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Rigorous Bureaucrats or Robber Barons ?
How Do Governments in Europe Compete ?

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How do Governments in Europe Compete?[1]

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Governments everywhere use the language of brotherhood and co-operation to each other, but even as they use it they compete vigorously for resources. These may be natural resources such as oil or water, disputes over which are the single most common cause of war. They may be human resources, or more abstract geographical resources such as access to profitable markets. Governments also compete strenuously for ideas. It is a competition that sometimes spills over into violence, and even under the most stable peace it involves a continual effort to capture economic advantages for the governments themselves and for the citizens they represent, or repress, or both. To deplore the existence of such competition is futile, but many serious thinkers have sought to find ways to moderate its excesses and to turn its energies to a more collective benefit.

The foundation of the European Economic Community was not just, and famously, an attempt to give the citizens of Europe so great a stake in their mutual prosperity that they would never again resort to war. It was also based upon the more precise idea that this prosperity itself required the states of Europe to do more than lay down their swords and wait for the ploughshares to appear. It was not enough just to allow their citizens to return to the tasks of production, consumption and trade, tasks whose banal lack of heroism was all the more welcome after the years when heroism had exacted such a terrible price. The states of Europe needed also to co-operate in multitudinous ways to encourage trade, open markets and allow free movement across their borders, in the face of their own constant temptation to interfere in this process. To control so strong a temptation required an international treaty, enforced by an international court. A common market could not be presumed to be sufficiently in the individual interest of Europe's nation states that their co-operation in its realisation would follow of its own accord.

After nearly thirty years the launch of the Single Market Programme in 1985 was, in a sense, recognition that the urge of governments to compete too much and to co-operate too little was proving harder to tame than even the Community's founders had imagined. But that is not quite what the rhetoric that launched the programme actually proclaimed. The 1985 White Paper, and even more so the Cecchini Report that followed, are enthusiastic in their praise of another sort of competition, that between firms. The existence of the remaining

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obstacles to such competition is treated as a largely technical matter, as though the member states had allowed a large amount of detritus to pile up in the trading corridors of Europe in a fit of absence of mind.

But from time to time a more subtle diagnosis shows through. The continued existence of barriers to trade and competition was no accident. Governments, left to themselves, would be continually tempted to soften the process of competition between firms. Governments had favourites. Governments, for all their rhetoric, were constantly tempted to steal a march on each other, to «yield to protectionist measures» for example (p.38). There is a splendidly stern sentence on page 21 of the White Paper which says: «experience shows that a State's membership of the Community is not always sufficiently reflected in the attitudes of its administrations». (I am reminded of the time I heard a World Bank official describe a country – an entire country – as having what he called «an attitude problem».) What the society and the economy of Western Europe needed in the mid-1980s was more competition between firms and less competition between governments.

There was an important area of exception to this general principle insofar as co-operation between firms in certain knowledge-intensive fields was to be encouraged, but in general more rather than less competition was acknowledged to be desirable. At the same time it was no less explicitly accepted that, in order to realise the gains, member states should engage in less competition and more co-operation among themselves - whether in the field of standard setting, competition policy or public intervention in the economy more generally. Again there were areas of exception (notably those highlighted in the debate over subsidiarity; see Begg et.al., 1993) but broadly speaking collaboration rather than competition was the aim for governments, in sharp distinction to the aim for firms. The aim of collaboration had already been sounded clearly in certain areas of Community policy, notably state aids, where a Commission communication of 1971 had spoken of «the need to end the competition for investment by means of regional aid and to coordinate such aid schemes at the Community level» (CEC, 1995, p.198).

These two prescriptions were intimately related to each other: a degree of collaboration between governments was viewed as a necessary condition for bringing about greater competition between firms, since in the absence of co-operation governments would tend to shield their own firms from competition. Indeed, any kinds of market failure - not just inadequate competition - were thought to require a cooperative solution; governments pursuing independent objectives would inevitably bring about an outcome that was worse for them all. The Cecchini report referred to «the perverse effects which may arise between countries which are highly interdependent but which fail to coordinate their economic policies» (Emerson et.al., 1988, p.221).

