1 Institutional Competition: An Orientative Framework*
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In economics, it is generally agreed that competition discloses knowledge, enhances efficiency and restrains power. It is also generally accepted that one main reason for the evolution of modern states has been that certain goods, due to their non-exclusive character, are not supplied by markets – for example, legislation and social services. It seems to follow logically that the state is forced to be in a monopoly position precisely because no one else is prepared to provide these goods. Unfortunately a monopolistic setting not only lacks a device that may serve as a discovery procedure for knowledge, but it also entails the dangers of inefficient provision of goods and a concentration of power that may eventually lead to a Hobbesian Leviathan. Therefore a predicament seems inevitable.

However, even though governments are monopoly-like organizations, which are not exposed to competition within the state, states do compete and always have competed with each other. In recent years, the argument has arisen that competition among states, just as competition within economic markets, may serve as a procedure of disclosing knowledge, inducing an efficient supply of public goods and limiting the power of government, thus compensating for the lack of competition within the state.

Public goods which are supplied by the state consist to a large extent of designed rules. In line with Institutional Economics, another term for rules is institutions. In so far as states compete with each other through designed rules, one may therefore speak of competition by legislation or of institutional competition. As in democratic constitutional states single actions, such as police operations and payments of social benefits or of subsidies, are generally based on a formal law, even in these cases legislation is essential. From this perspective, what is decisive for the competitive process is not the single action but the design of the underlying law. Therefore this paper will concentrate on competition by the design of law, that is institutional competition, viewing competition by single actions as a subordinate consequence of competition by legislative activities.

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This paper will focus on competition among states. However, not only states but also other social entities may be exposed to some institutional competition. Therefore the concept of institutional competition in principle is not restrained to competition among states. In section 1, a concept of institutional competition for social groups in general is derived. Section 2 analyzes how institutional competition among states may come about and discusses economic policies that are commonly used in the competitive process. In section 3, vertical structures of states are incorporated into the model, and the impact of the formation of international trade associations on institutional competition is discussed. Section 4 relates competition among states to competition in economic markets and critically discusses the application of the neoclassical market model to institutional competition. Section 5 finally points to specific problems of a normative evaluation of economic policies when institutional competition is taken into consideration.

1 A GENERAL CONCEPT OF INSTITUTIONAL COMPETITION

In this chapter, section 1.1 discusses the fundamental question of how different types of rules come about and how they relate to different kinds of social orders. In section 1.2, concepts of competition are briefly discussed. Section 1.3 compares types of competitive actions, focusing on institutional competition. Finally, in section 1.4, institutional competition is related to the evolutionary process of rule selection.

1.1 Types of Rules and Their Formation

Institutions are rules that constrain actions of individuals and thus channel them into specific directions (North, 1990, pp. 3-4; see also Veblen, 1919, p. 225; North, 1989, pp. 238-40; Furubotn and Richter, 1991, pp. 2f). Rules form because individuals in social interaction aim at reducing complexity and uncertainty caused by their limited ability to gather information (Heiner, 1983) or at lowering transaction costs (Williamson, 1975, 1985). Social groups are characterized by systems of such rules. They coordinate in one way or another the actions of the individual members of the group and thus produce a certain social order as defined by Hayek (1973, p. 36), that is also called order of actions (for example 1967, p. 66, 1973, p. 67). Hayek distinguishes between two types of orders: organizations and spontaneous orders (1969, pp. 34-7, 1973, pp. 36-8).