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Comments on "Institutional Competition" by D.C. North

by

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Introduction

Douglass North has written a broad and thought-provoking paper on the nature of institutional change. (Perhaps any paper on such a subject is bound to be broad, but it is not bound to be thought-provoking, and we are indebted to Professor North for that.) Economic theory, known for its precise models and sharp propositions, struggles a bit in trying to cope with institutions and institutional change. In thinking about institutional change, we need to careful not to lose sight of basic issues, we need to range widely in considering alternative formulations, and we need to test our ideas against diverse experiences.) This is certainly an area in which we can benefit immensely from historical perspective, such as that provided in North's paper.

In my limited time, I would like to discuss intergovernmental competition, focussing especially although not exclusively on its fiscal aspects, in order to see where it may or may not fit into the analytical framework sketched by Professor North. It is especially interesting to consider intergovernmental competition since governments are major instruments of redistribution, which Professor North sees as a possible drag on economic performance. I will argue, at the end, that intergovernmental competition is to a significant degree a phenomenon that is being driven by more fundamental long-term economic forces, especially those that are contributing to the process of economic integration, not only in Western Europe but throughout the world – an argument that seems to fit well with the general Northian perspective.

I would like to organize my comments around three main sets of questions, all of which relate to the analytical framework set out by Professor North.

1. In Northian terms, are governments institutions or organizations? Does it matter, for analytical purposes?

2. Whether intergovernmental competition is institutional or organizational, how do we decide whether it is contributing to better or worse economic performance? North argues that the Netherlands and England were "success stories" in institutional competition. I will argue that defining winners or losers in the process of intergovernmental competition is quite a bit more involved than North's remarks suggest, in part because the process may entail changes in redistributive policies; by their nature, such changes creates both gainers and losers. I would also like to ask whether a nation is an appropriate unit of analysis in evaluating intergovernmental competition. There are many types of governments in existence, and both subnational and supranational structures can be found in practice. The process of intergovernmental competition itself may entail changes in governmental structure, redefinitions of citizenship, and movements of people among political units. It challenges our standard conceptions of "national economic welfare."

3. Is fiscal competition "typically incremental" and "path dependent"? What really lies behind recent concerns about fiscal competition and is there a "fiscal competition revolution," or will developments in this area "turn out over time to be far less revolutionary than ... initial rhetoric would suggest"?

Discussion

1. According to North, institutions are rules, regulations, norms, and their enforcement characteristics. By this standard, governments look like institutions. The GATT, NAFTA, and the EU all look like institutions, too. Organizations, by contrast, consist of groups of individuals with some common objectives. The residents of a particular locality, region, country, or group of countries might fit that description. Indeed, when economists model the ways that governments choose their tax, expenditure, and regulatory policies, it is common for them to postulate some sort of utility function or social welfare function which it is the purpose of the government to maximize. These objective functions often become crucial elements in a positive *behavioral theory* of government policymaking, that is, they are used predictively. They are also often used to make statements about the welfare properties of different equilibria. One encounters assertions such as "jurisdictions will choose low rates of taxation on mobile capital, limiting government expenditure on public goods and services. This is (a) good or (b) bad from the viewpoint of social welfare in the jurisdiction." In this type of analysis, governments become players in the game, not the rulemakers of the game, that is, organizations rather than institutions.[1]

If the study of institutions requires the "conceptual separation of institutions from organizations," (North, p. 2) then, how are we to regard governments? Perhaps more importantly, does it really matter? Perhaps we should regard governments as organizations for some purposes and as institutions for other purposes, and we should just choose the most convenient approach depending on the problem at hand. The economic concept of an "industry" has never been very precisely defined, but that has not hindered economists from using the concept productively in innumerable contexts. Still, it would helpful for Professor North to clarify further the distinctions between institutions and organizations so that we can see how to apply his ideas in particular concrete cases.

2. Sometimes competition among governments seems to produce good results, for instance by inducing governments to rationalize commercial law, establish useful product standards, and develop more coherent structures of taxation for individuals and businesses. Then again, sometimes governments impose regulations that transfer rents to favored industries or population groups, use control over product standards to serve protectionist interests, or build special loopholes into the tax law. When this happens, does it mean that there is insufficient intergovernmental competition, that the competition is dysfunctional, or simply that there has been a competition in which certain interests have won and other interests have lost?

