

Committee 3:
Values and Social Order:
Order by Rules and Rules by Order

FIRST DRAFT — 16 Aug. 1995
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Competitive Federalism for the Era of Globalization

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XXth International Conference on the Unity of the Sciences
Seoul, Korea 21-26 August 1995

This is a draft in response to a late invitation to the conference. It was begun without precise information about the intended audience and desired format. No doubt, it will require much re-working and more integration with the existing literature.

Abstract

The Nation State under Challenge: Since government was invented in the Neolithic revolution, the rulers have exceeded the mandate of the citizens. The most effective antidote against this principal-agent problem, which hinders freedom, material prosperity and human satisfaction, is the competition amongst jurisdictions — a process which has gained great and irreversible momentum from the recent increase in the global mobility of capital, knowledge, enterprise and other production factors. Globalization combines with improvements in the relative cost of information gathering and communication for small operators and certain social developments to create a mighty challenge to the conventional nation state, and in particular its transfer activities.

The Competitive-Federalist Response: One consequence of globalization has been to create incentives for the devolution of central government tasks, at times to provincial and local administrations, at times into private hands. Subsidiarity in government often enables communities, and the nations they form, to compete better in world markets and promotes the evolution of institutions and administrative organisations. If subsidiarity is encouraged, the agent-principal problem is likely to be attenuated, with governments concentrating on the support of competing producers and with redistributive transfers being curbed.

Frequently, there are advantages for local and regional polities to remain associated within a general national (or wider) framework of governance, because that can lower transaction risks and costs, promote non-discrimination, and curb protectionism and violence. We call the arrangement under which local and provincial polities compete horizontally within a wider cooperative framework of shared institutions and organizations "competitive federalism".

For competitive federalism to promote a free and productive society, it is necessary to supplement subsidiarity with the principles of exclusivity in allocating of government tasks to the different level of government, fiscal equivalence (the ban on vertical transfers), and the rule of origin.

It will also be necessary to allow the full feedback from failing values, institutions and policies — within and amongst nations — to impact on the communities that have chosen them. At times, it may not be easy to control instincts of solidarity and to permit the creative destruction of values, institutions, and organizations, but we have to realize that undifferentiated charity is a pillar that supports domineering, fat Leviathan.

Competitive Federalism for the Era of Globalization

1 - The Nation State under Challenge

The nation state as we know it — with its geographic spread, its centralization and pervasive and often coercive influence on private and business life — is a creation of the last two centuries. But government of course goes back at least to the Neolithic revolution when — in the wake of the invention of agriculture, animal husbandry, socially respected several property rights and civic life in settled communities — much collective action was organized in government administrations, and much human interaction was subjected to rules passed down by law givers, such as Hammurabi, and enforced by a formalized judicial system. It is probably no coincidence that permanent settlement, property rights and formal, external institutions and government organisations to protect them emerged together in the Mid-east, China, elsewhere in East Asia and the Americas.

Ever since, rulers have exceeded their mandate, expanding government activity in their own interest and infringed on the principals' (i.e. the citizens') individual freedoms. This has become a central obstacle to freedom and material progress. But even in antiquity, the agent-principal problem was limited by challenges of competition (Bernholz, 1995b). We shall argue that globalization and the competition between jurisdictions to attract mobile production factors has been the most effective means to stem the growth of government and to make governance more citizen-friendly. We shall also try to show that present-day globalization will exert some influence to devolve powers from central national governments to provincial and local polities, a development that should be actively encouraged in the interest of liberty and human satisfaction.

The Rise of the Centralized Nation State

Throughout much of history, improvements in transport and communications technology have frequently assisted to extend the geographic reach of central government. Indeed,

communications advantages of central government — for example the Roman, Arab and Korean systems of signal towers to transmit military messages, the Mongolian "pony express" whose speed was not equalled over the vastness of Asia till the 20th century, or the big Chinese war junks that allowed the Medieval Chinese navy in the days before Columbus to engage in long-distance exploration as far as East Africa¹.

The great technical innovations of the 19th and early 20th centuries probably served to form the modern centralized, pervasive nation state: Because of indivisibilities, rail networks had to be controlled or owned centrally, often by national governments, who welcomed the pioneer rents from these new technologies. The same indivisibilities applied to the postal system, the telegraph, the radio, early (mainframe) computer technology, nuclear development, and space exploration. These technical developments boosted the influence and capabilities of central administrations relative to those of the citizens and the business communities. In times of conflict, the central power of the nation state was further enhanced by military pursuits where big, central governments normally enjoy advantages of scale and scope. Ideological developments — such as the rise of nationalism — and social developments — such as the disruption of inter-generational welfare provision within families and kinship groups in the wake of the industrial revolution and urbanization — further reinforced the tendencies that gave rise to the modern centralized nation state or that exerted a centralist pull on federations such as the US, Switzerland or Australia.

New Challenges to the Centralized Nation State

However, as of the late 20th century, the centralized nation state which is often held to be immutable, is coming under growing challenge from above and below for a number of reasons:

- Migrations of people have ensured that virtually no nation is mono-ethnic anymore.