That is not a diagnosis with which I propose to disagree today. What I want to do instead is to ask what kind of judgement about the nature of competition it presupposes. In the process I want to indicate just how primitive is our understanding of exactly what is going on when governments compete against each other. Since the end of feudalism we have become used to the idea that governments have to offer something to their citizens to justify their continued existence and activity. Governments and citizens are involved in a process of exchange, we might say. This much is common to most of post-Renaissance thinking about the nature of the state, and in this respect governments are not unlike firms. But is this resemblance merely superficial, or does it signal something deep about these two types of organisation? When the Commission claimed that Europe needed more competition between firms and less competition between governments, was it telling us that firms and governments are two different types of social animal, and interact according to intrinsically different rules? Or was it making a much more contingent and empirical judgement that Europe in the 1980s happened as a matter of fact to have too much rivalry between states and not enough between firms?

Two or three decades ago most mainstream economists could have given a straightforward answer to such a question. Competition between firms and competition between governments are two intrinsically different processes, it would have been said, because firms and governments are two different kinds of organisation, with different goals and ways of behaving. Firms exist in pursuit of profit, more or less. Governments exist in pursuit of the social good, or at least the social good as construed by their own citizens. When firms compete this is healthy because they eat away at each other's market power; they therefore drive down prices and stimulate output. When firms co-operate, by contrast, it is always with the aim of exercising monopoly power. As Adam Smith famously put it, «people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices».

With governments, so the story goes, there is nothing to be gained from competition. Since they exist for the social good, competition can only result in their being distracted from its pursuit. More precisely, under competition each government's concern for its own citizens may be pursued at the expense of the citizens of neighbouring states. Co-operation, by contrast, allows these cross-border effects, «spillovers» or «externalities» as they are sometimes called, to be taken into account. Since there is no need to question the government's good faith in doing so, we may legitimately wonder whether the co-operation will be adequate, but we need not fear that it will end in a conspiracy against the public. So we need no empirical analysis to tell us that the Commission in 1985 was right. That firms did not compete enough, and governments competed too much, followed from the very nature of governments and of firms themselves.

Nobody seriously believes this story in its simple form today. But anyone who drives a car will be familiar with the way in which one can sometimes find oneself following a route, with all its twists and turns, even though it is leading in quite the wrong direction, simply because it is a route one used to take regularly in the past. So it may be that this story, of vicious firms tamed and virtuous governments led astray by competition, is a story people still drive by even though they do not believe it at a conscious level.

So is there a better story available? The answer is no, or at least not yet. My aim in this lecture is to persuade you that although we know a reasonable amount about what competition between firms can and cannot be expected to achieve, we know much less about the character of competition between governments. We do not really know how to characterise what governments try to do, what motivates the individuals that compose them, let alone what are the consequences of the interactions between them. Much of the supporting argument will have to be postponed to the lecture course that begins tomorrow, so those of you (the majority, I expect) who cannot attend will have to think of today's talk as a sort of censored trailer for an X-rated movie, which if it arouses at all, does so without satisfying.

The structure of the argument will be as follows. First I shall review briefly the way in which the thinking of academic economists about the behaviour of government has evolved in the last three decades or so. Much of this will be theoretical, since sufficiently rigorous empirical work on the question has been sparse. It will have two aspects, the first corresponding to the question what governments do, and the second bearing on the question how governments interact. Then I shall ask what kinds of empirical evidence we have about the effect of competition on the behaviour of firms, and specifically whether any of this evidence is applicable to governments. Finally, I shall return to a fundamental question of principle. What, if anything, makes us think that firms and governments are intrinsically different kinds of creature? Are they just two, contingently different ways in which ambitious citizens try to make their mark on the world? Or do they represent a fundamental division in our conception of social space? Two radically different spheres in which human beings interact? I shall suggest that the appropriate perspective here is historical as well as analytical. How has the modern state evolved? Is it just medieval plunder made respectable? Robber barons with peerages? Or has its evolution given it a radically different character from that of the haphazard entrepreneurship that characterises what we now like to call the private sector? Not surprisingly, I have no confident answer to this fascinating question. Like all academics I am just trying to make an honest buck by telling you that further research remains to be done. But I shall at least try to justify this mercenary claim by offering some suggestions about where we might look for an answer. Among other places I shall suggest that in the recent experience of the formerly planned economies, where both firms and governments have been forced to reinvent themselves, we may find some interesting insights into the question what distinguishes these two types of social organisation.

