

Political Entrepreneurship and the Formation of Special Districts

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Abstract

Where general purpose governments provide a bundle of services within their boundaries, special district governments provide specific services inside the boundaries of general purpose governments. The alternative to forming a special purpose government is providing the service within a general purpose government. Formation of a special district represents the establishment of a new political enterprise, in contrast to the addition of a new product line to an existing government. We explore the formation of special districts as a particular form of the universal entrepreneurial search for gain or profit from exchange. Political entrepreneurship, like market entrepreneurship, operates inside some framework of rules, and the formation of special districts reflects the search for political gain within that framework of rules. We use an entrepreneurial framework to formulate several hypotheses concerning the formation and organization of special districts.

Keywords: special districts, political entrepreneurship, public enterprise, public-private interaction, enterprise-based public finance, constitutional political economy

JEL Codes: D72, H11, H71, L32

1 Introduction

The literature on political economy treats the standard unit of government as a general purpose unit that provides a variety of services, as illustrated by counties, cities, and towns. While it is understandable that people might think of governments as being of the general purpose variety, we would note that within the United States special districts are nearly as numerous as general purpose governments. According to the U.S. Bureau of the Census (2007), there were 37,381 special district governments in 2007 in comparison to 39,044 general purpose governments (see Table 1).¹ How do special districts come about and how are they organized? We analyze the formation and the characteristics of special districts as the outcome of efforts by political entrepreneurs. This entrepreneurial framework allows us to formulate several hypotheses concerning the nature of special districts.

Special district governments undertake a wide variety of activities that include flood control, mosquito control, fire protection, soil conservation, pollution control, libraries, parks, and airports. Many of these activities are also supplied in some places by general purpose governments. Many special districts cover small territory and deal with simple situations, as illustrated by the Goose Pond Maintenance District which covers two townships in Massachusetts. But there are also special districts that cover wide territory and deal with complex situations. For instance, the Metropolitan Washington Airports Authority oversees two airports (Reagan and Dulles), operates a toll highway, regulates ground transportation and concessions, and is governed by a board appointed by

several different political bodies located in two states and the District of Columbia. Table 1 shows the growth in the number of local governments within the US at five-year intervals between 1962 and 2007. Over that period, the number of special districts more than doubled, growing from 18,323 to 37,381. In contrast, the number of general purpose governments was nearly constant, rising from 38,193 to 39,044.

The phenomenon of special purpose governments is not limited to the United States. Special purpose governments exist in many countries. In Swiss cantons, for instance, independent special purpose communities provide such services as schooling, water, and electricity (Frey and Eichenberger 1996, 322). In Spain, communities can form so called *Mancomunidades* that provide certain services to a set of participating communities (Garrido 2007). And in many other European countries municipalities cooperate to form special purpose governmental units that provide a broad variety of services (for an overview of European cases, see Hulst and van Monfort 2007).

Special districts are enterprises that are established through political processes, which would seem to suggest the potential merit of examining their establishment through an analytical framework of political entrepreneurship. Commercial enterprises are, of course, continually being created, and we would suggest that the creation of special districts can be reasonably understood through the same entrepreneurial framework, once that framework is modified to take account of the political setting in which special districts are formed. Just as the formation of a new commercial enterprise takes place within some particular

institutional framework, so does the formation of a special district. The institutional environment concerning the formation and organization of special districts affects what kind of profit opportunities political entrepreneurs perceive as exploitable via special districts. We argue that individual entrepreneurs drive the formation and organization of special districts in face of the applicable rules that circumscribe the set of available exchange relationships. We further posit that for political entrepreneurs the seizing of a profit opportunity through some department of a general purpose government is the most relevant alternative to a special district. Therefore, the organization of a special district has to carry some net advantage for the political entrepreneur over setting the enterprise up within a general purpose government. Using the framework of political entrepreneurship, we formulate several hypotheses concerning the nature of special districts by exploring institutional rules regarding (1) the establishment of boundaries, (2) the generation of revenue, and (3) the internal governance of special districts.