¹ Australian economist Collin Clark stressed time and again the decisive role of transport and

- Falling transport and communications costs and other influences have led to globalization, i.e. the greater mobility of capital, technical knowledge and skills and enterprise across borders.
- The enormous spread of specialized knowledge and the progressive worldwide division of labour are also eroding the position of big, centralized governments. Once it may have made sense to organize armies of unskilled erstwhile peasants to blindly accept regimented industrial work habits, but present-day "knowledge society" rewards diversity and individual, innovative competitors, the independent, alert mind, the lateral thinker, the sovereign competitive frame of mind. Top-down authority, therefore, is more readily challenged and the rationale for regimentation is more readily rejected.
- The promise of big, central government to solve many of our problems has frequently been overstated by politicians — not least in the West in the fatal, conceited promise of the welfare state. After having mortgaged the wealth of future generations by incurring massive national debts, many governments are now going bankrupt, not only because of budgetary miscalculation but because they inadvertently changed deeply held instinctual values and social institutions that once favored individual self-help, saving and hard work².
- The relative-cost and other advantages in communication and information processing that central administrations were gaining up to the 1970s have been quickly eroded by the "pulverization" of computer power and general access to cheap and convenient communications networks. The shift in relative prices in favor of small, dispersed actors will not only be permanent, it will increasingly empower small, competing jurisdictions relative to erstwhile central-government monopolies.

² The welfare state, with its cradle-to-grave promise of welfare provision, has only taken hold in countries whose collective philosophy is shaped by Judeo-Christian traditions. The new industrial countries of the Confucian world have made little attempt at nationalizing welfare. The cultural competition between East and West is another reason for predicting the demise of the national

- The end of super power rivalry and the reduced threat of global nuclear annihilation has in many instances deemphasized the defense argument for centralization. This may give traditional nations scope to assert their identity, but the process does not stop at the national level: the regions are also demanding more autonomy back.
- As people are more exposed to different cultures and as the pervasive controls of their own, often remote national governments often fail, they seek renewed social identification at the smaller, more intimate community or regional level, where they have more influence and control over collective actions.

Globalization and Institutional Evolution

Although in essence widely known for a long time, the globalization challenge to the centralized nation state bears restating briefly so one can understand its future effects on the size and structure of government. The great technical changes in transport and communications have been cutting the relative costs of producing goods and even services at a distance from the market or the source of supply. This — as before in history — is at the heart of epochal change; but other, and related, factors such as long-lasting peace between the core countries of the integrated global economy, institutional changes such as the widespread acceptance of GATT's non-discrimination rule and the deregulation of international capital flows, as well as the emergence of globally thinking business and intellectual communities have also been decisive in triggering the new locational competition amongst nations and jurisdictions.

Once certain production factors are relatively footloose, we know the immobile production factors (land, labor, government administration) are compelled to compete in order to retain and attract the mobile resources. This was already known to economists like Johann Heinrich von Thünen (1783-1850/1966) and Max Weber (1927/1981), and was rediscovered by economic historians and others (North-Thomas, 1973, Rosenberg-Birdzell, 1986, Radnitzky, 1987, Jones 1981/1987, E. Weede, 1990, 1995; Bernholz, 1995b) who have shown that the locational competition for mobile production factors had beneficial educational

feedback on the institutions, underlying values and cultural attitudes of resident populations, we well as government structures and policies. Once, this process had created the very institutions on which the capitalist industrial civilization was based (the rule of law, due process, property rights, free contracts). More recently, the splitting-off of small, open states in East Asia from the once-closed Chinese world (such as Taiwan or Korea) and their exposure to global competition repeated the process with spectacular results. The values and institutions that had once been considered an obstacle to change (neo-Confucianism) have been converted into a world-beating cultural asset in international competition (Kasper, 1994).

Institutional reactions to the greater mobility of capital, knowledge and enterprise are not surprising, since the internal institutions of society and the externally imposed institutions of governance can serve to economize on information and transaction costs³. Nowadays, these are often nearly half of all the costs incurred in producing and distributing the national product and which are decisive for a community's innovative potential. Transaction costs (and the risks inherent in gathering and using information) will only be competitively low within a community which partakes in the global division of knowledge and labor, if the culture, economic morality and the external institutions of governance (legislation, regulation, administrative practice) are shaped so as to support local producers in the new global competition.

Locational competition has forced small, tribal communities to change their ethics and to adjust it to that of the open society. It is now undermining the nationalist and socialist extensions of the "tribal mentality" (Giersch, forthcoming) and weakening the monopoly powers of government. As already noted, it is the most effective antidote against the progress of the juggernaut of coercive government. Where governments have a restrictive hold on private and business affairs and tax heavily, some nowadays migrate away to more profitable

³ We shall use Ludwig Lachmann's terms: The 'Internal Institutions' of society evolve in the light of experience, are informal and their infringement is normally sanctioned only loosely. They constitute customary law and other restraints of opportunistic behavior. 'External Institutions' are imposed by political processes on civil society, are formally spelled out (codified), therefore tend to be more rigid, and are normally coupled with formal penalties inflicted by a third-party authority for infringements (Lachmann, 1970).

jurisdictions. And where government controls hinder the discovery, testing and use of new knowledge, be it by legalized controls or arbitrary rent-seeking, they will soon discover that they are being deserted by many of the production factors that are essential to economic growth. Thus, the global mobility of knowledgeable, enterprising people and capital exerts a powerful feedback into the formal and informal institutions. Rulers, who have no innate sympathy for freedom or democratic controls of government, find that they adjust to the maxims of the open world — often for the sake of economic growth which supports military security. Under competitive pressure, politicians and bureaucrats are shifting from selective discrimination and redistribution to facilitative support for competitors (what I labelled "functional policies", Kasper, 1994; 1995). These effects of locational competition are for example documented by the political shift to more effective controls over the rulers in Taiwan, South Korea, the Philippines, Thailand, and many Latin American countries; even in totalitarian one-party states like China and Vietnam there is some, albeit haphazard and tenuous movement towards more consistent rules, limited government and less insecure property rights.