Before beginning, though, I want to return to the assertion I made a moment ago. Nobody, I said, believes any more that firms and governments are different just because each of them is motivated by different aims, the one by profits and the other by the social good. Why does this now seem so obviously false? Well, one reason is that we now ask much more careful questions about who makes the decisions in firms and in governments. These decisions are made by real people, with real anxieties, real concerns, and facing real constraints. Firms and governments recruit their personnel from a common pool of citizens, and it is these citizens who end up determining what their organisations do. Do we have any reason to think that the people who run governments are fundamentally different from the people who run firms? Could it be that the people who are recruited into business are the sort of people who care about profit, while those who are recruited into government are the sort of people who care about the social good? They might be different, but as it happens there is not yet any convincing evidence that they are.

To give you just one example, an area of research in social psychology that has become newly fashionable (because it promises to give rigorous quantitative examination to the tenets of folk wisdom) is the study of the effect of birth order on political behaviour. Frank Sulloway has recently claimed that «first-born children are more likely to identify with authority whereas their younger siblings are predisposed to rise against it» (Sulloway, 1996). The title of Sulloway's book (*Born to Rebel*), gives you his conclusion in a single arresting phrase. Could it be true that first-born children tend to join the ranks of government (and pursue a high-minded *mission civilisatrice* while there) whereas younger children become entrepreneurs, and hunt for profit to compensate for their unfavourable early start in the competition for family resources? Yes, it could be true, but Sulloway has not even begun to show that it is. His arguments are based upon samples of individuals culled in a suggestive but far from random way from historical records of great events, revolutions, scientific discoveries and so on, and his statistical methodology is unsystematic, to put it kindly. Other attempts to construct samples of political leaders, judges, military leaders or other members of the government establishment have tended to find one of two things. Either they find that there is no greater tendency for first-borns to be represented in such samples than in the population at large (there are evidently exceptions here and there, as statistical theory warns us to expect: first-borns are over-represented in the US House of Representatives, for example, though not in the Senate (Somit et.al., 1996, p.102)). Or else, and more significantly, they find an apparent over-representation of first-borns which is likely to be due to a failure to control for other variables, far the most important of which is education. First-borns better educated on average than the rest of the population, for a variety of reasons. So are political leaders. But so, for that matter, are business leaders. This is a field in which partial correlations are everywhere, and on their own are entirely meaningless. As Albert Somit and others have put it in their recent book *Birth Order and Political Behavior*, «in this vast scientific and popular literature, birth order [has] been associated with such diverse attributes and phenomena as left-handedness, lesbianism, smoking, eccentricity, body weight, suicide, sports preference, honesty, high blood pressure, marital bliss, choice of college major, unwed motherhood, religiosity, traffic tickets, criminality, Rhodes Scholarships, chronic back pain, sensory deprivation, volunteerism, sensitivity to pain, alcoholism, personal popularity, susceptibility to various diseases, moral sense, virginity, judicial sentencing behavior, depression, sexuality and, to offer only one more compelling example, being a professional strip-teaser» (ibid., pp.3-4).

Someone in this room may prove me wrong, but I do not know of the existence of any rigorously conducted study, based on a properly random sample, that shows any systematic tendency for independent psychological determinants of behaviour (whether due to birth order or to anything else) to be represented to different degrees among those people who enter the service of governments and those who enter the service of firms. Until such a study appears we shall do better to assume that any apparent systematic difference in the goals pursued by these two types of organisation is due to the different constraints on the behaviour of those who take the important decisions within them. What those constraints are, and how they operate, is a question whose implications for the study of government are only slowly beginning to be explored.

This is a less cynical starting-point than it may appear. One of the characters in Balzac's *Splendeurs et Misères des Courtisanes* asks: «Est-ce qu'il y a des opinions aujourd'hui? Il n'y a plus que des intérêts». It is no part of my claim that interests are all that motivates those who serve in government. Opinions (or ideology as they used to be called) matter too, though opinions may sometimes be shaped in the service of interests, and though the scope for these opinions to make a difference will depend on how tightly the rules of procedure and the mechanisms of monitoring allow them to do so. But opinions and ideology matter in business too. No less than political leaders, business leaders build empires, give money to charities and political parties, make gestures on behalf of communities, lecture us on how to save the world. Government has no monopoly on high-mindedness. How free business leaders are to do so depends on how closely they are monitored or motivated by those whose resources they expend in doing so. Whether businesses and governments are characterised by different kinds of monitoring and motivation is part of the question I am seeking to answer, not an assumption I wish to make before I start.

