The Limits of Public Choice

"The statesmen who should attempt to direct private people in what manner they ought to employ their capitals, would .... assume an authority which . . . would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself to exercise it."

F.A. Hayek, Road to Serfdom, *ch. 5.*

"[The] role of government includes facilitating voluntary exchanges by adopting general rules––the rules of the economic and social game that the citizens of a free society play."

M. & R. Friedman (1980), p. 50.

"Unless restrained by constitutional rules, special interest groups will use the democratic political process to fleece taxpayers and consumers."

J.D. Gwartney – R.L Stroup (1993), p. 79.

"Democracy is a way to rule the state, not a way to rule society."

J. Norberg (2001), p. 257.

The Shortcomings of Collective Choices

So far, we have discussed private choices to coordinate individual decisions about property uses. However, it is not always possible to attach private property rights to assets, as we saw in Chapter 4 when discussing public goods, externalities and common goods. When either the supply or the demand for an asset cannot be made exclusive, it becomes necessary to make collective choices about asset uses. Then, matters become much more complicated, as public policy is not subject to the same disciplines of market competition. This is so for the following reasons:

a) Instead of two parties agreeing on a contract, collective choice requires that numerous parties have to agree, or at least tolerate the decisions of others. This makes for less welfare and complicated trade-offs.

b) Whereas individual contracts can be tailored to suit the two parties, collective solutions normally have to obey the maxim "one size fits all". Most people's diverse aspirations are then less well satisfied. In other words, the market can serve you à la carte, whereas collective provision offers only one set canteen menu. Where there is less variety, there is also less potential for discovery and progress.

c) Collectives, such as governments, have to aggregate individual preferences, often relying on appointed or elected agents. They proceed on the basis of more or less agreed voting procedures, many of which inflict considerable political coordination costs.

d) Government agents are often elected or appointed on the basis of political patronage and owe little allegiance to those whose preferences they are supposed to represent. The principal-agent problem often leads to collective decision makers acting corruptly in their own self-interest and the population remaining ignorant of what their agents really do. A free press may make government more transparent, but the rulers are frequently capable of capturing the press. Governments buy newspapers, radio and TV stations and make the government-owned and private media part of the ruling elite. Principal-agent opportunism tends to be controlled effectively by market competition, but it is hard to recreate a similar discipline where matters are decided by government, ie. a power monopoly or a cartel among elite groups of the society. This is an eternal problem even in long-established democracies.

e) In bilateral market contracts, the give and the take are clearly defined. Both contracting parties believe that they gain from an exchange because what they trade is at least equivalent in their eyes. By contrast, collective choices involve fuzzy, non-mutual, multilateral give and take. The temptations to opt out of the giving and to free-ride in the taking are considerable (moral hazard). Consequently, considerable monitoring and compulsion are required. Tax contributions to collective activities require compulsion, inflicting high agency costs. This often causes feelings of powerlessness and disenfranchisement among the tax-paying citizen-principals. The distribution of the benefits of collective action has also to be decided by the political agents, giving them great power. Because it is costly for the citizen-principals to keep themselves informed of complicated government actions, political agents are often inherently beyond proper control. This reinforces the danger of major and intractable principal-agent problems in politics.

f) In democracies, the re-election motive dominates collective action. It is therefore likely that time horizons in political choice are shorter than in private choices. Whereas private citizens often look beyond their lifetime to the well-being of their children and grandchildren, elected politicians, from the day of gaining office, think mainly about their re-election in two to four years' time.

g) In modern democracies, the free will and the responsibility of elected people's representatives are limited by the demands that political parties impose on parliamentarians. As a consequence, most political decisions are in reality made by small, powerful backroom committees, and not the elected majorities of the representatives who are directly responsible to the citizens. It is quite common in political decision making, that a few keenly interested persons dominate a committee that fixes party policy on a particular matter and that parties automatically and uncritically vote for committee recommendations. As a consequence, modern parliaments are turned into an instrument of exploitation of the majority by avid, self-seeking minorities.

h) This problem is aggravated by the combination of

- small, organised interest groups who have much to gain from political preferment,
- an electorate which faces high information costs and therefore remains "rationally ignorant" about the business of government, and
- organised political parties of parliamentarians who will do almost anything to obtain the support and financial donations to get re-elected.

Rent-seeking, rent-creating, opportunistic crooks who neglect the will of the citizen-principals are therefore endemic in all political choices.

For these reasons, collective action is very much a second best to private action in coordinating human activity, except in a limited number of circumstances. This leads one to conclude that government should constitutionally be limited to a few areas, and that as much of economic activity as is possible should remain private (Graph 8). One also has to conclude that the agents of government have to be controlled so that they do what the people desire rather than seek their own ends.