Despite lags, lapses and accidents, the general impact of globalization has been to liberate and empower people and businesses and to constrain the rulers. Very importantly for the purposes of this paper, it is — on the whole — undermining the central controls by national governments.

The world market — the demands of mobile investors, traders and multinationals — tend to clash with traditional administrative cultures which go by precedent, orderly procedure and directive — supported if necessary — by coercion, within hierarchies that do not have the incentives to make risky decisions and act fast on the basis of bounded rationality. As long as national governments had a certain monopoly within their jurisdictions, citizens and businesses had to submit and comply with this administrative *modus operandi*. But globalization has now given many owners of mobile factors the clout to play by their own rules — enterprise rules where time is money, where trust is capital, and where low compliance and transaction costs are decisive competitive factors. This has forced many a

government to jettison or streamline regulations, reduce business taxes, and act in a businesslike manner, often through special foreign-investment or industrial-development agencies. In many instances, the incentive to attract investment or knowledgeable people has become so strong at a lower, regional level that regional governments defy national power centers and make the run in microeconomic reform and business dealings. In big nations (US, Canada, Australia, even the provinces of China), sub-national governments have broken rank to become active competitors for growth resources by behaving in ways that clash with the cumbersome administrative procedures once developed within national monopoly bureaucracies. In some parts of the world, governments have even gone as far as anticipating changes in globalization and engaging in "functional development policies": they mobilize domestic production factors (skill formation, saving, development of industrial estates) and reshape public administration for the express purpose of suiting global investors (Kasper, 1994; Hughes, 1995). The success stories in administrative reform are being imitated, for example by Thailand and Indonesia, and the better use of organizational and institutional knowledge is thus spread further afield. This contributes to the rising living standards of the growing world population, but it has also enhanced individual liberty and the electoral control of governments.

Governments — and communities — that come under global competitive challenge may of course also respond in defensive ways by protecting the *status quo*, using more coercion and discriminating against outside competitors. Populists may, at least temporarily, gain considerable electoral support by promising collective protection against globalization. They may appeal to tribal or nationalist instincts and cultivate a degree of superiority feeling or xenophobia as an emotional cement for such strategies, as exemplified by officially organized "Euro enthusiasm" or the anti-Western machinations of the Hindu parties in India.

In today's conditions, the centralist defences are unlikely to hold over the long run. Even totalitarian regimes, such as the Soviet Union, crumbled in the wake of the modern systems competition and even remote places with deeply entrenched defense mechanisms against international competition, such as New Zealand, had to reform out of sheer material self-

interest. This is not to say that discriminatory protectionism cannot at times take even the form of pathological tribalism and resort to violence (such as in Africa or the Balkans), but in a growing part of the world it will promote liberty and prosperity.

Growing Relative Advantages of Small Operators and Networking

The second, and less widely known, consequence of technical change which we want to discuss here is the shift in the cost and access of small players to transport, communication and information relative to big players such as central governments and big corporations (Drucker, 1993; Naisbitt, 1994). More than the invention of the car and the truck, which became the 'freedom machines' of individual citizens and small firms, microchips now give small operators scope to compete independently. To understand the impact of technical change on the competitive opportunities of small against big operators, we need to draw on organization science and the new institutional economics:

- Transaction and information costs explain the existence of permanent organizations, such as firms, because the costs of open-ended, formalized cooperation within organizations are often lower, and the risks less, than if each coordinative step in the division of labour were made between independent individuals through markets (Coase, 1937).
- The size of organizations, such as firms and government agencies, depends greatly on the ratio between transactions costs/risks in markets relative to organization costs/risks within organizations (Williamson, 1985).
- This cost/risk ratio depends on the internal and externally imposed institutions of a society and the technology to monitor compliance, costs and risks. Better defined and enforced property rights for example, favor relatively more market transactions, and an absence of institutional checks on opportunistic behavior favors vertical integration. Likewise, distributed information processing and open communications networks have favored small firms and subcontracting, as well as smaller government agencies (North, 1990).

The mainframe computer is an example of the technology that gave advantages to big corporations and big government agencies, and their demand in turn promoted the development of improved mainframe systems in the 1960s and 1970s. But since then small, dispersed operators have gained a relative advantage: many centralized mega corporations now look like dinosaurs; devolution and reduction to the core business are the new fashions both in business organization and government (Drucker, 1993; Naisbitt, 1994).

These changes are coming as a shock to government. Probably since the first beginnings of the modern nation state in post-Medieval Spain and Richelieu's France, centralized governments have enjoyed transaction and information advantages over private people and regional communities. They have done much to foster their advantage by legal and administrative changes. But now much of the cost advantage is evaporating, for example through the possibility of partitioning the radio spectrum, the fax, Internet⁴ and many other technical innovations which give small operators easy access to new sources of information and means of coordinating spontaneously and across borders through networks (Naisbitt, 1994). As border-crossing networks grow, strictly national controls are becoming pointless: What is the purpose of national monetary policy in the face of the globe-circling financial market? What is the sense of national press censorship, when satellite TV and electronic bulletin boards make this a pointless relic of a bygone era? Some countries like Iran and Singapore, prohibit satellite antenna, but e-mail and fax undercut these controls⁵.