Consider more specifically the fiscal interactions among governments. It is well-known that tax and transfer systems can differ widely among jurisdictions. For example, significant interjurisdictional differentials arise in the taxation of the returns to business investment due to differences not only in statutory tax rates but, often much more importantly, in the definition of taxable income, what North might think of as part of the rules of the game (depreciation rules, loss carryover provisions, inventory valuation procedures). When tax systems are unindexed or poorly indexed, as is normally the case, effective rates of

[1] The literature on intergovernmental competition is large and growing. See, for instance, a recent compendium of papers in the November, 1991 *Regional Science and Urban Economics* (vol. 21, no. 23) containing several examples of models of "governments as organizations."

taxation on capital income both at the household and corporate level are typically quite sensitive to rates of inflation and thus to monetary policy. For households, levels of and eligibility for benefits from public pensions, unemployment assistance, and health benefits vary substantially among countries and sometimes among lower levels of government as well.[2] There are obvious efficiency arguments that favor making effective fiscal treatment of firms and households more uniform. How can these differentials persist if governments compete? Or, should we conclude that these differentials are no larger than they are because governments do compete? To pose the issue in the European context, would it be a good idea for the EU to help different countries "harmonize" their fiscal systems, or should they go their separate ways – perhaps to arrive in the end with harmonized systems in any event, as though by the influence of an invisible hand?

This sort of issue is very contentious. Some would say that the EU provides precisely the right framework for coordination and and rationalization of fiscal systems. How can Europe compete effectively, for instance with the US, when it subjects its residents – or prospective residents – to a conflicting welter of murky, idiosyncratic tax laws, regulations, and social benefit programs? A more uniform and thus more transparent EU-wide fiscal system might reduce the opportunity for individual countries to exploit some of their residents for the benefit of others – that is, it might contribute to "evolutionary progress" (N., p. 4) by raising the pay-offs to "productive activity" while reducing those to "income redistribution."

But then again, one could argue that agglomerations of power, including fiscal authority, are generally anti-competitive. So-called "harmonization" of fiscal systems may just be a codeword for recentralization of power in an otherwise increasingly competitive world. Perhaps the real goal of harmonization is just to provide a way for the current winners in the competition for fiscal spoils to protect their privileged position. If so, fiscal harmonization might lead to a "declining competitive position" for the EU countries.

By way of comparison, we might ask whether the US economy would be more competitive if the Federal tax structure were eliminated altogether and replaced by 50 state tax structures with less uniformity of bases, enforcement, and rates. Indeed, perhaps the US economy – or, one should rather say, the people who reside in what is now called the US – would be better off if there were no central government at all, and just 50 or so state governments. We will never know, but practically speaking it seems likely that some people in the "disunited" 50 states might be much better off than they are currently, while others might be much worse off. Perhaps overall output levels would be higher. If so, would this mean that "the economy" of the region is more successful in some relevant sense? Would we even wish to ask this question, any more than we now ask about economic performance in North America as a whole, or in the western hemisphere? Perhaps we would simply look at North America the way that Professor North looks at early modern Europe, with its "lack of large scale political and economic order that created the essential environment hospitable to political/economic development." (N., p. 10) Perhaps some states would "work" and others would "fail." However, there are definite economic benefits from the freer movement of goods and factors of production that the US has provided to its "member states," and

[2] For comparisons of effective tax rates on capital in Europe, see Tanzi and Bovenberg (1990) and, for general discussion of tax competition and further references, Deveruex (1994). Fiscal differentials in labor markets have not been studied so thoroughly as yet; Peterson and Rom (1990) discuss interstate variations in welfare benefits among US states and Wildasin (1994b) discusses intra-EU differentials in public pension programs. The largest potential fiscal differentials in European labor markets arise between the EU and the non-EU countries.

it might have been difficult to realize those benefits other than through a unified political structure. It would probably be fair to claim that the central government has been a focus of some redistributive activities which would not otherwise have taken place. One may favor or oppose this redistribution. Even if one is generally unsympathetic with it, however, it is not clear that much more governmental decentralization would have given better results, in some overall sense, than the mixture of centralization and decentralization that has emerged in the US federal structure. (One objective of an upcoming conference at Vanderbilt on "Fiscal Aspects of Evolving Federations" will be to learn more about the benefits and costs of the centralization and decentralization of government.)