Before we can discuss these important concerns any further, let us look at the functions of government.

The Functions of Government

At various points we touched upon two roles of government. When discussing institutions in Chapter 3, we saw a role for government in backing-up the internal institutions of society by imposing and formally enforcing external institutions. This is the protective function of government. And when discussing the various forms of property in Chapter 4, we saw that not all assets can be assigned to exclusive private ownership. There is a case for government getting involved in providing, even producing some public goods (productive function). In other words, government has protective and productive functions. In addition, elected parliaments in mature democracies have greatly expanded an additional government function: redistribution by confiscating the property rights of some and allocating them to others[1]. Indeed,

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[1] Some writers would assign government a further function: stabilising the economy. It seems, however, more appropriate to subsume the stability of the value of money under the protective function (protecting holders of monetary assets from 'cold expropriation by

Graph 8: Private and Public Choice

	Private Choice	Public Choice Collective Action
Exchange:	reciprocal direct given and take	multilateral indirect
Shrinking:	monitored, curbed by institutions (contract)	shrink contribution, but claim hand-outs
Cordination mechanism:	voluntary	coercive
Meeting of wants:	diversity, choice; creativity, “chaos”, duplication	uniformity (“one size fits all”); “unity of purpose”
Principal-agent problem:	self-control among competitiors economises on need to know (division of knowledge)	control by authorities, rent-seeking prevails; “rational ignorance”,
Monitoring/ enforcement:	often spontenous	costly, cumbersome
Innovation:	markets generate information by catallaxis	political power used to resist change

Therefore: Privatise where private action is feasible (i.e. where property right can be attached to assets and the benefits/costs of their uses).

this has been the biggest cause for the relentless expansion of government in the 20th century (Buchanan, 1975).

The protective function of government requires a commitment of policy makers to supporting abstract, universal rules without fear or favour. This may well mean that the application of a rule has sometimes unwelcome or politically unpopular specific outcomes. Placing time-tested, non-discriminatory institutions above the pursuit of specific outcomes requires genuine, far-sighted leadership and strong constraints on political opportunism. In present-day democracies, elected politicians, as well as

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inflation’). Beyond this, experience has taught us to doubt the capacity of governments to stabilise aggregate demand, let alone demand in particular markets. Price stabilisation in particular markets may serve particular interests, but it tends to undermine the overall coordinative efficacy of the market economy.

unelected judges and bureaucrats, are under pressure from well-organised lobby and advocacy groups, who pursue particular outcomes ruthlessly. They do so irrespective of whether this violates the time-tested rules of society or not. In their pursuit of votes and financial contributions, many politicians become the captives of such interest groups. They may even abandon the core values of their professed political creed and betray the core function of government, namely to ensure the non-discriminatory protection of universal rules (Downs, 1957; Olson, 1965; Tollison, 1982; Sowell, 1990).

In some instances, governments of course have to prescribe certain outcomes, for example setting health, environmental and other standards (Chapter 3). This is widely accepted in the community as legitimate because such government activities help citizens in economising on information costs and in feeling secure. When government agencies, for example, license certain pharmaceuticals, they save the citizens high, if not fatal costs of finding out whether or not a certain drug is effective in controlling a given medical problem. However, the proliferation of specific, prescriptive protection can easily undermine private initiative and the spontaneous order. As Ludwig von Mises demonstrated as long as half a century ago, proliferating and supposedly well-meaning protections pervert the spontaneous market order and make it as ineffectual as a centrally controlled economy (Mises, 1949).

Caution with the political supply of specific institutions seems advisable also because outcome-specific prescriptions tend to have unforeseen side effects. They tend to cumulate so that competitors become insecure and people shirk knowledge-exploration costs. Another side effect of pervasive, prescriptive regulation is high compliance costs. Health or safety regulations may well save human lives, but the gain of one life saved may impose tens of millions of dollars in compliance costs (Viscusi, 1996). Then, the question arises whether the resources absorbed in complying with and enforcing such regulations, which cost tens of millions of dollars, could not be employed more effectively to save human lives. When certain risks are accepted and the "insurance" costs are saved, it may be possible to buy more dialysis machines and save many more lives. In any event, one has to approach this issue with the realisation that collective regulation cannot protect all citizens from all risks!

The second function of government—the productive function—is often justified by writers who discuss public goods. When not all benefits and all costs of certain activities can be privately appropriated, the incentives of private property do sometimes not work well in allocating resources, or not at all. But this does not automatically justify the production of such goods and services by government-owned and -managed monopolies, as we saw. In reality, public production has of course been extended far beyond cases of pure public goods. Governments often set up public production—or entire nationalised industries—to control markets and resources and to raise revenue without having to incur the political opprobrium of taxing. This is why many governments nationalised the telegraph, power and rail systems in the 19th and 20th centuries; why governments run salt mines, oil companies and cigarette factories; and why many toll roads are collectivised.