The computer and communications revolution is also affecting the relative advantages of different levels of government. As measuring and information processing has become

⁴ Internet is an example of a spontaneous order. It is a computer communications system without a centre or a central authority, similar to the market system. Tens of millions of users now interact without anyone in authority policing the 'traffic rules' or the content of the communications. But conventions and rules have emerged, for example a spontaneous ban on commercial advertising. Opportunists who have broken this convention have discovered to their disadvantage that other participants inundated them with retaliatory nuisance mail, which even forced some bad offenders off the Internet.

⁵ While an article of mine in an Australian periodical about corruption in Vietnam was being blackened out by the Vietnamese censors, several translations of it were promptly fed into Vietnam over e-mail and Internet bulletin boards. This led to lively debate in the Vietnamese community, at home and abroad, and to official denials even before anyone had been officially

cheaper, the relative position of local and provincial governments vis-a-vis central administrations has improved. They can now assess local taxes more effectively and cheaply and can conduct certain administrative actions better, for example the computerized processing of land titles, or measuring road usage. On the whole, this appears to favor "fee for service", rather than general taxation, and privatization, but it is also favoring devolution within governments to more local levels (see below).

The scope of this paper prevents me from reviewing the growing evidence of governments failing to fulfill promises, such as on public welfare, the emergence of a well-educated generation of sceptics who do not unquestioningly accept the dictum of central government, or the growing disaffection with the national political process in all Western democracies. Nonetheless, these factors now interact with the others to challenge the monolithic nation state in fundamental ways⁶.

II. The Competitive-Federalist Response

Continued Demand for Government

Some may deny that these historic forces will undermine national governments, such as the socialists in all parties and the communist leaderships in China and Vietnam who hope to maintain central Party control over "their" increasingly open and diverse regional economies. Others may claim that the new challenges herald the demise of government. Given the long existence of government and external institutions under differing technical and social conditions, referred to in the introduction, and the need for occasional, externally imposed back-up of internal institutions in a modern mass society (see below), it seems safe to assume that government has a future, as do external judicial systems that help enforce

⁶ We should mention in passing that the same constellation of technical, organizational and social factors now challenges the grip of the monopolistic power of the other immobile production factor, organized labour. This is documented by the continuing decline of union-membership in all Western countries and the emergence of competition-supporting, non-adversarial unions in

politically initiated external institutions. But the form and task of government will have to be reinvented to better meet the need of pluralist, multi-faceted communities that are wide open to intensifying global cooperation and competition⁷.

This prediction is based on a number of considerations:

- (a) As more people venture across political and cultural borders into extra-territorial, lightly governed spheres, new informal institutions will evolve of the sort that the Curzon Price paper documents (Curzon Price, 1995, this volume) and which facilitate the spontaneous creative interaction among far-distant partners in trade, investment and finance. No doubt, there will be many more self-enforcing devices of the sort that Oliver Williamson, Anthony de Jasay and others have described (Williamson, 1985; de Jasay, this volume; also Eggertsson, 1992). In an increasingly complex world and with an increasing complexity of contracts to cope with the growing division of labor, these devices will economize on the need for central authority whose capability is, in any event, limited.

Nevertheless, self-enforcement — such as the granting and taking of "hostages" and the defense of reputations — is not cost-free. In many instances, the external reinforcement of internal institutions may be cheaper to society as a whole and to the merchants concerned directly, even if they have to pay for a third party to run and enforce the external institutions. Governments will often enjoy important scale economies, because political legislation, administration and judicial enforcement give blanket coverage and because "free-riding" is then precluded (North-Thomas, 1973). In other instances, it may simply not be technically possible to resort to self-enforcing reciprocity. This seems particularly true when new information needs to be found and outcomes of actions are highly risky, and when people engage in once-off transactions. In short, anarchy would cost a high price in terms of living standards and future economic growth; external back-up of internal orders is sometimes efficient.

⁷ This chapter has benefitted greatly from the observed mishaps and misdeeds of central

- (b) The codification of clearly spelled-out, transparent, formal rules and the presence of an external authority may also make the behavior of people more predictable and save information and other transaction costs as well as reducing risks. Imposed traffic codes serve to speed up the traffic. Although informal, evolving orders often have the advantage of adaptive flexibility, clarity and rigidity of the rules may be required in other circumstances, in particular where complete strangers interact. When customary law is codified, this often enhances the signalling function in coordinating people. This is often an advantage, for example when speedy institutional changes are required and the time-consuming alternative of trial and error in institutional evolution would be costly.

External, formal institutions may sometimes be better capable of overcoming prisoners' dilemmas, i.e. situations where cooperation benefits all. An example that comes to mind is the imposition of standardized weights and measures or of uniform technical standards on communities that previously persevered with their own parochial standards.

- (c) While informal conventions are able to reduce transaction costs enormously within confined commercial networks, access to informal networks may be limited. For example, the unwritten traditions of the bazaar, extended Jewish or Chinese family networks and the Korean *chaebol*-government compact have been extraordinarily efficient in facilitating trade and credit by reducing transaction costs for the network-insiders. But they invariably reach limits of scale and scope and are closed to outsiders, who then resent the "privileged" insiders⁸. This imposes not only costs in terms of social harmony and stability, but also limits the growth process: the modern market economy and industrial growth require the open, extended order — institutions that ensure that you get ahead for what you know and offer, not who you are. At that juncture in the development process, a clear, legislative framework and objective judicial

⁸ Informal insider networks (such as middlemen clubs) can frequently only work by remaining exclusive: reputations can only be known about a limited number of participants and the

enforcement (i.e. government) promise great productivity advances over systems that are based exclusively on internal institutions (North, 1990).