So is there anything which intrinsically distinguishes governments from firms? Of course there is. Governments in most countries have a monopoly on the issue of the currency, a monopoly on the use of large-scale force, and consequently (in theory) a monopoly on the right to demand money with menaces, a right dignified by the name of taxation. Note that this is not some timeless Platonic truth about the nature of governments. In some countries and at some periods of history there is real and fierce competition for these privileges. It is just that any organisation, however it began, that emerges dominant from this process of competition is one we then call a government. It is not just history but political theory that is written by the winners. Sometimes the state's dominance is only partial, as in many parts of the former Soviet Union today, where organised crime offers to many citizens the services of contractual enforcement and physical protection more effectively than the state has so far done, and charges a high price for doing so. This does not mean it has displaced the state, but rather that the boundaries between state and business activity have become disconcertingly fluid. The fact that the state does control certain activities in a way that other entrepreneurial organisations do not, indeed changes in fundamental ways the nature of state activity and the consequent character of competition between governments. I shall say a little more about this at the end of the talk.

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Let me now do what I promised and review briefly the way in which thinking has evolved within academic economics about the nature of governments and the way they compete with each other. During the high period of general equilibrium theory in the 1950s and 1960s, governments were supposed to provide public goods, correct market failures due to externalities and monopoly power, and stabilise the macroeconomic fluctuations of the economy. Incidentally, the enforcement of contracts did not feature explicitly as an activity of government since general equilibrium theory took contractual enforcement for granted. They were supposed to do these things by choosing policies to maximise some function representing social welfare. The use of cost-benefit analysis is one adaptation of this approach, for the special case of decisions or projects that are sufficiently small not to change the relevant shadow prices for the economy as a whole[2]. Whether governments actually did this was on the whole a question ignored. After all, economists are a high-minded bunch, many of whom thought themselves to be offering advice to political leaders. When you offer advice to someone more powerful than you are, it is usually prudent as well as good manners not to speculate too loudly as to whether the person will in fact have the objectivity and good sense to follow your advice.

This view of governments had an implication for the nature and the consequences of competition between them. No good could come of a competition in which governments engaged in a struggle to attract economic resources by adapting their taxation and other policies. If one country lowers its tax rates on business because it is partly motivated by the wish to attract businesses that might otherwise have set up elsewhere, the gains to the first country are offset by costs to its neighbours. The result is a «race to the bottom», or at least in the direction of the bottom, in which taxes (and therefore public expenditures) are lower than they would otherwise have been. If they would otherwise have been chosen optimally, competition is obviously bad news. The same applies to competition in regulatory systems, including such matters as employment and environmental standards. The fear of social or environmental dumping, as it is sometimes called, is linked to a sense that governments can better be trusted to get these matters right without the distraction of trying to attract footloose economic resources at each other's expense.

Note, however, that although there may indeed be a race to the bottom it does not follow that this problem will be worse for social or environmental dumping than across the rest of the range of public goods. Indeed, for some environmental public goods (clean drinking water, for example) the temptation to race to the bottom must be muted by the consideration that to attract a few marginal firms one must lower standards for the rest of the immobile population. It's hard to imagine dirty water being so great a lure to the executives of international firms («Get on the first plane to Portugal, Perkins; they've just relaxed pollution standards. And don't forget your health insurance»). It follows that to reach international agreements on merely a subset of public goods may actually make things worse, for it may distort the already restricted availability of public goods even further away from those that are left out of the agreements. Controlling the excesses of competition between governments through international agreements is a delicate matter in which good intentions alone do not always make for good policy.

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[2] Shadow prices represent the per unit contribution of each good to social welfare, and are therefore the appropriate marginal valuation of the outputs and inputs involved in a project. For tradeable goods these will typically be given by border prices adjusted for transport costs.

