined (Logan and Schneider 1982 and 1984; Schneider and Logan 1981; Stahura 1988; Massey and Gross 1991; Massey and Eggers 1993). That is, previously high levels of intrajurisdictional segregation have been replaced by interjurisdictional segregation (Weiher 1991, 87-115).³ Indeed, because the judiciary discourages the former but turns a blind eye to the latter (Weiher 1991, 92-95), this externality is ever more uniquely a result of reliance on Tiebout quasi-markets than in the past.⁴

While proponents of Tiebout quasi-markets show appropriate regret about persistent discrimination, the two remedies that are usually offered are not sufficient. The first solution is for a higher level of government to engage in redistributive spending (E. Ostrom 1983, 101; Hill, Wolman, and Ford 1995, 165-68; Dowding, John, and Biggs 1994, 773; Parks and Oakerson 1989, 22-23), a policy recommendation that rings quite hollow in the face of two decades of federal cutbacks in redistributive spending. The second solution only brings us back to the problem of monopoly and failure in quasi-market formation. That is, Elinor Ostrom (1983, 103) suggests, even with segregation, the poor and blacks still can benefit from the consumer sovereignty enhancing advantages of quasi-markets by forming their own Tiebout enclaves. The problem, of course, is that existing suburbs often have cornered the tax base necessary to make such incorporation viable. Or if the property market is not already cornered, business interests opposed to incorporation can use their

³See Farley (1983) for an even more pessimistic interpretation.

⁴Inattention to the serious distributive implications of Tiebout quasi markets can no longer be excused, as it was by E. Ostrom (1983, 95), who noted that racial discrimination within cities is just as bad as it is in the suburbs.

superior political resources to resist incorporation, thereby erecting a quasi-legal barrier to access to the market (Hoch 1985). For example, what was nearly the only black suburb of Louisville was forced to incorporate as a donut around the only meaningful business district in the vicinity and, as a consequence, proved so nonviable that disincorporation shortly followed (DeHoog, Lowery, and Lyons 1991). In such cases, it is the Tiebout quasi-market itself that constitutes a semilegal barrier to entry.

FAILURE BY PREFERENCE ERROR

The second and third sources of failure address the role of demand in quasi-markets, with the second suggesting that quasi markets can fail due to erroneous preferences. This problem might strike some as inconsistent with the very notion of consumer sovereignty, if sovereignty is taken too literally. But the issue of erroneous preferences long has been recognized in the analysis of market transactions (Rothenberg 1962, 277; March 1992, 230-31). Indeed, economists have explored a number of ways in which preferences might be characterized as erroneous, and each has a quasi-market parallel.

First, markets, nonmarkets, and quasi-markets can fail if consumers lack sufficient information to make choices that reflect their true preferences (J.B. Stevens 1993, 66-67). This is not an especially rigorous requirement. As Tibor Scitovsky (1962, 265) noted, there will be "no great loss of sovereignty as long as [the consumer] . . . is able to distinguish the good from the bad and to recognize solid construction, good design, and practical and imaginative ideas." Not all consumers must be so well informed to generate the efficiency advantages of markets, only a number sufficient to initiate and sustain the selection process that lies at the heart of competitive markets. Others may free ride on the efforts of better informed consumers without great individual or social cost so long as the preferences of informed marginal consumers are representative of those of all consumers were they fully informed. But it is not clear how many informed marginal consumers are required to ensure a competitive market, or if the preferences of marginal informed consumers can always represent those of consumers more generally. Teske and his colleagues (1993, 709; but see also Lowery et al. 1995, 706) cite evidence that a competitive market will be generated in simple transactions if even as few as 10 percent of consumers are informed. Even in such simple cases, at least some economists doubt whether the requirements of consumer sovereignty can be met (Scitovsky 1962, 266). In short, even markets are not spared debates about what constitutes informed preferences.

The problem is likely to be even more severe for quasi-markets that rely on direct decisions by consumers—vouchers and the Tiebout model—for the simple reason that the goods and services exchanged are often much more complex than those typical of private market transactions. In Ferris and Graddy's terms, "The more complex the product, the better suited it is to public production" (1986, 333). Yet, this point generally is overlooked, given that the portrait of market transactions found in the literature on quasi-markets (e.g., Savas 1987; Chubb and Moe 1990; Tiebout 1956) is often the simple caricature found in introductory economics texts. While not all transactions within quasi markets concern complex goods and services, when they do, such simplified interpretations of market exchanges may hide more than they reveal. This does not mean that market economics cannot provide useful guidance in analyzing complex transactions, only that such guidance is more likely to be found in more sophisticated works like Williamson's *Markets and Hierarchies* (1975) than in the stylized markets of introductory economics texts (e.g., J.B. Stevens 1993, 20-39).

It is obvious, for example, that quality education is a very complex service (Chubb and Moe 1990, 70-71). Do enough parents have sufficient knowledge about what constitutes quality education to produce a competitive market using vouchers? Chubb and Moe (1990) certainly do not provide any evidence bearing on this issue. Indeed, the question is not even raised in *Politics, Markets, and America's Schools*. Smith and Meier (1995, 126), while also lacking direct evidence, express doubts in their assessment of school choice in Florida: "The market solution assumes parents and students will have enough information to make a decision on what school offers the 'best' education. This assumption appears to be patently insupportable." Or rather, insupportable so long as one is unwilling to simply assume that preferences are fully exogenous and that education is a simple good.

At a minimum, proponents of quasi markets should evaluate levels of consumer information when they advocate vouchers or the Tiebout model. In one of the few studies to do so, Teske and colleagues (1993) examined survey data from Long Island to evaluate Tiebout quasi-market provision of education services. They did not measure knowledge about education quality per se; they simply measured whether survey respondents could accurately identify whether their school district's expenditures were above average, about average, or below average among the seventy-one districts in Suffolk County. While many object with good reason to the use of expenditures as indicators of quality, the former surely must constitute the denominator in any

plausible indicator of efficiency and should, therefore, be considered to be an essential part of the information consumers need in order to make informed choices. Still, only 21 percent of participants gave accurate responses even through Long Island school districts provide a most unusual cue in the form of annual budget referendums (Inman 1978, 54). And the informed consumers so identified were not representative of the larger population of consumers of school services—they were much wealthier (Teske et al. 1993, 707-08). If preferences for education services vary by income, then the actions of these informed consumers are likely to drive markets by a somewhat different set of preferences than those of average consumers were they fully informed.