- (d) Informal orders often advantage those with money and influence. They will be able to have the rules enforced, whereas the poor may not. At the risk of standing accused of ignoring the high cost of formal justice in the late 20th century and the iniquities of much government activity, I would argue that external, formal and therefore more transparent institutions often offer the *chance* of more just treatment of all, in the sense that equal circumstances are treated equally under the law irrespective of the individual and that negative liberties are guaranteed. Whether that chance is taken up, depends on control of and information on the political process (see below). A related and frequent advantage of formal, imposed law enforcement is that due process has a greater likelihood of being ensured and that spontaneous sanctions for unproven misdeeds are prevented (see Tullock's comment on Benson, 1995).
- (e) Last, not least, even economists who have a professional bias to focusing on the competition among independent units, should acknowledge the communitarian argument for government. It is based on the recognition that there is a human need to associate and a satisfaction from close interaction with others with whom we are familiar. Modern telecommunications networks seem most unlikely to ever meet all the requirements for human interaction and bonding. Maybe, we will even develop more pronounced demands for some sorts of communitarian interaction in spatial proximity and in close communities as we are more exposed to global competition (Giersch, forthcoming; see also Tullock, 1994). It is easy to revile parochialism and the emotional adherence to a tribal identity. But we should be aware that a close cultural identity often saves transaction costs and reduces risks in human interaction. In other instances, we may treat "community" as a good that we consume because it satisfies a deep-rooted tribal instinct, even if that costs resources and efficiency. And while a community is primarily defined by shared internal institutions, its members will normally also opt for shared symbols and some external governance structures.

Hierarchies of jurisdictions do not end with the conventional nation state. With the growing intensity of international exchange and movement, there may be a need for the integration of some government functions — in rule setting, ensuring non-discrimination and security — at supranational levels. Where these follow on the evolution of market integration, such developments of the external institutions may well serve to support and facilitate private interaction. However, national governments often try to impose integration ahead of genuine, organic community formation from the bottom up — such as in the European Union. Delegating functions to more distant supranational authorities may often be tempting to the rulers because that removes controversial and electorally costly matters of government further from individual control and accountability.

Devolution of Collective Action

The contention that government has a role does not necessarily mitigate against the hypothesis that central, national government will — and should! — give way to a more devolved, multi-level array of governments⁹. As governments have to compete internationally, existing government cartels of neighborhood, local, provincial and national authorities are likely to fall apart¹⁰. The analogy with the theoretically and empirically well-founded concept of contestability — that outsider competition splits cartels and deprives monopolies of their power — seems convincing. As long as nation states were fairly closed, government functions could gravitate towards the center irrespective of the cost. But under inter-jurisdictional competition, the costs of governance need to be controlled. And this can often be done by shaping government organizations so that they are commensurate to task: often local and regional collective action may be more economical than nation-wide action because of the information and control advantages within the smaller polity.

⁹ Nor does the argument in the preceding section amount to a rejection of the thesis (Inherent, for example, in Benson, 1995, and de Jasay, 1995) that external institutions have often replaced internal institutions unnecessarily or to the detriment of the citizens.

¹⁰ We use the words neighborhood, local, provincial (or State) and national government in a loose sense to designate hierarchies of government levels, but not to imply that these are the only possible levels.

The single, most important argument for decentralization derives from the Hayekian knowledge problem. As the world becomes more and more complex and conditions change more frequently, national, central governments that want to maintain uniform external rules are up against an ever-more complex task. Decentralizing the need for knowledge, and hence the implementation of external rules, is one way of avoiding entropy. Another is of course greater reliance, where this is feasible and efficient, on devolution to private actors, and reliance on the internal institutions of society. If tasks are devolved to very low levels of governments, say neighborhoods, and if people may opt out at low cost, the model of the club and the model of government approximate each other.

That national governments know less and less how to cope with the institutions they have promised to run is reflected in the spread of electoral disaffection with the political process that one may observe in all Western democracies. By contrast, local and provincial politics often attract great popular interest and engagement.

The knowledge problem is related to the problem of corruption in aloof, distant government agencies. Corrupt practices are much harder to keep secret, if collective action is devolved to a level close to the citizen, if local or provincial government has real responsibility and if governments have to compete with one another. Accountability evolves where governments rival with each other and have to build up "reputation capital" to attract business. These conditions are more likely in open, local and provincial administrations than at the national level.

A related consideration derives from the fact that, at the local and provincial levels, government action is more likely to be facilitative of individual pursuits and less redistributive. One reason for this is that political leaders at the lower level are more exposed to the demands of all, and not selected, influential citizens, another that openness and the 'migration threat' are greater in small jurisdictions. Those who point to actual cases of corrupt or redistributive government at local and provincial levels are likely to find that these instances are not part of competitive federalism as defined here. Should local or provincial

known and the feedback of comparisons with the neighbors exerts, before long, a corrective influence, whereas those tasks entrusted to distant national monopoly governments, such as Washington or Tokyo, will often be bogged down in complex political games and inaction.

As long as nations were closed, provinces accepted inter-regional transfers by the central government reasonably readily, hoping to get a distributive windfall some other day. But regional rent-seeking at the expense of other states is less actable when global competition bites, and investors desert regions that have to bear the transfer burden (Aranson, 1995, p.12). Where local and provincial governments are strong and national administrations relatively weak, there is probably also less likelihood of closing national markets, for example by tariffs, because disadvantaged provinces fight against such rent-creation games.