In this context, one has to beware of a confusion within the language: "public good" means "public access good" (or "public domain good"), not "publicly produced good". What is often required of the government is to ensure that all members of the public have access to certain facilities. For example, schools and public transport, need to be accessible to all members of the public because of network and information advantages. But that means neither public ownership nor the management of power, communications, schools and transport under the unwieldy rules and disincentives which are prevalent in public administration.

It is now widely accepted that (a) there is general advantage in the competitive production of goods and services (cost control, innovative benefits of competing suppliers), and (b) access to such goods and services can be provided even for poor people by government-provided vouchers and similar public funding mechanisms, if that is desired. Thus, transport, education and health services can normally be produced more effectively by private, competing operators. This does not preclude that they are paid for, at least in part, by tax-financed vouchers, if the community decides to do so on equity grounds.

This insight has given rise since the late 1970s, to an accelerating worldwide wave of privatisation. Between 1985 and 1995, privatisation amounted to an estimated $535 billion worldwide (O'Leary, 1995), and in 1997 alone $ 157 worth of socialised assets and publicly-owned trading enterprises were privatised. The countries with large socialised sectors, such as Italy and Australia, have been among the most avid privatisers. In some countries, such as the Peoples Republic of China, the inefficient public sector is allowed to whither away, with new dynamic privately owned firms taking over markets and carrying the burden of economic modernisation. The governments of many developing countries have successfully withdrawn from running hospitals, refineries, railroads, ports, agricultural trading networks and white-elephant airlines, freeing scarce resources for more important priorities and relieving politicians of the blame for poor service.

The benefits of private ownership and competition in controlling costs, enhancing product quality, and innovating products—as compared to public monopolies—are evident around the world[2]. Privatisation has also often lessened the rents reaped by the workforce and the management of socialised firms. It is therefore not surprising that organised labour, public-service lobbies and some managers of government-owned enterprises oppose the sell-off of state-owned establishments.

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[2] Throughout history, shifts have occurred away from a big public sector to competing, private operators. The results have always led to rising prosperity. For example, when trading shifted from state temples in the competing city states in ancient Mesopotamia to private entrepreneurs, trading networks expanded, innovations flourished and wealth grew (Moore-Lewis, 2000, ch.3). When the new Han Emperors of China reduced the taxation of crop yields from 50% under the preceding Qin Dynasty to 3 per cent, they laid the foundation of a long-lasting prosperity and a Dynasty that lasted four hundred years.

The redistribution of private property rights, the third function of government, has expanded fastest for most of the 20th century. In the mature welfare states of the west, a very large part of public budgets does not go to protection and service provision, but is expended for the purpose of hand-outs by subsidy, and most of the publicly-owned production serves in reality the government's redistribution and patronage function. The redistributive role of government does not stop there; in addition, governments interfere directly in many market processes with redistributive aims to reallocate incomes, for example by fixing minimum prices or licensing a limited number of competitors. If food prices are fixed at low levels, this is a political transfer to the urban population, which disadvantages the farmers and generates food deficits. And if petrol prices are fixed below world market levels, this deprives everyone of export income and burdens the budget. Of course, all such redistributive policies divert resources and taxpayers' money into bribes that serve politicians to get re-elected. To better understand the enormous expansion of the redistributive function in most countries, one has to turn to the phenomenon of rent-seeking in politics.

The Game of Rent Creation and Rent Seeking

Citizens, who face high information costs about what happens in politics and who know that they have little influence over collective decisions, are rational in choosing to remain ignorant about parliamentary and bureaucratic games of income and wealth redistribution. This increases the likelihood that their elected politicians and unelected bureaucrats will be tempted to act in their own interest to get re-elected or wealthy. They will not faithfully represent the—often poorly articulated—will of the people. Political choice therefore gives rise to corruption and massive principal-agent problems (Downs, 1957; Stigler, 1971; Buchanan, 1987; Buchanan *et al.* (eds.), 1991).

