Federalism: A Market Economics Perspective

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Introduction

Two very good years were 1776 and 1787. The first of these years saw the publication of Adam Smith's *Wealth of Nations* and the Declaration of Independence, two of the most influential documents in Western thought. The second of these years saw not just the drafting of the U.S. Constitution but, even more important, the initiation of a series of essays by Alexander Hamilton, John Jay, and James Madison, which came to be known as the *Federalist*. The sense in which these essays may be considered of greater importance than the Constitution rests on the notion that how we think about complex phenomena is usually more important than some objective "truth" about that phenomena; and while any constitution will have problems over time, a way of thinking about it, which is what the *Federalist* presents, may help us find solutions.

During the past dozen years, bicentennial celebrations of Smith's *Wealth of Nations*, the Declaration of Independence, and the Constitution have been publicized extensively, but there has been very little recognition of how close intellectually the ideas in these works are. Indeed, a good case can be made that they are so complementary that an understanding of their implications can be reached only if they are examined together rather than separately. This is especially the case for understanding the *Federalist;* without some understanding of complex systems, such as markets or multi-organizational struc-

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tures, these essays do not appear to have a consistent theoretical framework.[1]

In the analyses that follow, the similarities and differences between Smith's approach to markets and social coordination will be compared with the *Federalist's* approach to government. While this method results in some obvious conclusions, they might not be so obvious without the benefit of the last 30 years of intellectual revival, which was based on self-consciously using the logic of economics for institutional analyses. Many of the conclusions of these analyses could be derived as well from the work of James Buchanan, Gordon Tullock, Mancur Olson, Vincent Ostrom, and others associated with public choice theory.

Basic Theory

All theories are abstractions, and any summary of a theory or body of related theories must be selective in features chosen for comparison. For purposes here, I will summarize a few elements of market and federalist theory, including both assumptions and generally recognized conclusions.[2]

Market Economics

Many important elements of market economics have remained unchanged since economics began to emerge as a discipline during the 18th century, including assumptions of scarcity and rational, self-interested behavior.[3] For example, in his *Wealth of Nations*, Smith

[1]An analysis of the difficulty political scientists have had in dealing with the theoretical structure of the *Federalist* is presented in Ostrom (1971). There are also political scientists who consider the *Federalist* to possess a well-integrated theoretical structure. See, for example, Ostrom's (1971) discussion and Alfred Diamond's writings. For an integrated interpretation by an organization theorist, see Boschken (1982).

[2]For a more detailed analysis, see Bish (1977).

[3]Justification of the assumption of rational behavior—that is, reasoned behavior to relate means to ends—includes its predictability and the fact that only *some* people need be rational for models to yield good predictions, in addition to the notion that survivors in a competitive system must have acted *as if* they were rational. Rational choice does not require assumptions of perfect information and equilibrium, and the rationality postulate can be applied to any situation of scarcity and choice.

The assumption of self-interested, rational behavior in a world of imperfect knowledge appears to be identical to the way Hamilton, Madison, and Jay viewed individuals and their environment. The authors of the *Federalist* also emphasized (pp. 226–30) that humans are fallible and can learn. Their conception of rational behavior does not imply a mechanistic "irrational" passion for rational calculation in a world of perfect information, nor does it imply social aggregates, such as governments. Thus, the Smithian and the *Federalist* view of man is significantly different from the view held by many contemporary economists.

demonstrated how self-interested behavior could result in a more efficient use of scarce resources and, hence, a higher standard of living for citizens than was likely to be achieved in a society where the sovereign directed the allocation of resources.

There are both positive and normative components to Smith's argument. Normatively, the economic system was to be judged by the degree to which it resulted in citizen/consumer satisfaction, not by how well it satisfied the preferences of producers or the sovereign. In the positive or predictive argument, the division of labor was important for achieving a higher standard of living; the complexity of a system of specialized individuals and businesses was too great for the sovereign to obtain information about consumers' preferences and how to organize production. Smith anticipated that a market economy would include a great number of cooperating and competing individuals and organizations. He also was among the first to discuss a key theme in the theory of markets, namely, how social coordination can occur without central direction. Subsequently, Hayek (1945) and other economists continued to emphasize "information" as one of the most important outputs from market exchange. Furthermore, only by seeing preferences "revealed" through voluntary choices could an outside observer infer what people really want (Buchanan 1959).

Smith was also concerned with the problem of monopoly. He specifically warned that a popular use of government was merchants advocating laws that create monopolies, which in turn reduce benefits to consumers. According to Smith, all suggestions for government involvement in business should be viewed with skepticism. Smith did recognize and advocate using government to maintain the legal system and to provide military security and public works. His major concern, however, was with explaining the operation of markets, and his analysis of government consists primarily of identifying the consequences of governmental policies or recommending that the government should or should not do certain things. Smith provided no real analysis of how government could be organized so that it would be more likely to do the things he recommended rather than those he recommended against.[4]

Since Smith's *Wealth of Nations*, the dominant developments in economics, especially in the United States, have been less concerned

[4]Smith's arguments are virtually identical to those of Mancur Olson in his *Rise and Decline of Nations* (1982), which applies the logic of collective action and public goods to interest group formation and activity. Olson also lacks an answer to the dilemmas he poses.

with information, monopoly, and social coordination. The focus has shifted to the logical development of implications of different conditions within a known environment where government was abstracted from, or treated as if it were run by a benevolent despot who would accept and implement an economist's advice. Only recently have economists extended their postulate of rational self-interest to the public sector and begun to examine the problems of information, monopoly, and social coordination in government. It is within this framework that modern economists can learn from the authors of the *Federalist*.

