Preface

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In the policy debate there has been much talk about institutional competition – or the new systems competition, as some prefer to call it. It has been argued, for example, that institutional competition leads to a race to the bottom in terms of eroding government revenues, redistributing wealth from workers to capitalists, and limiting democracy by forcing politicians to please international investment capital instead of working for their voters. Negative assessments of institutional competition have thus predominated.

This volume introduces new perspectives into this debate, basically by turning the argumentation on its head. Why is institutional competition regarded as something bad, when competition is regarded as good in all other economic contexts, and the absence of competition regarded as a bad thing in all other standard analyses? The volume analytically and empirically explores a number of issues surrounding this question. Some important themes that recur in different chapters in this volume consider:

- Whether institutional competition might facilitate liberty and democracy, rather than inhibit it;
- The extent to which competition might involve experimentation and learning that can be beneficial for society;
- How institutional competition may act as a corrective force to reduce inefficiencies and rent-seeking;
- Institutional competition can enable governments to become allocatively efficient in relation to their constituents' preferences;
- Whether institutional competition really does lead to a decline in government revenues.

These perspectives recur in different chapters, but the chapters also differ in many respects. Though there are some overlaps, each contributor is, of course, responsible for what is expressed in their chapter alone.

The volume opens with Höijer's conceptual discussion of institutional competition. He conceptually discusses both 'institutions' and 'competition'. Institutions have been conceived in different ways, for example as (equilibrium) behaviours, as rules, or as rules enforced by sanctions and actors. Höijer notes that each perspective has its own merits and shortcomings, but suggests that when considering institutional competition it might be most meaningful to consider a more extensive concept of institutions as consisting of both behavioural rules and the sanctions and actors that enforce them.

Höijer next considers in which sense institutions can be said to compete with each other. Arguing that the economic contribution of institutions is to coordinate actors, and solve information and governance problems, Höijer suggests that institutions also compete with each other in terms of supplying a specific coordination service. According to this view institutions basically compete in a factor market and supply a distinct production factor: 'coordinating rules'. Höijer notes that some difficulties with externalities and pricing such coordination services might exist, but maintains that in principal competition and pricing are possible.

Importantly, Höijer notes that, in general, when we speak of institutional competition, we in fact mean competition between states or governments. States are institutions that are particular in that they 'monopolize' the use of violence for the purpose of enforcing their institutional rules. However, they only nominally monopolize the use of violence; from an international perspective many states exist and no state monopolizes use of violence in the entire world. What states do is to establish partitioned markets, in which each state is a 'local monopolist' in each particular market segment, and it is difficult for consumers of their services to switch from one supplier to another. Competition between states is, however, possible and as the costs consumers incur from switching between governments decrease, we may also expect that competition intensifies and induces governments to set taxes and outputs of public services at levels in line with the demand of their constituents.

In the following chapter, Roland Vaubel traces the history of thought on institutional competition, from David Hume's 1742 statement that 'Nothing is more favourable to the rise of politeness and learning than a number of neighbouring and independent states' until contemporary times, where he discusses Hans Werner Sinn's critical analysis of institutional competition. Using extensive citations Vaubel demonstrates that the most important liberal thinkers in history have held positive opinions about institutional competition, generally much more so than theorists in the last 20–30 years. He introduces the idea that institutional competition might be conducive to the establishment of liberty and democracy, and shows that historical writers such as Montesquieu, Adam Smith, Kant and Lord Acton, argued in favour of institutional competition largely for this reason. (Modern writers, on the other hand, have focused more frequently on how institutional competition might effect the economic allocation of resources.)

Vaubel also introduces the important distinction between 'yardstick competition' and 'resource-based competition'. The point of yardstick competition is that if different competing governments exist, then they may compare themselves with each other, and also learn from each other. This introduces the idea that competition might be conducive to experimentation and learning. In Vaubel's words 'diversity, by extending the scope for comparison promotes learning and innovation'. Vaubel notes that yardstick competition has been taken to promote learning in such different fields as 'arts and sciences', 'political life', 'industry', or creativity in general.

Resource-based competition, on the other hand, concerns how governments compete for mobile capital. According to Max Weber, for example, 'The competitive struggle among the European nation-states created the largest opportunities for modern western capitalism. The separate states had to compete for mobile capital.' Vaubel notes that according to historical writers the exit mechanism may operate either through the movement of capital or the movement of labour (though in contemporary discussion it is often presumed that only capital is mobile). Vaubel also discuss the landmark contributions by Tiebout and Hirschman, and draws a parallel between resource-based competition and Hirschman's 'exit' mechanism.

