



Constitutionalism, division of power and transaction costs *

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Abstract. According to many democracy theorists, there is an unavoidable trade-off between constitutionalism and the need for political action. This paper criticizes that belief. Rather, it argues that a division of power, while sometimes entailing high political transaction costs, can nevertheless be beneficial *and* that it is not necessarily the case that a division of power does entail high transaction costs. The analysis expands the framework of Buchanan and Tullock (1962). Constitutionalism is thus defended against one of its main perceived deficiencies: its bringing about gridlock. This does not always happen, and when it does, it is often a good thing.

1. Introduction

Constitutionalism is the doctrine that governmental power and the majority rule should be constrained by individual rights and a system of checks and balances, codified in a formal constitution. At the core of this idea is the view that a well-functioning political system needs a clear division of power.

While constitutionalism by most analysts is considered to have a number of important advantages,¹ several important democracy theorists have also argued that there is an unavoidable trade-off between constitutionalism and the need for political action. The high transaction costs believed to be associated with constitutionalism and the division of power may block, it is argued, desirable political accomplishments. In other words, it is thought that a constitutionally bound state will hamper governmental decision-making and, thus, make the state less efficient.

In particular, Elster (1988) argues that there is a “three-corned dilemma” between democracy (defined as majority rule), constitutionalism and the need for discretionary action by the executive. Likewise, Cooter (2000) argues

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that a division of power slows down the pace of legislation and privileges the *status quo*, since interest groups with influence over only one branch of government can block legislation.

Similarly, Mainwaring (1990) and Linz (1994) argue that the division of power, e.g. between the president and the legislature, may stalemate decisions and lead to executive gridlock. The difficulty of decision-making and the tendency towards deadlock has also been one of the recurrent complaints of the constitutional system of the United States, as pointed out by Robinson (1985). The necessity of efficient decision-making is moreover a common theme in the present discussions of the constitutional future of the European Union. In a widely cited article, Scharpf (1988: 269) laments the “inefficiency and inflexibility of European policy making” caused by constraints on the majority rule; see also Peters (1996) and Scharpf (1999).

This article is a critique of these views. We argue that a political system with a division of power, in spite of sometimes causing transaction costs to be high, can be a positive thing by reducing special-interest influences and by causing the quality of political decision-making to improve by increasing the role of deliberation in the political process. In addition, we argue that a high division of power need not, in fact, lead to high transaction costs.

2. The Buchanan–Tullock contribution

Our point of departure for the analysis below is the well-known contribution by Buchanan and Tullock (1962) on how to arrive at the optimal decision rule for collective decision-making. The idea is to look at two different costs related to the decision rule in place: on the one hand, transaction costs (C_t) and, on the other hand, external costs (C_e). The former refer to the difficulty of reaching a decision valued by a certain individual, and the latter refer to the costs for that individual of having decisions taken which are at odds with his own preferences. One mechanism through which such costs come about, and, possibly, the most important such mechanism, is special-interest influence which entails a risk for exploitation. The objective: to choose the decision rule which minimizes the sum of these costs (here termed the social interdependence cost, C_{si}). Both of the costs, as well as the social interdependence cost, should be interpreted, throughout this article, as *expected* costs and as present values, although this is most often not explicitly spelled out for reasons of brevity. An illustration is provided in Figure 1, where the optimal rule is referred to as x^* .

An implication of this way of looking at how to design political institutions is that the simple-majority rule, i.e. viewing collective decisions as legitimate if at least $n/2+1$ out of n voters approve, is really not intrinsically

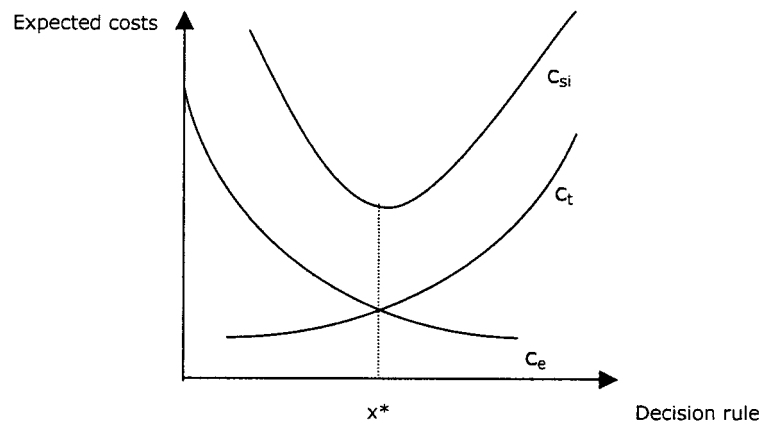


Figure 1. The optimal decision rule

preferable to other decision rules, entailing qualified majorities of different kinds. This result is at odds with a traditionalist interpretation of democracy that goes back to Rousseau (1967) and whose proponents, e.g. Lively (1975), Dahl (1989), Sartori (1987) and Hermansson (1998), argue that the majoritarian principle is a necessary *procedural* criterion of democracy.

The ideal from which this analysis receives its inspiration is formulated by Wicksell (1896), who started from the premise that unanimity is the most preferable decision rule, since it meant that no citizen could be used as a means for the obtainment of the goals of others. Legitimacy in decisions concerning collective affairs is thus the result of everyone giving their consent (which is the application of a kind of contractarian philosophy). Wicksell realized that there was a drawback to this ideal, pertaining to the resulting difficulty in reaching decisions which would benefit the vast majority of the electorate while, for instance, only marginally harming a small minority. Hence, he proposed the usage of qualified majorities of 5/6 for fiscal decisions.

This insight is reflected in the Buchanan-Tullock framework. If there were only external costs, then unanimity would be optimal as a cost-minimizing decision rule, since the only concern then would be to hinder decision not in one's own interest. However, since there are also transaction costs, a concern for good proposals not being implemented renders the optimal decision rule somewhere in between unanimity and the simple-majority rule.