Federalist Theory

Scholars of federalism seem to agree less on a common paradigm than do scholars of market economics.[5] It does seem clear, however, that federalism as a system of government is viewed as a potential solution to Hobbes's problem of constraining the Leviathan, that is, of maintaining a constitutional government where government officials operate within the law and have no power to change the law to suit their own self-interest (Hobbes [1651] 1962). This normative objective is clearly set out in the Declaration of Independence and repeated throughout the *Federalist*. Contained within this analysis is the explicit assumption that people, including government officials, act in their own self-interest. Furthermore, they will use government to advance their own interests unless they are constrained by persons who have recourse to other government officials to protect them from those officials who would abuse their authority (*Federalist* No. 51). In economic terms, monopolies in government are to be avoided just as are monopolies in the market. Hobbes's problem of the Leviathan could also be labeled "a monopoly problem."

The authors of the *Federalist* also address market economics in their analysis of information problems, especially knowledge of the preferences of individuals that the government is to serve. They argue that the economy and policy are so complex that issues should be debated and scrutinized in several forums to be certain that the viewpoints from people with different information are considered before adoption (*Federalist* No. 69). They also emphasize how difficult it is for an external observer to know or understand an individual's preferences, stressing that each person is the best judge of his own self-interest but *not* possessing the capacity to judge his own

[5]My own theory of federalism and interpretation of the *Federalist* have been heavily influenced by the work of and working with Vincent Ostrom, especially *The Political Theory of a Compound Republic* (1987).

interests in relation to the interests of others (*Federalist* No. 10). It also seems clear that the authors of the *Federalist* anticipated both cooperation and rivalry among governments (for example, rivalry with concurrent taxation and cooperation in tax administration [*Federalist* Nos. 35–36]), just as Smith recognized cooperation and competition among individuals and organizations in the market. Competition among and within governments is critical to prevent monopolization and to preserve a governmental system with an enforceable constitution. At the same time, cooperation emerges because related activities are often performed more effectively by organizations of different sizes; hence, citizens could be made better off by the same kind of specialization and trade that occurs among manufacturers, wholesalers, and retailers in the market. It is also important to recognize that in the *Federalist* (No. 36) local governments—called "the system of each state within that state"—are included as part of federalism. This inclusion is a natural additional division of labor that recognizes thousands of governments instead of just those at state and national levels. It is this vast system of governments that is viewed in the same manner that Smith viewed markets, and it is this extension of Smith's logic to the analysis of constitutions and institutions that is the critical contribution of the *Federalist* to an understanding of the problem of social coordination among governments when no single government or group is "in charge."

There is one area, however, where the authors of the *Federalist* specifically differ from at least the "laissez-faire" economists. There is nothing "automatic" about the creation of a governmental system where governments serve citizens and not themselves. In fact, even the authors of the *Federalist* viewed the creation of such a government as a rare experiment in a world populated primarily by governments whose structure was dependent on accident and force (*Federalist* No. 1).

Smith's market economics and the constitutional analysis of the *Federalist* reflect a similar way of thinking. Both view individuals in the same way, both have a similar normative perspective, and in both the issues of competition, monopoly, information, and coordination among many independent individuals and organizations are central to the analysis. These similarities indicate that further application of market economics concepts may enhance our understanding of federal systems.

Voluntary Agreements and Exchange

The market economy runs on voluntary agreements, most of which are of an exchange nature. In its simplest sense, individuals choose

to enter into agreements with other individuals where they perceive that they will obtain the greatest net gain. Societal coordination occurs when each person selects among substitutes, and competition stimulates individuals to be efficient and to try to offer more than their competitors. This process works best when there are many buyers and sellers, freedom of entry and exit, well-specified and enforceable property rights, and relatively high levels of information. It is important to consider whether or not we can transfer applications of the concept and conditions of exchange that lead to mutually beneficial social coordination in the use of scarce resources to a federal system.

By definition, in a federal system there are multiple individuals and organizations that need to interact with one another without central direction. In addition, this interaction occurs within a set of rules (a constitution) analogous to the rules of property that operate in markets.

So far so good. But is there anything automatic about voluntary exchanges among different components of a federal system or between citizens and different components of a federal system leading to the kind of social coordination and efficient resource usage that Smith envisaged for private markets? Is it possible that a constitution could create a federal system that resolved the Hobbesian problem, that is, could it prevent any monopoly organization from taking over the system, while failing to create a system where an individual's responses to incentives lead to lower rather than higher levels of citizen consumer satisfaction? The answer to both these questions is yes.[6] The

[6]Two important questions need to be asked to demonstrate this. First, can citizens effectively articulate their demands and be responded to; second, can citizens avoid costs imposed on themselves when benefits accrue to others? Both questions are equally important for evaluating the performance of a political system. Yes or no answers to these questions provide four potentially different situations:

		Responsive to Citizens	
		No	Yes
Citizens Can Avoid Political Externality Costs	No	Tyranny	Gargantua
	Yes	No Government	Contractarian Ideal

If a governmental system does not respond to citizens and yet citizens must pay for it, it can only be described as a tyranny. This is the kind of system the Founding Fathers wanted to avoid, and for the most part they were successful. If a government were not responsive and citizens could avoid paying for anything that did not benefit them, the result would be no government.