Quasi-market proponents do offer some solutions to problems of inadequate information. Some call for government subsidization of information (Chubb and Moe 1990, 221). But given the sheer mass of information now freely available about schools, it seems implausible that much more will make any great difference *absent enhanced incentives to retrieve and use any information*. But proponents suggest that the simple establishment of a quasi-market institutional structure will itself provide strong incentives for schools to provide information and for parents to become better informed. Entrepreneurs working within quasi-markets also might have incentives to provide information to consumers (Teske et al. 1993). Yet, this claim seems implausible for Tiebout quasi markets given that the Long Island school districts studied by Teske et al. (1993)—in which only 21 percent of respondents were identified as well informed using even the simplest of criteria—are already described as Tiebout-like. And a quasi-experimental analysis of parent information networks in two school choice districts—one in New York City and the other a suburban district in New Jersey—matched with two nonchoice districts in the same states found little support for this claim when applied to vouchers. Schneider, Teske, Roch, and Marshall (1996, 18) report that "[d]espite the incentives to gather information built into choice, by most measures networks are not better in choice districts. At the most basic level, choice has no effect on the size of networks, which is often taken as the sine qua non of network quality." And perhaps most telling, one of the choice districts in this study is the very one among all existing choice districts in the nation that Chubb and Moe (1990, 214) suggest "deserves to be held up as a model for all the others."

To this point, we have seen that quasi-market failure due to erroneous preferences arising from inadequate information is plausible. Only two more complications need be added before turning to the information problem that underlies the other quasi-market institution of contracting. First, for all of the difficulties

associated with information about education, it remains the single good or service provided by local government that is most salient to consumers. When we examine even the most basic levels of knowledge about local goods and services, the results are even more dismal. Lyons and Lowery (1989), for example, report that citizens in the Tiebout quasi-market of suburban cities in Jefferson County, Kentucky, make a distressingly large number of errors in simply identifying whether or not their city provides eleven common services.

Second, the problem becomes even more severe when we examine the full promise of Tiebout quasi-markets. That is, our examination of the information requirements of vouchers and the Tiebout model so far have been applied to the case of a single service. Most empirical studies of Tiebout quasi-markets have been restricted to but a single service (e.g., Teske et al. 1993). The Tiebout model, however, speaks to choices among *market baskets of goods and services*, not to a single good or service in isolation. When consumers purchase school services in a Tiebout quasi-market by moving to a new city, they also purchase police, fire, sanitation, and streetlighting services. Because an informed consumer must know about each of these goods and services, standards of informed preferences within a Tiebout quasi-market must be even more stringent and demanding than those for vouchers or even for most market transactions.

Unlike quasi markets that are dependent on direct consumer choice, it seems more plausible to expect that preferences will be adequately informed when governments engage in contracting, since expert—or at least experienced—public officials make choices among contract options. While this ameliorates the problem of complex goods it does not eliminate it. The complexity of contracting may itself generate costs that are rarely considered when opting for this mode of production. That is, the full costs of public goods and services include both production costs *and* the transactions costs associated with bargaining over contracts and monitoring their execution (Ferris and Graddy 1994, 128). Yet, most studies that advocate the cost advantages of contracting fail to consider their enhanced transactions costs (Globerman and Vining 1996, 579; Ferris and Graddy 1991, 542). When attention is on short-term budget savings, city officials are all too likely to follow suit by ignoring transactions costs. Such simple comparisons of the costs of direct public production and contracting often lead to an excess demand for the latter. Additionally, even if such costs are incorporated into the contracting decision, government may have a difficult time simply deciding what is to be produced. As John Donahue (1989, 217) concluded on the basis of an extensive review of the literature, "The first lesson seems

simple enough, yet often goes unheeded. If government does not specify what it wants from suppliers, or does not evaluate what it has received, it should not expect to get what it needs." For both reasons, city governments can fail to be adequately informed consumers.

The real question must be, *Why* do governments fail this test? If, on the one hand, failure is due to incompetence or negligence, it is merely a problem of implementation—at least if one believes that governments have incentives to correct errors. Such incentives might be generated internally through a mix of democratic and bureaucratic controls, or they might be generated externally in Tiebout quasi-markets by consumers who vote with their feet. Many public choice scholars, of course, have grave doubts about the former (Niskanen 1971; but see also McCubbins and Schwartz 1984; Weingast and Moran 1983; Moe 1985; Wood and Waterman 1994; Brehm and Gates 1997) and considerable faith in the latter.⁵ So whether we can expect errors of implementation to be corrected—and the efficiency gains of contracting realized through informed consumer choice—depends to a considerable degree on the structure of incentives bearing on city governments. Advocates of contracting should be expected, therefore, to clearly specify these incentives and to demonstrate their effectiveness. Indeed, plausible advocacy of contracting is to a great degree dependent on specification of a model of bureaucratic control. Given the wide range of extraordinarily divergent models of bureaucratic control now available (Lowery 1993), this is not a simple or easily satisfied requirement.

On the other hand, however, the problem may reside less with public employees than with the good or service contracted for. As Donahue (1989, 217) notes, "Many municipal services are readily definable and easy to measure and evaluate." But many others are not (Thompson 1993), especially human services (DeHoog 1984; Smith and Smyth 1996). The complexity of choice has long been noted about goods and services that have multiple and competing objectives and difficult-to-observe outcomes. What is rarely understood—for exceptions, see Thompson (1993); Globberman and Vining (1996)—is that complete specification of the requirements of contracts in such cases presupposes a rational decision process that can deal with this complexity by clarifying means and ends relationships, identifying valid and reliable measures of performance, and often doing so in the context of inadequate theory and limited experience.

Many political scientists have extreme reservations about the plausible capacity of rational decision processes to accomplish this, arguing instead that it is often more rational to muddle

⁵It might be informative to test the Tiebout model by examining whether the contracting procedures of isolated cities are less well developed than those of comparable cities that operate within a Tiebout setting.

through by defining ends and means simultaneously over time via incremental learning (Lindblom 1968; Wildavsky 1964; Straussman 1978). As Williamson notes, "In circumstances where complex, contingent claims contracts are infeasible and sequential spot markets are hazardous, internal organization facilitates adaptive, sequential decision making, thereby to economize on bounded rationality" (1975, 40; see also Thompson 1993; Globerman and Vining 1996). From this perspective, it is not at all surprising Smith and Smyth (1996) found that *trust* or what Williamson (1975) refers to as *confidence*—rather than highly detailed contracts—characterized the relationship of substance abuse service providers and producers in North Carolina.

