

Mirian Fabian Breuer

Master of Arts in Political Economy

King's College London

mirian.breuer@kcl.ac.uk

Ignorance, Competition, and Jurisdictions: How Jurisdictional Competition Can Help to Foster Learning, and Discovery to Improve Public Services

One of Hayek's most important insights was the acknowledgement that individuals are cognitively limited and nobody possesses all the relevant knowledge to design institutions and political systems (Hayek, 1973). He also focused on ways which could enable individuals in society to make use of much wider knowledge than the bits each individual possesses (Hayek, 1945). Learning is, thus, a crucial part of his oeuvre. Human's ignorance and the importance of the institutional environment to foster learning represent crucial insights of Hayek's work (Hayek, 1945; 1978). These aspects have experienced an increased academic attention in the last two decades (Kirzner, 1973; Kirzner, 1979; Kirzner, 1997; Mantzavinos, et al., 2004; North, 1990; Ostrom, 2005; Pennington, 2011). My essay focuses on both points – ignorance and learning.

In the following, I will assume that agents' "imperfect" knowledge arise from (i) their subjective perceptions (which can diverge from the objective realities), and (ii) the dispersion of local knowledge. These two points are discussed in Hayek's famous paper Economics and Knowledge (Hayek, [1948] 1958b). This will also raise the related question of which institutional environments foster learning most effectively. I consider an institutional environment's property to foster learning in terms of how it *communicates* the flawed individuals' perceptions and how it facilitates the *discovery* of new local knowledge.

Economic markets and 'quasimarkets' for jurisdictions, that is, the "markets" for public services and governance, represent the institutional environments I examine (Boettke, et al., 2011). I shall show if and how competition enables (in the case of economic markets) and could enable (in the case of jurisdictional 'quasimarkets') to solve knowledge problems.

Problems of a politico-economic order: the knowledge problem(s)

The introduction of "imperfect" in human knowledge opens the door for often-neglected aspects of learning and change. In the following, I shall explain what is meant by (i) subjective perceptions, and by (ii) dispersed local knowledge. I will also demonstrate how these 'unavoidable

imperfections [...] of knowledge' give rise to two knowledge problems (Hayek, 1945, p. 530), which I call the 'communication' and the 'discovery problem'.

(i) Individuals' knowledge is subjective: According to Hayek ([1948] 1958b), individuals' perceive the world from their own point of view. Thus, their perceptions and beliefs can differ from the objective data.¹ This reflects the assumption that individuals are fallible and possibly make wrong choices (Caldwell, 2004, pp. 212-213).

(ii) Parts of knowledge are dispersed: Hayek (1945) distinguishes between two kinds of knowledge – scientific knowledge and local knowledge.² 'Local knowledge is an understanding of social and commercial conditions unique to a particular time and place. Social conditions include people's desires, informal norms and culture, religious beliefs, expectations, speculations, and guesses.'³ (Skarbek, 2009, p. 417)

Change is the primer source of economic and political problems (Hayek, 1945, p. 523). Change in turn demands adjustments of individual choices and behaviors. In undertaking the constant adjustments to the 'ever-changing circumstances,' people primarily make use of their local knowledge.³ Thus, local knowledge is relatively more important than scientific knowledge in most of the politico-economic affairs.

Following Hayek (1945), local knowledge is dispersed. That is, every individual possesses his or her bit of this kind of knowledge – 'different people have access to different data' (Caldwell, 2004, p. 213). It 'never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess' (Hayek, 1945, p. 519). Its dispersed, subjective, and contradictory character renders it impossible to centralize and aggregate local knowledge.⁴

These two "imperfections" of individuals' knowledge – its subjective and dispersed character – make individuals in society face two knowledge problems⁵ – the 'communication problem' and the 'discovery problem.'

¹ The subjectivist nature of knowledge creates 'potential for a difference [...] between *the subjective perceptions of individuals* and *the objective data*.' (Caldwell, 2004, p. 212)

² Hayek (1945, p. 521) calls the latter 'knowledge of the particular circumstances of time and place'. Instead of this somewhat cumbersome term, I will rather speak of 'local knowledge' as for instance Skarbek (2009) does.

³ In the economic context, a change in the price (e.g., price increase) of a commodity leads to adjustments by individuals based on their particular (local) knowledge – for instance, knowledge about subjectively perceived close substitutes which are cheaper.

⁴ '... [T]he sort of knowledge with which I have been concerned is knowledge of the kind which by its nature cannot enter into statistics and therefore cannot be conveyed to any central authority in statistical form.' (Hayek, 1945, p. 524)

⁵ I am roughly following Kirzner's (1992) division of the knowledge problem. He is speaking of a 'basic knowledge problem' and 'Hayek's knowledge problem'.