Rent-seeking by corrupt public servants can be illustrated with the example of tariff making. Parliamentarians, ministers and bureaucrats have much to gain when they respond to organised industry interest groups by intervening in market processes. They do so typically to discriminate against the many buyers of imported goods and in favour of the few local producers. A car tariff interferes with the freedom of citizens to buy cars from the best source by restricting the public's access to foreign suppliers. This allows the local (normally foreign-owned) vehicle producers to charge higher prices and to save themselves many of the troublesome search costs involved in new models and cost cutting (compare Chapter 5). If, for argument's sake, a country's market is 400,000 passenger vehicles per annum and the average car can be sold, thanks to the tariff, for $2,500 more, then each of four domestic car producers (and their workers) gain on an average $250 million annually—a massive, politically allotted windfall. For such a prize, it is certainly worth lobbying and bribing cabinet ministers and brow-beating the public! By contrast, the average household may buy a car every seven years, in particular when cars are overpriced and of the uninspiring quality, which is typical of the products of "tariff factories". Each household then bears an average, politically imposed loss of some $360 per year—not worth the effort to inform oneself of the harm done by the politicians and to lobby them against the tariff, which is a "welfare policy for the car industry"! Over the longer run, the loss of "creative unease" in the industry leads to less innovation and poorer international competitiveness. In heavily protectionist India, for example, the motor industry was still producing 1940s models in the early 1980s and selling them at inflated prices to the public. This is why protective, selective industry policies have been a worldwide disaster.

After visiting India in 1955, Miltan Friedman observed: "The sensible way for India to get automobile transportation is to import second-hand cars and trucks. But India in effect says," 'we are too poor to buy second-hand motor vechicles from abroad, we must produce new ones at home' (Shah, 2000).

Politicians produce and supply interventions, which redistribute income and wealth. In other words, they allocate rents not earned in the market. They trust that those whom they surreptitiously deprive of wealth and life opportunities will not notice or will soon forget. Those to whom they distribute privileges will often share the windfall with them or their parties and associates. Such redistributional interventionism goes far beyond tariff making and pervades every walk of life. Sometimes, organised unions extract political preferment (for example, political exemptions from the normal rules of contract law) in exchange for electoral support. At other times, organised professions and industries obtain political favours, for example in the form of subsidies for export or research.

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Picking Winners: Can Anyone in Government Know?

The knowledge problem and consequent principal-agent problems in government are starkly highlighted in "industry policy". In particular, many developing countries have attempted to identify industrial winners by collective action instead of relying on competing private investors to find profitable activities. Governments are involved in interfering in market processes and industrial structures with the aim of advancing overall growth. The political fashion has long been to identify and subsidise supposed growth industries. However, this is now widely recognised as a costly way "to pick losers".

Can policy makers know any better than competing entrepreneurs where the future growth industries will lie, given the complexity and rapid evolution of the modern world economy? And are they more motivated than capitalists who risk their own wealth? These questions might perhaps be answered in the affirmative in new industrial countries where bureaucrats may be able to identify what has been successful in countries higher up the income ladder (e.g. post-war Japan, or South Korea after 1960). But even there, gross errors were frequent, e.g. the Japanese government telling Sony that transistors had no future, Honda that the car market was overcrowded and aircraft makers that they should build a Japanese airliner. The price for the close cohabitation of politicians, bureaucrats and rent-seeking industrialists has been that political parties get corrupted and that industrialists shift their entrepreneurial energies from innovation to lobbying. The rent-seeking also leads to social tensions. It is instructive for example that in South Korea, the 20 largest and preferred *chaebol* have greatly under-performed when compared to the S&P 500 companies in the USA (average 1990-96: 4.7 per cent net profits as against 1.1 per cent in Korea, *The Economist*, 22 November 1997, p. 88). Many of them were the first to 'melt down' in the Asian financial crisis of the late 1990s. It is also worth noting that Korea has one of the most acrimonious industrial relations records, similar to formerly interventionist Australia. This is not surprising because industry policy is ultimately not about earning a rate of return, but about the good life for the managers and how to distribute ill-gotten rents.

Among most economists and international economic organisations, selective industry policies have therefore long been in disrepute as an instrument of economic growth (Burton, 1983). Governments simply cannot know. And political interests tend to outweigh the economic rationale and the citizens' interests.

Industry policy problems are lessened when governments confine themselves to generic supply-side policies, mobilising resources through education, research, savings promotion, opening up land and providing hard infrastructures. This is increasingly the style of industry policy in East Asia. Recent experiences with specific industry policies have taught costly lessons. For example in South Korea, government-sponsored *chaebol* conglomerates accumulated huge bad debts, in Malaysia firms close to the ruling political party made huge losses in government-sponsored projects, and in Indonesia a small circle of favoured cronies have caused what is wrongly termed a "monetary crisis"—it is an institutional crisis. The same might be said of the efforts of the Indian government constantly bail out PSUs wherever they fall in the red.