The *second* source of erroneous preferences goes beyond simple lack of information to consider preference manipulation. This problem is not unique to quasi markets. It constituted the core of Galbraith's (1958) critique of the role of advertising as well as the New Left's assessment of manipulation within market economies more generally (Bach, Hymer, Roosevelt, Sweeny, and Lindbeck 1972). Much the same complaint has been raised in regard to nonmarket relationships in critical evaluations of political uses of legislative franking (Cover and Brumberg 1982) and casework (Fiorina 1977), the generation of fiscal illusions (Lowery 1987), and bureaucratic control of information (Niskanen 1971; but see also Miller and Moe 1983) to alter the preferences of voters and/or elected representatives.

It is not surprising then that the same concern has been raised about quasi markets. In regard to school vouchers, for example, Smith and Meier (1995, 28) explicitly raise the issue of preference manipulation via advertising in a manner that fully parallels Galbraith's argument (1958). A number of studies of contracting have raised questions about the power of vendors to manipulate the preferences of local governments (Smith and Smyth 1996, 285; Gormley 1996, 244). Thus, Milward's (1996, 194) empirical assessment of the hollow state thesis in human services contracting led him to caution that "third-party providers may organize politically to pressure elected representatives to intervene in disputes between the government agency and its network of nonprofits and firms." In short, problems of manipulated preferences are common to markets, nonmarkets, and quasi-markets.

For this common version of the problem, public choice scholars recommend the common solution that markets provide their own cure through competitive advertising (Bach et al. 1972, 661). Absent monopoly, competitors will have sufficient incentive to balance manipulative advertising with even more

advertising. While the efficacy of this solution often seems to be founded more on faith than evidence, it is at least plausible where there is actual competition, as opposed to cases where the market is merely contestable.

Another complication arises in quasi markets—Tiebout quasi markets especially—that makes this solution less tenable. As was noted before, Tiebout quasi markets are not comparable to markets for private goods and services, given the complexity of both the market baskets that are offered and the institutions that offer them. Packages of multiple goods and services provided by both spatially contiguous and overlapping jurisdictions—especially when combined with low salience—place greater demands on consumers than do private markets. Some confusion is inevitable (Ostrom, Bish, and Ostrom 1988, 66; Dagger 1981, 752), which greatly expands opportunities to politically manipulate consumer preferences should someone be in a position to manipulate them and be so motivated.

So, are any of the actors involved in the quasi-market processes of provision and production so situated and so motivated? And if so, why doesn't competition solve the problem? In regard to the first question, it requires no great stretch within a public choice framework to suggest that elected officials are strongly motivated to take advantage of opportunities to enhance their reputations among citizens. Among the things elected officials might wish to claim credit for are quality services (DeHoog, Lowery, and Lyons 1990) provided at a low price. And they seldom would hesitate to blame high taxes and poor services on someone else. Evidence suggests that elected officials can take advantage of institutional complexity to do both. Analysis of levels of citizen satisfaction with local government services in the Tiebout quasi-market of Jefferson County, Kentucky, provides strong evidence that errors in assigning blame for both good and poor services are systematically biased (Lowery, Lyons, and DeHoog 1990). That is, city officials are often credited with providing high quality services even when those services are actually provided by an overlapping or neighboring jurisdiction, and they avoid blame for low quality goods and services through citizens' attribution of responsibility to another jurisdiction. These attribution errors, in turn, systematically bias overall satisfaction levels in a positive manner, leading voters to be more satisfied with local government than they would be were they fully informed. The most plausible explanation for this outcome is the enhanced opportunity to shift credit and blame because of the confusion over just who is responsible for what (Lowery, Lyons, and DeHoog 1990).

The same scenario appears to be true for citizen evaluations of property taxes. A study of the unusually complex institutions of property taxation in Michigan suggests that overlapping institutional responsibilities enable local elected assessors to systematically underassess property and, thereby, please voters without losing tax revenue. That is, they routinely blame both county and state property tax authorities for the tax increases made inevitable by the county and state equalization processes that correct systematic underassessments (Lowery 1985). Such manipulation is a function of electoral incentives given that appointed assessors are far less likely to engage in this particular fiscal illusion (Lowery 1982a; 1984).⁶ On both the tax and spending sides of the fiscal equation, then, it seems that elected officials in complex institutional settings can and do act to manipulate consumer preferences.

Can competition solve this problem? Interestingly, the original Tiebout model provides no mechanism for such competition, since it views local governments as entirely passive actors. In a recent revision of the model, however, Teske et al. (1993; Schneider and Teske 1993) replace active consumers with entrepreneurial politicians and wealthy movers, thereby suggesting that competition might provide a solution. But it seems likely that incentives to collude are too strong. That is, county and state officials in Michigan accept the blame for tax increases arising from equalization for the simple reason that correcting the fiscal illusion might lead to resistance to local tax increases, thereby increasing demands on their own revenues (Lowery 1983). An elected official in city A has little incentive to tell voters in city B that their official's claim of credit for high quality sewers is undeserved. Not only can voters in city B not vote for the official from city A, officials in city B might then be motivated to retaliate by exposing city A's systematic manipulation of service attributions. Perhaps the only form of competition that might lead to a market in information is electoral competition *within* Tiebout-like cities. Why such competition did not provide sufficient incentives to correct the systematic attribution errors found in three of the five Tiebout cities studied by Lowery, Lyons, and DeHoog (1990) remains a puzzle and merits further research. Perhaps the most plausible explanation is that the benefits of holding office in these tiny cities are often so inconsequential and electoral competition so tepid that the gains from exposing such illusions are not sufficient to counterbalance the advantages that, through their maintenance, accrue to both reigning and aspiring officials.

The *third* source of preference error arises from externalities, interdependencies between the consumption by individuals

⁶Because the errors made by elected assessors are systematic rather than random, the errors are not due to the assessors simply being less technically skilled than are the appointed assessors (Lowery 1982a).

not captured by prices. The problem of external costs and benefits has been long recognized in market transactions (Rothenberg 1962, 271; Bergson 1962, 284; Mishan 1971). Thus, Cullis and Jones (1992, 41-42) note that when they are present, "markets, even perfectly competitive ones, no longer guarantee that a Pareto-optimal solution emerges. . . . While the externality exists, it is obvious that markets will not maximize welfare." Externalities also play an important role in analyses of nonmarket failure, with special attention accorded to the ability of nonmarket agencies to externalize costs onto consumers (Ostrom and Ostrom 1971, 210).