One notion that currently intrigues me is the possibility that liberalization of markets, for example through economic integration and reduction of barriers to factor mobility, provides an opportunity for spatial arbitrage and thus for *productivity enhancing* reductions in inequality. In the US case, the freedom of blacks to move from the rural South to the urban North raised income levels for some of the poorest members of society – though, the complexities of economic life being what they are – it may also have increased economic inequality within both the black and the white populations.[3] Going slightly further back in time, there is evidence to suggest (O'Rourke *et al.*, 1993) that nineteenth-century factor migration from the Old World to the New contributed to equalization of factor prices and presumably to an improvement in the economic circumstances of lower-income members of European society, in addition to its undoubted contributions to economic efficiency.

In the current European context, increased labor and capital mobility may lead both to efficiency gains and, from a European-wide perspective, to reductions in inequality. This could be problematic from the viewpoint of workers in high-wage countries, however, since their net incomes may decline as a result of such migration. They are unlikely to draw comfort from the fact that overall output may increase in the process. Their losses might in principle be compensated by government redistributive transfers. But programs of redistributive transfers may be undermined precisely by the greater mobility of factors that contributes to intergovernmental fiscal competition in the first place. Will economic integration lead to fiscal competition that destroys the welfare state? If so, exactly how and why (and when) will this occur? And, if it does occur, will it be a "good thing" or a "bad thing", and for whom? This process of competition, whether we describe it as competition of institutions or of organizations, has very complex ramifications, and it does not appear to lend itself to easy generalizations about "success" or "failure," as discussed in recent literature (see, e.g., Wildasin, 1991, 1992, 1994a, and references therein).

3. I am convinced that Professor North is right in stressing the incremental and path-dependent nature of many sorts of institutional change. As economic historians are likely to appreciate much better than the rest of us, major economic developments can often be traced more to long-term population and technological change than to the brilliance or stupidity of decisions made by economic policymakers.[4] I suspect that future historians will look back

[3] See Margo (1990). It is noteworthy that many public-sector policies during this period were inequality-preserving, not inequality-reducing; they also imposed significant efficiency losses. A similar situation exists in South Africa, where state efforts to enforce inequality have led to serious economic inefficiencies.

[4] It is easy to lose sight of fundamental forces in the midst of the sound and fury of political controversy. A wise economist once had this to say about becoming involved in policy: "It can be interesting to work in Washington. The problem is that after you are there for a while you begin to believe that what you are doing is really important."

at the large structural changes of our time – the collapse of the Soviet Union, the failure of the planned economies, the development of the European community – and attribute them, much more than we do today, to underlying changes in technology. The technology for transportation, communication, and dissemination of goods, factors, production technique, organizational forms, and commercial practice has improved dramatically. As a broad generalization, these technological improvements seem substantially to have raised the gains from greater openness of markets both within and among countries, and thus to a higher level of economic integration.

The tale of economic integration can of course be told, and much more dramatically, in terms of the Single European Act, the Maastricht summit, and the arm-twisting in Congress that led to the ratification of the NAFTA. These events are indeed noteworthy and personalities and politics play their part. But it is possible to confuse cause and effect. NAFTA and the development of the EC/EU can be viewed not as the *cause* of economic integration but rather as a *symptom* of economic integration. We could argue that increased economic integration, driven at least partly by technological progress, has been changing the economic environment within which government policy is formulated. The political actions that we associate with this process can be viewed as the institutional (or organizational) ratification of more fundamental economic forces.

It makes sense that issues of intergovernmental fiscal competition should attract more attention in an increasingly integrated economic environment. It might be useful, though difficult, for research in this area to devote more explicit attention to technological change, since this seems to be crucial for the phenomenon under investigation. In partial disagreement with Professor North, I do not think that neoclassical theory implies that all change must be instantaneous. It *can*, in principle, be used to model institutional change which, I do agree, tends to be incremental and path dependent. All (!) that we need to do is less comparative statics and more comparative dynamics. This of course is easier said than done.

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