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Polycentric Democracy and Its Enemies

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Democracy: one or two spontaneous orders?

The theory of spontaneous orders is most often associated with the work of Friedrich Hayek, and therefore with the market in its catallactic sense. But there are many more instances of spontaneous or emergent orders, including democracy as a way of reconciling conflicts regarding the funding and organization of various jointly consumed goods (diZerega 1989). Like markets, democracies do not have any intrinsic goals, yet operate in an orderly and predictable fashion. Also like markets, it is as difficult to predict specific quantitative outcomes as it is straightforward to predict qualitative tendencies. And the "producers" in a democracy gauge their performance by assessing vote tallies in a way that resembles the way profit-seeking firms assess their performance with the help of revenue and cost flows.

A single democracy does however have certain systemic weaknesses that one does not encounter in the catallaxy. The signaling of voter preferences is vague, bundled, and undifferentiated (Andersson 2010). For a rational voter, it does not pay off to be informed about the available political options, since the expected impact of a single vote is approximately equal to zero. The key actors are instead small well-organized groups that offer democratic producers (politicians) financial and other support in exchange for policies that favor the groups in question.

The most likely outcome is a set of policies where each constituent policy combines the characteristics of concentrated benefits and dispersed costs (Olson 1965)[1]. In the aggregate, the bundle of policies that benefit various small groups may become quite costly. The total policy package may even constitute a net loss to rent-seeking groups that benefit from one or more (individual) redistributive policies. According to Mancur Olson (1982), stable and durable democracies can be expected to produce an ever-increasing number of successful rent-seeking groups (“distributional coalitions”), with economic decline as the long-run consequence.

The overall performance of some democracies—particularly in North America and northwestern Europe—suggests that the political process is not necessarily as cataclysmic as Olson’s theory would suggest. While coalitions of farmers, physicians, or workers may sometimes have succeeded in their efforts to extract rents at the expense of consumers and potential entrepreneurs, these successes have only occasionally resulted in the predicted “arteriosclerosis” of democracies (such as in Argentina or India after World War II). And yet I would argue that public-choice economists have correctly identified the systemic tendencies that have enabled them to make these pessimistic pattern predictions.

The discrepancy between the public-choice model of democracy and its real-world counterpart is due to the fact that real-world—as opposed to fictional—democracies do not operate in isolation from one another. Interest groups seek to influence politicians and citizens vote, but those are not the only signaling devices that influence political decision-making. As Albert Hirschmann (1970) notes, one can signal one’s preferences by voice—by voting in elections or by expressing one’s opinions in other ways—or by exiting a jurisdiction or organization that is perceived as offering an insufficiently attractive bundle of services. However, people’s choices are affected by their loyalty to the entity in question (ibid.). Thus, a reasonable hypothesis is that the exit option becomes more popular if a jurisdiction is seen primarily as a provider of collective goods rather than as the symbolic manifestation of bonds of loyalty. Patriotism is thus bad news for the exit option. It weakens a higher-level spontaneous order that I like to call polycentric democracy. This higher-level spontaneous order can thus be assumed to be more effective when the residents of the constituent lower-level democracies do not have strong jurisdiction-specific attachments; a high level of household mobility is thus good for polycentric democracy.

In a polycentric democracy, individuals signal their dissatisfaction by relocating themselves or their movable assets to jurisdictions that offer more attractive conditions. Jurisdiction-specific accumulations of people and capital thus become a systemic resource that plays the same role in this order that votes play within each “monocentric” democratic order. There is therefore a limit to how far politicians are prepared to accommodate the demands of interest groups, no matter how attractive their inducements may seem on a case-by-case basis.

This insight is not new. Already in 1923, Max Weber wrote that "the competitive struggle [among states] created the largest opportunities for modern western capitalism. The separate states had to compete for mobile capital, which dictated to them the conditions under which it would assist them to power" (Weber, 1923/1961: 249). While Weber's observation does not require the presence of multiple democracies, it does require multiple jurisdictions and mobile capital.