Two solutions to the problem of externalities are commonly offered. The first is found in Coase's (1960; Furubotn and Pejovich 1972; Stevens 1993, 110-111) observation that a complete specification of property rights enables trades so that externalities are internalized and, thus, allocational inefficiencies are eliminated. Coase's solution requires that transactions costs be minimal, and it says little about equity (Mishan 1971, 17-26; Schmid 1978, 212; J.B. Stevens 1993, 110-11). When such considerations are deemed important, public-choice scholars admit that a second solution also might be legitimate: opting for a larger scale of provision so that formerly externalized costs and benefits are now internalized within a relevantly scaled decision-making unit (E. Ostrom 1983, 101; Hill, Wolman, and Ford 1995, 165-68; Dowding, John, and Biggs 1994, 773; Parks and Oakerson 1989, 22-23).

With these solutions in mind, how do externalities influence preferences in quasi-markets? To answer this question, we need to consider the plausibility of externalities in quasi-markets, the possibilities of fully specifying property rights, the equity implications inherent in their specification, and the likelihood of internalization by more encompassing jurisdictions. And we shall do so for three types of externalities—what Schmid (1978, 171-178) has labeled, respectively, technological, pecuniary, and political externalities.

Technological externalities occur when "somebody physically affects you or your good directly" without considering that impact when so acting (Schmid 1978, 171). While the possibility of such spillovers has been noted for Tiebout quasi-markets (E. Ostrom 1972, 487-88), they are rarely studied. The most obvious of these are the transactions costs imposed on consumers by Tiebout quasi-markets. But such costs also may arise from goods and services production within such settings. For example, McKinney (1985) analyzed externalities in police services (services provided by one jurisdiction to residents of another and

diversions of criminal activity across jurisdictions) with data on sixty-four metropolitan areas originally gathered by E. Ostrom, Parks, and Whitaker (1978). The findings provide modest support for McKinney's expectations, with the negative externality dominating the results; greater density of jurisdictions leads to higher than optimal levels of spending on policing as each city tries to divert crime into neighboring jurisdictions. More to the point, McKinney (1985) found that cooperation among police departments does not fully account for the excess spending.

Coase's (1960) work, however, would lead us to expect that contiguous jurisdictions will perceive gains from trade and bargain to eliminate excess spending. The most plausible answer to why such arrangements remain incomplete lies in Coase's requirements that property rights be well specified and transactions costs zero. The plausibility of both is limited for quasi markets, where joint consumption and nonexclusion characteristics are ubiquitous. And transactions costs—because of opportunism—are likely to be excessive in cases of bargaining between contiguous jurisdictions. Williamson (1975, 9), who defines opportunism as "a lack of candor or honesty in transactions to include self-interest seeking with guile," notes that opportunism is rarely a problem in market settings with many consumers. But Williamson also notes that when

opportunism is joined with a small-numbers condition, the trading situation is greatly transformed. All of the types of difficulties associated with exchange between bilateral monopolists in stochastic market circumstances now appear. The transactional dilemma that is posed is this: it is in the interest of each party to seek terms most favorable to him, which encourages opportunistic representations and haggling. The interests of the system, by contrast, are promoted if the parties can be joined in such a way as to avoid both the bargaining costs and indirect costs (mainly maladaptation costs) which are generated in the process. (1975, 27)

In sum, technological externalities are a real possibility within quasi markets. Indeed, Hirsch (1995b, 165) argues that they are quite common.

Pecuniary externalities, which arise when the choices of one actor influence the exchange value of another actor's goods or services (Schmid 1978, 173), are especially likely in cases of contracting. Contracting saves money. And despite early claims that these savings result from black box efficiencies inherent in private management (B.J. Stevens 1984), further analysis strongly suggests that they arise primarily from reduced labor costs (Donahue 1989, 143-46; Hirsch 1995b). By shifting public goods and services to quasi-market production, governments reduce the exchange value of the public employees' labor. The

issue here is not whether such shifts are justified but whether they enter into the decision to contract. If not, the benefits of contracting are likely to be overestimated relative to its true social costs, and, thus, demand for contract services will be nonoptimally excessive.⁷

Technological and pecuniary externalities arise from the nature of a good or service. In contrast, *political externalities* arise from structures of public choice that allow some to create costs for others, whether through the specification of property rights or a failure to do so (Schmid 1978, 176-78). The drawing of political boundaries constitutes one of the primary mechanisms for creating political externalities (Schmid 1978, 147-50).

As I have noted earlier, many critics of Tiebout quasi markets argue that they create local monopolies over land use regulations. This in turn facilitates the growth of a dual housing market that both excludes blacks from many suburbs and denies them any real opportunity to establish their own Tiebout jurisdictions so as to at least benefit from their presumed efficiency advantages in a separate but equal manner. Some argue that it is no accident that Tiebout quasi-markets generate these results (Hill 1974). Or as Weiher (1991, 191) notes, "There is a curious tendency to ignore the fact that segregative outcomes are purposive." This may be too strong. But while it is perhaps not an intended result of Tiebout quasi-market institutions, the opportunity to segregate secured through their adoption surely entail the externalization of costs by white suburbanites onto their black neighbors.

⁷Proponents of contracting will argue instead that public employees, through the power of unions, inflate wages over market rates. In effect, they suggest that public-sector labor markets are not competitive and thus constitute a case of market failure. From this point of view, contracting merely entails a reassignment of property rights so that markets will work. One might take this argument more seriously if public choice scholars did not usually hold firmly to a very different position in regard to the status quo distribution of property rights. In general, they argue firmly that any given distribution of property rights must define the beginning point for determining if markets succeed or fail (Buchanan 1975, 84-86; Buchanan and Samuels 1975). From this perspective, the pecuniary externalities that arise from contracting must be considered when the costs and benefits of contracting are calculated, if decisions are to satisfy the requirements of consumer sovereignty.

The consequences for both blacks and whites are significant. The private cost of voting with one's feet to promote efficiency in the provision of local goods and services will not reflect its true social costs. Clearly, affluent whites are charged some costs in the form of higher housing prices in Tiebout settings for the "benefits" of segregation they provide (Becker 1971), but it is not clear that these fully balance the social costs associated with a dual housing market. It is certainly clear that blacks receive little compensation (Phelan and Schneider 1996). If not compensated for, this externality will lead to excess demand for exclusive white suburbs and inadequate demand for integrated cities relative to what would be demanded had individual costs and benefits fully captured total social costs and benefits. Indeed, Downs (1994) and Rusk (1995) attribute many of the allocational inefficiencies observed in governmentally fragmented urban areas to such political externalities (but see also Hill, Wolman, and Ford 1995; Savitch 1995).