Political attempts to gain influence through rent-creation of course militate even against such general or generic supply-side policies. General industry promotion, for example by subsidising R&D or exports, have a habit of turning into subsidies for well-connected big firms, and they do nothing for small operators who do not have the time to fill in forms and visit ministries. Judging by copious international experience, there is a real danger that industry policy always becomes selective and will contaminate the probity of policy processes. The dividing line between corruption and probity is hard to discern when a

> government is committed to providing corporate welfare. In any event, such discriminatory policies always violate the equality of all citizens before the law and hence the institutional principle of universality.

As selective interventions proliferate, the constitution of competitive markets is upset and the overall intensity of competition—the risky, troublesome commitment to finding and testing new knowledge—is eroded. Market signals are then hard to read. The economic system loses some of its catallactic efficiency in uncovering growth opportunities. Economic development slows down. The opponents of capitalism then find a reasonable amount of evidence to castigate capitalism. Those who favour capitalism are therefore well advised to also favour untrammelled competition and not to side with big producers who seek rents.

The Failures of the Welfare State

Nowhere has political opportunism by parliamentarians, bureaucrats and judges in interaction with single-issue groups had a bigger impact than in the expansion of cradle-to-grave public welfare in the mature Western democracies. But even massive redistribution policies have not worked to eradicate inequality and poverty. Many welfare programmes in reality redistribute income and wealth from the middle class to the middle class (churning). In reality, the state rarely redistributes from rich to poor, but from the poorly organised to well-organised and vocal interests. This is readily understandable on the basis of the re-election motive.

The long-term availability of public welfare and the disincentive effects of progressive taxation have induced many citizens to cease making their own private, self-responsible welfare provisions by saving and acquiring work and life skills. The shift from self-responsibility to reliance on government agencies has led to much public posturing and lobbying and a loss of social harmony. The growing welfare burden of gradually ageing populations is frustrating the young generation, who feel disenfranchised and expropriated. In Western Europe, disaffection with public-sector inefficiencies and compulsory redistribution is growing and people discover that they do not simply want to be passive recipients of government hand-outs, but want to take responsibility for their own lives.

On a more fundamental level, government cannot logically fulfil its protective function (protecting private property rights and individual autonomy) and at the same time continually and massively confiscate and redistribute private property by compulsory political fiat.

The increasingly obvious failures of the welfare state pose serious problems for most advanced democratic societies, many of whom still profess a commitment to redistribution and egalitarian outcomes. By contrast, none of the fast-growing economies of East Asia has developed a welfare state. Welfare is a private affair, a matter of personal saving and family solidarity. When this fails, private and religious associations may step in, and the government then becomes a rare welfare provider of last resort. In China, where government-owned firms were expected to provide housing, health and old-age support and have been failing to deliver, there are now moves afoot to set up private, portable savings schemes. In Latin America, where many governments used to promise welfare support and routinely failed to deliver, provision of old-age and health care is also increasingly a matter of private saving and professional, state-monitored investment. It appears that many developing countries will not repeat the failures of the welfare states of Europe.

How to Control the Opportunism of Political Agents?

The opportunism of the agents of government is an age-old problem. Throughout history, it has exercised the minds of many great thinkers and reformers, though with limited success. The need for checks and balances on those who shape and implement public policy is no less urgent in present-day developing countries. The extent to which well-designed and enforced institutions are adopted will determine whether corruption is controlled and economic growth unfolds. This requires not one-off action, but an eternal pursuit of economic freedom. Principal-agent problems in government can only be contained by eternal vigilance and concentric, multi-pronged controls (Olson, 1965).

a) Ancient philosophers, such as Plato and Confucius, saw great merit in relying on the moral education of future leaders. Nowadays many are rather cynical about this. Yet, public vigilance and intolerance of selfish, short-sighted opportunism in high political office are important bed-rock conditions for good government. This requires high moral standards in the community and the public censure of those who excuse breaches of the rules of law or ethical standards by corrupt office holders. The ultimate line of defence against the opportunism of office holders and their cronies is an innate probity of the public and a readiness of citizens of property to stand up for economic freedom. In poor developing countries, most citizens do not have the means to fight for high standards in courts and they have to rely on the weapon of public agitation and the democratic vote.

b) Another control device of agent opportunism in government is of course the periodic check of democratic parliamentary elections. One can also popularly elect heads of state, government leaders and other officials, such as judges, police chiefs and auditors, as is done in many walks of life in the US. It is also important to prohibit the sale of offices and commissions. If you or your father have bought your job, you do not have to work hard to keep it. Indeed you will try to extract as many bribes as possible to get a return on the investment. All this makes some public offices contestable. But how effective elections are in controlling agent opportunism in public office, depends ultimately on informed citizens and their fundamental values—and on the degree of their personal security. If legitimate opposition to corrupt practices leads to government sanctioned bullying or violence, the citizens' readiness to stand up for themselves is understandably reduced.