The economic historian Eric Jones (1981) explains the superior performance of Europe over the past millennium—as compared with the rest of the world—using an argument that resembles Weber's:

> [H]ow did Europeans escape crippling exploitation by their rulers? … The rulers of the relatively small European states learned that by supplying the services of order and adjudication they could attract and retain the most and best-paying constituents … European kings were never as absolute as they wished. The power dispersed among the great proprietors was a check on them, as was the rising power of the market. (Jones 1981: 233; quoted in Vaubel 2008: 50)

While the rulers of authoritarian states may have a greater wish to exploit their subjects than democratically elected governments, it is still the case that citizens can escape the exploitation of governments beholden to interest groups to the extent that they are willing and able to move elsewhere.

It is instructive to note that successful distributional coalitions were especially influential in post-war Australia, Britain, and New Zealand (three of the world's most durable and stable democracies), and that as a result the three economies had nearly ground to a halt by the 1970s (Olson 1982). Faced with brain drains and capital flight, the three governments deregulated their market institutions in the 1980s. This was as true of the Labor governments of Australia and New Zealand as of Britain's Conservative government. Faced with an even more interlinked world in the 1990s, their successors in government (center-left in Britain and center-right in Australia and New Zealand) by and large continued policies that were designed to attract rather than repel capital and skilled labor.

What is important to note, however, is that transaction costs associated with relocation matter. The relative success of protectionist and subsidy-seeking groups in post-war Britain, Australia, and New Zealand was facilitated by the high costs associated with exercising the exit option. Both Britain and New Zealand are unitary and centralized nation states. Although Australia is a federation, there are only six states, each of which has less fiscal and regulatory autonomy than American states or Canadian provinces.

Polycentric democracy works most effectively when exit-related transaction costs are low and when the number of viable options is large. The closest approximations of a genuine polycentric democracy are the 50 American states and the 26 Swiss cantons[2]. In both cases there is considerable policy independence at the regional and local levels of government. It is also possible for mobile individuals and firms to combine similar informal institutions (e.g. the English language, business customs) with dissimilar formal laws and regulations.

Voting with one's feet in a polycentric democracy

The most extensively analyzed example of polycentric democracy is the United States. America is a particularly suitable laboratory of polycentric democracy not only because states have relatively high levels of institutional independence, but also because the American population is unusually mobile. Borjas, Bronars and Trejo (1990) show that ten percent of the American population moves between states in any five-year period, and that 40 percent of the population live in another state than they did when they were 14 years of age. The implication is that interstate migration was at least five times more common in the United States in the 1980s than cross-border migration in the European Union in 1999 (Katseli 2004).

Using neoclassical assumptions of perfect information and perfect mobility, Tiebout (1956) proposes that by voting with one's feet, an individual will choose the location that he or she considers most attractive. Most studies in the tradition of Tiebout focus on a utility-maximizing individual who makes migration decisions according to criteria such as "wage differentials, job opportunities, unemployment rates, local public spending and its mix, and location-specific amenities" (Greenwood 1997: 649).

Many of the factors that influence migration decisions are either formal institutions or economic conditions (for example unemployment rates or entrepreneurial opportunities) that are ultimately influenced by institutions. Individuals may seek low taxes and deregulated markets (Cebula and Alexander 2006) or better-than-average public services (Tiebout 1956).
Greenwood (1997) draws attention to the ways in which location-specific attributes influence migration flows and how government agencies attempt to influence migration patterns. The ways in which they might do this include tax incentives (or disincentives) and extensions (or limits) to an individual's economic or personal freedom.

If public choice theories about the behavior of rent-seeking distributional coalitions are valid, we should expect jurisdictions with less rent-seeking activity to be more successful in attracting inflows of people and capital, other things being equal. This would imply that jurisdictions with more economic and personal freedom, as conventionally defined, should disproportionately benefit from the exercise of the exit option by individuals.

There are a number of studies that support the notion that there is a negative association between "net in-migration" and state government size or scope. Cebula and Alexander (2006) find that income tax as a percentage of personal income, per capita death taxes, and per capita gift taxes are negatively associated with interstate net in-migration. Duncombe, Robbins, and Wolf (2005) report similar findings, while Clark and Hunter (1992) find that in-migration is a negative function of the inheritance tax rate.

Cebula and Alexander (2006) also find, however, that increased local government spending on education on a per-student basis is positively correlated with net interstate in-migration. That finding alludes to the qualification that some types of government intervention may be desirable. It is the nature and extent of the intervention that really matters. The least controversial function of government is that of protection; linked to this is a well-functioning legal system which upholds liberty and protects property rights. Slightly more ambiguous is the productive function of government; infrastructure investments have been shown to be positively associated with regional growth rates (Agénor 2008), and public investments in education have also been linked to economic growth (Lucas 1988; Agénor 2011). However, such investments inevitably involve substantial tax-funded expenditures, and may end up being misspent on unnecessary infrastructure or crowding out more innovative or less bureaucratic private education systems.