Vaubel concludes that while modern writers have largely focused on resource-based competition the historical writers were more concerned with yardstick competition.

In the last section of his chapter Vaubel discusses Hans Werner Sinn's influential criticism of institutional competition. He notes that Sinn objects only to resource-based competition, but argues that 'mobility-based competition cannot be appraised without reference to yardstick competition. For whoever proposes to restrict or suppress mobility-based competition by international coordination or centralization (as Sinn does) necessarily restricts or suppresses yardstick competition as well.' He also argues that Sinn adopts heroic assumptions about the benevolence and efficiency of governments, and argues that if we instead assume that some governments are less benevolent or efficient, then competition may act as a corrective force which compels those governments to more closely satisfy the demands of their constituents (a theme that recurs in several other essays as well). As opposed to Sinn's charge that competition between governments leads to the erosion of welfare states, Vaubel argues that empirical evidence points in the other direction; social expenditure and redistributive efforts have not decreased in modern periods of intensified institutional competition – an observation discussed further in the contributions by Victoria Curzon Price and Andreas Bergh.

An important mechanism in competition is the ability to learn from competitors. In Chapter 3, Michael Wohlgemuth introduces the reader to the theme of institutional learning through experimentation. Wohlgemuth describes creative learning as mostly out of reach for neoclassical mainstream theories. On the other hand, Austrian views of competition as a discovery procedure, identify important links between competition and learning. Hayek's argument, that competition would be pointless if we were certain beforehand who would do best, applies to institutional competition as well.

According to Wohlgemuth, institutions always have to prove their adequacy in view of changing problem situations. Rapidly changing circumstances increase the desirability of institutional pluralism and make it less likely that a benevolent central planner could plan the best institutional arrangement. In his contribution, Wohlgemuth also discusses the feedback mechanisms between individual choices of institutions – voting with one's feet – and the collective design of institutional arrangements, what Wohlgemuth calls 'institutional entrepreneurship'. A main point is that competing jurisdictions improve both citizens' and politicians' knowledge base and their incentives to react to shortcomings of present policies. Furthermore, parallel experimentation is superior to sequential or consecutive experimentation. Under institutional pluralism, bad policies will not necessarily imply great damage. On the other hand, when a political union is forced to follow one grand idea or all-embracing political theory, the potential social costs are extremely high. This is especially so if the size of the political union is large. In other words, size matters in a fundamental way for institutional competition. This theme is further developed by Peter Bernholtz, in Chapter 4, who notes that competition may occur on different levels: the domestic competition for political power, on the international level in terms of military and foreign policy measures, and the competition between favourable institutional frameworks.

On the level of international military competition and so on, Bernholz notes that in Europe feudalism gave rise to many different power centres and rulers who each sought to maintain and extend their powers. In order to become competitive they were induced to consider the well-being of their subjects and introduce reliable property rights, free markets and limited taxes. Thus international rivalry and competition resulted in domestic liberalizing and democratizing reforms. This conclusion echoes some of the historical arguments for institutional competition that were introduced in Vaubel's chapter.

On the level of domestic political competition, Bernholtz considers the competition between different interest groups in pluralist societies. He argues that where certain interest groups have a 'concentrated interest' in receiving certain government subsidies, but the costs of such subsidies are spread thinly over a larger population, then the smaller interest group will usually succeed in getting such subsidies introduced. In a society of competing interest groups this means that different interest groups will each lobby for increased government expenditure, leading to an ever-increasing expansion of the sphere of government and public expenditures. This reminds us of Vaubel's argument that institutional competition may act as a corrective force to rent-seeking activities and so on.

Bernholtz also considers the allocation of decision competencies in systems of multilevel governance. He notes that one meta-decision is most important: who (or what level) is granted the right to determine at what government levels different competencies should be allocated? Ultimately it is a normative question, but in terms of non-normative, economic, analysis it can be useful to investigate what distribution of competencies might be most appropriate instrumentally, in order to attain one's given normative concerns. Bernholtz notes that in terms of static analysis it is usually argued that if one promotes redistributive measures such decision authority normally needs to be centralized rather than decentralized. Furthermore, to the extent that economies of scale or externalities exist, decision authority should be allocated to those agencies that in size most closely correspond to the relevant economies of scale, or the extension of the externalities. Bernholtz himself considers dynamic arguments more important, and here he comes out in favour of extensive decentralization to lower levels of government. Decentralization is superior, he argues, because the decentralized distribution of decision competencies to many diverse units of government allows for a wider experimentation regarding solutions to different social problems, echoing Wohlgemut's argument regarding the importance of experimentation in institutional competition. Such competitive experimentation allows for better solutions to be identified and for different government units to learn from each other.