A political externality also occurs when school vouchers promote "cream skimming," the ability of a few schools to select or be selected by the best students. Cream skimming leads to serious deterioration in the quality of education in the schools from which the best students exit. Indeed, their analysis of this political externality in Florida schools led Smith and Meier (1995) to conclude that vouchers could very well lead to a two-tier educational system, an echo of separate but not so equal that most had thought long extinguished.

The recommended solutions do not seem especially promising. Following Coase (1960), we might specify property rights in access to segregated or integrated housing, education, or any other good or service. Indeed, the existence of fragmented Tiebout quasi-markets—given the unwillingness of the judicial system to address the externalities produced thereby (Weiher 1991, 92-95)—might be viewed as a tacit recognition that wealthy whites have an implicit property right to segregation. If so, then allocational problems could be eliminated by requiring blacks desirous of integration to simply purchase the segregation rights of whites.⁸ The plausibility of this scenario, not to mention its equity implications, highlights the difficulties of addressing quasi-market externalities via this mechanism.

The other solution for internalizing such externalities entails actions by a higher level of government. The institutional arrangement most commonly recommended is voluntary agreement among the governments comprising a Tiebout quasi market (ACIR 1987, but see Gilbert 1979). Because this solution relies on the unit veto, it is unlikely to be effective on issues where interests conflict. As Downs (1994, 171) concludes, when "policies require allocating benefits and costs among jurisdictions, sacrifices on the part of one locality or another, or other controversial decisions, this approach does not work." Redistribution by the federal government—taxing the wealthier to compensate the poor—is also acknowledged as a solution (E. Ostrom 1983, 101; Hill, Wolman, and Ford 1995, 165-68; Dowding, John, and Biggs 1994, 773). But while it is theoretically viable, federal policy in recent decades suggest that this solution has limited practical utility. The institutional arrangement that is never advocated by quasi-markets' proponents (Chubb and Moe 1990; E. Ostrom 1983) is the one that seems to work best in internalizing externalities—eliminating the quasi-market.⁹

FAILURE BY PREFERENCE SUBSTITUTION

Although complications were added when attention was focused on quasi-markets, neither of the previous sources of

⁸Oddly enough, economists have considered a variant of both this externality and its associated regressive compensation solution applicable to intracity contributions to taxes and use of services (Stevens 1993, 342-43).

⁹Given the inadequacies of the commonly recommended solutions, it is not surprising that many critics of quasi-market institutions invest their critiques with more heat than is commonly associated with discussions of externalities. Downs (1994, 58), for example, exercises a distinctly normative voice when he discusses externalities associated with Tiebout quasi markets: "No jurisdiction is an island. Every suburb is linked to its central city and to other suburbs. Therefore, policymaking arrangements that do not consider the welfare of people who may be significantly affected by the policies created are not morally legitimate."

institutional failure is fully unique to quasi-markets. The final source of quasi-market failure deals, like the last, with consumer preferences, but it is sufficiently unique to the operation of quasi-markets that it merits special attention. To understand this source of quasi-market failure, we must start with the central and most creative insight underlying the work of students of quasi-markets—that the public provision of goods and services does not require their production be insulated from market or market-like incentives (V. Ostrom, Tiebout, and Warren 1961; E. Ostrom 1972, 483; Parks and Oakerson 1989, 21).

While this insight highlights just what is so distinctive about quasi markets, it also raises unique problems for understanding consumer sovereignty. Simply put, the direct (vouchers and contracting) or indirect (the Tiebout model) separation of provision and production creates two sets of consumers—those who make the collective decision to provide a public good or service and those who consume what is functionally a private good within the quasi market. Both must be satisfied to provide for consumer sovereignty. If the preferences that guide the latter's choices—for convenience, *production consumers*—are different from those of the former, the *provision consumers*, then the collective good that is consumed will be something other than that which was intended. In effect, those who consume what are now essentially private goods will substitute their preferences for those of the providers. Not only will the providers' tastes not be satisfied, the efficiency gains they might have expected will not be realized, since markets and quasi markets will generate efficiency only for those traits upon which selection operates.

As a plausible example of this problem, consider what might happen if Texas decided to provide secondary education using vouchers. Let us assume that the provider—the Texas Legislature—would fully intend to provide quality education as commonly understood in terms of reading, 'riting, and 'rithmetic. But let us also assume that Texas parents select schools for their children on the basis of the quality of their football teams.¹⁰ Based on this plausible substitution of preferences and market incentives, we should expect that Texas schools would efficiently provide very high quality football teams. School choice in this case would likely have no effect on quality of education, since selection would operate on an entirely different set of traits. Or if anything, education quality would deteriorate as resources were diverted from "frivolous" to "essential" services, such as fancier uniforms for cheerleaders.

If you think that this example is frivolous, we will see below that reality is actually quite chilling. But before we do so, it is

¹⁰Both assumptions, however, might be unrealistic.

necessary that we first consider why some preferences should count more than others. Why shouldn't Texas parents have the right to define quality education in terms of outstanding football programs? This is an important issue, since much of the attractiveness of quasi-markets derives from their association with the normative meaning of consumer sovereignty—that consumers know best what they want and their preferences should count (E. Ostrom 1972, 481; Parks and Oakerson 1989, 25).

Even working within this criterion, however, we can and must draw distinctions among preferences. First, in the separation of provision and production, the decision to provide a public good or service comes first. Governments provide public goods and services because markets fail to provide them, or fail to do so adequately. Thus governments, through their provision decisions, are ultimately responsible for the goals of publicly provided goods and services. These goals might be quite broad, vague, or complex. So governments might well believe—given nonmarket failure—that they cannot adequately comprehend the full diversity of specific preferences that might be consistent with the broad goals already established by the provision decision. Hence, quasi-market production might be adopted as a means to better tap that diversity of preferences. No matter how diverse they are, not all the preferences of production consumers are legitimate, only those that are bounded by the broad goals established through the provision decision. Thus, the sovereignty of production consumers is more limited than that of provision consumers. Second, the sovereignty of both provision and production consumers also might be limited by prior commitments of the community. As Buchanan (1975, 95-96) notes, prior commitments establish rules of the game, and government well may be empowered to enforce those rules. No matter how displeased individuals might be when government then acts to restrict their preferences, consumer sovereignty—as bounded by the prior commitment—is not thereby compromised. Some preferences can and do count more than others.