Another argument in favor of devolving national government powers to subsidiary levels derives from Walter Eucken's general theory that sub-orders — to be efficient and stable — have to be compatible and consistent with each other (Eucken, 1952, pp. 180-184). As the frequency of international contacts increases with globalization, different national economic orders are likely to become incompatible with each other and the international order. This is less likely to be a problem on the side of spontaneously adapting customary international orders; but there will also be a need for externally imposed national orders to become more compatible with the international order and other national orders. It will often be easier to adjust sub-national institutions to global exigencies, given the shorter and more intensive feedback to local or provincial government and the lesser difficulties of demonstrating the advantages of legislative or regulatory change at local or regional levels. It is often easier to convince political coalitions in small areas that there is merit in an experiment with institutional change, for example with microeconomic reform. Single-issue pressure groups normally thrive in remote national capitals. If an external institutional adjustment by a local or State government is successful, competitive evolution will spread the innovation further afield. Frequently, therefore, institutions that are externally imposed at local or State level will adjust more readily to a changing, competing world.

For reasons of feedback and control, it is normally also easier to resolve "prisoners' dilemmas" at sub-national levels. Cooperation and "regulatory disarmament treaties" can often be better ensured among a few who live in proximity and share a perceived long-term fate. This explains why microeconomic reform is often undertaken by small, open entities that expect to capture the gains of reform quickly, whereas mega nations suffer from "deregulatory grid lock".

There is not the space here to discuss the evidence which shows that sub-national communities and their governments are now asserting themselves under the challenge of globalization and technical change. Suffice it to point to the recent rise of popular regional movements that have turned anti-Washington, anti-Canberra, anti-Moscow, anti-Quebec, that reassert State or local identities and that insist on policies coming from the people (Ayres, 1995) and discussion about "velvet divorces", and the rise of regional parties and party platforms. Despite the centrally concerted effort to whip up "Euro enthusiasm", the entropy of the European Community appears to promote popular support for decentralized governance and resistance to further centralization¹¹. We periodically read of demands for more regional political identity even in traditional central regimes, such as the United Kingdom and France (Boogman-van der Plaat, 1980), and of demands for secession (Sharman, 1994). Spain's metamorphosis into a genuine democracy was accompanied by greater regional autonomy, and Italy's and Brazil's attempts at reforming corrupt central governments are coupled with calls for devolving powers and finances to regional bodies. Even the growing defiance of Peking Center by internationally competing provinces in China fit the worldwide trend.

In short, the evidence is overwhelming that there is political support for subsidiarity, the principle that the lower-level government agency should be given a task, as long as it can fulfill it effectively.

¹¹ The surveys of the Henly Centre in the UK shows growing scepticism throughout Europe vis-a-vis

Subsidiarity and Competitive Federalism

As already indicated, one obvious advantage of devolving governance of tasks to subsidiary levels is that there will be horizontal competition amongst the rulers. Provincial or local jurisdictions often compete with each other by inventing new and differing administrative solutions to new problems. The competitive creativity of administrations stands the entire nation in good stead in the international competition for footloose production factors. Competitive-evolutionary innovation is therefore an essential feature of what I would loosely term "competitive federalism" (Kasper 1993; 1995). For lack of a better word, it designates the inter-jurisdictional competition within wider communities under higher-level authorities that impose certain restraints and bonds on the actions of lower-level government administrations¹².

To ensure genuine competitive federalism, the devolution of collective tasks of governance to subsidiary levels requires three supplementary administrative/political arrangements:

- (a) *Exclusivity*: Certain broad classes of spending tasks should be exclusively assigned to specific levels of government, preferably with the open-ended category at local council level, so that duplication is avoided. The reason for exclusivity is to make it harder for governments at all levels to shirk, to save on the tax costs of duplication and to save the citizens compliance costs when dealing with multiple and often contradictory authorities in the same field of activity. There is no corresponding need to assign taxes exclusively to one level of government or the other, but some federations may find this advantageous.
- (b) *Fiscal equivalence*: The devolution of spending tasks has to be accompanied by a dispersal of revenue-raising powers. In federations like the Australian Commonwealth, decentralized spending responsibilities have been increasingly coupled with a heavy

¹² 'Federation' is used here as a term to designate an association of governments that cooperate and facilitate association-wide exchange and mobility, rather than the formal constitutional structure of Federal and State governments. One might cite, as examples for competitive-federalist systems, the original Helvetic Federation and the General States in the Netherlands — both polities that succeeded in international trade and reached very high living standards in their time

reliance on taxation by the center and vertical transfers to the States. This allows local and State governments to act without the discipline of having to raise the revenue for big new spending schemes and without much direct interest in cultivating the local revenue base by fostering economic development under their jurisdiction (moral hazard, Kasper 1995). To save taxpayers compliance costs, tax collection for different levels of government can of course be done by one agency which acts on behalf of the various levels of government.

An interesting variant to assigning tax- (and debt-) raising powers to each level of government to finance its own tasks has been proposed by Dwight Lee (1995): to counter traditional centralist tendencies in federal systems and enhance competitive, inter-jurisdictional evolution, he has advocated a system of taxation where the States have the taxing power and the right to set their own tax rates, but where they have to remit a fixed proportion of their tax revenue to the federal government. Such a regime, if it could be made to stick, would certainly shift the power to the level of small, hence more open and more competitive sub-national jurisdictions. In federal mega polities — such as the US, the Economic Union and Brazil — the cult of "big and central is beautiful" seems heavily entrenched. There, the proposal of a bottom-up tax transfer regime can therefore anticipate massive resistance¹³.