The important question as to how institutional competition might affect democracy is the central concern of Viktor Vanberg in Chapter 5. As demonstrated in Professor Vaubel's chapter, many historical thinkers have maintained that institutional competition might enhance democracy, but modern writers have often argued that institutional competition impedes democracy in that elected politicians must sometimes refrain from serving their constituents' interests in order to try to attract internationally mobile capital instead. Vanberg considers these conflicting views, and argues that competition between governments might indeed enhance democracy, since it can assist democratic governments to advance the *common* interests of the citizenry.

While many writers define democracy in terms of majority decision rules (and other procedural aspects), Vanberg argues that democracies are properly conceived as cooperatives that are jointly owned by their citizens, and as such should be evaluated on their ability to serve the interests of those citizens. More precisely, democracies should be evaluated by their ability to serve the *common* interests of all citizens, not by the ability of majorities to serve their own particular interests. Vanberg argues that the granting of privileges to certain groups at the expense of others invariably imposes costs on the citizenry at large. This costly activity may be difficult to sustain under competitive pressure. Institutional competition can limit the scope for such privilege granting. By limiting the ability of majorities (or strong interest groups) to transfer resources to themselves, Vanberg maintains that institutional competition serves to enhance democracy in the sense of promoting the *common* interests of the citizenry.

Vanberg thus returns to the idea that (also regarding democracy) institutional competition may serve as a corrective force against rent-seeking and so on. Ultimately Vanberg's argument appears to have the form of a hypothetical imperative: if one agrees with Vanberg's normative position that redistributive transfers are undemocratic and undesirable, then institutional competition is means for limiting such transfers. (Needless to say, some persons would instead maintain that redistribution is a highly desirable activity for governments to engage in.)

Höijer (Chapter 6) focuses on tax harmonization, that is, the absence of tax competition. Such harmonization agreements between (otherwise competing) governments can in fact be considered analogous to a cartel on a private market, according to Höijer. He notes that otherwise it is generally assumed that competitive markets function better than non-competitive markets and that in other contexts anti-competitive measures are called, for example, 'collusion', 'cartelization' or 'monopolism', and are viewed with great suspicion. Yet in fiscal matters it is tax *competition* that is regarded as harmful and anti-competitive measures are being advocated as beneficial. Competition on ordinary markets puts pressure on prices and output decisions to more closely match the preferences of consumers. Apparently governments do not wish to be exposed to the same pressure themselves. Instead they form cartels.

Before analysis demonstrates why cartels would not be harmful in this particular context, one is left wondering why governments are so eager to form cartels themselves. Are there market failures that need to be addressed? In order to answer this question Höijer considers the contemporary policy debate regarding tax competition, and considers three prominent arguments that are invoked to defend tax harmonization: (1) tax competition distorts investments and violates capital export neutrality,

(2) tax competition undermines the financing of ambitious welfare states, and (3) tax competition will shift the tax burden from capital to labour.

Höijer, however, concludes that if governments provide valuable services, then tax rates would – under competitive taxation – only reflect the relative value of such services, not distort investments. He also notes that on other markets one does not propose the introduction of government monopolies/cartels, or similar interventions, unless some 'market failure' (such as externalities, information asymmetries, or the presence of monopolies) has been identified. The arguments against tax competition, however, do not concern such Pareto-relevant market failures, but usually simply concern cases where an actor is out-competed by another actor. No market failures are thus identified which need to be remedied. Instead it is simply suggested that a form of quasi-monopoly – cartels – should be introduced. Why introduce a market failure (a cartel) as a remedy to no market failure, Höijer asks?

In the following two chapters, Victoria Curzon-Price and Andreas Bergh deal with the effects that institutional competition has on rich OECD countries – in Bergh's case especially on a Scandinavian welfare state such as Sweden. They deal empirically with the question of whether institutional competition has indeed led to a decline in government revenues. Interestingly, they both find that although many tax rates have recently become lower, there is no 'race to the bottom' in tax revenues which, if anything, have risen.

Several mechanisms can explain this. Both Bergh and Curzon-Price point to tax-shifting induced by increased competition: from capital to labour, and from mobile parts of the work force to less mobile. Bergh notes that when the Scandinavian welfare states put a larger share of their tax burden on relatively few mobile production factors, this means that they tax middle- and low-income earners more heavily.