There are also two possibilities for responsive governments. If a government were responsive to the requests of all groups and yet citizens could avoid political externality

more important question is how an understanding of exchange helps us recognize how we can achieve either beneficial or perverse outcomes from the operation of a federal system.

One need look no further than Smith for an answer to how voluntary agreements can lead to poor outcomes for consumers. Smith explicitly recognizes that although competition is good for consumers, it is anathema to businessmen and that whenever possible they will collude to legally rig the market or seek monopoly status. In short, individuals and organizations are just as likely to enter into agreements with each other that disadvantage third parties as they are to enter agreements that create social well-being unless consumers always have substitute suppliers available to them. Although federalism is designed to provide "substitute" governments so that the officials of different governments or branches of a government watch each other, there is nothing intrinsic in federalism that would prevent collusion among government officials or between government officials and some citizens. In fact, because governments wield coercive power, the incentives to engage in such collusion may be even stronger than may occur among Smith's businessmen. But given the normative content of the *Federalist*, with its focus on protecting citizens against the state, is there any reason to be concerned about such collusion in the American federal system? The work of Anthony Downs, James Buchanan, Gordon Tullock, Mancur Olson, and other public choice theorists provides considerable insight into this question.

Downs, Buchanan and Tullock, and Olson all analyze situations where large numbers of people have difficulty striking mutually beneficial agreements because of high decisionmaking costs. Downs (1957) describes how politicians seeking office would seek a "median voter" position in small political units; but as the size of government increases, parties will be formed, specific information will be less

costs, those individuals and groups that benefited from governmental policies would have to pay for them. Individuals and groups would only demand programs where there were net benefits because they bear the costs. This is the system that would be expected to generate the greatest mutual benefits and could be called the contractarian ideal.

The final possibility is that government is responsive to citizens and organized groups but that other citizens cannot avoid paying the costs of the responsiveness; thus, very high political externality costs are generated. This "gargantua" outcome is most likely when political decisionmaking is primarily through bargaining among organized interests to obtain special benefits, yet costs are spread out over all citizens. In the extreme, most, if not all, citizens would find the cost of government exceeding benefits; but also know that if they give up their special benefits and others do not they will be even worse off. It is this kind of problem that may be most difficult to deal within a federal system where politicians and bureaucrats compete to be responsive.

visible, and ideologies and appeals to special interests will emerge. Buchanan and Tullock (1962) explain how lowering decisionmaking costs with less than the unanimous support required for political decisions may result in costs being imposed on those whose consent is not needed in the decisionmaking process. Mancur Olson (1965, 1982) analyzes how special interests can come to dominate political decisionmaking.

The conclusion emerging from these analyses is that a federal system can be one where narrow interests and governments act like Smith's cartels and monopolists, except that the situation may be worse because governments have the power to regulate and to tax—powers that Smith's monopolists lacked. In addition, because of the nature of political competition in large governments, there is no reason to predict that elected officials will make mutually beneficial decisions instead of catering to special interests at some cost to citizens. This does not mean that such costs can be infinite, because citizens can "vote with their feet" (Tiebout 1956) to escape tyranny; but, as with any "monopolist," if substitutes are more costly than they would be under competitive conditions, there is some transfer of wealth from consumers and excluded suppliers to the monopolist with a net loss in the process. Voluntary agreements within and among governments can lead to both positive and negative consequences.

Bureaucratic Production and Contracting-Out

Public choice theory implies that local governments, which are relatively small, homogeneous, and have a limited range of functions, should have the fewest problems in electing politicians who represent and have incentives to respond to citizens' preferences (Bish 1971). Local governments, however, face some unique production problems, because they are either too large or too small to produce all of their activities at the lowest average cost. There is also the problem that all producing organizations face in ensuring that their managers are efficient. Local governments usually respond to scale problems by recommending that the governments be made larger to capture economies of scale and that they decentralize internally for those activities lacking economies of scale. While appearing to be based on "economic analysis," these recommendations pay no attention to whether or not the managers of the organizations (who are like Smith's businessmen) have any incentive to produce efficiently. The best empirical evidence is that they apparently do not.[7] Many

[7]For an analysis of the Reform Tradition in local government, a tradition that recommended one local government for each metropolitan area on the assumption that it would produce local services at lower cost, see Bish and Ostrom (1973).

studies of the production of local government services indicate that after a local government makes a policy decision on what to provide to its citizens it can obtain much less costly production of the goods by contracting-out in a competitive bidding process.[8] For example, a recent study of garbage collection in all Canadian municipalities with over 10,000 in population indicates that municipally managed collection averages $42.29 per household and contracted-out collection averages $28.02 (McDavid 1985). The cost difference is a result of private contractors using large trucks with two-man crews who collect twice as many tons per man per day as do municipal crews using small trucks and three-man crews (who also spend a large proportion of the day riding back and forth to the dump). This is not unusual, as a recent survey of contracting-out in the United States and Canada indicates (Bish 1986).