This is the framework that we will try to expand below, in an analysis of constitutional systems. In particular, it is our contention that two related things are missing from the Buchanan-Tullock contribution that are important for gaining additional insights into how to design a constitution. First, an ana-

lysis of the effects of a division of power is not included. The exclusive focus on the decision rule in place for making collective decisions makes the analysis tractable and elegant, and in some respects it can be substituted for other political institutions (as is noted by the authors e.g. in presenting a bicameral system or the generality principle as alternatives to qualified-majority rules). However, this simplification misses some points when it comes to analysing constitutional systems as a whole, in particular with respect to the division of power.²

Second, the effect of improving the collection (and usage) of knowledge, i.e. making factual errors in decision-making less prevalent, is not included either. It is not only the case that a more stringent decision rule (or, in our case, a higher degree of a division of power) reduce the scope for decisions not desired by the evaluating individual; it also brings about a more thorough analysis of issues.

These aspects will be expanded upon below, not so much in polemic to Buchanan and Tullock, whose framework we greatly appreciate and will use, as to some leading democracy theorists in political science.

3. Central concepts defined

In this section, we define and clarify six central concepts that we use in the ensuing analysis, viz., constitutionalism, division of power, transactions costs, ability to act, rationality and public interest. It bears noting that all of these can be viewed as characteristics of any system of political institutions or of any constitution.

3.1. *Constitutionalism*

As mentioned, constitutionalism is the doctrine that governmental power should be constrained by individual rights and a system of checks and balances, codified in a formal constitution. The constitution should, moreover, be considered superior to other laws (*lex superior*) and be enforced within a legal system with independent courts.³ At the core of this idea is the view that a well-functioning political system needs a clear division of power. Lane and Ersson (2000: 287–291) distinguish between *thin* and *thick* constitutionalism, where the former is characterized by “procedural accountability, representation and division of powers” and where the latter, in addition, includes “a rigid constitution, a bill of rights and minority protection as well as judicial review.” When we use the term “constitutionalism,” it is in the latter sense.

3.2. *Division of power*

The classic statement of the doctrine of the division of power of course comes from Montesquieu (1748/1990), with the division of the executive, legislative and legal branches of government. To this James Madison added the idea of checks and balances, that each branch of government should be “so far connected and blended as to give each a constitutional control over the others.”⁴ Hayek (1960), Buchanan (1975) and others have added important aspects to such a system. For instance, the vertical division of power within a federal system is often considered as important as the horizontal division of power between the organs of the central state.

Generally, a fully developed system of division of power in a democratic state is characterized by an independent judiciary and judicial review, individual rights and a generality principle, federalism, a bicameral organization of the legislature, an independently elected executive and referenda.⁵

3.3. *Transactions costs and an ability to act*

As North (1990: 27) notes: “The costliness of information is the key to the costs of transacting, which consist of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements.” In short, *transaction costs* are the costs for contact (finding partners with whom to enter into some form of exchange), contract (reaching an agreement and devising its form), and control (ensuring that agreements are kept).

This definition most often refers to market activities. In the economic sphere, transaction costs are unequivocally regarded as negative in that they make it more costly to engage in voluntary market activities (which, within the bounds of the rule of law, are generally welfare-enhancing). Indeed, the rationale for many economic institutions is precisely their function of reducing transaction costs by reducing uncertainty and, thereby, enabling more cooperation (see North, 1990: 57–58).

Transaction costs also exist in the *political* sphere, and it is this type of transaction costs that is discussed in this article. They can be defined as the costs associated with reaching a collective decision in accordance with some pre-specified decision mechanism or, in other words, the difficulty with which a collective political decision is reached under some pre-specified decision mechanism. These costs have one, sometimes two, central component(s): on the one hand and always, the costs that stem from difficulties reaching an agreement due to different preferences among political actors (in turn dependent on ideology and self-interest); and, on the other hand and sometimes, the costs that stem from an imposed difficulty in reaching an agreement due

to the set of political institutions in place, defining the collective decision mechanism.

However, quite unlike economic transaction costs, political transaction costs are multifaceted in terms of their welfare effects: i.e., sometimes they are good and hence imposed with beneficial effects. This will be elaborated upon in the next section.

There is another concept which is related to political transaction costs, viz., *ability to act*. For our purposes, low transaction costs and a strong ability to act are equivalent, as are high transaction costs and a weak ability to act. For any given goal, its obtainment through a political decision (i.e., the ability to act in the sense of bringing about this purpose) is directly dependent on the size of the transaction costs that characterize the political system in question.

3.4. *Rationality*

By *rationality* is meant that actions lead to the attainment of a specified goal, whatever that goal is. This is a strictly instrumental view of rationality.⁶

3.5. *Public interest*

Oftentimes, a distinction is made between public interest and self-interest, but it is quite rare to see these concepts defined, as pointed out by Riker (1982: 291). By the satisfaction of the *public interest* we mean a situation characterized by the satisfaction of the long-term preferences of most citizens within legally specified boundaries in the form of rights. By *long-term* preferences we do not mean actual preferences but, rather, preferences in a situation where individuals have knowledge of the general consequences of actions and decisions, both in the present and in the future, without knowing their exact positions.⁷ By “within legally specified boundaries in the form of rights” we refer to legal and absolute constraints on actions, irrespective of the consequences, as perceived by most people’s long-term preferences.⁸ Human rights are examples of this. It should be pointed out that we consider this definition of the public interest tentative. One problem concerns the case where a minority has strong preferences and a majority weak ones: should not the former be able to outweigh the latter without this implying that the public interest is not being served? Possibly, the part of the definition that introduces rights can solve most instances of this problem; on this, see Hare (1981: 142, 154–155) and Posner (1987: ch. I). Another problem concerns the subjectivity that follows from using the concept long-term preferences, since these actually do not exist.