The existing literature on special districts can roughly be divided into two strains. The first strain explores consequences of special districts for the provision of government services. Contributions to this line of work focus on the examination of efficiency properties of governmental fragmentation. Such things as the effects of varying degrees of governmental centralization on economies of scale in the provision of public services and the effects of different patterns of centralization on the creation or extinction of externalities are addressed (see, among many examples, Ostrom, Tiebout, and Warren 1961; Wagner and Weber 1975; Hooghe and Marks 2003). We are not concerned with these efficiency

properties, and are concerned instead with the creation and organization of special districts from the point of view of a positive theory of political economy, which as Backhaus (1994) explains requires recognition of differences between public and private enterprises even if entrepreneurship is present in both. Our efforts are directed towards providing a framework that allows us to better understand the formation and organization of special districts; they are not directed toward comparing the observed pattern of special districts to some hypothetically ideal pattern. In this paper we are concerned solely about special districts as a product of the pursuit of perceived opportunities for gain by political entrepreneurs. The overall landscape of political enterprises emerges out of interaction among a multitude of entrepreneurs, and is not the outcome of any singular act of choice.

The second strain of work focuses on an exploration of the formation of special districts. Much of that work is concerned with the effects of differences in state laws on the frequency of special district formations across states (DiLorenzo 1981; Bollens 1986; Foster 1997; Carr 2006). Where this literature seeks to relate variation in special district formation to variation in state laws, we seek to provide a framework grounded in political entrepreneurship which gives rise to those special district formations. Along the lines of Wagner's (2007) emergent orientation toward collective activity, we do so by identifying the political entrepreneur as the driving force behind the establishment and organization of special districts.

Closer in spirit to this paper are various efforts to explain special districts in what could be called *quasi-entrepreneurial* terms. For instance, Austin (1998) models cities as supporting the formation of special districts as a means of facilitating the subsequent annexation of unincorporated territory. Feiock and Carr (2001) analyze the individual incentives of “boundary entrepreneurs” to spur various forms of collective action that can lead to changes in the boundaries of local governments. In a similar vein, several authors treat special districts as a means of circumventing budget limitations that states have imposed on general purpose governments (Bowler and Donovan 2004; Mullins 2004; Shadbegian 1999; Lewis 2000; McCabe 2000; MacManus 1981). To the extent tax or spending limits are applied to general purpose governments, it is reasonable to expect special districts to expand. Our approach differs from these *quasi-entrepreneurial* approaches in that we explicitly ground our investigation of special districts in a general framework of political entrepreneurship in order to explore the nexus between entrepreneurial action, rules concerning special districts, and the formation and organization of special districts.

In the next section we present a framework of political entrepreneurship and apply it to the institutional context of special districts. In section 3 we derive several hypotheses concerning the nature of special district in light of certain facets of the institutional rules under which special districts are formed and organized. Section 4 contains concluding remarks.

2 Institutional frameworks and special district formation

All entrepreneurial action starts from some individual who senses an opportunity for gain and subsequently pursues it (Kirzner 1979). While entrepreneurship is most commonly thought of as being pursued commercially, it is also present in nonprofit organizations (Auteri and Wagner 2007) and in the organization of collective activity (Lewis 1980; Osborne and Gaebler 1992; Schneider and Teske 1995). All enterprises originate in entrepreneurial acts that are pursued on either the public or market square. Those entrepreneurial acts, moreover, will always take place within some framework of applicable institutional rules. Those rules influence both the anticipated returns associated with efforts to establish enterprises and the organizational characteristics of the enterprises that are established. The resulting landscape of enterprises will be an emergent quality of the ecology of entrepreneurial actions within the governing institutional frameworks, along the lines of Schelling's (1978) treatment of the spontaneous emergence of order out of individual action. Although issues regarding the formation and the organizational structure of enterprises are necessarily intertwined, we separate formation from subsequent organization for analytical purposes.

All entrepreneurial effort is directed toward replacing a lesser valued with a higher valued alternative, as these valuations are perceived within some given set of rules. The market arrangements centered on private property present one set of rules for forming enterprises. Private property provides a simple institutional framework within which people can create enterprises of great

complexity (Epstein 1995). There exists variation among states in the regulatory requirements that are imposed on the formation of commercial enterprises. A substantial literature now exists on the effects of such institutional variation in the formation of commercial enterprises. For instance, differences across states in the rules for forming corporations appear to influence the number of incorporations (Romano 1985).