Contracting-out occurs not just between local governments and the private sector but among governments as well. Robert Warren's (1964, 1966) studies of Lakewood Plan cities in California indicate that governments can compete with private sellers when they have the incentives to do so and that governments of different levels can resolve both incentive and scale problems by contracting with one another and with private firms. Contracting-out with competitive bids eliminates the monopoly position of the government bureaucracy and introduces more information and competition into the system. These changes contribute to better results for citizens, as both Smith and the *Federalist* would predict.

Government Collusion

Smith emphasizes that businessmen will form cartels that disadvantage consumers. So will government officials. One striking example of empirical research on a "cooperative agreement" among government officials is Dolores Martin's (1976) analysis of Local Agency Formation Commissions (LAFCOs) in California and similar arrangements restricting the creation of local governments in other states. LAFCOs are comprised of the representatives of existing government units that must approve new governments and government boundary changes. Many economists would argue that LAFCOs would reduce public service costs by simplifying and rationalizing the local government structure. Others would hypothesize that because they are comprised of officials of existing local governments, LAFCOs would act as a cartel would and simply exclude competition from the market, resulting in higher local government costs over time. Martin

[8]For a recent analysis of evidence on contracting-out, see Bish (1986).

found significantly higher annual cost increases for local government after LAFCOs were created in California relative to the cost before their creation. Her nationwide, cross-sectional study also indicates that states with this kind of arrangement face significantly higher local government costs than found in non-LAFCO or "free-entry" states.

It is precisely this kind of hypothesis building and empirical testing that is critical to understanding the relationship between intergovernmental relations and outcomes in federal systems. It is also direct evidence that Smith's logic is as applicable to the public sector as it is to the private sector. There are many more examples of market-like behavior, including exchanges for mutual benefit, such as contracting-out production and collusive behavior, which impose net costs on citizens.[9] The important point here is that thinking with a market economics model helps us understand how federal systems operate.

Fiscal Federalism

Neither studies of contracting-out nor collusion among government officials would generally be considered to be studies of federal systems in the context of a body of literature generally referred to as "fiscal federalism."[10] Historically, fiscal federalism has considered tax coordination and competition; more recently, it has included grant programs and functional responsibilities for different levels of government. These later analyses have been facilitated by the theory of public goods and externalities and the recognition that most public goods and externalities affect areas smaller than the entire country. This work, however, poses interesting problems for conclusions based on market economics and the federalist models, because fiscal federalism studies arrive at conclusions that are directly contrary to conclusions based on market economics and the political theory of federalism.[11] Not only are the conclusions different, but their normative recommendations would also eliminate the most distinguishing feature of a federal system, competition among governments.

[9]For example, revenue-sharing has been viewed as a collusive agreement to raise all local government revenues while avoiding the competition that would come from "voting with one's feet" (Bish and Ostrom 1973, p. 64; McKenzie and Staaf 1978). For further analysis of governmental cooperation that benefits citizens and cooperation (collusion) that disadvantages citizens, see Bish (1978).

[10]Some of the points made in this section are treated in Bish (1977).

[11]Three significant exceptions are the work of Nathan (1975), Scott (1973), and Wagner (1971). None of them, however, directly confronts the dilemma posed by the application of public goods theory to federal systems.

In *Fiscal Federalism,* Wallace E. Oates (1972) reaches the same conclusions as have other major economists, including Musgrave (1969), Tiebout (1961), and Head (1974). Oates presents a highly simplified and essentially normative model of the public sector: "In this pure model there is a *clear division of functions among levels of government,* one that leads to the attainment of a welfare optimum" (p. vii, emphasis added). Oates's conclusion does not follow from basic economic theory unless we are willing to assume that a monopoly behaves in the same way as does an organization where citizens have alternatives. Oates has focused only on scale problems; that is, different government activities may most efficiently be provided for different sized geographic areas or produced by different sized organizations. Oates simply ignores the monopoly problem, which is so important (and which provides the very rationale for a federal system) as presented in the *Federalist.*

Analyses of federalism that ignore the monopoly problem and focus only on scale problems are indistinguishable from analyses of decentralized unitary government systems—a point Oates (pp. 16–17) recognizes explicitly, without concern. There are, however, reasons for neglecting the monopoly problem. One could assume that public officials would not act in their self-interest and instead be benevolent monopolists, like Plato's philosopher king. I do not think that Oates intends to make that assumption, because his analysis of intergovernmental grants and taxation requires self-interested officials to respond to particular incentive systems, and they cannot all be schizophrenic. A second reason could be that electoral competition alone will keep public officials responsive, but this argument is not stated and could easily be refuted by drawing on economic analyses of the problems of managing government bureaucracies (Tullock 1965; Niskanen 1971; Ahlbrandt 1973). Thus, a critical question remains: Are Oates and other economists who study fiscal federalism logically inconsistent in their behavioral assumptions and neglectful of empirical evidence on political competition, or does the introduction of the concept of a public good really force the conclusion that a system of monopolies producing public goods on an appropriate scale is superior to a federal system characterized by competition among governments that provide substitutes for one another? Were Smith, the Framers of the Constitution, and the authors of the *Federalist* that wrong? Or do serious problems exist in "fiscal federalism"?