The democratic vote and other political freedoms have typically only been obtained *after* economic liberties were asserted. Once a European middle class arose on the basis of economic freedom, democratic constitutions followed in the 18th and 19th centuries. Likewise, the East Asian tiger economies of the 1960s and 1970s became electoral democracies with lively political debate in the 1990s, once the children of the new middle class realised that continued prosperity required more direct controls of erstwhile autocrats, who had started the economic reforms a generation earlier. There are cases such as colonial Hong Kong where a high degree of economic freedom and a competitive capitalist system long existed without political freedom. But such cases are exception. It is revealing, that of the 25 freest economies in the world, all but Hong Kong are democracies of long standing, and that the poorest and least free economies have no democratic control of government (Gwartney–Lawson, 2001, p. 9). In Africa and other parts, democracy and political freedom have often been introduced *before* economic liberalisation, and these democracies have often failed or worked less well.

Democracy functions much better when people have a certain amount of economic wealth (and are literate), so that they can defend their rights in courts, by public campaigns or electoral promotion of suitable and untainted candidates. This is not to say that democracy has no merits in poor countries, but there it appears to have a harder time of delivering appropriate and just controls of the wealthy and powerful.

In turn, democratic government tends to deliver a better protection of private property and the freedom of contract.

c) Political writers of an earlier age, such as Charles de Montesquieu (1689–1755), and the shapers of the US constitution proposed and implemented the separation of the powers of government between the rule-makers (parliament), the rule implementors (administration) and the rule adjudicators (judiciary). Bi-cameral parliaments have a similar function of distributing power (Upper and Lower House).

The merits of the division of political powers are now widely recognised. In Westminster-style systems of government, the separation of powers is rather weak. Here, the parliamentary majority party or parties—or the leadership group—dominate not only the legislature, but also the executive. Over the long run, the elected political party also has great influence over who is appointed to the Supreme Court. Only when the Upper House majority is not matched by a Lower House majority, is there a parliamentary check on executive power. Even then, of course, political deals are done. As a result, parliament and executive in Westminster-style parliaments can get away relatively easily with discriminatory political interventions.

d) Another method of controlling agent opportunism in politics is the separation of powers between local, State and central governments (federalism). If these three levels of government are assigned separate tasks *and* made responsible for raising all requisite taxes to fulfil them, there is scope for effective mutual control. Competing States or provinces also have a considerable incentive to foster prosperity and a growing revenue base. Competing jurisdictions tend to offer attractive and citizen-friendly administrative solutions to collective problems. Competitive federalism induces governments to incur knowledge-search costs and to mobilise much valuable political-administrative creativity (Kasper, 1995). A lot can be gained from devolving certain tasks from the centre to the States or provinces. Yet, it must also be recognised that certain tasks of government are best left to a central agency, namely where there are distinct scale economies, such as defence, where there is great interaction, such as standardised traffic rules, and where competition amongst jurisdictions may have harmful consequences. Ensuring the same living conditions throughout the territory, irrespective of location, resource endowment and political behaviour must, however, not be an objective of policy if one wants an effective federal system. This objective only leads to income redistribution and stifles self-reliance and competition among provincial governments.

e) When discussing the failures to effectively check the concentrated powers of political parties over central governments, Friedrich Hayek proposed a separate Third Chamber of Parliament (Legislative Assembly). It would set fundamental framework rules, which constrain what elected politicians can do. This Legislative Assembly would be elected comparatively by age cohorts and for a long period, so as to ensure a degree of independence from the party system (Hayek, 1979, pp. 147–65). Hayek proposed that a traditional parliament, which he called the 'Governing Assembly' should be party-based and normally elected to pass enabling legislation, which compels citizens to act in certain ways and which appoints the administration. Hayek's hope was that the combination of a Governing and a Legislative Assembly would turn at least some parliamentarians into protectors of the citizens' liberties, a role British parliamentarians had fulfilled in the 18th century. To some extent, Hayek's Legislative Assembly could play the role of an independent Supreme Court (roughly as it does in the US). In large countries, the Legislative Assembly could also be constituted of members elected or appointed by regional entities.

f) Other controls of political opportunism, which are practiced in some jurisdictions around the world, are term limits for office holders, to ensure that political agents do not lose contact with the citizen-principals and do not get captured excessively by rent-seeking groups. In some jurisdictions, citizens can also exercise rights of recall and impeachment to constrain abuses in office. To the same end, provision can be made to indict politicians suspected of corruption before special tribunals.

g) Transparent information is needed about the conduct of collective action so that the electorate can judge whether office holders properly represent them. Such information is contained in annual budgets, public audits of the budget accounts, and the scrutiny of the conduct of office holders by a free press, academics, independent think tanks and other outside observers. Frequently, government officials manage to disguise relevant information to avoid scrutiny. Parliamentary privileges, limits on the freedom of information, defamation laws and other such devices are used to limit access to information about the collective actions of government. Care must therefore be taken that administrations do not erect such barriers to being scrutinised.