If the same individuals can play dual roles in quasi markets as citizens and consumers, influencing both provision and production decisions, how can their preferences diverge as they move from one role to another? They can diverge in two ways. First, the same set of individuals may not play both roles. In the revised Tiebout model offered by Teske and his colleagues (1993), for example, the critical consumers are high-income movers, while the citizens who make provision choices through elected representatives are residents. And in the case of school vouchers, the entire community has a stake in how the collective good of education is provided. Those who use vouchers are

parents with school-age children; their views on what constitutes quality education may differ from the views of the larger community. Second, the issues brought to bear on the decision to provide a collective good may be more encompassing than the issues that guide use of what is transformed into a private good in the form of a voucher. Therefore, the same individuals might make inconsistent choices when those choices are framed in different ways.¹¹

In trying to determine how serious this source of quasi-market failure might be, we need evidence about the preferences of both those who provide and those who produce local public goods and services. Advocates of quasi-markets all too rarely examine what actual behavior reveals about preferences.¹² Still, it seems reasonable to make at least some assumptions about preferences in order to simplify analysis. This is especially true for the preferences of providers. We can assume, for example, that providers of education services are actually seeking quality education when opting for production through vouchers. I also assume that providers in Tiebout quasi-markets are attempting to provide high quality public goods and services at low cost, an assumption that is appropriate for all local governments—whether operating in a fragmented setting or not—opting for production via contracting. These assumptions rest only to a small degree on faith in the sincerity of providers' claims when justifying the use of quasi markets; nonmarkets and democratic political systems can fail. But if there is a problem at this level, such as a provider actually promoting racial segregation under the guise of enhancing incentives for efficient production of education, it is a more general social choice problem, not one of quasi-market production per se. Quasi-market production is used fraudulently in this example to provide segregation, which might have been provided equally well via nonmarket production.

With reasonable assumptions about providers' preferences, we can analyze preference substitution by asking if the preferences revealed by the consumption choices of production consumers are consistent with those of provision consumers. This is precisely what Smith and Meier do in their devastating assessment of school vouchers, *The Case Against School Choice* (1995). They (p. 64) challenge what Chubb and Moe (1990) term the institutional theory by pointing out that "[t]he primary demand of both students and parents, posits the institutional theory, is quality education. . . . The demand assumption is just that, an assumption. No proof exists that parents' primary demand is for quality education." If the assumption is valid, no preference substitution will occur and quasi-markets will do what they are good at doing—produce quality education efficiently

¹¹Another conceptual issue that merits attention arises from the claim that the problem of preference substitution is unique to quasi-markets. That is, some might view it as a variant of the principal-agent problem. While they have much in common, the degree of similarity varies depending on the type of quasi market examined. For contracting, the problem of preference substitution often can be treated as a straightforward principal-agent issue (Hirsch 1995b, 463-64; Lynn 1996, 300-02). Both the bureaucrat who selects a producing unit and the producing unit itself are agents with contractual obligations to the providing government. Even for contracting, though, a principal-agent framework may be limiting if one of the production consumers of concern is the state in the form of legislative and even constitutional mandates for service provision. Treating users of vouchers as agents seems less appropriate since their only obligation is to freely consume what is functionally a private good following the government's decision to provide a public good. Moreover, the principal-agent framework breaks down somewhat when it turns to preference substitution in Tiebout quasi-markets, since Tiebout governments are entirely passive and acted upon by consumers who vote with their feet. Characterizing this as a principal-agent problem would be equivalent to suggesting that the environmental forces that constitute selection pressures in biological evolution are the agents of the individuals and species being selected for. If there is any principle here, it traces to the local founding fathers who established the fragmented governments within a metropolitan area, and they are likely to be long gone. So the quasi-market preference substitution problem is more appropriately viewed as a distinct concern about quasi markets arising from the decision to bring market-like forces to bear on public production either by arranging for Tiebout quasi-markets or by separating provision and production.

(Smith and Meier 1995, 126). If the assumption is not valid, then the quasi market will fail to produce quality education, but will instead produce something else.

Smith and Meier (1995) test the demand assumption with educational quality and enrollment data on Florida schools. The study examines data regarding students who exit the public school system to enroll in private schools and the relationship of such exiting behavior to temporal changes in the racial composition and educational performance of public schools in order to determine what actual choices reveal about preferences. Their conclusions (p. 72) are sobering: "Exiting the public school system appears to have nothing to do with the system's academic record. The causal link is instead grounded on a demand for religious services and segregation." Adopting a school voucher plan within such a setting will lead, they suggest, to substituting the providing consumers' preference for quality education with the production consumers' preference for segregation. Given the nature of markets, we can expect that racial and religious segregation will be produced efficiently. And since selection pressures will not bear on education quality, education quality should remain largely unchanged.

The Tiebout model assumes that consumers move to secure the efficient provision of preferred local public goods and services (Tiebout 1956, 418). But locational decisions might be driven by any number of preferences. As Weiher (1991, 35) notes, "[H]ouseholds and individuals who are moving are attempting to satisfy certain preferences. . . . These preferences are likely to concern the quality of housing, the quality of certain publicly provided services, the life style likely to predominate in a new location, and the socioeconomic status, race, ethnicity, and nationality of neighbors." While support for the Tiebout hypothesis does not require that individuals relocate *only* on the basis of market baskets of public goods and services, it does require that at least some selection be conducted on that basis. Otherwise governments would lack any incentive to match goods and services with preferences or to do so efficiently. Given the many reasons people move, preference substitution might easily overwhelm choices based on public goods and services.

There has been considerable research on location choice in fragmented metropolitan settings in order to assess the preferences thereby revealed, and the results are controversial. Still, the best evidence seems to point overwhelmingly toward preference substitution and against the Tiebout hypothesis.¹³ Let us examine two key test implications of the Tiebout hypothesis (for a full list, see Dowding, John, and Biggs 1994). First, if

¹²This charge has been leveled more broadly at rational choice theory (Green and Shapiro 1994). While recent research on bureaucracy (see Brehm and Gates 1997) suggests that this criticism is not inherent, it remains a serious problem for the quasi-market literature.

¹³One reason is that many studies that purportedly support the Tiebout model rely on survey data (e.g. Percy, Hawkins, and Maier 1995; Teske et al. 1993; Dowding and John 1996). They usually fail to consider rival explanations, including moving on the basis of preferences for segregation, which is especially difficult to tap using survey data—for reasons that should be obvious. For these reasons (including criticism of Lyons, Lowery, and DeHoog 1992), Stein and Bickers (1995) argue strongly that preferences are better studied using actual location data. (See Dowding, John, and Peters 1994, 784.)

preferences for public goods and service vary, if location choice is at least in part guided by these varied preferences, and if quasi-markets generate incentives to respond to them, then Tiebout quasi-markets should provide heterogeneous market baskets of goods and services (Tiebout 1956, 421). Second, however, consumers' satisfaction with selected market baskets should not vary across local jurisdictions since goods and services will be well matched with the diversity of preferences, and the mean of these satisfaction levels should be higher than the mean level found in consolidated jurisdictions (p. 419).