The ‘communication problem’ is related to the subjective nature of individuals’ knowledge. It raises the question of how individuals can learn about their wrong perceptions – how these mistakes can be *communicated*. This encompasses the problem of how officials/entrepreneurs learn about their constituents’/consumers’ real wishes. The communication problem represents a lack of coordination of current information. Misperceptions of agents are still present and thus the full potential of present ‘coordinatedness’ is not yet achieved.⁶ In economic terms, society is not operating on its production possibility frontier but inside it.

The ‘discovery problem’ is related to the dispersed nature of local knowledge. It gives rise to the question of how individuals can learn about and make use of the dispersed local knowledge of others – it deals with the issue of how new local knowledge can be *discovered*. How can we enable and motivate the discovery of new and better ways to satisfy constituents’/consumers’ wishes? To put it in Kirzner’s words, how we can assure the ‘generating flows of information or of signals that might somehow stimulate the *revision* of initially uncoordinated decision in the direction of greater mutual coordinatedness’ (1992, p. 147). The extent and seriousness of this problem is not known in advance – we don’t know what we don’t know. In economic terms, it is concerned with how to discover ways to shift the production possibility frontier outwards.

Market competition as a communication and discovery procedure

In the former section, I presented the two knowledge problems in a general context. In this section, I discuss both communication and discovery problem in the sphere of economic markets. The attention will first be directed towards the communication problem and how *consumers’ exit* in competitive markets provide a solution to it. Subsequently, I shall focus on the importance of *entrepreneurial entry* to remedy the discovery problem in markets for private goods.

Exit: free prices and the communication problem

Individuals’ subjective knowledge creates the possibility of making pure mistakes. In fact, entrepreneurs are often ignorant about what consumers really want. Their subjective perceptions do not always match ‘economic realities’ on the market place. Based on these wrong perceptions they make unrealistic plans. As Kirzner (1992, p. 154) notes, entrepreneurs often commit ‘over-optimistic mistakes’ – they misestimate demand curves. The result of these flawed plans is a discoordination between their preferences and their consumers’ (first knowledge problem).

In order to solve this discoordination, the relevant agents (here: entrepreneurs) need a *communication mechanism* which enables them to learn about the underlying economic realities (what

⁶ With ‘coordinatedness’ (Kirzner, 1992), I mean the degree to which ‘producer’s’ plans (resulting from their preferences) are aligned to the ‘consumer’s’ plans (likewise as a result of their needs).

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consumers really want). In markets, the price system constitutes such a mechanism. It represents a process of learning through trial-and-error (Hayek, [1948] 1958a, p. 100), which mainly operates through negative feedback in the form of disappointment and regret (Kirzner, 1992).

An entrepreneur may be seduced to demand a higher price for her goods because of the high demand she is expecting. If this expectation arises from wrong perceptions about consumers' wishes (over-optimism), her profit will not reach the expected figures, as consumers' preferences have not been sufficiently met. The disequilibrium prices (in our example, a too high price) and the resulting profits or losses 'alert market participants' about the disappointments (Kirzner, 1992). Disequilibrium prices alert producers that they have not realized all possible current coordination, and that there is room for improvement in regards to both their satisfaction and their consumers'.

Profit and loss (as a result of the price mechanism) signal whether an entrepreneur is doing right or wrong. Particularly losses (or lower profits) are the most powerful feedback. This negative feedback gives rise to disappointment (not the profit entrepreneurs' had hoped for) and regret (wished they had changed their plan in advance).

Bad plans become corrected and improved as either the failed entrepreneurs adjust their plans (motivated by disappointment and regrets),⁷ or the ones with bad plans become replaced by ones with better plans (Alchian, 1950). Thus, the price mechanism of competitive markets induces a process of error elimination (Caldwell, 2004, p. 213), which allows for more beneficial outcomes over time (Alchian, 1950).

How does this feedback mechanism come into existence? It is the *consumers' exit*, which can be undertaken in two ways. Firstly, consumers decide to buy a particular good from another entrepreneur, as they are unsatisfied by the services of the former – consumers decide to leave the particular entrepreneur's supply. Secondly, consumers decide to stop buying a particular good completely and rather choose more of other goods – consumers decide to stay away from a particular market. Consumer's exit (which is an expression of a changing demand curve) affects prices and thereby communicates the necessary (negative) feedback.