- (c) *Rule of origin*: To ensure legal-regulatory competition (and the evolution of regulatory systems) it seems necessary throughout nations and internationally to propagate the rule of origin. This means that a product which is legally produced in one province or nation is automatically legal for sale and use in the others. This rule needs to be asserted as a general principle to combat regulatory protectionism and to act as an antidote to the capturing of national authorities by single-issue lobby groups. The argument that resulting regulatory competition would lead to an intolerable lowering of standards seems spurious: if jurisdictions lower health or safety standards of products below

¹³ A historic precedent for the Lee proposal is the early German Reich, post-1871. Military conflict and the promise of popular public welfare provision soon enabled the cash-starved Berlin center

levels that markets accept their reputation as a regulator would soon suffer. Industries would desert such jurisdictions or apply voluntarily their own higher standards to maintain their competitiveness.

A competitive-federalist arrangement would probably slim total government, as collective support structures are maintained only where the "citizen client" demands them (and pays taxes or user fees for them). Where too many political wealth transfers are attempted, solidarity with a specific jurisdiction will wane and people on whom the transfer burden is inflicted will move away to another province or another country. Factor mobility may also shift some tax burdens to the owners of immobile factors of production (tax incidence on land and consumption, rather than on capital and business).

We cannot necessarily assume, however, that competitive federalism will trigger a race to minimal government. Jurisdictions will rival with different mixes of taxation, administrative services and infrastructures. But it will be for the mobile citizen and footloose firm to decide whether they want elaborate, gilt-edged public services and high taxes, or skimpy government services and infrastructures combined with low tax. Regulatory orders will be decided by people who are able to vote with their feet and not single-issue pressure groups. All this will set in motion much evolutionary learning and give rise to much political-administrative entrepreneurship at local and provincial levels. In the process, governments will find out what we, the citizens, really want.

Competitive federalism will also set in motion spontaneous institutional innovation at the community level. A degree of shared local patriotism may be perceived as a valuable and useful bond for more humane, low-level communities, institutions, and shared values to support them (Röpke, 1948). Thus, at the local level, externalities of cases of poverty and unemployment and their effects on the attractiveness to mobile production factors may be felt acutely. This may give rise to locally funded income transfer schemes or altruistic, voluntary assistance to those down on their luck (Giersch, forthcoming). Where government gets involved with citizen-to-citizen transfers, as it does in Western democracies, the transfer task should be located at the local council level. Control of abuse, shirking and non-material

aspects of help are better ensured there than at the anonymous national level. Just imagine how much personal attention and help the unemployed would be getting, if council rates had to pay for the dole!

Central Governments to Support Order and Openness

In some activities, higher-level governments still have advantages of scale and scope over competing lower-level governments, most notably in ensuring that jurisdictions do not become protectionist and close themselves off to discriminate against their neighbors, and that powerful communities do not use fraud and violence to extract advantages¹⁴.

Federal or supranational governments have advantages in standardising and enforcing those general, minimal rules that uphold openness and competition. Often, competitive action will of course establish that uniform standards are accepted spontaneously, thereby economizing on information costs, but some rules may have to be designed centrally and imposed uniformly from above, because universal acceptance does not emerge. There is no gain in each local government area having its own weights and measures, its own traffic rules, or its own local time, as Europeans gradually discovered 150 years ago. The advantages in central, formal rule setting are likely to be strongest where general, fundamental rules are involved that leave room for decentralized, competitive trial and error on the specifics ("order policy"). This would leave federal governments with setting the general framework for interaction, policing the non-discrimination rule, military defence (see below) and international affairs, but the latter without a monopoly.

The judicial system of different provinces should also be subject to a minimum of shared general rules, including constitutional rules on how the rules can be changed (helping with the spatial consistency of orders), at least to reduce information costs and buttress the

¹⁴ When jurisdictions rival with each other in attracting capital and enterprises, this should also extend to the proscription of preferential subsidies to newcomers or other selected firms and individuals, whether these are financed from recurrent tax or by raising debt. The reason for advocating such a ban on preferment is that governments tend to be poor 'at picking winners' and that the feedback from picking losers can be long-term and then extremely costly, apart from being corruptive of the free society (Kasper, forthcoming). National governments that see their role primarily in an *ordo* liberal protection of competition as a public good should also

evolution of customary, internal law. The more specific and prescriptive the legal codes are, however, the better are they located at a more decentralized level where they can be better matched to local ethics and conventions. Embedding legislation and regulation in the informal, shared ethics and culture is, after all, the only guarantee that formal laws are effective and economical to enforce. A general principle of subsidiarity, supplemented by a preference for internal institutions, would seem an appropriate guide to avert undue centralization.

Legitimate Uses of Force

One difficult problem that we have, so far, not addressed explicitly arises when one asks where to locate what type of legitimized use of force, both to police opportunistic behavior — negligence, shirking, fraud, abuse, violent infringements of individual rights by third parties — and to safeguard external security, that is to ensure the future freedom of society. One cannot realistically assume that opportunistic behavior can always be stopped by good example and moral suasion alone, as many idealistic Christian and Buddhist churchmen and many in the peace movement do. Neither can one, regrettably, trust completely in the spontaneous, disciplining forces of competition. As long as thuggery and opportunism exist, there are the twin problems of legitimized use of force and of the control of those to whom force is entrusted — and with it the agent-principal problem of government. Some rule enforcement may of course be delegated to private agencies (see, for example, Friedman, 1979; Benson, 1995), but the danger of abuse of force exists both with private and collective enforcement. The fact remains that the history both of domestic law enforcement and international security indicates advantages of collective action. The legitimate use of force is amongst the classical functions of even the minimal state, and the real task is how to control the "violence professionals" in the police and the military.