What is clear, however, is that government programs that have been initiated by rent-seeking groups—typically with concentrated benefits and dispersed costs—should repel potential in-migrants. The reason for this is that such programs benefit jurisdiction-specific insiders at the expense of all others. Targeted subsidies, occupational licensing schemes, protectionist barriers, and closed-shop or union-shop regulations are examples of successful rent-seeking legislation that protect established interests at the expense of new entrants. The expected systemic effect of such regulations is a net loss of entrepreneurial dynamism within the affected jurisdiction.

Constitutions and organizations

While single and polycentric democracies are spontaneous orders, their governments and bureaucracies are not. Individual governments, governmental organizations, and political parties are analogous to firms, business associations, and trade unions in the market order. They are all instrumental organizations that pursue goals that may be mutually contradictory. At the same time, instrumental organizations are influenced by the shared institutions of the particular spontaneous order that structures their interactions with one another as well as with potential consumers of the bundles of consumption attributes (see Andersson 2008) that they offer in exchange for money or political support.

The key difference between a market and a democracy is that whereas the former depends on unanimous agreement, democratic decision-making always involves some type of majority rule. While a unanimity rule is inherently more attractive since it is associated with universal ex ante gains from trade, James Buchanan and Gordon Tullock (1962) explain that transaction-cost considerations sometimes render non-unanimous decision rules attractive to the affected individuals. The clinching factor is whether the future flow of desirable collective decisions offsets the flow of undesirable collective decisions from the subjective point of view of each individual. If the benefits from the expected desirable decisions are greater than the expected costs, an individual can be expected to enter or remain in a jurisdiction (in this context it should be noted that the costs are the opportunity costs of the policy bundles associated with other competing jurisdictions within the relevant polycentric democracy).

The explicit or tacit acceptance of jurisdiction-specific constitutional rules is frequently analyzed as an all-or-nothing proposition. But in a world of multiple jurisdictions, there is the possibility of choosing the constitution that offers the greatest expected net benefits among a finite set of constitutions. This is particularly important in view of the two risks that rules that require less than unanimity impose on citizens: "first, the risk that the representatives' agents to whom the citizens delegate decision-making power misuse the authority granted to them to serve their own interests and, second, the risk that the political process is misused by subgroups within the citizenry to advance their own special interests at the expense of other members of the polity" (Vanberg 2008: 116).

These risks are exactly the risks that figure so prominently in public choice theory. And they are also the main risks that should make potential citizens wary of joining any democracy that does not offer a low-cost exit option. But the implications of polycentric democracy extend even further than this; it implies that footloose people and capital indirectly serve the interests of even the most stationary citizens of democratic polities. Mobile people and capital serve democracy by making it more difficult for political agents to cater to special interests rather than the general interest.

A common criticism of interjurisdictional institutional competition is that it leads to "a race to the bottom," as mobile capital relocates to the least regulated jurisdictions with the lowest labor cost. This critique is especially common among environmentalist and other left-wing politicians. As Viktor Vanberg (2008) rightly notes, the validity of this argument against institutional competition rests on an unstated assumption that governments exclusively impose burdens on jurisdiction-users; they never provide any valuable services (which, ironically, is more in tune with anarcho-capitalist assumptions than with environmentalism or socialism). In a particularly apt analogy, Vanberg (2008: 121) compares this assumption to an assumption that "people choose the restaurant they visit for dinner only in light of the prices they find on the menu, disregarding the quality of the food and the décor of the place."

In fact, it is the least innovative (and therefore the least attractive) industries that tend to look for jurisdictions with the lowest labor costs and least environmental regulations, with little attention to other jurisdictional details. For high-tech and other innovative industries, the choice of jurisdiction is much more likely to be based on a comparison of benefits—such as infrastructural quality, agglomeration economies and general "quality of place"—with costs in the form of taxes and regulations (Florida 2002). A jurisdiction remains competitive as long as the benefits it offers outweigh any losses due to rent-extracting legislation. The existence of mobile capital and labor dampens the intrinsic tendency of democracies to increase wealth-reducing legislation at the behest of various interest groups.