Dowding and his colleagues (1994, 775) point to both the key problem underlying tests of the first hypothesis and the most valid extant analysis: "That sorting occurs . . . is almost certainly true but the research shows mixed evidence that local tax and expenditure variables affect the process. Stein's work is the most comprehensive and therefore his negative results must represent the current state of knowledge." Stein (1987) tested the sorting hypothesis with data on 11,483 noncentral cities in 224 metropolitan areas. Contrary to expectations, he found that the market baskets of public goods and services were poorly differentiated. In terms of revealed preferences, he concluded that "[t]astes and preferences for police, fire, sewer, and sanitation services tended to be relatively homogenous. . . . People rarely concern themselves with the manner in which these basic functions are performed." While a more appropriate conclusion might be that location choices do not indicate that residential selection is based on preferences for goods and services, rather than that preferences did not vary, this finding provides little support for the hypothesis.

The second hypothesis was tested by Lyons and Lowery (1989; Lowery and Lyons 1989) who used survey data on citizen satisfaction in five Jefferson County, Kentucky, suburban communities. Contrary to expectations, levels of satisfaction varied greatly among the communities, suggesting that heterogeneous tastes were not matched with heterogeneous goods and services packages, thereby leading to homogenous service satisfaction. And importantly, variation in satisfaction across the Tiebout quasi-market communities was far greater than among matched neighborhoods in the decidedly non-Tiebout consolidated government of Lexington, Kentucky, a setting where heterogeneous tastes and relatively homogeneous goods and services packages should have produced greater cross-neighborhood variation in satisfaction. In sum, neither of these studies supports the notion that variations in tastes for goods and services packages drive location choice and Tiebout quasi markets.

The preference substitution hypothesis neither suggests that people select residential locations randomly nor rejects the very plausible notion that quasi-markets do indeed operate within fragmented government settings (Dowding et al. 1994, 775). Rather, it suggests that something other than preferences for local public goods and services drives location choice. And the quasi-market thereby generated is a quasi-market in that substituted preference. So, what preferences actually matter? The most comprehensive test, and perhaps the single most devastating assessment of the Tiebout model, is again Stein's (1987) study of 11,483 cities, which employed a number of variables to account for the many reasons leading to location choice. Stein reports that "[t]he expected relationship between service-bundle differentiation and the homogeneous sorting of residential populations is undetected, *except for the race variable*" (1987, 155-56; emphasis added). Production consumer preferences do lead to sorting, but the preference that matters is associated with race.

Oddly, Stein interprets this finding as providing partial support for the Tiebout model, suggesting that "[t]he fact that Tiebout's model receives its strongest empirical support in the equation for race suggests that a community's racial composition *provides meaningful cues about the shared policy preferences of its residents*" (1987, 154; emphasis added). Other scholars whose work has produced similar findings (Miller 1978 and 1981; Weiher 1991; Logan and Schneider 1982 and 1984; Schneider and Logan 1981; Rusk 1995; Downs 1994) draw far less optimistic lessons from these results. Logan and Schneider (1984, 886-87) are especially critical of the idea that the choices of blacks reflect preferences for local public goods and services; noting that blacks are often restricted to jurisdictions with unusually weak tax bases and high tax rates, Logan and Schneider conclude that "[i]t is not plausible to argue that blacks are attracted to such places or that whites are more sensitive to fiscal differences than blacks. Instead we believe that this finding indicates that the dual housing market effectively steers blacks to disadvantaged communities. Other governmental variables—general and social service expenditure levels and indebtedness—have no significant effect." Race—and income in some studies—seems to dominate location choice, not local public goods and services.

In sum, preferences for segregation, not about tax and service packages, govern choices in the quasi-market of Tiebout metropolitan settings. The preferences that providing consumers have for complex packages of goods and services to meet the heterogeneous tastes of producing consumers are replaced by the latter's preferences for segregation. Thus, it is unlikely that Tiebout quasi-markets insure provider consumer sovereignty—

satisfying diverse preferences efficiently. On the other hand, we should expect the quasi-market to provide segregation in an efficient manner, since that is the trait upon which selection bears.¹⁴

But preference substitution is not restricted to race. Old fashioned electoral incentives can matter too, as seen in a contracting example. The state of Michigan requires that its cities and townships assess property for purposes of taxation, and the Michigan constitution requires that all property be assessed at 50 percent of true cash value. We have already seen that appointed assessors are much better at this than are elected assessors, who can gain votes through systematic underassessment. But what of assessors who work under contract? Do they provide accurate assessments at low cost, as claimed by proponents of quasi-market production (Bowman and Mikesell 1978)?

Unfortunately, the same elected city officials who benefit from high revenues, but pay an electoral price for high taxes, select the contract assessor. They can benefit electorally if they select contract assessors who are willing to underassess properties both across the board and differentially, with lowered assessments especially benefiting those voters who are most attentive to taxes. Therefore, they have some incentive to substitute the state of Michigan's preference for accurate assessments with their own preference for electoral security. It appears that they do just that (Lowery 1982b); contract assessors, while they are often highly qualified, appointed professionals in other jurisdictions, mimic the practices of elected assessors when they are subject to the powerful selective pressures of competitive contracts. Such consequences of quasi-markets may occur whenever the preferences of providing and producing consumers diverge.

CONCLUSION

We have seen that there are good reasons to believe that the choices individuals make within at least some quasi-market institutions are not always good choices, good in the sense of fully satisfying the requirements of consumer sovereignty. Quasi-markets can fail in a number of ways. *In almost all these cases, the failure will not be obvious in any overt or explicit way. Vouchers will be used, contracts will be bid and executed, and feet will be used to vote.* But consumer sovereignty may still be compromised if there are too few competitors, if preferences are ill-informed or are biased by manipulation or by externalities, or if the preferences of production consumers are different from and substituted for those of provision consumers. When any of these conditions obtain, quasi-markets will work only in the narrow sense of ensuring that at least some exchanges are transacted.