Rules regarding the formation of special districts provide a different framework by which enterprises can be formed, but special districts are likewise formed according to institutional requirements that vary across states and with the services provided by special districts. It is reasonable to expect that state rules regarding the formation of special districts will have observable consequences for the frequency of special district formation and their modes of organization across states. For instance, Louisiana and Missouri are similar in size, population, and population density. Yet they differ greatly in the special districts they contain. Where Louisiana has 2.0 special districts per 100,000 residents, Missouri has 30.²

With respect to the formation of a special district, the primary question to be addressed is the identity of the relevant alternative. A reasonable answer, we think, is that the relevant alternative is to pursue the activity within the framework of a general purpose government that is already in place. A special district will be advocated if the advocate senses that it offers higher anticipated net gains than working within the general purpose government. Political entrepreneurs can gain access to collections of rules that by circumscribing the range of feasible

exchanges determine the expected benefits and costs from acting upon an opportunity in the political arena in either the environment of a general purpose government or a special district. An investigation of the rules that apply to special districts and underlie the exchanges connected to special districts appears to be appropriate to better understand why special districts get formed in some cases and not others.

Whereas the collection of rules as a whole determines whether or not an entrepreneur chooses to form a special district, the various subsets of rules that speak to the possibility of certain exchanges affect the modes of organization of special districts. The rules determine, for instance, what goods and services can be exchanged, with whom exchanges may take place, or under what conditions a special district can force individuals into exchanges. Entrepreneurs aim at an organization of special districts that allow them best to exploit available gains from exchange. Sets of rules that pertain to market enterprises and differ across state borders affect the organization of commercial enterprises too. For instance, Wald and Long (2007) argue that differences in rules across states have an impact on the capital structure of firms. Capital is an input into the exchanges an enterprise engages in, but the capital structure is not independent from the rule-environment that regulates the kinds of exchanges feasible for the enterprise.

Political enterprises potentially allow entrepreneurs to realize gains from trade that are not available to market enterprises. Among other considerations, market enterprises, unlike public enterprises, are not in the position to force individuals into exchanges via taxation. At the same time political enterprises,

special districts included, do not have access to all opportunities to benefit from exchanges that market enterprises enjoy. For instance, there are no capital markets for equity in political enterprises, because the residual claimancy of political enterprises is established not by property rights but more subtle mechanisms. Consequently, political enterprises and market enterprises are organized according to different principles (Ruiter 2005). Sets of available exchanges also vary between special districts and political enterprises within the confines of general purpose governments and thereby give rise to differences in their modes of organization.

3 Rules and special districts

In general, the more discretion an entrepreneur has with respect to the organization of an envisioned special district the more attractive the special district option becomes relative to pursuit of the opportunity under the umbrella of a general purpose government. The presence of constraints in form of certain rules that apply to special districts limits the range of feasible exchanges. We identify three different sets of rules that set bounds to the exchanges to which special districts have access: boundary rules, rules of revenue generation, and rules of internal governance.

3.1 *Boundary rules*

About 80 percent of special districts in the U.S. lie within the border of a single county (U.S. Bureau of the Census 2002, 15). The remaining 20 percent cross

county lines and in some cases even cross state lines. Special districts that reside within a single county can, moreover, cross the boundaries of such other general purpose governments as cities and towns. The simplest special district would reside inside unincorporated territory within a single county. In this case, the entrepreneurial alternative to creation of a special district is to pursue the desired activity within the county's budget process. In the other cases, the alternative would involve participation in the budgetary processes of two or more general purpose governments.

While numerous specific rules govern the delineation of boundaries for special districts, the key feature of those rules is the degree of consensus they require among those who would reside within the district's territory. William Riker's (1962) size principle would suggest entrepreneurial support for a form of fiscal gerrymandering whereby the territory contained a bare majority of supporters and a minority who opposed the district but were taxed to support it. Supporters would realize gains from trade to the extent that their tax contributions are below their willingness to pay. Whereas opposing residents who would be forced into the exchange would suffer from losses to the extent that their willingness to pay is below the tax payments imposed on them. For instance, a Business Improvement District (BID) might be sponsored to provide security and transit services within the designated territory (BIDs are explored in Nelson, McKenzie, and Norcross 2008). To the extent the boundary of the BID exceeds the area where the services would be demanded, users of the service

will be subsidized by the outsiders, provided that the BID is financed by property taxes and not by user charges.