One way to promote transparency has been the recent proposal for governments to report not only flows of receipts and expenditures (the budget), but also its balance sheet of all independently assessed assets and liabilities. In other words, government has to reveal the same information that it demands of big corporations. This was successfully done in New Zealand with its *Fiscal Responsibility Act of 1994* (Kasper, 1996) and subsequently in Australia.

h) Agent opportunism in high office may also be controlled by rules of an over-riding, constitutional quality. Critics of parliamentary democracies have proposed constitutional rules that constrain "vote-seeking auctions" by parliamentarians (Hayek, 1960; Buchanan, 1987, 1988; Brennan-Buchanan, 1985; McKenzie, 1984). Such rules may take the form of procedural constraints, for example prescribing a two-thirds majority to raise taxes or authorise deficit finance. Strict limits can also be imposed on the government's claim on resources, for example by sunset clauses on specific government programmes and formal limits on the size of the budget (as a percentage of the national product) or rates of taxation. Another result-oriented limitation is to oblige the government to adjust income tax rates automatically by the rate of inflation (so as to prevent the insidious method of tax creep, which pushes many ordinary wage earners in Western countries into high-tax brackets).

Politicians of course reject formal limitations of parliaments on the basis of the doctrine that Westminster-style parliaments must remain sovereign, indeed that they cannot even bind themselves against future opportunism. However, a variation of Lord Acton's famous dictum applies: "Power corrupts, and absolute power corrupts parliaments absolutely!"

i) Another institutional control device is the citizen-initiated referendum (CIR) which allows citizens, when they observe what they deem abuses of their will, to throw out government measures they do not like (Walker, 1987). The experience with the CIR device in Switzerland shows that citizens hardly ever initiate more government activity. Normally they vote to reduce the ambit of collective action, defending their own autonomy. There is much to be said for stimulating direct, democratic citizen involvement in political decisions at the local level, even in developing countries. In today's world, as schools and libraries obtain computers, it seems possible—at least in middle income countries—to allow citizens to initiate referenda by electronic means and to express their preferences by computer.

j) Given the increasingly political role of some Supreme Courts, it seems appropriate to ask whether the appointment of judges should not be subject to new constitutional rules. One check might be the appointment of judges by confirmation in public hearings, for example before a high-level gremium representing the people. Another would be to alternate the right of candidate nomination between Federal and State governments. Yet another would be to introduce the possibility of repeal by the people. As long as judges concentrated on procedural justice and on keeping the legal system coherent and universal, such checks were not necessary. But many Supreme Courts and their equivalents have been shifting to reformist activism and have become subservient to elected or unelected governments.

k) Arguably the most powerful control of political and bureaucratic opportunism is openness: free trade, free capital mobility and migration. When citizens disagree with how the government taxes, regulates them and provides for them, some may vote with their feet and exit. They may relocate to other jurisdictions to invest their property, to spend their free time or even to reside permanently. In closed economies, government officials can only be controlled by the "voice option" (protest, agitation, elections etc.), but in open economies, some citizens also exercise the often more effective "exit option" (Hirschman, 1980). The exit challenge in early modern Europe paved the way for constitutional government, private property rights and the rule of law, as we saw (Chapter 1). Now, similar international strictures are constraining the power brokers of East Asia. These strictures are resented, but, ultimately, they are effective in controlling political power. When the power instincts of rulers are constrained by the exit option, they will sooner or later learn to offer rule-bound, limited government as a way to attract resources (foreign investment), often despite themselves (Kasper, 1999).

When international markets are courted for the sake of economic development, openness becomes the driving force to establish effective institutional constraints on official opportunism. When politicians can avoid inter-jurisdictional competition, economic growth tends to be slow and unemployment high. Cases such as Burma, post-1975 Vietnam and many closed economies in Africa demonstrate the point.