Public Goods Theory and Federalism

Public goods are defined as goods, services, or valued states of affairs that when once provided no one can be excluded from bene-

fiting (nonexclusion) and no one's consumption reduces another person's consumption (nonsubtractability). The nonexclusion characteristic generates a free-rider problem; that is, voluntary contributions will not support provision because noncontributors cannot be excluded from benefits. Public goods are predicted to remain unprovided (or underprovided) in a purely market economy. The solution to the free-rider problem is through coercive taxation, where all beneficiaries are forced to pay, with the power to tax being a general characteristic of government. If a public good is pure—that is, if the characteristics of nonexclusion and nonsubtractability are extended nationwide—then the potential low-cost provision system, *ceterus paribus*, would be a single governmental unit. By adding different kinds of "impurities," such as geographically confined benefits or geographic differences in people's preferences, one can develop arguments for provision by smaller governmental units.

What is being discussed here is provision, that is, demand articulation and collection of taxes, not actual production. Production may be undertaken by an organization either larger or smaller than the government that provides the service through intergovernmental agreements and contracting. Some economists have assumed that provision and production are undertaken only by the same organization; thus, they have combined the economies-of-scale criterion with the provision criteria to determine the variety of optimal-sized governments in a system (Rothenberg 1970). This reasoning process is equally appropriate for either decentralized unitary or federal governments.

But does this logic lead to the conclusion that different public functions should be provided exclusively by different levels of government? What constitutes the "public good" here is critical. For example, if public safety means providing a night watchman, a small government may be efficient. If public safety means capturing bank robbers, then a large organization—or at least one covering a larger geographic area—may be more efficient. If public safety means bringing criminals to trial, a prosecutor and a court system may be appropriate. If public safety consists of all of these elements, then the function may be best provided by multiple governments at the same time. Just what is the public good? If we apply our definition of public good only to single activities—for example, the patrol by the night watchman—and not to groups of activities constituting functions, we can conclude that a single organization should provide a single activity within its area of benefits. This approach is consistent with a logic of different activities for different levels of government and is implicit in the work of Head (1974), Tiebout (1961), and

Musgrave (1969). It is also consistent with Oates if we assume that his terms, services, activities, functions, and programs describe only single activities. From this, Oates concludes that an economist's theoretical model should indicate a clear division of functions but that the "real world" appears to be one of increasing participation of different levels of government providing the same functions. If Oates had applied his public goods theory to only specific activities and recognized that different activities comprising the same function could be undertaken by different levels of government, his ideal model would be consistent with observed trends in multilevel fiscal activity and permit him to go much further in analyzing federal systems than he has been able to do. He could also avoid trying to justify an ideal type that obviously does not fit. In addition, it is precisely the observation that different activities of functions may be provided by different levels of government that makes a solution to the monopoly problem—which Oates totally neglects—possible in federal systems.

Public Goods and Monopoly

The logic of a public good is such that provision by a single organization in an area is most efficient. If there are multiple organizations, then it is rational for each to let others provide the good; members of the nonproviding organization may then consume the good without having contributed to its cost. When there are multiple organizations, some organizations will be free-riders.

The logic that a single organization is needed for a public good poses a monopoly problem: if the officers of the organization do not efficiently provide the public good to meet citizens' preferences, the citizens have no substitutes to turn to. For example, if one organization provides all public safety activities and its officers harass citizens when they call for help, there is no other source of assistance, including protection from harassment by the officials themselves. In contrast, even if patrolling activities are provided by a single law enforcement agency, if other public safety activities are provided by employees of other organizations (such as sheriffs, federal marshals, state patrols, prosecutors, and the FBI), then there are substitutes; if local police do not perform well, citizens will have recourse to an alternative organization. Thus, it is precisely because no single organization provides all public safety activities or can prevent others from performing similar activities that a monopoly over public safety activities is avoided. Each activity can be adjusted to an appropriate scale and the resulting overlapping of organizations can resolve the monopoly problem. Public goods theory, then, when applied to activ-

ities rather than entire functions, aids our understanding of federal systems in a way that is consistent with federalist theory and market economics.

The substitutes that preclude monopolization in the public sector are not the same as "perfect substitutes" or identical products so popularized in developing welfare conclusions from models of "perfect competition." Substitutes need not be perfect (e.g., a fence and guard dogs may substitute for a police patrol) to stimulate competitive behavior among producers. This concept of competition is associated with Smith and is well expressed in Hayek's "The Meaning of Competition" (1948); it is not the much narrower view of a perfectly competitive market.

Competition

Competition is a key theme in Smith and in the *Federalist*, and a closer look at how the concept of public goods is used in the fiscal federalism literature shows that competition can be included in that analysis as well. Given the importance of competition, it is important to ask if there are situations where competition goes wrong. Two such situations are directly relevant: problems of common property and imperfect information.