A whole literature appeared in the 1980s showing that certain policies which would be bad for governments if pursued in isolation could become attractive to them in the context of international competition, since more of the costs than the benefits of such policies would be borne by the citizens of other countries (see Brander & Spencer, 1985; Dixit & Kyle, 1985). Tariffs, quotas and subsidies to national champions were examples of policies analysed in this way. The results would be bad for the world as a whole, but individual countries would gain from them relative to not undertaking them because of the way they could transfer the costs to each other in a game of beggar-thine-international-neighbour.

Sometimes the likely costs of such policies to the world as a whole are indeed large. A couple of years ago Damien Neven (of the University of Lausanne) and I calculated that support from European governments for the Airbus consortium, while probably beneficial for Europe, had probably resulted in substantial costs for the world as a whole because of reduced scale and learning economies in aircraft manufacture as a result of the presence of three rather than two major firms in the civil aircraft industry (Neven & Seabright, 1985). On the other hand, work I am currently doing with Tim Besley of the London School of Economics suggests that competition between EU member states to attract foreign direct investment is probably less damaging than it might at first appear. The argument for this conclusion will have to await the course tomorrow, but it is based on considering that the strategies governments use to bargain with the firms whose business they seek to attract may in fact succeed in internalising many more of the international spillover effects than they seem to do at first sight.

Nevertheless, although what might be called the high-minded consensus about the role of government did not always yield clear policy implications about how to mitigate the effects of intergovernmental competition, it certainly viewed such competition with undisguised mistrust. Many current policy harmonisation initiatives follow from this consensus, notably the efforts by the Commission to reduce disparities in corporation tax rates across the EU. (Indeed the Internal Market Commissioner not long ago described tax competition between member states as a form of illegitimate state aid, thereby implicitly threatening member states with what one might call the Full Monti).

What changed this consensus in academic research was not, at first, the brave efforts of political scientists and economists outside the mainstream to understand how economic policy is actually made. There was the work of Anthony Downs, for example, on median voter theories of democracy; the idea that parties cluster towards the centre of the political spectrum for the same reasons as ice cream sellers cluster towards the middle of the beach. There were the «public choice» school associated with the James Buchanan and Gordon Tullock; the theory of «regulatory capture» associated with George Stigler of the University of Chicago, according to which regulated monopolies, far from disliking the hand of the state, lay back and enjoyed it because of the protection it gave them from competitors. There were theories of «rent-seeking behaviour», according to which restless Schumpeterian entrepreneurs were as happy to seek profits by manipulating bureaucrats and politicians as by manipulating customers; and so on. These theories are now part of the mainstream, but what put them there was not originally a reaction against theories of state benevolence, but rather a reaction against theories of state omniscience. As the Bretton Woods system collapsed and unemployment and inflation rose, it was the fundamental ability of governments to intervene that was called into question. Their ignorance of basic conditions in the economy was so profound, so the story went, that they often risked making matters worse. Or, as Jules Romains' wonderful character Doctor Knock might have (but didn't) put it, «les gens bien pensants sont des maladroits qui s'ignorent».

In fact the academic research that began to incorporate government's ignorance of the economy explicitly into its models did not argue that governments were more ignorant than they supposed. In James Mirrlees' theory of optimal income taxation for example (an application of the work on principal-agent relationships for which he won his Nobel Prize last year), the government knows exactly how ignorant it is (in the sense of knowing the distribution of individual characteristics across the population even though it does not know which individual has which characteristic); it therefore scales back its interventionist ambitions accordingly (Mirrlees, 1971). On its own the ignorance of government was not a new idea. Researchers in public finance had worried for many years about how a government might establish the willingness of taxpayers to pay for the provision of public goods, since it was in the nature of public goods that non-payers could not be excluded from consumption of the good in question. One ingenious idea proposed by CM Tiebout (1956) had been to allow competition between localities in the provision of local public goods. The idea was that individual citizens might choose where to locate on the basis of the overall package of local taxes and local public goods. Local governments could therefore be seen as like firms, providing differentiated products. In principle this did not have to involve competition: a central government could simply implement a locally differentiated pattern of public goods supply and watch citizens seek out their preferred combinations of goods and the tax rates that went with them. But if local government were enabled to enter into competition (subject to similarly stringent conditions as in the theory of general competitive equilibrium between firms) the result would be efficient. And most remarkably of all, it would be efficient provided what motivated local governments was the wish to maximise profits, exactly the same ambition as for firms (see Bewley, 1981). This is to prove of great significance later in my story.