4. A critique of the doctrine of efficient decision-making in government

In this section we wish to defend the two theses outlined above: *firstly*, that high political transaction costs, which oftentimes results from a division of power, do not render a division of power undesirable, because of its bringing about a higher quality of decision-making and less scope for special-interest influence, and, *secondly*, that a high degree of a division of power is not necessarily related to high political transaction costs, not least because the domain of political decision-making can be divided such that the focus of the decision-making is facilitated and enhanced. To the extent that these two theses are true, they constitute an effective rejoinder to those who oppose constitutionalism because of viewing political transaction costs as unequivocally malign and a necessary (or highly probable) result of a fully developed division of power.

It bears noting that both theses can be true at the same time, as a system with a division of power entails institutions some of which increase the transactions costs and some of which reduce them. If the system as a whole is characterized by higher or lower transaction costs than, say, a monistic system depends on the mix of institutions.

Political institutions can be designed in different ways, and if they are characterized, jointly, by constitutionalism, we assert that, *ceteris paribus*, they can be conducive to a more rational political decision-making process that, to a relatively high degree, is guided by a consideration of the public interest. This presupposes, as we shall see, that the particular form of constitutionalism in place has been designed wisely such that, generally, good decisions are not blocked and such that bad decisions are blocked.

4.1. *The first thesis: A division of power can be good even when it gives rise to high transaction costs*

An ability to act, as has been exemplified above, is oftentimes viewed as a most desirable component of a political system. There is a fear of gridlock and locked positions. This is justified, but only partially. Figure 2 clarifies the logic behind this assertion more precisely.

The figure expresses plausible relationships. For example, if one holds that it is not desirable to act, then one generally also holds that it is a good thing for there not to exist an ability to act, etc.

In practice, in the realm of institutional design, there is a problem which the figure helps clarify, viz., that it is often a matter of dispute *when and how it is desirable to act*. This is where different judgments come in and result in diverging views on how to design political institutions. Here, we wish to focus on the view of those who are proponents of a general ability to act

| | | Ability to act? | |
|-------------------|-----|-----------------|------|
| | | Yes | No |
| Desirable to act? | Yes | Good | Bad |
| | No | Bad | Good |

Figure 2. Evaluation of when an ability to act is good and bad

because of a tendency to largely disregard the *lower* row of the figure. An ability to act is only good when it is desirable to act: and a central insight, we posit, is that this is oftentimes not so. When it is, and when it is not, in turn hinges on evaluations of both a normative and factual kind. Two persons may agree on the facts, yet disagree because they value different ends; and two persons may agree on values, yet disagree because they understand reality differently.⁹ Oftentimes, arguments concerning institutional design proceed without attempts from the participating discussants to clarify underlying values and assumptions regarding facts. This renders the reason for disagreements unidentifiable.

Let us assume henceforth that there is agreement on values but a disagreement on facts. These facts concern how the political and economic systems function e.g. what motivates political actors, how well-informed they are, and what facets of an economy that produce high economic growth. If we interpret reality such that political actors are benign and altruistic in everything they do, that they are always well-informed and competent, and that there are no negative effects of taxation and regulation on economic growth, then it follows that the lower row of Figure 1 – i.e., that it is at times not desirable with an ability to act – is regarded as irrelevant. If, on the other hand, we interpret reality such that political actors are oftentimes egotistic, not-so-well-informed or competent, and that taxation and regulation may generally hamper economic growth, then it follows that the lower row – i.e., that it is at times not desirable with an ability to act – becomes highly relevant when contemplating how to design political institutions.

Comparing these two views, then, we sympathize with the latter. Surely, this is not new in itself. E.g., it was in many ways the view of the founders of the U.S. (as is clear from Hamilton, Jay and Madison, 1778/1961, and their

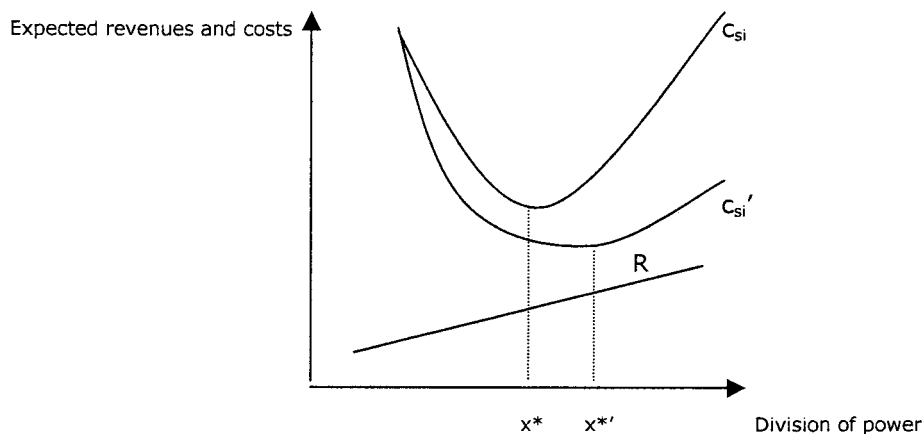


Figure 3. The optimal degree of division of power

inspirer Montesquieu, 1748/1990); and it also forms the basis of research and scholarship within the fields of public choice and Austrian political economy.¹⁰ The way in which a division of power with high transaction costs can be good, then, is in making actions that are not desirable more difficult to undertake. This makes the political decision process more rational and in line with the public interest.¹¹

This insight is captured in the Buchanan-Tullock analysis, as illustrated in Figure 1, in the form of decreasing external costs. However, they only capture the (avoidance of) costs of having decisions made that one dislikes (which can come about because of special-interest influence over the legislative process) and not the positive value one places on more rational decision-making. We assert that the latter effect is at least as important as the former and that leaving it out renders the conclusion as to how the political institutions are to be designed somewhat incorrect.