The Problem of the Commons

In economic theory, competition "goes wrong" when users compete to use a commons, which is a resource for which property rights are only partially defined (a right to use but no right to exclude others from use). The "tragedy of the commons" occurs when the value to users is sufficiently great that users overuse and destroy the commons, leaving everyone worse off than they would be had they been able to agree on a more complete assignment of property rights for rationing purposes. The problem of the commons, which arises because of an inadequate specification of basic property rights, clearly creates a situation where competition leads to undesirable results.

Studies of the commons began with an examination of "unowned" natural resources, such as fisheries and groundwater (Gordon 1954), but the analyses have been expanded to include the destruction of public goods after congestion sets in, as occurs in public parks. The general principle is simple: whenever the benefits of something exceed its realized costs, people will choose to have it, even if the sum of their costs plus costs imposed on others exceed total benefits. In government, the most striking example of this problem is that many politicians, bureaucrats, and citizens appear to view the public

treasury as a commons that each wants to use for his or her own benefit. Special interest groups find that their special benefits exceed their tax increase (which is spread over all taxpayers) for their special project, even though all citizens may end up paying to finance all special interests that exceed their own benefits. This problem is likely to be even more severe if expenditures are financed with deficits.

The usual suggestions for resolving the "commons problem" are either assigning complete property rights or introducing a monopoly regulatory agency with the coercive power to limit access. Both suggestions constitute fundamental changes in the legal structure and are analogous to effective changes in the Constitution. This problem is clearly one that can emerge from competition among politicians and bureaucrats to satisfy citizen preferences in a federal system.[12]

The Problem of Imperfect Information

A second area where competition may appear to go wrong is where consumers or producers possess only biased or imperfect information. In order to make good decisions on the use of scarce resources it is necessary to have a system that produces and makes available information on demands, opportunity costs, and production alternatives. A major argument in Smith and refined in Hayek (1945) is that markets produce and transmit this information in the form of prices more effectively than could a mercantilistic state or a central planning agency. In fact, it is because markets operate on the basis of decisions made in response to prices that many economists call market systems "price systems," and most economists would be at a loss to explain how a market system could work without prices. Applying the logic of markets to federalism then leads to very important questions: Are prices really necessary for the operation of complex systems? And what are the prices in a federal system?

The first question can be answered in the negative. An example would be the ecological survival of the fittest model where organisms or species are adapted to fit the environment and may not engage in any purposeful behavior. If there were tighter control between citizens and preferred policies so that governments that did not meet expectations were eliminated, the system would adapt to citizen preferences even without prices or conscious attempts by management to meet citizen preferences. Both Alchian (1950) and Tiebout

[12]The literature often refers to the negative consequences of competition within government as resulting from "rent seeking" (Buchanan et al. 1980).

(1957) have explained such a model in economics, but most of us would expect purposeful human behavior with the right incentives to result in an improvement over a pure no-information random adaptive system. We should be aware, however, that a large federal system can operate—and may be operating—without the kind of prices that economists consider necessary to get efficient resource allocation.

The problems of introducing prices that reflect values and opportunity costs into the public sector are serious ones. In order to intentionally undertake production to satisfy customers, managers have to know demand prices, resource prices, and the production function (the relationship between resources and the value they add to the output). Given the nature of many governmental activities, the prices necessary to make these decisions are largely unknown. For example, there is no quantitative measure for "public safety," let alone a demand price; nor is there precise information on the contribution of different resources—such as police cars, policemen, computers, and crime laboratories—toward the objective. In short, managers do not know either the demand price or the production function for many government activities. Of course, there are other activities, such as water supply or garbage collection, where prices can be identified and the production function specified without difficulty, although the way in which the public sector is organized makes it possible that such information will not be as readily available to managers or elected officials as it would be for comparable activity in the private market. Given the range of activities in which governments are engaged, such diversity in government activities should be anticipated.

Federal systems do not produce the same price information as do "ideal" market systems, nor are they likely to produce as much price information as do real market systems. The information problems, however, may be more a matter of degree than of fundamental difference. For example, large corporations undertake many activities internally and must make management decisions without knowing the precise contribution to output of some activities. It is also difficult to measure the outputs of many private firms, such as a law firm. In these cases, the conditions of "perfect competition" are not met; but as long as markets are competitive, those businesses that do relatively better are most likely to survive and provide net benefits to consumers. Thus, while one must recognize the difficulty of developing ideal prices in federal systems (and try to improve information where possible, such as with contracting-out), the lack of ideal prices is not a barrier to using market models to understand federalism. Explicit recognition of the lack of ideal prices, however, reemphasizes the

potential lack of relevance of economic models that include as a basic assumption the availability of perfect information.

Implications of a Market Perspective

The major arguments of the paper can be summarized as follows:

1. The basic way of thinking in market economics, such as is presented in Adam Smith's *Wealth of Nations,* is highly congruent with the way of thinking about government presented in the *Federalist.* Both view people as acting in their own self-interest; both are aware of the difficulty of producing and transmitting information; both place considerable importance on competition to get good results for consumer/citizens; and both oppose the creation of monopolies.
2. Empirical evidence supports the position that greater competition can improve production efficiency (contracting-out) and that governments will engage in collusive behavior to the disadvantage of citizens (LAFCOs).
3. Recognition of the difference between functions and activities when applying the concept of public good can reconcile federalist and market approaches with the fiscal federalism literature. This approach also indicates the importance of a broad definition of substitutes, not just the identical substitute of perfectly competitive models.
4. Competition may lead to undesirable results when it is for a commons, and the public treasury may be analogous to a commons when viewed by special interests.
5. Federal systems do not generally produce as much price information as do private markets, but they still function more like markets than like single firms or hierarchical bureaucracies.