Although Mirrlees' theory had not departed from the assumption of government benevolence, its logic was much more deeply subversive. For if a government could not control the behaviour of citizens whom it could not perfectly observe, citizens in their turn would not be able to control the behaviour of a government they could not perfectly observe. So what assurance could they have that the government would act in their interests? Only so much assurance as could be provided by the system of monitoring and motivation that citizens were able to put in place for their political representatives. This may strike some people as a classic example of economists catching up with political theory about two centuries late, but the point is a little more subtle than that. Economists had previously assumed that monitoring and motivating political representatives was the job for an essentially political system of checks and balances, and economic policy-making could get on with its own job knowing that this side of things was being taken care of elsewhere. By the 1970s they had begun to realise the very deep extent to which economic and political checks and balances interact. Since neither is perfect each must take account of the imperfections of the other. Competition between governments is therefore potentially as much a part of the process of motivating governments to act in the interests of their citizens as are the more obviously political mechanisms of electoral competition, judicial review, the separation of powers, and the making of constitutions. If the political checks and balances worked perfectly, economic competition would be unnecessary. But then, as Tiebout's theory had shown, if economic competition between states worked perfectly, the political checks and balances would be unnecessary too. The beauty of Tiebout's theory is that it showed the potential for competition to tame even governments that cared nothing for social welfare, and maximised profits as ruthlessly as the most buccaneering entrepreneur.

In a doubly imperfect world, though, what could competition between governments be expected to achieve? Competition in the setting of tax rates, for example, would probably reduce them below what they would otherwise be, though researchers differ as to the extent of this effect in practice. If they were substantially too high to start with, as the public choice school and its Leviathan theory of government believed, competition to bring them down could only be welcome, supplementing the imperfect mechanisms of electoral competition to keep the grandiose empire-building of politicians in check. If taxes were about right to start with, or only a little too high, competition might easily make things worse. What about the level of public goods and services that governments provide? Under the Leviathan theory these are not necessarily too high, because Leviathan governments tend to tax too much and supply too little in return. Overall public expenditure is typically too high, but the services it delivers are inadequate because they cost too much. So government competition could both reduce taxes and raise effective supply of public goods and services, by driving down the costs of their supply. Is this too good to be true?

One reason it might be too good to be true is that exploitative governments do not typically exploit everyone equally, but rather tend to favour some interest groups against the rest. Governments facing competition might find it in their interest to attract economic resources by favouring certain already fortunate interest groups. It seems likely, for example, that big business already does well out of the imperfect process of political monitoring, and is perhaps even favoured by political competition because business can offer campaign contributions in return for regulatory, tax and other favours from the successful candidates. But far from restraining this phenomenon, competition between governments may exacerbate it by increasing the temptation to aid such firms in order to help them penetrate overseas markets. In other words, competition between governments may allow them to shift onto each other some of the costs of the capture of their own political processes by powerful lobbying interests. This in essence is the real case for restraining state aids to industry in the European Union as well as in such international fora as the World Trade Organisation. But it is a case that has to be made with care, both because it presupposes a substantial element of political failure in the countries to which it is addressed, and because in the presence of such political failures it is not all forms of competition between governments that need to be restrained. On the contrary, the presence of such political failure is what underlies the case for welcoming competition between governments in the first place.

An example of the tensions to which this can give rise is the relation between harmonisation of tax policy in a body such as the European Union and harmonisation of policies restraining public expenditure (such as state aids). The case for EU state aids policy rests on the view that there is political failure, from which some interest groups benefit disproportionately at the expense of others. The case for harmonising tax policy is that by and large sovereign states do not suffer too badly from political failure, and that competition between them results in tax rates' being set «too low». It's not impossible to believe both things, but it needs some explicit argument, and saying that low taxes are like state aids is not enough (the difference between them is that low taxes benefit everyone, or at least a substantial majority, while state aids in the familiar sense benefit a tiny sub-group of the population). More importantly, if member states do have a tendency to waste their money on such things as state aids, and if community state aid control is not enough to help them resolve the problem (as it is not). then tax competition which puts pressure on their budgetary resources has additional virtues as an inducement to fiscal discipline, virtues that the traditional arguments for tax harmonisation entirely ignore.