Now, this reasoning can be illustrated by means of a Figure 3, which is an extension of the Buchanan-Tullock construct.

This figure differs from Figure 1 in two respects: first, a new revenue curve (R) has been included which depicts beneficial effects from a higher quality of decisions; and second, the variable on the horizontal axis has been changed into the "division of power."¹²

The variable change has been made because of our focus on constitutionalism. One can view the Buchanan-Tullock variable as interchangeable with it, in that both purport to portray how difficult it is, due to the design of the political institution(s), to reach a collective decision.

The new revenue curve introduces a new dimension into the analysis which we think has been neglected in much constitutional analysis, in the

public choice/constitutional economics field as well as in parts of political science. It concerns *the quality of decisions*, which is a positive function of the degree of division of power, and for given goals, this means that more of rationality and attention to the public interest is introduced into the political system under constitutionalism than under monism and unbridled simple-majority rule. From the point of view of the evaluating individual, then, this constitutes a revenue which, together with the decreasing external costs, exerts a counterweight to the negative, increasing transaction costs.¹³ It bears noting that R is not the inverse of C_e . Rather, the quality effect is distinct, it is a result of decision-makers having incomplete knowledge of things and a limited capacity for information processing, and it exists even if there are no special-interest problems at all.

In general, our argument is that constitutionalism and the division of power will increase the role of *deliberation* within the political system, and that this deliberation can increase the quality of the political decisions. In other words, the quality of decisions undertaken in politics is influenced by the institutional set-up and can thus be regarded as endogenous, to a large extent, to the design of the political system. This effect of institutions on the scope and quality of deliberation in politics has, to our knowledge, not been explored previously.

In the traditional public choice literature, politics is portrayed either as voting or as bargaining. In both cases the preferences as well as the information of the actors involved are taken as *given*, and democracy is viewed as if it serves only to aggregate these given individual preferences into a public decision (see Wohlgemuth, 2002). And in both cases the well-known problems with cycles, strategic behavior, logrolling etc. occurs. However, there is also a third mode of political action, namely *arguing* (see Elster, 1998b). In situations characterized by arguing, discourse or deliberation, the actors ideally engage in careful and serious weighing of reasons for and against some proposition, and, thus, have incentives to collect more information about the matter at hand and may even in the end change their own preferences. Such a view of politics goes back at least to Burke (1975) and Mill (1861/1972), and there is a modern discourse, the theory of *deliberative democracy*, dealing with the same issue.¹⁴

The argument is that even though there may also be pathologies involved, as noted by Stokes (1998), on balance, political deliberation is good because it improves information and lessens the impact of bounded rationality; induces argumentation based on principles and justifiable demands; makes for larger consensus and Pareto-superior decisions; and legitimises the ultimate choice (Elster, 1998a); see also Fearon (1998) and Gambetta (1998).

However, what is lacking, to a large extent, in this literature is a treatment of the role played by the political institutions. In our view, constitutional rules could be designed to encourage a particular kind of deliberation that promotes the quality of political decisions.¹⁵ In particular, a division of power will promote decisions of high quality through the introduction of checks, balances and delays. It stems from at least four sources: first, since several decision-making units have to agree before a certain decision can finally be made, this provides incentives for collecting knowledge in order to be able to persuade others; second, the delays a division of power entails gives more time and opportunity for collecting facts and gaining knowledge; third, since there is a division of competence between different institutions, this means that specialization is easier for each respective institution compared to a monistic situation where one unit is given sole responsibility for all vital decisions;¹⁶ and fourth, a division of power induces involved actors to care more about general principles and rights and to lift themselves above their own day-to-day interests (in particular because of an independent judiciary, judicial review, and the existence of constitutional principles and rights; on this, see Peczenik, 2002). More about the precise effects of various political institutions within a system with a division of power on the quality of political decisions can be found at the end of Section 4.2.

There is clearly a great need for more empirical research in this area, but there is some fairly strong empirical support for the view that deliberation may increase the quality of political decisions. First, Benz and Stutzer (2002) have shown that citizens in Switzerland are better politically informed when they have more extended participation rights in the political process. Their conclusion is that voter information should be treated as endogenously determined by political institutions. This, in turn, can be expected to make political decision-makers more responsive to their principals, the voters, and it also indicates that politicians themselves are plausibly responsive to the effects of political institutions when it comes to acquiring knowledge. If one looks at political and, especially, economic outcomes, other studies focusing on the vertical division of power in Switzerland lend support to the thesis that this system induces decisions of a higher quality to be made: see e.g. Frey (1994), Frey and Pommerehne (1995), Feld and Savioz (1997), Frey (1997), Moser (1999), Feld and Kirchgässner (2000), Feld and Matsusaka (2000), Matsusaka (2000), and Zimmerman and Just (2000). Second, Fishkin and his colleagues (see McLean, List, Fishkin and Luskin, 2000, and List, 2002) have conducted a number of so called “deliberative opinion polls” where the result is that people’s views and preferences on matters decided upon collectively, in fact, change after public discourse. An interesting result is that deliberation appears to lead to preference structuration in the sense that it induces single-

peakedness. Third, on a more general and directly relevant level, Lijphart (1999) finds that *consensus democracies*, among other things characterized by a high level of public discussion and deliberation, outperform majoritarian democracies in a number of central dimensions. We shall briefly return to this below.