The role of agglomeration economies in institutional competition

It is not only low taxes and protected property rights that attract people or firms to jurisdictions. And other factors are not limited to natural features such as a mild climate or natural beauty. Perhaps most important is a set of factors that together constitute agglomeration economies, or the various benefits that arise from co-locating individuals and firms in the same city or region. While the affected areas almost never coincide with the spatial extent of jurisdictions, they nevertheless influence the competitiveness of regions that belong to one or more jurisdictions. As an example, the agglomeration economies associated with the New York metropolitan area affect parts of four states, but the institutional attributes of New York only affect the part of the metropolitan area that is located within that state. Another consequence is that New York's unusually onerous taxes and regulations (Ruger and Sorens 2011) will be perceived as more burdensome in other areas of the state than New York City.

Economists with an interest in regional development stress agglomeration economies as an important source of competitiveness. In the early 20th century, Alfred Marshall stressed the importance of idea creation as well as the benefits that firms involved in similar activities gain from locating in close proximity to one another (Marshall 1920). Such benefits include the transmission of tacit knowledge and the reduction of various transaction costs associated with the production and distribution of goods. Jane Jacobs later extended economists' understanding of agglomeration economies by examining the beneficial effects of local economic diversity on creativity and innovation (Jacobs 1961; 1969).

In the past, it was often assumed that the migration decisions of households were determined by the location of desired jobs. Richard Florida (2002), however, argues that there is more to an individual's choice of location than expected employment prospects. Individuals—especially those who are unusually creative or innovative—are attracted to what Florida terms "Creative Centers." Traditional pull factors such as tax breaks and an abundance of sports franchises and shopping malls are not necessarily as attractive as "abundant high-quality amenities and experiences, an openness to diversity of all kinds, and above all else the opportunity to validate their identity as creative people" (Florida 2002: 218).

In *The World is Flat*, Thomas Friedman (2005) argues that one of the effects of globalization is that the importance of location has lessened. Many popular commentators have made this assertion but Florida, along with most regional economists and economic geographers, disagrees. In "The World is Spiky," Florida (2005) reasserts his belief in the importance of location, paying particular attention to the geography of patents. Patents require invention and innovation and the vast majority of patents originate in just a few of the world's major urban centers. The continuing growth of large metropolitan areas stems from the knowledge externalities that are created when people co-locate, and these agglomeration economies should therefore be one of the key factors that account for the movement of both people and capital.

Agglomeration economies are thus a worldwide phenomenon. Florida (2002) argues that the main reason for their existence is neither to reduce transportation costs, nor is it to increase the static efficiency of doing business. The main reason is the local abundance of well-educated and creative individuals. This is a notion that has come to be known as the human capital theory of regional development. If human capital theory holds, it tells us that economic development will mostly occur in unusually educated and creative regions. However, it does not necessarily explain why highly skilled or creative people choose to co-locate in certain places.

Florida (2002) asserts that individuals choose a location based on both economic and lifestyle factors and his "Creative Capital Theory" states that the location choices of creative people drive economic development. First, a distinction is made between human capital in general and a more creative or entrepreneurial type of human capital that Florida terms "creative capital." Second, the theory proposes a number of factors that creative people take into account when choosing a location. Thick labor markets, social interaction opportunities, diversity, and authenticity are all seen as key factors.

In order to measure the creative "pull" of American cities and states, Florida (2002) introduces a "Creativity Index." This index uses the so-called "3 T's" of economic development, where the 3 T's refer to measures of talent, technology, and tolerance. Talent is measured as the proportion of the population with creative occupations and the proportion having at least a bachelor's degree. The technology measure reflects scores on the Milken Institute Techpole Index and the number of patents per capita. Tolerance, finally, is a composite measure that includes the prevalence of same-sex couples, the proportion of the workforce in artistic ("bohemian") occupations, and the proportion of the population that was born outside the United States.

If Florida's theory holds, we should expect—ceteris paribus—those states that score high on the creativity index to be most successful in attracting in-migrants, especially highly skilled and creative in-migrants. The Creativity Index for states tends to reflect the degree of urbanization, since patents are spiky and the returns to human capital tend to be greater in urban locations.