It is not my place here to try and judge what exactly are the forms of competition between governments that are healthy in a political system like the European Union, and which kinds should be restrained. I don't know the answer to that question, and I don't believe anyone else knows the answer either. What I do want to emphasise is that the answer will depend among other things on what motives best explain the actions of those who take decisions on behalf of governments, and therefore on the extent to which the process of economic competition between governments must complement the political processes that exist to monitor and motivate governments to act in the interests of their citizens. We can no longer take those motives for granted.

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To find the answer, whatever it is, will require not just theory but empirical research. We know much less empirically about the effects of competition between governments than about competition between firms, and most of what we do know comes from studies of competition between states of the USA. For example, Netzer (1991) concludes a review of studies of inter-state competition for economic development in the following terms: «Economic development incentives are, for the most part, neither very good nor very bad from the standpoint of efficient resource allocation in the economy. With all the imperfections, the offering of incentives does not represent a fall from grace, but neither does competition in this form operate in ways that truly parallel the efficiency-creating operations of private competitive markets. Given the low cost-effectiveness of most instruments, there is little national impact, only a waste of local resources in most instances» (pp.239-240). So the picture is one of substantial political failure at the state level, but which competition does little either to check or to encourage.

Getting good enough data to draw such conclusions is not easy, and we know rather more about the effects of competition between firms, where comparable data are more readily available. Even here there are substantial conceptual and practical difficulties in making the appropriate comparisons, because the degree of competition is a property of a whole market, not just of individual firms within it. To see what difference competition makes we need to look at two markets, or at one market at two different points in time, and hope that when the degree of competition varies not too many other things are varying at the same time. There are very few industries for which we can do this with any confidence, but where we can the picture is broadly favourable to the conclusion that competition tends to enhance the productive efficiency of firms. It used to be thought that the problem with monopoly was that it led to prices way above costs, but we have come more and more to realise that the really reprehensible monopolists are not those that make large profits, but those that waste their potential profits in inefficient production methods and what John Hicks once called «the quiet life». There is indeed evidence that competition helps to reduce that kind of waste. John Kwoka, for example, concludes a recent careful study of the US electricity industry by arguing that, contrary to many people's expectations, private ownership is not systematically superior to state ownership (broadly speaking, private ownership performs better in power generation, state ownership in power distribution). But either form of ownership is made considerably more efficient by the presence of competitive pressure on the firms concerned. «Competition», he writes, «imposes cost and price discipline on both privately owned, regulated utilities as well as on those that are publicly owned» (Kwoka, 1996, p.146). Studies of the US airline industry corroborate the importance of competition, and work I have been doing with Charles Ng of the University of Cambridge on the European airline industry confirms this. Actually our results suggest private ownership and competition are both good for efficiency, and indeed reinforce each other's effects. We interpret this not as a general statement about failures of public ownership, but rather as a statement that public ownership no longer has anything to offer this particular industry. In the lecture course I shall be going into some of this evidence in more detail, and also looking at evidence on industries (such as the German banking system; see Edwards & Fischer, 1994) which have often been misleadingly claimed to encapsulate the virtues of co-operation rather than competition between firms.

I suggested earlier that where competition between governments works best it will be precisely through driving down the cost of provision of public goods and services, so to some extent the findings from firms about the effect of competition on productive efficiency are encouraging. But much depends, of course, on whether competition between governments works in a similar way to competition between firms. In particular, the proportion of a firm's customers that will leave in disgust if it rips them off is probably larger for most firms than the proportion of a state's citizens (or more generally, of the economic resources they command) that will leave under similar provocation. This means the capacity of states to discriminate between the mobile resources and the immobile ones, offering a better deal to the former at the expense of the latter, is probably more to be feared than in the case of firms. The ludicrous system of duty-free allowances, which gives a wholly unjustified subsidy to those of us who travel frequently across borders at the expense of those who do not, is a trivial but symbolic instance of a potentially much more serious problem.