There are several ways in which actual processes of boundary formation for special districts can limit the extent of such fiscal gerrymandering. For instance, rather than securing majority approval over the entire territory as a unit, approval could be by some such smaller unit as a precinct, and with the special district including only those units where majority approval was secured. Territory could also be excluded from a proposed boundary through special hearings, either legislative or judicial, and such procedures would operate to increase the degree of consensus in the formation of special districts. It would, of course, also be possible to use qualified majority voting as a means of expanding the degree of consensus present at the formation of a special district. Such rules increase the proportion of residents who expect to gain from the exchange relationships established by a special district and make the special district option less attractive for political entrepreneurs as they interfere with his boundary plans for the special district.

The rules concerning boundaries of special districts may either be relatively rigid or flexible over time. How easily the boundaries of a special district can be changed after its establishment potentially influences the set of activities pursued by the special district. If the boundaries are flexible, a special district potentially has an incentive to cater to individuals outside of its territory in order to secure support from citizens who might in the future be targeted as additional members of the special district. Commonly, local governments are assumed to

have an interest in receiving but not in providing external benefits. A special district with relatively flexible boundaries, however, could have an interest in providing services to outsiders. Such behavior can be understood as an exchange of services today in return for support at some point in the future. In contrast, if the boundary rules are such that boundaries remain relatively fixed over time, we would expect special districts to pursue a more inward-directed strategy and not to have an interest in providing benefits to citizens outside of their boundaries.

3.2 *Rules of Revenue Generation*

At the outset, an entrepreneurial decision to pursue formation of a special district entails rejection of the alternative of seeking to obtain funding of the enterprise mainly through the budgetary process of a general purpose government. It is easy to see how the state imposition of a budget limit on general purpose governments would induce an entrepreneur to seek to form a special district. To illustrate, suppose the service is demanded by one-third of the residents in the general government. If other services are more widely demanded, we might expect that the restrictive impact of a budget limit would be concentrated on the service in low demand, because it would be more difficult to find supporters for these services in the budgetary process. If so, it would be services in this position that would be candidates for the formation of a special district to take advantage of the opportunity to force unsupportive residents into the exchange. But the special district in turn might not be autonomous with respect to its form of

revenue generation. It is here where revenue rules become relevant, even beyond the relevance of the rules that govern the budgetary processes of general governments. For instance, taxes and tax rates implemented by a special district might be subject to electoral approval, or perhaps subject to some kind of legislative oversight. The more the mode of revenue generation is left to the discretion of the political entrepreneur the more attractive the pursuit of a special district is for him and the more often the special district alternative is chosen.

Besides the constraining effect of rules of revenue generation, we can make a statement concerning the character of the services most likely to be provided by special districts. Similar to tax earmarking, which protects the median citizen or legislator from having to face all-or-nothing choices with respect to combinations of certain collectively provided goods (Buchanan 1963; Goetz 1968), special districts provide entrepreneurs with an alternative source of revenue outside the budgetary process. In the context of general purpose governments, we might plausibly expect services in relatively inelastic demand to be bundled with services in relatively elastic demand through tie-ins to confront the decision-maker with an all-or-nothing kind of choice in the fashion of a Niskanen bureaucrat (Niskanen 1971). Whereas Buchanan (1963) and Goetz (1968) analyze the decision of some median voter, either a citizen or a legislator, we are interested in the opportunities available to individual political entrepreneurs. The entrepreneur who provides a service that is in relatively inelastic demand might prefer a special district because otherwise the budgetary

process of the general purpose government could bundle that service with services that are in relative elastic demand. If the supporters of services in relatively elastic demand are able to control the budgetary process, the service in relatively inelastic demand will secure less financial support than it could receive through a special district. We would therefore expect that entrepreneurs who provide services in relatively inelastic demand would generally tend to pursue their enterprise through special districts. Similarly, we would expect supporters of services in relatively elastic demand to favor the inclusion of services in relatively inelastic demand into the domain of the general purpose government because it would allow a form of cross subsidization.