I have previously hypothesized that jurisdictions that are less afflicted by political rent extraction should be more attractive to mobile people and capital. In this section, the hypothesis is that many of the most productive people are attracted by agglomeration economies. The states with the least rent-seeking are however not necessarily the same as the states with the most agglomeration economies. While favorable institutions facilitate the gradual accumulation of agglomeration economies, the process is both slow and path-dependent (Holcombe forthcoming). The massive agglomeration economies that are present in locations such as Manhattan or Silicon Valley therefore reflect favorable institutions at an earlier stage of its development. Above-average agglomeration economies have two main features—they are difficult to reverse and they allow governments to pursue more value-destructive policies than is feasible in inaccessible and sparsely populated locations.

As it happens, there is a negative correlation between the state freedom index as calculated by the Mercatus Center at George Mason University and the state creativity index as calculated by Richard Florida's group at the University of Toronto. Fortunately, the negative correlation is not perfect. While New York combines high creativity with low economic freedom and South Dakota combines low creativity with high economic freedom, it is also possible to observe other combinations, as in Colorado (high creativity and freedom) or Louisiana (low creativity and freedom). The key question therefore becomes whether accumulated agglomeration economies or current institutional quality is most important in deciding a jurisdiction's current attractiveness to human and material capital.

Institutional quality vs. agglomeration economies: what matters most?

Andersson and Taylor (forthcoming) analyze the relative importance of institutional quality and agglomeration economies by comparing the effects of state scores on freedom and creativity indices on net domestic in-migration in the 2005 to 2007 period. They look at four different migration flows: total migration (all ages), total migration among individuals aged 22 to 39, migration among individuals aged 22 to 39 with a bachelor's degree, and migration among individuals aged 22 to 39 with an advanced degree.

American and international experience tells us that migration decisions are not uniformly distributed over the life cycle. Most interstate and international migration takes place in conjunction with three distinct events: the start of a college education, the first full-time job, and upon retirement. This in effect implies that people are more likely to relocate in their late teens, in their twenties, and in their sixties. Family formation and the accumulation of local social capital implies much greater transaction costs associated with leaving one's labor market area at other ages.

Andersson and Taylor (forthcoming) propose the hypothesis that lower taxes and fewer regulations should be especially attractive to people with low-to-moderate levels of education as well as to retirees. The rationale behind this hypothesis is that entrepreneurial opportunities and the availability of low-wage jobs are negatively associated with increases in taxes and regulatory burdens. These groups of migrants can also be expected to be less attracted than highly educated migrants by the type of agglomeration economies that Florida's creativity index measure, since agglomeration economies are associated with higher costs of housing and recreational services.

The results of Andersson's and Taylor's study (ibid.) conform to their pattern predictions. Table 1 shows that while low taxes and light regulations are important pull factors to the population of migrants as a whole, the importance of these factors decrease with the level of education of the migrants. The table also shows that while relative agglomeration economies (as approximated by the creativity index) do not influence general migration flows, they are very important to young migrants with a college education. Another interesting tendency is related to the scope of institutional features that seem to influence migrants. People in general are most attracted to states that—other things being equal—not only offer low taxes and few regulations of labor and business, but also avoid imposing paternalist policies such as high alcohol taxes, gambling bans, strict gun laws or non-recognition of same-sex couples. For the average young migrant with the highest level of education, the only institutional feature that still matters—if it matters at all—is the fiscal policy of state and local governments.

For state governments the conclusions are clear. High taxes, onerous business and labor regulations and other institutional features that for the most part reflect past rent-seeking activities repel some migrants that the state could otherwise expect to attract. But the most educated migrants are—on average—much more concerned with the extent of human capital, technology, and diversity that is available in the state. The caveat is that this may only apply within the range of institutional variability that the fifty states represent. It is possible that higher taxes and more burdensome regulations than is imposed by the most interventionist state would repel many of even the most highly educated migrants. In this context, it is important to remember that the process of institutional competition can be expected to inhibit some government interventions that would be more likely to be forthcoming in a less competitive environment; even New York may be considered laissez faire if it is compared with most jurisdictions outside the United States.

Within the United States, there were three states that outshone the rest by offering tax and regulatory burdens that were much lighter than the American average in the 2005 to 2007 period: New Hampshire, Colorado, and South Dakota (Sorens and Ruger 2009). At the other end of the institutional range, New York was by far the most regulated and heavily taxed state, with New Jersey and Rhode Island following at a considerable "institutional distance." Table 2 illustrates the migration patterns by looking explicitly at these six states.