The net effect of this extended analysis, compared to that of Buchanan-Tullock, is to push the optimum to the right, i.e., *ceteris paribus*, more of a division of power is beneficial in a situation where it induces a positive revenue effect in the form of better decisions (hence, the shift in the optimal degree of a division of power from x^* to $x^{*'}$, as R shifts the c_{si} curve downwards and to the right, into c'_{si}). The analysis demonstrates that contrary to what the ability-to-act proponents say when they want to make the action space of politicians very large, there are strong arguments for introducing constraints on political decision-making: both to avoid special-interest exploitation (captured in the external costs above) *and* to enable political decision-making to become more rational and of higher quality (captured in the revenue curve above). Of course, as Figure 3 clarifies, there is always a trade-off of these two effects against the one of having excessive transaction costs.

4.2. *The second thesis: A division of power need not yield high transaction costs*

An assumption underlying the first thesis was that there is a positive relationship between the degree of the division of power and political transaction costs. This is also an assumption of those who oppose a high degree of a division of power because it is thought to induce an inability to act. Here, we argue that this is a simplified assumption which oftentimes is incorrect.¹⁷ To reiterate, above we argued that *to the extent that the assumption holds*, it need not constitute a strong argument against a high degree of a division of power. But it is not only the case that transaction costs are sometimes good; it is also the case that a high degree of a division of power does not necessarily result in high transaction costs. The relationship is, thus, a complex one. The constitutional challenge is one of trying to devise a system that, on net, imposes high transaction costs on decisions that are not rational and conducive to the public interest and low transaction costs on decisions that have the opposite characteristics. A wisely devised division of power, or constitutionalism, is a useful organizing principle in this regard.

This is so since a constitutional system consists of a large set of components which, depending on how they are combined, produce complex patterns with reference to how easy it is to act in different areas. However, unlike in

Table 1. The effects of components of constitutionalism

| Constitutional component | Transaction costs | External costs | Quality of decisions |
|---|-------------------|----------------|----------------------|
| Federalism | ↓ | ↓ | ↑ |
| Independent judiciary and judicial review | ↓ | ↓ | ↑ |
| Rights, generality principle | ↓ | ↓ | ↑ |
| Bicameral legislature | ↑ | ↓ | ↑ |
| Independently elected executive | ↓ | ↓ | ↑ |
| Referenda | ↑ | ↑ | ↑ |

These are all somewhat uncertain effects highly dependent on the particular design of the institutions in question, and the more precise reasoning behind the table are found in the text below; ↑ = increase, ↓ = decrease

the Buchanan-Tullock analysis, and the one produced in Figure 3 above, these relationships and effects are rarely continuous.

To analyze the issue of the central effects of a system with a high division of power, we focus on three areas: transaction costs, external costs, and the quality of decisions. As specified in section 2, such a system is generally characterized by federalism, an independent judiciary and judicial review, rights and a generality principle, a bicameral organization of the legislature, an independently elected executive (most often called a president), and referenda. While realizing the complexity of the problems involved in the analysis, Table 1 nevertheless presents our view of the effects of these constitutional components, *ceteris paribus*. Clearly, then, our conclusions, as summarized in Table 1, do not apply in every case but are contingent on how a particular system is designed in detail and should hence be regarded with some amount of caution.

Let us go through each of these effects, and let us begin by focusing on *transaction costs*. A system with a high division of power, through the institutions specified, may interestingly contain elements that bring about high transaction costs as well as others that bring about low transaction costs. An important reason why low transaction costs emerge is that certain constitutional components – most notably federalism, an independent judiciary and judicial review, rights and a generality principle – cause a division of the action space of political decision-makers such that it is easier to know in what area and in what way to make decisions.¹⁸ By *partitioning the domain* of politics, it is easier for decision-makers to make decisions since the alternatives between which to choose are decimated.¹⁹

This can be illustrated by means of a Venn diagram, in Figure 4.

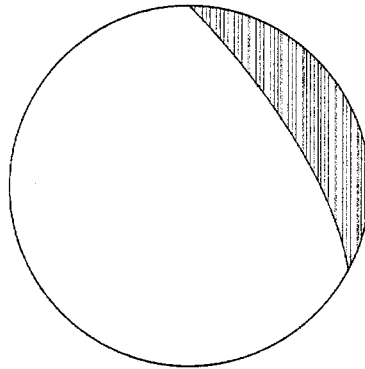


Figure 4. The partitioned domain of political decision-making

The empty area refers to the decisions that are allowed in everyday political decision-making, whereas the striped area refers to the decisions that are out-of-bounds because they violate some constitutional rule. In the terms of Dworkin (1977: 294–330), there are *principles* and *policies*, and the former constitute the basis of rules that delineate what type of policies that can be pursued. Dworkin defines a “policy” as “that kind of standard that sets out a goal to be reached, generally an improvement in some economic, political or social feature of the community.” He defines a “principle” as “a standard that is to be observed, not because it will advance or secure an economic, political or social situation deemed desirable, but because it is a requirement of justice or fairness or some other dimension of morality.”²⁰ When it comes to rules based on principles, most often constitutional rules, it is desirable to have high transaction costs for taking action in violation of those rules and for changing them; but when it comes to policies, action should be easy to undertake and be determined, ideally, in accordance with the changing majority preferences of voters as expressed in elections. Especially note that rules based on principles *can* be changed, albeit with more difficulty than policies, and hence they are thoroughly democratic.

In accordance with this, different decision rules can be used for different kinds of decisions, depending on which area of the Venn diagram they, respectively, belong to. Hence, through this division on the basis of the character of political decisions, a simple-majority rule can oftentimes be used for most everyday decisions (in the non-striped area). Interestingly, in a situation where no division of this kind is made, a qualified-majority decision rule may be required for *all* decisions, in order to make the decisions yielding undesirable outcomes very costly.²¹ With this proposed way of viewing things, a higher degree of precision is obtained in constitutional design – which in this

case has the effect of enabling a *reduction* of transaction costs in the realm of ordinary political decision-making.

Now, in our setting, we specify a set of institutions that, jointly, create a system with a high division of power and a resulting complex set of effects on transaction costs.