Besides possible forms of revenue creation for the special district unit, revenue rules also relate to bankruptcy. Bankruptcy, after all, can come to any enterprise, so a subset of revenue rules potentially speaks to the assignment of liability in the case of bankruptcy. There can be rules that in case of bankruptcy of a special district regulate which creditors are to be served first and who is in charge of the dissolution of the special district. A bureau that is situated within a general purpose government usually cannot go bankrupt independent of the overall government organization. A county government can go bankrupt but a single bureau within the county government can commonly not. In contrast, special districts as units that are independent from general purpose governments can become bankrupt. The value a political entrepreneur might place on formation of a special district over participation within ordinary budgetary processes surely depends to some extent on what rules apply in case of

bankruptcy. Similar to firms under socialism as discussed by Kornai (1986, 1998), political enterprises within general purpose governments appear to face relatively soft budget constraints. The political entrepreneur can expect losses to be compensated through the raise of tax revenues or the taking on of additional debt by the general purpose government. The political enterprise as special district that can potentially go bankrupt faces a relatively hard budget constraint; though bailouts of special districts e.g. by state governments can be observed (Foster 1997, 15; Axelrod 1992, 63-91). We therefore expect political entrepreneurs who perceive their enterprise to be relatively risky to try to organize their enterprise in the context of a general purpose government where they face relatively soft budget constraints. In turn we expect political entrepreneurs who perceive their undertaking to be risk-free to try to realize it as special district.

Rules concerning the revenue generation might constrain special districts in the form of tax limitations, whether expressed in terms of limits on rates or in terms of limits on tax bases. Special districts can also acquire revenues through fees and charges, and with various rules governing the types and levels of those fees and charges. One other form of possible limitation concerns indebtedness. Special districts typically can borrow, and with various rules being in place with respect to such borrowing. In some cases a governing board can approve borrowing, while in other cases referenda are held. In all these instances the applicable rules influence the modes of revenue generation and thus the organization of special districts. A special district that has to rely entirely on

voluntary contributions of users of its services through fees will establish a different relationship with its customers and be more responsive to their wishes than a special district that is able to force some of its residents into the exchange relationship, while only being accountable to the supportive majority.

3.3 *Rules of Internal Governance*

Special districts are subject to various rules of organizational governance. Those rules include such things as the composition and selection of governing boards and the relation between those boards and the managerial team of the special district. The creation of a special district resides in an entrepreneur's seizure of a perceived profit opportunity. Therefore, governance rules will speak to the capture of profit, which in turn typically will involve exchange relationships with enterprises organized on the market square. By governance rules we refer to the rules that govern relationships among the various participants whose interactions constitute the activities of the special district. An entrepreneur may have the idea to sponsor a special district, but the actual operation of that district is conducted by a set of governing officials whose relationships with one another comprise the constitutional framework of the special district.

Governance rules might speak to succession in the membership of boards. A sitting board might be able to select new members. Alternatively, elected officials might be able to replace board members. Yet again, the replacement of board members may be subject to some kind of electoral process that might involve some elected officials and some members of the current

board. Yet further rules speak to the operation of boards, particularly whether they can conduct their business in private or whether they must conduct it in some public forum. If the latter, there will be a further subset of rules that govern such things as setting the agenda, scheduling appearances and allotting time, as not everyone can get a hearing when time is scarce. Still another set of rules relates to possible issues of liability regarding members of the board. The actions of the district and of its board may be subject to independent audit, a possibility that raises in turn the question of who chooses the auditor. Only if the feasible governance framework of a special district allows for the establishment of more attractive exchange relationships than the general purpose government alternative, is a political entrepreneur inclined to opt for the use of a special district.