The picture that emerges is that those states that combine a high freedom score with a high creativity score gain population in all demographic categories, with Colorado as an obvious example. By contrast, New York was a net exporter of people in the 2005 to 2007 period, except that it gained a small addition to its young college-educated population. Note, however, that the corresponding gains were much greater in New Jersey, which had much better (although still substandard) institutions. New Jersey is an interesting case because it is a feasible jurisdictional option for people with jobs in New York City.

Table 1: Net domestic in-migration as a share of state population, 2005-2007

Explanatory variables	**Total migration**		**Ages 22-39**		**Ages 22-39 with BA/BS**		**Ages 22-39 with advanced degree**	
	b	*t*-value	b	*t*-value	b	*t*-value	b	*t*-value
Constant	3.48		4.55		.49		-.97	
	Institutional quality							
Economic freedom (Fraser Institute)							.13	1.54
Economic freedom (Mercatus Center)			6.21	3.70**	.96	1.81*		
Overall freedom (Mercatus Center)	4.02	3.96**						
	Agglomeration economies							
State Creativity Index (R. Florida)	.52	.40	6.50	3.69**	2.40	4.29**	1.25	5.01**
	Control variables							
Heating degree days (largest city)	-.0008	-3.86**	-.001	-4.98**	-.0004	-4.45**	-.00009	-2.04*
Homicide rate (largest city)	-.06	-2.88**	-.08	-2.93**	-.01	-1.37	-.004	-.99
Alaska or Hawaii (dummy variable)	-5.91	-4.49**	-2.41	-1.30	-.58	-.98	.41	1.49
	Coefficient of determination (R^2)							
	.561		.543		.492		.428	
	Number of observations							
	50		50		50		50	

Source: Andersson and Taylor (forthcoming); *p<.05,**p<.01 (one-tailed)

Table 2: Net domestic in-migration 2005-2007 as a percentage of the 2005 population, states with the three highest and three lowest Mercatus Center Overall Freedom Index (OFI) scores

OFI rank	State	OFI score	Total migration	Ages 22-39	Ages 22-39 (BA/BS degree)	Ages 22-39 (advanced degree)	State Creativity Index: rank
1	**New Hampshire**	0.432	.6	.28	.03	.03	20
2	**Colorado**	0.421	1.3	.66	.19	.11	6
3	**South Dakota**	0.392	.5	.27	-.04	.05	47
48	**Rhode Island**	-0.430	-1.6	-.19	-.08	.03	14
49	**New Jersey**	-0.457	-1.9	.30	.13	.09	11
50	**New York**	-0.784	-3.4	-.70	.02	.03	3

Sources: Sorens and Ruger (2009); Stolarick (2011); The Pew Research Center; The Center for Higher Education Management Systems

The democratic system constraint

All spontaneous orders rely on an order-specific system constraint to guide their evolution over time. This concept was first introduced by Langlois and Koppl (1991) in order to explicate individual behavior in markets. In the neoclassical model of perfect competition, the system constraint exhibits maximum tightness, since individual firms must adopt given prices and efficient production technologies. In Austrian and evolutionary accounts of the market process, the relevant system constraint is much looser. With imperfect knowledge and the possibility of entrepreneurial profits, it is possible to have many different viable choices. The system constraint that firms face is then merely the attainment of sufficient long-run fitness; only strategies that yield persistent losses force firms to sooner or later exit the market. The implication is that real-world entrepreneurial markets present participants with a variety of viable choices and therefore market action is properly understood as a specific type of system-constrained discretion.

In a hypothetical democracy where its citizens cannot exercise an exit option, the system constraint is even less demanding. The viability of a governing party (or coalition) depends on its ability to offer a bundle of policies that appeals more to the median voter than that of the opposition. The implication is that the successful policy package may not be very attractive to anyone, although it will never be what the majority considers to be the worst imaginable package.

In a polycentric democracy, the system constraint is more severe. Competitive pressures are not limited to the periodic challenge of defeating the political opposition. They also include competing jurisdictions that potentially vie for the same human capital, consumption spending, and entrepreneurial investments.

Increases in the mobility of people, goods, and capital have the effect of tightening the system constraint, since substandard institutions are then more likely to lead to a reduced tax base. Interstate or international agreements that allow people, goods, or capital to flow freely thus have the predictable effect of making it more difficult to introduce value-destructive institutions, such as those initiated by rent-seeking distributional coalitions.