As for federalism, the striped area refers to the decisions that *central* decision-makers are deemed competent to make; the empty area are the decisions that *local* decision-makers are considered best suited to make. For decision-makers at any level, then, this division means that it is easier to know what to gather knowledge and decide about: in effect, transaction costs for policies become lower through this mechanism.²²

As for an independent judiciary and judicial review, these institutions facilitate decision-making by clarifying, interpreting, and upholding rules in the presence of disputes. This induces decision-makers to focus on implementing good policies.²³ In a sense, then, these institutions help clarify the precise nature and scope of the type of division illustrated in Figure 4.

As for rights and a generality principle, they also reduce transaction costs in the political system by categorizing all (potential) political decisions into one of two areas: those that are permissible (the empty area in Figure 4) and those that are not (the striped area). The generality principle does this by requiring all decisions to treat all citizens *qua* citizens in an equal manner (cf. Buchanan and Congleton, 1998); rights do this by requiring all decisions not to violate the particular rules incorporating the rights. By knowing that certain alternatives are out-of-bounds, decision-makers can concentrate their sparse time on deciding on other matters and do so more easily.²⁴

As for a bicameral legislature and referenda, they reasonably raise transaction costs (which, as argued above, need not be a bad thing, on net, depending on the effects on external costs and the quality of decisions). The former does this by requiring all decisions to pass through two deciding instances instead of one, which is more cumbersome; and the latter do this by opening up for rather complicated and demanding procedures which are more difficult to engage in than regular legislative work.²⁵

As for an independently elected executive, its effect on transaction costs depends on what powers are vested in this institution. For instance, a president can have the capacity to initiate various forms of political action, but he can also have the capacity to block the proposals put forth by other actors in the constitutional system, such as the legislature, most often in the form of some veto power.²⁶ If the capacity to take initiatives, rather than the capacity to block, dominates a presidential system, and if this capacity is formed in such a way that it can resolve deadlocks in the legislature, e.g. by causing referenda to be carried out or by putting forth proposals in certain, specified areas, then

there is good reason to expect a president to exert an influence that reduces political transaction costs in the system as a whole.²⁷

Now, the second effect in Table 1 concerns the effect on the *external costs* from various institutions. Here, we suggest that the introduction of all the institutions listed bring about lower such costs, except for referenda, which may also increase them.

The lowering effect of federalism stems from the introduction of several levels of decision-making which limit the effects of decisions: first, by locating decisions to regions to a larger extent and second, by enabling people to exit if they dislike certain regional decisions (cf. Macey, 1988: 506); the lowering effect of an independent judiciary and judicial review stems from the ability of these institutions to uphold constitutional rules incorporating rights and generality (cf. Dworkin, 1977); the lowering effect of rights and a generality principle stems from their directly enjoining certain decisions which run contrary to important interests;²⁸ the lowering effect of a bicameral legislature stems from making it more difficult to pass legislation which are beneficial only to special-interest groups, especially if the two chambers are composed in different manners (cf. Buchanan and Tullock, 1962: ch. 16); the lowering effect of an independently elected executive stems from the public-interest perspective that he or she can pursue, independent of parties and factional interests often central to strict parliamentarism;²⁹ and the increasing effect of referenda stems from their oftentimes opening up for populism, which tends to increase external costs.³⁰

The third effect in Table 1 refers to the *quality of decisions made* as a function of the institutions in place. As noted, this third aspect of a constitutional system has often been neglected, but we think it important and hold that constitutionalism enhances the decision-making process in a qualitative manner, quite aside from its blocking special interests to a relatively high degree. Holmes (1998: 227) emphasizes the *enabling* dimension of constitutional rules: “[A] democratic constitution does not merely hobble majorities and officials. It also assigns powers (gives structure to the government, guarantees popular participation and so forth), and regulates the way in which these powers are employed (in accord, for example, with principles such as due process and equal treatment). In general, constitutional rules are enabling, not disabling.”

As for federalism, it enables the level best suited for deciding upon a certain matter to do so; as for an independent judiciary and judicial review, they induce more of rational deliberation into the judicial and political process (cf. Peczenik, 2002); as for rights and a generality principle, they tell decision-makers to spend time on collecting knowledge for decisions which are not anathema to the basic principles of the constitution; as for a bicameral

legislature, by requiring decisions to be discussed, analyzed, and passed in two separate chambers, it provides more in-depth penetration of issues; as for an independently elected executive, given a wise design of this institution as expanded upon above, the increase in public discussion and deliberation introduced by the need for the executive and the legislature to cooperate, tends to increase the quality of decision-making; and as for referenda, it is reasonable to also think the effect positive, since popular discussions can serve to broaden the treatment of issues and make them better understood as more perspectives come to the forefront of decision-making.³¹

Not least, one may view this quality effect of constitutional rules as a result of the way human beings function: i.e., with limited information, restricted cognitive capacities, and bounded rationality.³² Without these shortcomings, the quality of decisions would tend to be very high indeed, irrespective of the institutional setting (although other matters, especially the problem with special-interest influence, would still provide a rationale for rules). Rules, wisely devised, formal or (oftentimes) informal, help us receive better pay-offs in various activities than if we would go about, seemingly rationally, analyzing each decision, down to the smallest one, before acting. Either we cannot do it or it is too costly, in terms of resources, to do it.³³ The positive effect of rules, in terms of quality, then is that they make it easier to make certain decisions rather than others and that they give time and guidance for gathering facts and information.

To summarize this section, we have found that the oftentimes assumed effects of a system with a high division of power, most notably that it entails high transaction costs and that these make the system undesirable, are dubious. Rather, a system with high transaction costs for undertaking actions that are not in the public interest are a good thing, as external costs become lower and as the quality and rationality of decision-making is enhanced. Furthermore, such a system need not only entail high transaction costs: indeed, wisely designed, it may entail low such costs for actions that promote the public interest.