The Constitutional Convention of 1787 created a framework that has facilitated economic development and has left the United States one of the best governed nations in the world. While that was no small achievement and should not be underrated, social scientists who study the public and private sectors should be proposing ideas that will improve things. If they are right, there may even be some changes.

Before one can make recommendations, however, it is necessary to understand how something works. In order to understand the U.S. constitutional system, it is necessary to understand federalism. The *Federalist* provides an excellent basis for understanding how federalism works, but the logic of economics also makes a major contribution because of the congruence between the theoretical framework

presented in the *Federalist* and the theory of markets. This does not mean that we can simply adopt Smith's conclusions, even if supplemented by the analyses of public choice theorists, and apply them to the public sector; but it does mean that we can use the logic of market economics to understand federalism more fruitfully than has been done in the past.

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Federalism from a Market Perspective

David W. Rasmussen

Introduction

Arguing that the *Federalist* is an intellectual cousin of Adam Smith's *Wealth of Nations,* Robert Bish desires to show how an understanding of exchange helps us understand how our federal system operates. Federalism is seen as a mechanism to constrain the government's power to pursue its interests at the expense of the governed. In seeking a solution to this "monopoly problem" Bish sees the Federalists sharing with Adam Smith the insight that competition is the most effective antidote to monopoly. Principles of exchange in the Federalist system are exhibited in a division of labor among many governments and the Founding Fathers' awareness that individuals know their own preferences but not those of others. Like Smith, they wrestled with the problem of how citizen preferences can be made known to their representatives.

In this commentary we will discuss the role of competition in our federalist system, emphasizing two aspects of Bish's paper while largely ignoring significant areas of agreement. First, it is argued that Bish may be exaggerating the principles that link the economic market perspective to American federalism. Secondly, Bish does not discuss adequately the public sector's role in the redistribution of resources, a dominant feature of contemporary federalism.

Economists' affection for market analogies to the public sector are based on what Albert Hirschman (1970) called the exit option. Exit is the primary way consumers register their displeasure with producers in markets. If a firm's product does not please a customer in a competitive market, he simply buys from a different firm. This principle is basic to Tiebout's (1956) model of fiscal decentralization which emphasizes citizens vote with their feet in search of a preferred tax/service combination.

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Competition among governments may be a potent antidote to the monopoly problem in the United States. Exit has been an integral part of the American character. Most Americans have roots in a foreign country, the Western frontier offered opportunities for exit from the East, and the affluent deserted our central cities to form new suburban governments. The Federalists, however, may have placed more value than Bish on Hirschman's alternative to exit, i.e., voice—involvement in the political process. That voice would be dear to the heart of the Federalists is suggested by Bish when he notes that they argued policy should be "debated and scrutinized in several forums to be certain that the viewpoints . . . are considered before adoption." Bish dismisses the reliability of this political process as a means to combat the monopoly problem in one sentence because of "economic analysis."

Bish's rejection of political competition in favor of the voluntary exchange model as a solution to the monopoly problem may not reflect Federalist thought. Aside from their interest in political involvement, a resurrected Federalist might object to Bish's contention that they constructed a political system analogous to the competitive economic marketplace. Not trusting central government power, the Constitution divides power among three branches of government. In setting up the system of checks and balances for which our Constitution is famous, the Founding Fathers in fact set up a system of countervailing power—a system very different from the competitive processes envisioned by Bish. Rather than interpreting the *Federalist* as a companion volume to the *Wealth of Nations*, the Founders could be thought of as having anticipated Galbraith's (1956) interpretation of American capitalism.

Competition and the Monopoly Problem

Bish states that "contracting-out with competitive bids eliminates the monopoly position of the government bureaucracy and introduces more information and competition into the system." The availability of private production provides information with which the government, political entrepreneurs, or citizens can evaluate public production of the service. As long as the government has a statutory responsibility for the service (e.g., incarceration of criminals) it inherently has a "monopoly" on the provision of the service although it can choose not to produce the service. This important distinction between provision and production of public goods is emphasized by Bish in another context. Hence the question to be answered is why

does the government decide to contract-out to a low-cost private producer?

One answer is that elected officials want to "do good" rather than "do well," that is, they are benevolent monopolists. There is no reason to deny that some elected officials may genuinely act on principles of good government (which would imply low-cost contracting-out if public production was inherently more costly). Nevertheless, this seems a weak foundation on which to build our hopes for good government.[1]

An alternative is that electoral competition may force public officials to adopt cost-effective private alternatives to public production. Although Bish probably would reject this hypothesis, much can be said for this argument. First, let us assume that citizen-voters are satisficers in their consumption of public services. This generally plausible interpretation of human behavior (see Simon 1952) is particularly appealing in the public arena where it is often difficult to measure output or quality of service. In contrast to finely tuned maximizers seeking marginal advantages, these satisficers respond only when actual outcomes deviate significantly from the optimum.