¹⁴Before considering an example of preference substitution in contracting, it is necessary to consider the issue of race, an issue that has appeared in one form or another in our discussion of all three sources of quasi-market failure. It is especially important that we look more closely at this issue for this source of failure, however, because explanation by preference substitution must entail demonstration that the production consumer's alternative preference is a plausible one. It is also necessary because hints of racism—aimed, however indirectly, at those who support quasi-markets—can bring highly charged responses. I think it most unlikely that Smith and Meier would argue that all parents of school children are racists. And I do not think that it is true for most movers in Tiebout quasi markets (but see Massey and Gross 1991). Why, then, does race seem to matter so much.

The most obvious reason lies in the interaction of the continuing high salience of race in American life—especially when compared to the low salience of most local government goods and services—and the land use powers of suburban governments. These allow for continued segregation outside the reach of the judicial system, which has restricted practices of intracity—but not intercity—discrimination (Hill 1974; Massey and Denton 1987; Farley 1983; Weiher 1991, 87-95). Rejecting this traditional explanation as incomplete, Weiher (1991) and Downs (1994, 24-26) explain preferences for racial and income segregation as a function of an unequal initial distribution of income by race, the resulting stratified housing market, and differential preferences for integration by whites and blacks. The three factors combine to insure that neighborhood tipping still segregates the races (Stahura 1988).

Other explanations have public choice origins. The two key elements of Teske et al.'s (1993; Schneider and Teske 1993) modification of the Tiebout model are its attention to the roles of informed marginal consumers and local public officials as entrepreneurs. Unfortunately, the marginal consumers that matter most may

Worse still, even these inadequate exchanges can generate serious problems of their own. As we have seen in the discussions of Tiebout quasi-markets and education vouchers, the consequences of quasi-market failure can be especially malign when race influences the choices of at least some individuals. Not all quasi markets invoke the issue of race, and not all quasi-markets fail. But when quasi-markets touch America's hottest hot-button—race—the potential consequences for both community and market can be frightening.

Criticizing quasi-markets requires little in the way of theoretical innovation. The concepts provided by prior work on market and nonmarket failure are readily extended to considering quasi-markets. Perhaps the only new wrinkle added in examining quasi-markets arises from their unique disjunction of provision and production, which creates opportunities for preference substitution. The cases examined are prominent in the literature. So it remains something of a puzzle why public choice proponents either have not explored these issues in any depth or continue to dismiss them with pallid and unpersuasive excuses (e.g., E. Ostrom 1983). Since proponents of quasi-markets are rarely "inclined to be self critical" (Haque 1996, 205), critics should no longer allow them a free ride.

¹⁴(continued)

not be those who are attentive to public goods and services but may be the minority who remain racists. Weiher (1991, 81-82) has observed that "discriminatory actions need not be frequent to result in metropolitan areas that are highly segregated by jurisdiction." Given the role of informed marginal consumers, we can expect that location based on race also need not be frequent to ensure continuing segregation. With regard to entrepreneurs, Russell Hardin has recently argued in *One for All: The Logic of Group Conflict* (1995) that they are all too often motivated by self-interest to mobilize racial and ethnic antipathies for their own purposes. He argues that leaders' "self-interest can often successfully be matched with group interest. And when it is, the result is often appalling." While Hardin's examples are from afar, the conditions he discusses ring alarmingly true when we view the Tiebout quasi markets of American cities; this is especially so as we give renewed attention to local officials as entrepreneurs. In some ways, this is an old story that has often been repeated in American politics (Key 1949).

Public choice scholars have contributed much to critical thought about the public sector by pointing out that market failure does not imply nonmarket success. Proponents of progressive reform institutional arrangements now carry a heavier burden of proof by having to demonstrate that they will indeed do what they are purported to do. *By the same token, nonmarket failure does not imply quasi-market success.* Therefore, advocates of quasi-market institutional arrangements should be asked to shoulder a comparably more rigorous burden of proof. This entails demonstrating that quasi-markets are competitive and provide equal access to all, that choice is based on informed and unbiased preferences, and that the preferences exercised by production consumers fall within the bounds set by provision consumers. Of course, expecting markets, nonmarkets, or quasi-markets to work perfectly is an unreasonable standard, as noted for the last by Chubb and Moe (1990, 34); advantages must always be assessed relative to available alternatives. But this should not let any of us—either proponents of nonmarkets or supporters of quasi-markets—off the hook by settling for simple assumptions and implausible assertions.

More generally, the theory of quasi-market failure takes a small step toward rejustifying progressive reform institutions of centralized bureaucratic production with metropolitan

governments. One of the most important virtues of progressive reform institutions inheres in what they are not. While they are never completely insulated from society, metropolitan government, hierarchical and centralized bureaucratic production, and a professional public service are less easily influenced by both politics and markets than are other institutional arrangements. There are situations where prudent and responsible governance may require neither responsiveness nor efficiency. As Frant (1996) has noted, the low-powered incentives associated with bureaucratic and not-for-profit production should be used when the high-powered incentives associated with politics and markets prove too costly. Institutional choice, then, should depend on comparison of the full costs and benefits associated with relying on both types of incentive structures.

Analysis of quasi-market failure provides at least a minimal justification for relying on progressive reform institutions. They become a plausible default when the consequences of both market and quasi-market failure are too severe. Many, however, will be less than satisfied with this minimalist perspective. Those who try to legitimize public bureaucracy by reference to its responsiveness or to its democratic representativeness may be especially outraged since the minimalist perspective outlined here suggests that the core worth of progressive reform institutions is that they emphasize neither. Even those who reject the idea that we can or should legitimize progressive reform institutions by reference to representativeness or responsiveness may be dissatisfied, since the minimalist position outlined here provides nothing in the way of a positive case—even in terms of such nondemocratic values as efficiency, predictability, and stability. Developing a positive case will require something more than a theory of quasi-market failure.¹⁵ Nonmarket failure will remain an impediment to easy recourse to the institutions of progressive reformers. Until a positive case that blunts the rough edges of nonmarket failure is in place, we might find comfort in the minimalist defense of progressive reform institutions provided by the theory of quasi-market failure.

¹⁵While a theory of quasi-market failure is alone inadequate to justify reliance on progressive reform institutions, it helps to redress the current imbalance in discussions of alternative institutional structures by mirroring well-developed analyses of nonmarket failure. Once the two sets of institutions are placed on a more equal and more realistic footing, analysts can get down to the real task of comparing the costs and benefits of relying on each. Williamson (1975) provides a useful set of theoretical concepts to guide such comparison. Boston (1994) provides an excellent example of how this task should be conducted for real institutions.

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