But the system constraint is not equally binding on all governments in a polycentric democracy, as the example of New York illustrates. Substantial agglomeration economies—mainly in the shape of local knowledge externalities and good inter-regional accessibility—offer opportunities for political opportunism beyond the minimum experienced by jurisdictions with the least favorable initial conditions. These least favored—and therefore most constrained—jurisdictions tend to be remote, sparsely populated, cold, and lacking in valuable natural resources. In other words, they tend to be like South Dakota.

But this does not mean that states or cities that benefit from the agglomeration economies that past institutions have made possible are insured against economic decline. Holcombe (forthcoming) notes that Detroit has been afflicted with long-term decline as the predictable consequence of successful rent-seeking by corporations and labor unions in its car manufacturing cluster. Likewise, California's burdensome state and local institutions have prompted some high-tech firms to relocate to creative centers with more competitive institutions, such as Austin, Texas. In the long term, institutional vicious cycles such as those experienced by Detroit and (to a lesser extent and much later) by Silicon Valley should prove to be self-correcting in a vigorous polycentric democracy, since persistent losses of people and capital sooner or later leaves a jurisdiction with insufficient taxable resources for privately profitable rent-seeking.

Conclusion: decentralization as the antidote to rent-seeking

One of the intrinsic features of democracy is persistent rent-seeking by distributional coalitions. This was the great theoretical discovery by public choice economists such as Mancur Olson, James Buchanan, and Gordon Tullock. But there are also limits to rent-seeking, owing to the existence of an exit options for jurisdictional consumers such as entrepreneurs, capitalists, and workers. With decreasing space-bridging costs and lower institutional barriers to the mobility of resources, these limits are becoming increasingly obvious to politicians at all governmental levels.

The implication is that the exit option, which is the system constraint of polycentric democracy, imposes more checks on abuses of power the more decentralized a government is. Greater decentralization leads to more jurisdictional options and lower relocation costs. It is therefore a plausible hypothesis that the most egregious abuses of power in the service of distributional coalitions should occur at the highest levels of the largest governments.

The world's largest government is the federal government of the United States. No other governmental unit has such immense resources at its disposal. It is also much more costly to exercise the exit option for citizens of the United States than it is for citizens of any of the world's small or medium-sized democratic nations. A pattern prediction is therefore that the most value-destructive policies among Western democracies should occur within—and in exchange with—the federal government of the United States. While it is relatively inexpensive to avoid California's land-use regulations or New York's sales taxes, it is much more costly to escape from America's national military-industrial complex. This is perhaps the prime example of how rent-seeking distributional coalitions extract tax-funded income in exchange for services that destroy value in more than an opportunity-cost sense.

Notes

[1] A relevant typology as regards democratic decisions would point to four categories. Apart from policies with concentrated benefits and dispersed costs, we would then get three additional categories: concentrated benefits/concentrated costs; dispersed benefits/dispersed costs; and dispersed benefits/concentrated costs. Normatively, we may then conclude that democratic decision-making should be limited to those issues where both benefits and costs can be dispersed throughout the community. Obvious illustrations of policies with such characteristics are territorial public goods such as law enforcement and large-scale transportation infrastructure. More controversial policies, such as insurance, would however also be among the policies that would figure as legitimate political concerns (although voluntary market insurance may still be preferable on consequentialist grounds). Still, many existing public policies would not be justifiable if we were to limit political action to goods or services with dispersed benefits and costs: for example targeted subsidies (or bailouts) to specific individuals, firms, or industries (concentrated benefits and dispersed costs); bans on unpopular

minority behaviors (dispersed benefits and concentrated costs; an example is the recent Swiss referendum that outlawed the construction of new minarets); and policies that attempt to mimic what standard economic theory shows that rivalous markets do best—the distribution of goods with concentrated benefits and concentrated costs.

[2] A general consequence of self-organizing systems is that the units or building blocks of the system will tend to be subject to Zipf's law (a distribution where the small units are much more numerous than the large units). In federations such as the United States or Switzerland we tend to observe more political bodies and responsibilities at the local level (municipalities, school districts etc.) than tends to be the case in unitary democracies such as France or the United Kingdom. This may be an indication that federalism exhibits stronger features of dynamic self-organization.

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