Internal policing should probably be spread over the various levels of government, with revisions of sentencing for certain crimes by the higher-level jurisdiction. Dispersed police powers would seem to promise better control of the police. But, at times, there are also certain indivisibilities, e.g. people from jurisdictions with differing laws have to agree on

which set of rules applies in border-crossing transactions. That may itself cause transaction costs and risks which can be saved when the rules are policed uniformly across council areas and provinces.

An even more difficult problem for competitive-federalist devolution arises from the fact that the use of military force internationally tends to benefit from distinct advantages of scale and scope. Big nations tend to prevail in conflicts because they have more concentrated and relatively stronger military means of coercion. Central governments have historically used the defense argument in military conflicts as an excuse to centralize more powers in their hands and one may indeed mount a convincing argument for locating the creation and control of military force at the highest level of government that brackets a cohesive community. But this creates the danger that the military capture the central government authority. Since higher-level jurisdictions are less open to the discipline of locational competition and since effective accountability is more difficult at more distant levels of government, there is a need for supplementary — albeit second-best — non-violent controls through constitutional safeguards, such as a division of powers and periodic electoral control, as well as fostering a culture of ethical and political control of the military. Locating military force at a level beyond the cohesive, organic community (a "world police" run by the UN, or even a multinational army under the command of the European Community) seems not feasible, because it involves difficult free rider problems and often leads to entropy in decision making.

There is scope for disagreement on the issue of where to locate the use of force. Taking a position here was primarily meant to highlight this difficult aspect of government. The issue is likely to surface time and again, as the clearly defined delineation of the nation state is becoming fuzzy.

Finally: Inter-jurisdictional Solidarity and Evolution

Evolutionary learning depends on the feedback of trial and error, not only on the profits, but also the red ink, not only the joy of success, but also the pain of mistakes. One therefore has

to be quite candid in asserting that any attempt to ensure equality of outcomes undermines learning new knowledge and negates the benefits that flow from new knowledge.

The belief that federations and nations must not allow local and provincial governments to go bankrupt and must protect the citizens from suffering the consequences of having elected bad leaders, clashes directly with the maxim for evolutionary competition. As long as communities are indemnified for the consequences of bad government, moral hazard will prevail and instinctual-tribalist solidarity will prevent rational learning from mistakes. This is one reason why the principle of fiscal equivalence, the restraint on vertical fiscal transfers, was included in the list of the essentials of "competitive federalism".

Global Solidarity and Learning from Mistakes

Global communications has induced some to preach the virtue of undifferentiated solidarity with all of mankind. Others argue that there should be at least some minimum degree of international solidarity and transfer by government akin to welfare provision within the Judeo-Christian nations. On that basis, they tend to stipulate positive rights for all in the "global village", such as the UN-sponsored notion of basic rights to food, shelter, health care etc. But the concept of the "global village" is misleading. The position of global solidarity is not only fallacious, but harmful to material progress and freedom. In the long-term history of mankind, all our forefathers started at — by today's standards — incredibly poor living conditions. The phenomenon of sustained long-term growth in per-capita income started with inter-community competition and untempered feedback from successes and failures.

Making this point so bluntly may offend noble instincts of solidarity, which we all acquired during hundreds of thousands of years of human evolution within the small group and the formation of our basic values within the small family group (Hayek, 1988). Should we not say that the long-term fate of poor Africans or Indians is more likely to be improved if they are left to suffer the full consequences of their and their leaders' current values, cultures and institutions, even to the extent of high mortality? It may also offend when one speaks openly

of superior and inferior cultures and values (measured in terms of economic development; Weede, 1995; also Sowell, 1994), but cultural relativism that denies the material consequences of different cultures hinders material progress — and with it reduced child mortality, better health, more leisure for cultural and spiritual pursuits, and the many other non-material benefits of economic growth. Besides, the concept of global, undifferentiated charity has little credibility with the population at large, as is shown by the widespread 'aid fatigue' in all affluent countries.

International transfers attenuate the immediate material consequences of harmful values and actions and therefore undermine cultural and institutional changes¹⁵. Hand-outs to those with ineffective institutions or destructive attitudes, such as xenophobic protectionism, only prolong the survival of these attitudes and institutions. Kleptocracies and political-military priviligentsias that hold their citizens back are all too often supported by foreign aid. Unfortunately, moral hazard travels in the wake of promises of equal outcomes and welfarism, internationally as much as it does within nations. Attempts to equalize outcomes by appeals to solidarity and transfers from the successful to those who fail would destroy the very mechanism that has set in motion global economic growth and that alone can serve to ensure the long-term prosperity of the growing world population. It also undermines freedom (Hayek, 1988).

One may argue for some modification of the above radical position, for example in cases where transfers help people to help themselves or where transfers can be credibly tied to the condition of greater openness and non-discrimination in the future. By proscribing discrimination and enforcing this, the constructive feedback of international and inter-community competition could in certain circumstances be even enhanced.

Nonetheless, one must not lose sight of the overriding merits of competition, also between governments, and of the fact that charity is one of the pillars that support the domineering and overwhelming Leviathan.

¹⁵ They may also reduce the likelihood of international migration, which in turn may be in the direct

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