5. Implications

As most readers surely have recognized, the analysis in the sections above have a number of implications for democratic theory and practice. In this section we will indicate a few of these.

The analysis fits nicely into, and should add important insights, to the well-known distinction between two major types of democratic models proposed by William Riker (1982). The major differences between the models

Table 2. Characteristics of populist and liberal democracy

| Populist democracy | Liberal democracy |
|--------------------|--|
| State sovereignty | Legality principle (<i>lex superior</i>) |
| Parliamentarism | Division of power |
| Monism | Pluralism |
| Majority rule | Minority veto |
| Unitary state | Federalism |

of *populist democracy* and *liberal democracy*³⁴ are summarized in Table 2 below.

With one exception, the concepts in the table should be well known and do not require further definitions. However, the term *monism* is simply the opposite of pluralism. A monistic state is centralised and unitary, with no independent power centers.

What our analysis shows is, first of all, that the higher transaction costs regularly associated with the model of liberal democracy will often be a good thing – the deliberation introduced in governmental decision-making are likely to increase the quality of the political decisions.

Secondly, it will not always be the case that liberal democracies have higher transaction costs than the more centralised, unitary and populist democracies. Given, of course, that the relevant institutions are wisely designed, a liberal democracy will have low decision costs, because of the partitioning of the domain of political decisions, and a high capacity to act in areas where it is appropriate, as well as a slow and more tedious decision process in areas where it is not appropriate to act without further deliberation. Overall, a liberal democracy should, according to our analysis, be more in the long-term public interest.

Interestingly, there are some empirical results that seem to support our view, even though a lot more work needs to be done in this area. For example, a number of studies show that the rate of inflation is lower, the size of the public sector smaller and the rule of law stronger in federal states than in unitary states. Certain types of referenda and bicameralism, furthermore, have a lowering impact on public spending. Factors such as bicameralism and presidentialism seem to contribute to higher wealth.³⁵

Moreover, there are also some indications that the quality of democracy itself may be enhanced by an elaborate system of division of power. In his seminal study of thirty-six stable democracies Lijphart (1999: 301) found that, what he calls, *consensus democracies* (which in most respects corresponds to

Riker's liberal-democracy type) outperform *majoritarian democracies* of the Westminster type: “... / majoritarian democracies do not outperform the consensus democracies on macroeconomic management – in fact, the consensus democracies have the slightly better record – but the consensus democracies do clearly outperform the majoritarian democracies with regard to the quality of democracy and democratic representation.”

6. Conclusions

In conclusion this paper shows, firstly, that a system with a division of power can be a good thing in spite of giving rise to high transaction costs, not least because of the higher quality of decision-making that it brings about through enhanced deliberation within the political process. Secondly, it is shown that a division of power, or constitutionalism, is not unequivocally related to high political transaction costs, because the domain of political decision-making can be divided such that the focus of the decision-making is facilitated and enhanced.

The constitutional challenge is hence one of trying to devise a system that, on net, imposes high transaction costs for decisions that are not rational and conducive to the public interest and low transaction costs for decisions that have the opposite characteristics.

Consequently, democracy theorists who have argued that there is an unavoidable trade-off between constitutionalism and need for political action are clearly wrong. In fact, the increased quality of the political decisions within a strong constitutional state with a vertical as well as a horizontal division of power should have important implications both for democratic theory and practice, not least in the present discussion of the constitutional future of the European Union.

Notes

1. Most importantly, the promotion of good governance and the rule of law, and the avoidance of an influence for special interests and myopic decisions. See e.g. Buchanan (2002).
2. The same critique applies to Cooter (2000) and his version of this diagram.
3. For a historical exposé, see Gordon (1999). For more analytical presentations, see e.g. Bellamy (1996), Castiglione (1996), Lane (1996) and Bogdanor (1997).
4. *The Federalist* No. 48 in Hamilton, Jay and Madison (1778/1961).
5. Cf. Henisz (2000) and the related, emerging literature on how multiple *veto players* reduce political uncertainty and increase political transaction costs (with beneficial economic effects).

6. Cf. Buchanan (2002) and Peczenik (2002) for two different perspectives on how constitutional rules, in the latter case in the form of judicial review, can induce rationality.
7. This is the application, to borrow a term from Hare (1981: 105), of “a requirement of prudence” when looking upon preferences. Long-term preferences are akin to preferences behind a veil of ignorance – cf. Rawls (1971) – but differ from them in the sense that individuals are not assumed entirely *ignorant* about the position of themselves, nor about the positions of others. They are, however, assumed to be *uncertain* in this regard – cf. Brennan and Buchanan (1985: 30).
8. Such rights, a kind of “trump cards”, to use the term used by Dworkin (1977: xv), which cannot legally be put aside, can be motivated on the basis of several different philosophical approaches. Cf. Rawls (1971: 130–136), Nozick (1974), Buchanan (1975), Hare (1981: ch. 9), Sen (1987), and Almond (1993).
9. On how interests and theories may differ in constitutional pondering, see Vanberg and Buchanan (1989); cf. Elster (1998a: 100 f.). On their relationship and character more generally, see Ayer (1967).
10. For a synthesis, see Karlson (2001).
11. Cf. Posner (1987), Macey (1988) and Miller and Hammond (1989).
12. For simplicity it is here assumed, firstly, that transaction costs increase monotonically with the division of power and, secondly, that the division of power can be measured continuously. These assumptions will be relaxed below.
13. A similar point is made by Cooter (2000: 175–177), although in a less general application concerning the optimal, cost-minimizing size of legislatures.
14. Cf. Habermas (1992), Gutman and Thompson (2000) and Karlson (2001: 200).
15. Cf. Brennan and Hamlin (2000) who argue that a division of power may be “virtue-enhancing.”
16. This point is a direct parallel to the Hayekian idea of the market as a discovery procedure (Hayek, 1937), as noted by Voigt (2001: 8); cf. Posner (1987). It also forms part of the basis for Hayek’s (1960) proposal to introduce a second legislative chamber with a different composition and set of tasks than a first chamber.
17. Notably, whereas both Posner (1987) and Macey (1988) make points similar to our first thesis, they do not provide any discussion of the possibility of the second thesis. Cooter (2000: 54, 112) discusses how political organization can reduce transaction costs (e.g. by exchanging a unanimity rule for a simple-majority rule), but there is no explicit discussion of how a system with a high division of power can entail distinct elements of low transaction costs.
18. Cf. Buchanan’s (1987: 310) analysis of the Wicksellian constraint’s “apparent restrictiveness.”
19. It is important to note that this type of “enabling” constraint, like other constitutional constraints, are thoroughly democratic in nature so long as they are instituted, accepted, and changeable (albeit with some difficulty) by the legitimate democratic decision-making bodies. In a sense, then, this is about a democracy self-binding itself in certain respects because of the beneficial effects thereof (cf. Elster, 1979).
20. Cf. Hayek’s (1973) distinction between “law” and “legislation” and Brennan and Buchanan’s (1985) distinction between the “rules of the game” and the “plays of the game within those rules.”
21. This implies that a constitutional system with high division of power in a certain sense can be viewed as a substitute to a qualified-majority decision rule – or, perhaps, that the precise design of such a system is complex and that its constituent constitutional components to some extent are interchangeable.