The effectiveness of the (negative) feedback mechanism of consumers' exit results from the relative low exit costs in competitive markets. Market competition is featured by a great number of suppliers of the same or similar goods – *overlapping supply*. This overlaps creates a low exit cost environment for consumers. High exit costs hamper consumer's exits as well as the movement of free prices. Additionally, prices communicate less clearly the preferences of consumers. Therefore, the higher the exit costs in a market, the more difficult is to solve the communication problem.

⁷ However, these adjustments in order to 'survive' in the marketplace are left to themselves. They adjust by making use of their unique knowledge.

Entry: profit-opportunities and the discovery problem

In economic markets the ‘discovery problem’ is concerned with both entrepreneurs’ search for new ways to satisfy consumers’ needs, and the anticipation of new consumer wishes by developing new consumption possibilities.

Since entrepreneurs, who risk introducing a new production procedure or a new product, are only in possession of parts of the relevant knowledge, their success is not certain. Thus, the intensity of entrepreneurial experimentation and the discovery of ‘new input-output combinations’ is often lower than desirable (Pennington, 2011, p. 22). Entrepreneurs’ limited knowledge about the possible gains of unachieved coordination often gives rise to ‘over-pessimism’ (Kirzner, 1992, p. 168). As a result, they risk less experimentation and discovery due to their underestimation of profit opportunities arising from a ‘higher level of coordination’ (Kirzner, 1992).

There is no automatic feedback mechanism that informs entrepreneurs of their over-pessimism (the erroneous underestimation of profit opportunities).⁸ However, the prospect of profit arising from unexploited coordination gains motivates entrepreneurs to experiment. Some entrepreneurs, alerted by local knowledge, may spot these gaps of discoordination. Considering that some individuals are more alert of unachieved coordination gains than others – local knowledge is neither equally dispersed nor random (Pennington, 2011; Skarbek, 2009) – directs the attention towards the importance of *entrepreneurial entry*.

An individual, who has yet to participate as an entrepreneur, may be aware of an unexploited profit opportunity due to his particular local knowledge. The new entrepreneur’s local knowledge alerts him of profitable movements towards a higher level of coordination. In order to solve the ‘discovery problem’ individuals need to be free to enter markets, as through this, the currently needed local knowledge they possess enters too.

The idea that an entrepreneur holds the belief that there are ‘gains of a higher level of coordination’ does, however, not necessarily mean that it is true (his *subjective* beliefs can be flawed). Again, profit and loss signals if an entrepreneur’s discovery is desired by the consumers. Pure entrepreneurial profit is the driving force of experiments, discoveries, and innovations. Entry of local knowledge enabled by entrepreneurial entry is their perquisite.

Humans’ imperfect cognitive abilities call for an institutional environment which foster learning. As Hayek has already recognized, the competitive market provides such an institutional setting.

⁸ In contrast, in the case of the first knowledge problem flawed plans and thereby the discoordination become automatically revealed by the price mechanism. The detecting of this kind of discoordination does not require a particular alertness of the producers (entrepreneurial alertness, see Kirzner (1973; 1979; 1992; 1997)).

Jurisdictional competition as a communication and discovery procedure

In this section, I focus on the two knowledge problems in the context of jurisdictions. Jurisdictions will be considered as providers of governance and public services. That is, as ‘enterprises offering local services in return for taxes’ (Frey, 2009, p. 7; Tiebout, 1956). Jurisdictional units will be characterized (and defined) by their functions rather than their attachment to a territory (Frey, 2001). First, I highlight the major differences between the jurisdictional ‘quasimarkets’ and genuine economic markets by reusing the categories *exit* and *entry* (Leeson, 2011; Boettke, et al., 2011). Subsequently, I focus on how effective competitive forces can be induced into the realm of jurisdictional services.

Economic markets versus jurisdictional ‘quasimarkets’

The nature of jurisdictional services, in contrast to most private goods, entails “natural” limits for the effective functioning of exit and entry (such as, spillovers or network effects). However, there are also considerable “artificial” (government-made) barriers to competition. I shall discuss both aspects in the following.

Exit

Competitive markets are characterized by great *overlaps* of different suppliers and a manifold variety of goods, which yields both a ‘diverse choice set’ and low exit costs (Mantzavinos, 2010). This effective exit option of the market is absent in politics (Buchanan, 1995, p. 21). Political decisions are mostly centrally conducted. The smallest unit is often the community (consider how many entrepreneurs act within a community, which indicates the stronger decentralization of markets). The considerably higher degree of centralization in the quasimarket for governance indicates its more monopolistic structure.