Overall, therefore, we need a great deal more evidence before we can pronounce with confidence on how competition between governments works in practice, here in Europe or indeed anywhere else. I suspect it may be healthier than the Commission in its single market programme has given it credit for, but so far at least that is only my suspicion.

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Now finally let me return to the more conceptual question with which I began. Might firms and governments behave differently in principle, because of the kinds of organisation they are? Whatever else they do, governments also provide protection and the enforcement of contracts, unlike almost all firms. Might this fact by itself affect the way they compete, and the value of competition between them from a social point of view? In current work with Jayasri Dutta, also of the University of Cambridge, we are trying to explore theoretical aspects of this problem. We start from a simple idea, which is not our own but which has been explored by economic thinkers since at least the middle ages. It is that the technology for producing protection is not like that of most ordinary goods. Once armies and police forces are established they can indeed produce a good, namely protection, but they can also produce a bad, namely plunder. In order to induce armies and police forces to protect rather than to rob their citizens, tax rates have to be sufficiently high to induce them to use their power for good rather than destructive ends. But monopolies of protection, although often cheaper to set up in the first place, can work out very expensive for the citizens to support, because the power of monopolies to extort taxes unchallenged is also very high. Competition between providers of protection has an obvious danger, but it also provides a restraining influence on the demands that any one protector can make.

In this simple form the only relevant question is «how much competition should there be?», but we are also interested in what kind of competition is appropriate. In countries where there is much private protection and much personal insecurity, as in Russia today, one feature of private armies is that they are located much closer to those they are supposed to protect than are standing armies belonging to the state. Private bodyguards live on the doorstep, one might say, while the regular army is in a garrison some distance away. Bringing the technology of protection closer to your home has the advantage of making it more effective in defence, but also much more dangerous if in treachery it chooses to attack you instead. Many of the emperors of history, after all, have been murdered by their own palace guard.

There turn out to be some very interesting interactions between people when they decide how close to home they should station their soldiers. If my bodyguards live on my doorstep they may protect me better but they also potentially threaten the security of my neighbours. My neighbours, in turn, may feel sufficiently threatened to want to station their own bodyguards close to home, which in turn threatens me and makes me feel justified in my original decision. However, if we could all agree to station our bodyguards some distance away, or better still, to convert our bodyguards into a regular state army with its own garrison and rules of engagement, we would collectively be much better off. Indeed, distance can be taken as a metaphor for anything that makes armies harder to mobilise in both attack and defence. It turns out that the greater the distance at which the armies are garrisoned, the lower the taxes they can extort, and the fewer the benefits to the citizens from having competition between them. One of the features of modern states is that they set limits, physical and constitutional, to the exercise of their powers of physical threat, and it is these limits that make it prudent to run the risk of monopoly or near-monopoly in the provision of protection. Where, as in Russia today, many of these limits have broken down (see Varese, 1994), we see both more competition between providers of protection and much more uncertain boundaries between the provision of protection and the provision of other kinds of economic function. Both the history of modern states and the hazardous rivalry for the mantle of the state that is now taking place in some transition economies remind us that what distinguishes governments from other kinds of entrepreneurial organisation is in part the simple fact of historical success. As David Hume expressed it in 1748, «Almost all governments which exist at present, or of which there remains any record in history, have been founded originally, either on usurpation or conquest, or both, without any pretence of a fair consent or voluntary subjection of the people...and this is all the original contract they have to boast of».

Our parable of distance as a metaphor for constitutional restraint is only a simple parable, of course. But I think it provides some interesting insights into the fact that imposing restrictions on how governments behave towards their own citizens changes the nature of, and the benefits and risks from, competition between them. I don't want to push the metaphor too far, and certainly not just because I promised to talk about robber barons, a promise you may not have thought sufficiently redeemed by my brief discussion of the Leviathan state.

But the general lesson is that competition between governments is not an abstract and general good, nor an abstract and general evil. If we value it as part of the political process, that is because of the caution we quite properly feel about trusting the rest of the constraints that process places upon the actions of those who may protect us, but whose power to do so enables them also to exploit us. The insight is an old one. La Fontaine in his fable «Les vautours et les pigeons» made the point thus:

> Tenez toujours divisés les méchants;
> La sureté du reste de la terre
> Dépend de là. Semez entre eux la guerre,
> Ou vous n'aurez plus de paix.

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