Curzon-Price also identifies another mechanism to explain the absence of a race to the bottom: dynamic Laffer-effects mean that lower tax rates do not necessarily imply lower tax revenue. While top marginal income taxes as well as tax rates on corporate income have fallen, and while value added taxes (VAT) have increased only slightly during the last 20 years or so, government revenue has not suffered.

Curzon-Price goes on to suggest that if tax revenues were to decline because of increased competition, governments might want to think about reducing expenditure before immediately seeking to 'make up the shortfall' in revenue. If governments tend to maximize rather than optimize their expenditure, increased competition may be beneficial rather than harmful.

Bergh notes that increased mobility of labour may potentially cause problems of strategic welfare migration for big welfare states, if people enjoy tax-financed benefits without paying the taxes to finance them. It is demonstrated, however, that big welfare states have already responded by tying benefits more closely to labour force participation. In all, it is not necessarily the case that the biggest welfare states will decrease in size as a result of institutional competition – but they will most likely become less redistributive (in line with Vanberg's argument that institutional competition may serve to limit redistribution). The process can be understood as one where the welfare state is altered beneficially for those voters whose position is strengthened by institutional competition. Using several examples from Sweden, Bergh illustrate that this process has already begun.

Our volume ends with two empirical chapters, one quantitative and one descriptive. In Chapter 9, Lars P. Feld notes that if institutional competition has positive effects on economic development, these effects should be possible to measure and estimate. Existing empirical evidence summarized by Feld, however, yields no clear verdict. As already discussed, there are substantial problems with quantification of institutional competition, potentially explaining the lack of robust empirical results.

Feld embarks on an empirical investigation of his own, using a measure of the decentralization of tax revenue in 19 OECD countries from 1973 to 1998 to try to capture the degree of sub-central fiscal autonomy. The aim is to examine whether higher decentralization, measured this way, has any effects on economic growth. Interestingly, Feld fails to find a robust impact of fiscal autonomy on economic growth. One obvious complicating factor is that several beneficial effects of institutional competition may require a long time to appear. For example, the effects of learning through institutional experimentation (as described by Wohlgemuth) can hardly be expected to show up in the growth data for a 25-year period.

Feld does find, however, that when sub-central governments co-determine tax rates or tax bases in systems of joint taxation, this negatively effects growth. This empirical finding fits well with Höijer's idea that supranational political organizations may work in ways similar to a tax cartel, and can be harmful for economic development.

Finally, Erich Weede provides an example of institutional competition between two large countries (India and China) over a long period of time. Weede asks why China and India fell behind the West during the past three hundred years, and also seeks to explain the relative success of these two countries in recent times.

The explanatory factors that Weede points out are institutional: Europe and the West benefited from institutional competition which the Asian giants did not, and as a consequence weak and inadequate property rights, a lack of scarcity prices, and deficiencies in economic freedom developed in Asia's giants as compared to the West. Furthermore, political fragmentation in the West resulted in limited government and comparatively free markets. Similarly, China was able to do better than India and start to catch up with the West only after climbing out of the socialist trap via a de facto improvement of property rights and economic freedom.

The role Weede proposes for property rights and the incentives thereby created, relates both to the classics, such as Adam Smith, and to contemporary writings, such as Hernando de Soto. However, like Wohlgemuth, Weede also relies rather heavily on Hayekian thinking: a central idea is that knowledge is wasted without economic freedom and decentralized decision-making. Thus, institutions characterized by the latter two will make better use of existing knowledge and for this reason also enjoy a superior economic development.

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To summarize, the chapters in this volume introduce a number of new themes to the analysis of institutional competition. Many of the chapters, for example, draw attention to positive learning and information effects from competition that are not discussed otherwise. The contributions also draw attention to how institutional competition might enable governments to become allocatively efficient.

In contemporary discussions a particularly important argument is perhaps the presumption that institutional competition leads to a reduction in government revenues. As a consequence those who favour big government often fear institutional competition, while those who want small government appreciate institutional competition. These tendencies might also be reflected in some of the chapters in this volume. Interestingly, however, the empirical contributions find no strong support for the notion that institutional competition reduces government revenues. And analytically, the contributions in this volume do not clearly point to any reduction in the size of government revenues. What is predicted is instead that institutional competition will enable governments to reduce inefficiencies, and also enable them to more closely match their supply of services with their constituents' preferences, as they are revealed in a competitive price system. These consequences may be palatable to those who favour big governments, as well as those who prefer smaller governments.