Central to the governance framework is the selection of a supervisory board. This governance framework has several aspects. One concerns selection to the board, particularly just who or what procedure it is that populates the supervisory board. Oliver Williamson (1985, 1996) explains that corporate boards are typically comprised of representatives of strong interests in the conduct of the firm. In similar fashion, we can ask who would be attracted to membership on the supervisory board of a special district. Membership on such supervisory boards would be differentially attractive to some sets of people, depending on the resulting opportunities for capturing gains from exchanges, just as would be membership on corporate boards.

For instance, a special district might be created to provide local rail service. Such rail lines typically are beneficial to land in the vicinity of points of exit. This consideration might lead someone to expect that landowners in the vicinity of possible exist points would find such service particularly attractive. The construction of such lines will also entail heavy construction, and membership on such a board might be particularly attractive to someone with connections to heavy construction. The central point behind any particular illustration is that creation of the special district is thought to be a source of gain relative to the relevant option. Profit, after all, is just another word for gain; a nonprofit enterprise can return profit, only that profit will have to be appropriated indirectly through connections between the special district and market-based enterprises. Through those connections, profits that could have accrued directly had the special district been a profit-seeking entity are channeled into market-based enterprises that have direct exchange relationships with the special district.

Figure 1 can be used to illustrate our point. Panel A provides a point of departure by illustrating a mutually profitable relationship between two commercial entities. The circles denote the enterprises and the arrows that connect them illustrate a relationship of exchange. The small arrows arising out of the circles and the small circles at the points of the arrows denote the extraction of profit from the relationship. With the relationship being mutually advantageous, profit accrues to both parties to the transaction. In panel B, the square denotes an enterprise organized on the public square, a special district in this case. The relationship is still mutually profitable, only the special district

cannot generate directly appropriable returns for its sponsors. Yet it does generate returns, only that return must be filtered through a market-based enterprise. This filtering is illustrated by the two-angled arrow that runs from the special district to the market-based firm and with the extraction of profit denoted by the small arrow pointed in a southeasterly direction.

The particular course that this indirect channeling of profit can take varies with the particular type of activity provided by the special district. A special district devoted to rapid transit might channel profit to construction companies or engineering firms. A special district devoted to hospitals might channel profit to pharmaceutical companies or manufactures of medical equipment, similar to the argument developed in Pauly and Redish (1973). Whatever the particular path that the channeling of profit takes, a special district will be organized in modes that facilitate such challenging.

4 Concluding Remarks

The map of governments and their activities is continually changing through a variety of processes that entail the creation of new governments and mergers among existing governments. Special purpose governments are part of the process of change. In this paper we have sought to locate such change not within the confines of some notion of an equilibrium pattern of government but within the confines of entrepreneurially driven processes of seeking for profit or gain. In this respect, we would note that the nonprofit character of governmental

entities does nothing to abolish the search for appropriable profits, as against changing the paths and the forms that such profit seeking takes.

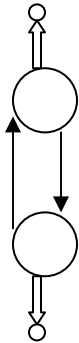
With the rules of boundary establishment, revenue generation, and internal governance, we identify sets of rules that circumscribe the feasibility of political transactions related to these aspects of special districts. In turn, these rules influence the extent to which special districts are conceived of as attractive vehicles to pursue profit opportunities in the public arena and how such enterprises are organized if pursued as special districts. We hope that the hypotheses we formulated with respect to the expected effect of certain rules on the formation and organization of special districts might serve as a starting point for further research.

Table 1:
Types of Local Governments in US

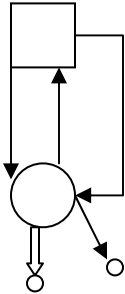
Year	Special District Governments	General Purpose Governments
1962	18,323	38,193
1967	21,264	38,202
1972	23,885	38,552
1977	25,963	38,726
1982	28,078	38,851
1987	29,532	38,933
1992	31,555	38,976
1997	34,683	39,044
2002	35,052	38,967
2007	37,381	39,044

Sources: U. S Bureau of the Census (1992, 2002, 2007).

Figure 1:
Profit Seeking through Special Districts



Panel A: Market-confined Relationship with Profit



Panel B: Profit through Enterprise Filtering

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Notes

¹ There were also 14,561 school districts, which is also a type of special purpose government though this type is usually placed in a distinct category of government.

² As based on our calculations from data in U.S. Bureau of the Census (2007).