We now assume the public sector is providing a service for which private production can be substituted at apparently lower cost. If the advantages of contracting-out are significant and clear, a political entrepreneur may seize this issue to improve his well-being, that is, by wresting office from an incumbent or solidifying his political position. Whether a political entrepreneur enters the political marketplace over this issue depends on the elasticity of response of electors to the perceived savings from contracting-out the service to private vendors. The elasticity of response to cost differences (and quality variations) will depend on the size of the item in the government budget, the ease with which cost differences can be demonstrated while assuring quality is maintained, and the risk associated with a breakdown in the service.[2]

[1]A bureaucrat might contract-out to a low-cost private producer in order to get additional discretionary resources. Public benefits from this lower cost production, either additional services or lower taxes, may not be forthcoming in this situation.

[2]That voters will not respond to cost savings in trivial budget items is straightforward. In many cases, however, cost savings provided by private vendors may be suspected of harboring declines in quality. For garbage collection the cost comparisons are straightforward and the quality of service clear, e.g., number of pick-ups per week. Garbage is readily contracted-out. The Thatcher government's 1986 proposal to privatize water services in the United Kingdom represents a complicated issue with uncertainty about quality when costs differentials are known. In this case, debate focused on the quality question and the uncertainty of monitoring potentially hazardous practices of private vendors. Oliver Williamson (1976) emphasizes that the complexity of contracting-out some services can undermine the feasibility of privatization.

The political marketplace is highly competitive in that there are always new entrants hoping to displace the old. Indeed, it is entirely possible that political entrepreneurs share an important characteristic with their economic counterparts, that is, they are most innovative before they hit the "big time." Bish notes that substitutes need not be perfect to preclude monopolization; this observation seems to be as apropos in support of the efficacy of the political marketplace as in Bish's arguments for alternative institutions to prevent monopoly power by the government.[3] While Bish has made an interesting contribution in noting some of the similarities between Federalist thought and that of market economics, he has probably underestimated the role of the same competitive forces at work in the collective decisionmaking process.

Political competition, like competitive markets in economics, can go awry. This is widely recognized. Bish applies the "commons problem" to the federal budget, claiming that "many politicians, bureaucrats, and citizens . . . view the public treasury as a commons that each wants to use for his or her own benefit." Thus we are not assured political competition will yield a desired result—the monopolist government may go unchecked.

Modern Fiscal Federalism

Political competition as outlined above probably works best for relatively small local governments (Bish 1971). Investigation of the division of labor among U.S. governments suggests that it is the state and local governments that provide services for people while the federal government is more oriented toward redistributive activities. Of course, the federal government is a monopolistic supplier of national defense. In 1981 about 88.9 percent of state and local expenditures were for current operations, capital outlay, and interest. Public welfare accounted for about 11 percent of outlays; half of which were financed by the federal government. In contrast, 47 percent of federal expenditures were for redistributive activities via payments to individuals. This figure increases to 62 percent if the transfers are taken as a percentage of nondefense outlays.

These data suggest that political competition and competition among governments are such that the state and local public sector avoids a serious monopoly problem in that they provide services to citizens

[3]William Baumol's (1982) concept of "contestable markets" rests on the premise that a monopolist could be held in check by potential competition, i.e., a monopolist is aware that potential rivals make his position vulnerable. Politicians are clearly engaged in contestable markets in that they are aware of potential but as yet unknown competition.

who have competitive alternatives. Benson and Johnson (1986) support this view when they report that tax competition among states is a significant force affecting the location of manufacturing investment.

The federal government has evolved to the point that income redistributive activities have grown to rival the goods and service producing functions. Bish's discussion of the concepts of competition implicit in the *Federalist* does not provide much insight into the growth of this phenomenon—redistribution is only mentioned in the context of the commons problem. Implicitly, his treatment of redistributive activities suggests that market failure is characteristic of the operations of the monopolistic federal government. Viewed in this light it is possible to argue that our bold constitutional experiment really failed, that the commons problem at the federal level associated with political competition ultimately resulted in a trammeling of the citizens rights via confiscatory redistributive schemes.

Considering the composition of these transfer payments, this judgment may be too harsh. Of total transfers to domestic persons, the Social Security programs aiding the elderly, disabled, and surviving dependents account for 65 percent; including retirement programs raises this figure to over 77 percent. Widespread political support for Social Security does not suggest this program represents a trammeling of citizens' interests; in fact support may rest on the proposition that virtually the entire population will ultimately receive some benefits. Although the most affluent members of society may prefer private insurance, there is no evidence that this large transfer program is government run amuck vis-à-vis citizen preferences.

Since Musgrave (1959) enunciated the division of labor among governments, conventional public finance has emphasized that the federal government should take the lead in redistributive activities while the local governments should primarily provide goods and services. As a nation proceeds from an agricultural society to a highly urban industrial economy, the bonds of community and family become weakened from rising mobility and the decline of the family as an economic unit for the production of goods and services. In this context, we may expect an increase in redistributive activities, reflecting a commendable institutional flexibility in response to the economic development process. However one judges this rapid rise of federal redistributive activity in the past two decades, the role of transfers in our federalist system must be carefully considered in any discussion that seeks to clarify our understanding of modern fiscal federalism.

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