Many newly independent nations were driven by tribal instincts of political power and economic nationalism. They have cultivated inward-looking attitudes by tariff barriers, investment controls and animosity towards multinational companies. This has empowered government agents and organised interests. However, the commercial necessities of the new age of globalisation began to tip the balance to openness and constrained government. Institutional reform has quite often followed an inconsistent, erratic course over the past two decades. Instead of embracing openness pro-actively and shaping highly competitive institutions to improve international competitiveness, as was done in many East Asian countries, reformers often act only under duress and hope to stave off the "affront of globalisation" wherever possible. They relapse into politically opportune interventionism when they think they can get away with it.

l) Development aid has normally been proferred to a established priviligentsia of the top-down rulers; and conditions of aid through which foreign aid-givers insist on changing harmful institutions have rarely been obeyed or enforced. This is why an increasing number of observers see development aid as an enemy of institutional reform and a support of harmful statism, and consequently an obstacle to economic development (Bauer, 1972; Bauer, Kasper, Siwatibau, 1991). Attacking and refusing foreign aid therefore may well be a means of facilitating pro-market reforms and replacing discredited political elites by new political entrepreneurs.

Not all of these reforms are equally applicable to developing countries, such as India. Other kinds of reform may be necessary to overcome age-old discrimination according to religion, caste or regional origin, which originate not in external institutions, but in internal rules of society. Modernity and development will automatically help to overcome some of these private discriminations, because in a market economy, discrimination is costly and competition punishes discriminators. Others will require external rules and their consistent enforcement. We have nevertheless listed some of the methods now being discussed around the world because some of these methods may one day be useful to defend a free economy and democracy.

Like a mother's job, the fight for citizen-serving government is never quite done! No single device will ever suffice to control inherent agent opportunism in government. The problem can of course be contained at its root by leaving as little coordination as necessary in the hands of collective action (minimal government). The linchpin to all the controls of agent opportunism in public office listed above is openness to trade, travel, the flow of ideas, investment and enterprise. It is the rock on which good governance, reliable property rights and individual autonomy rest in the face of ever-present political temptations of rent seeking and rent creation. Openness invariably goes together with high incomes and income growth induces the control of opportunism in government and promotes the provision of good, citizen-friendly institutions (Kasper-Streit, 1998, ch. 12). The top 12 countries according to an Index of Trade Openness were compared in a recent study with the bottom 12 out of 123 countries. The average income in the former group was an astounding 7.2 times that of the latter, and the economic growth rate in the 1980s and 1990s was 2.55 among the most open, as compared to only 0.3% among the least open (Gwartney-Lawson, 2001, ch. 3).

A country's own chosen trade and investment policy is much more decisive to the living standards of the people than foreign aid or initial factor endowment. This verity has not yet sunk in fully in many developing countries. Once the people wake up to the challenges of the age of globalisation, they will have to think hard how to create attractive institutions, which empower them to beat the global competition. Then, they will have to consider reshaping and universalising the fundamental rules of economic cooperation. In other words, the constitution of capitalism will be high on the agenda.

Centre Knows Best—A Satire

"Centre always knows better. Centre has the overview, at least the belief in their overview, and the card index. Men of limitless zeal busy themselves against each other at the Centre; yet, they tap you on the shoulder and say: 'Dear friend, you cannot judge this properly from your position out there! We at Centre….'

Centre has one main concern: how to remain central. Heaven help a subordinate body that might dare to make a decision of its own! Whether the decision was reasonable or not, whether it was necessary or not, whether things were afire or not: Centre has to be consulted first! This is why it is the Centre! Otherwise it would not be the Centre, always remember that! Those on the outer can fend for themselves.

Centre is staffed not by the intelligent ones, but the clever ones. For those who work away at their own little tasks may well be intelligent—but they are not clever. If they were clever, they would shirk work, and to this end there is only one means: a proposal for reform. Reform proposals lead to the creation of new departments which Centre of course subordinates, coordinates and associates. . . . One fellow cuts the timber and 33 others stand around: they are the Centre!

Centre is an institution whose role it is to subvert signs of energy and initiative among the subordinates. Centre never has an idea, and the others are delegated to implement it. Centre is a trifle less infallible than the Pope, but looks a lot less splendid.

Ordinary, practical people therefore do not have an easy life. They grumble about the Centre, rip up all the directives and wipe their eyes with the bits. Afterwards, they may marry the daughter of the head honcho to advance and be coopted into the Centre. They advance and get into the card index. Once there, they clear their throats, straighten their ties and cufflinks and begin to rule: members of the anointed elite, filled with deep contempt for the ordinary, practical people, and in profound conflict with their colleagues at the Centre. They sit like spiders in their nets which others have built, hinder intelligent work, pass unintelligent directives and know everything best.

(My diagnosis applies also for kindergardens, newspapers, Union governments, Departments of Local Government, Industry Ministries and company headquarters. It is of course a jocular exaggeration, which does not at all apply to one organisation, namely yours!)

Kurt Tucholsky (1925).
German writer and social commentator (1890-1935)
[my translation]