22. This predicted effect hinges on a basic definition of federalism, e.g. as expressed by Riker (1975: 101): “Federalism is a political organization in which the activities of government are divided between regional governments and a central government in such a way that each kind of government has some activities on which it makes final decisions.” In contrast, Lijphart (1999: 4) asserts that other characteristics of a political order are needed, in addition, in order for it to qualify as federal: “The secondary characteristics are strong bicameralism, a rigid constitution, and strong judicial review.” If these are added to the definition, then the effect of federalism is ambiguous, as e.g. bicameralism increases transaction costs.
23. This reasoning – that these institutions can stimulate good policies – presumes that the constitutional court is *de facto* largely independent and that its judges are prone to further the public interest. However, there is a risk that these conditions do not hold, as is indicated by the activist social or labor courts in Germany and Sweden. Also, see Landes and Posner (1975) on how the judiciary may further the influence of special interests. To the extent that this holds, good policies may not be forthcoming. Nevertheless, transaction costs could still be expected to be lower, as any constitutional court helps clarify what decisions are, and what decisions are not, out of bounds.
24. Macey (1988) proffers the view that this type of rules are superfluous as they are always open to (re-)interpretation by the decision-makers themselves. However, in a proper *procedural* setting, as outlined here, we do think that they have the ability to influence what actions are taken, albeit (as always) in an imperfect manner. On these grounds, Macey’s critique may hit the Buchanan and Congleton (1998) argument harder, as they advocate the generality principle, to some extent, as a substitute to a more intricate institutional setting, to accompany the otherwise largely unchecked simple-majority rule. We, then, take the view – a synthesis – that a rule (e.g. the generality principle) can matter in a substantive manner, but only in the proper institutional context.
25. If the referendum takes the form of an initiative, this may lower the political transaction costs instead, as the legislative decision process may be circumvented altogether.
26. The former capacity is termed “proactive” and the latter “reactive” by Mainwaring and Soberg Shugart (1997). Furthermore, note that there are also semipresidential systems, which combine a president with a prime minister: see e.g. Duverger (1991).
27. Perhaps the presidential system of Ireland comes closest to what we are describing here.
28. Buchanan and Congleton (1998: chs. 2, 3) clarify that this effect is analytically akin to eliminating the off-diagonal positions in prisoners’ dilemma-type games.
29. See Charlot and Charlot (1992) who describe how the “Élysée effect” tends to turn the French president into more a public-interest oriented official, once independently elected and free of formal party liaisons. Cf. Moberg (1998), who, among other things, contrasts the incentives and working properties of parliamentary and presidential systems.
30. Majorities may be guided by sentiments detrimental to minorities and impose external costs on the latter and, in other cases, that minorities may have special-interest characteristics that enable them to influence a referendum process and impose external costs on others. The former problem may be mitigated by a constitutional specification or rights and by designing the referendum institute such that the legislature defines the issues to be voted on; the latter problem is reasonably particularly acute when initiatives are used and when e.g. wealthy organizations can secure support for certain issues to be taken up for voting. Cf. Moberg (1999).
31. This is a comparative statement that constitutes a positive answer to the following question: Can the population in some cases be thought to bring about a higher quality in decision-making than legislators? See the discussion on and the references referring to

this in section 4.1 above. Frey and Stutzer (2002) also note that (the option of) participation in direct democracy tend to increase the happiness of citizens. Buchanan (2000) and Frey (2000: 14) stress that referenda constitute but *one* component of multifaceted constitutional systems, and their positive effects probably depend on there being certain other elements in place.

32. Buchanan (2002), in a section entitled "Rules as Rationality," makes a similar point. On bounded rationality, see Simon (1955, 1990). For rationales for rules of thumb in a complex world, see Vanberg (1994).
33. Cf. the arguments for rule-consequentialism (as opposed to act-consequentialism) in Hooker (2000).
34. Other authors have other terms, such as *machtstaat* versus *rechtsstaat* (Lane, 1996), to make the same distinction.
35. For references, see Berggren and Kurrild-Klitgaard (2002) and Wachendorfer-Schmidt (2000). Also see Lane (1996), Lane and Ersson (2000), and Persson and Tabellini (2001a,b).

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