The monopolistic powers in jurisdictional markets are even higher than monopolistic powers in economic markets. In jurisdictional markets, not only is there one jurisdictional service offered within a monopolistic environment, but also close substitutes are most likely centrally supplied. Furthermore, citizens are obliged to contribute to the services in form of taxes. The only way to “escape” from a particular jurisdictional market (if individuals or communes do not have the right to secede) is by changing their place of residence, which involves substantial exit costs.

The high exit costs render its feedback mechanism to be less effective. Individuals are less likely to exit, even though they might be very discontent with the services provided by their particular jurisdiction. The lack of overlaps and the monopolistic structure of quasimarkets for governance and public services undermines competitive forces.

Entry

Jurisdictional services are often provided within geographical and, or functional monopolies. As Frey (2009, p. 3) remarks, '[e]ach government controls a particular territory, and each territory belongs to a particular government.' That statement contains two implications. Firstly, governments' territories are usually fixed and strictly defined (they are often physically contiguous (Frey, 2001)). Secondly, a particular territory is not associated with more than two governments on the same level. That is, services and authority of governments do usually not geographically intersect (Frey, 2009, p. 10).

Jurisdictions (communities, federal states, etc.) usually have a *territorial monopoly*, but are also in possession of a *functional monopoly*. That is, even lower jurisdictions, not only private firms or associations, are not allowed to compete with higher-level jurisdictions. In most countries, lower jurisdictions have for instance very restricted rights to levy taxes. They are often not free to decide which or how they provide public services. They are also financially heavily dependent on financial allocations of higher levels of government.

The monopolistic structure of many jurisdictional markets represents entry barriers for new 'jurisdictional entrepreneurs' and, thereby, entry barriers to new local knowledge. Restraining entrepreneurship hampers experimenting, discoveries, and innovation. Thus, it hampers the possibility to exploit the gains of a 'higher level of coordination.' Some individuals may, for instance, recognize that some constituents' wishes could better satisfied by different or new services. Officials of a particular jurisdiction might realize that they could provide their services more cheaply and satisfyingly also to other territories. These forms of jurisdictional experimentation are intensely restricted.

Jurisdictional services sometimes display natural monopoly characteristics (e.g., due to non-rivalry in consumption, or network externalities). Moreover, the fact that some goods are non-excludable give rise to problems of decentralization (Casella & Frey, 1992, p. 642; Buchanan, 1965), or the existence of network effects create higher costs of exit and entry (Leeson, 2011, p. 304). However, the territorial and functional monopoly positions of many jurisdictions are mostly of "artificial" origin. That is, the monopolies are the result of politically or constitutionally implemented restrictions, and not due to a natural development. As per Kirzner (1973), freedom of entry determines the markets competitiveness. The fact that jurisdictions are commonly in possession of functional and territorial monopolies displays an exceptional potential for competitive forces.

“Design” of effective jurisdictional competition

The strikingly higher exit and partially prohibitive high entry costs in jurisdictional “markets” make it more difficult for officials to learn about citizens preferences. The considerable barriers in jurisdictional markets seem to represent very “imperfect” conditions for effective competition. However, as Hayek ([1948] 1958a, p. 103) stresses, ‘competition is the more important the more complex or “imperfect” the objective conditions are in which it has to operate.’⁹

Following Frey’s (2009, p. 8) assessment that exit and entry are the important factors to create a competitive jurisdictional markets, I will argue that one has to tackle the prevailing “artificial” barriers. I propose two points that I consider as the prerequisites for such an effective jurisdictional competition: firstly the *overlapping (polycentric) organization* of jurisdictional services, and, secondly, the enabling of *jurisdictional entrepreneurship*.

Polycentric or overlapping jurisdictions

Which services, regulations, and kinds of governance do citizens desire? This question is hard to answer for every official in charge. Decentralization of jurisdictional service provision, for instance in form of federalism, can help to tackle this ‘communication problem.’ On the one hand, ‘local politicians are more aware of the local needs and constraints’ and citizens’ preferences can be better anticipated (Frey, 2009, pp. 5-6). On the other hand, the greater diversity constituents face increases their choice set (Mantzavinos, 2010). Their choice becomes, thereby, ‘finer’ and more articulate. Even in federalism, the scope for exercising exit is relatively small.

A way to eradicate some of these “artificial” exit barriers and, thereby, to substantially lower exit costs would be giving political units (or also individual citizens) the right to secede. As Buchanan (1995, p. 21) notes, if the separate federal states would ‘be constitutionally empowered to secede from the federalized structure, that is, to form new units of political authority outside and beyond the reach of the existing federal government,’ this would help to create a more competitive federalism. If federal states could secede, they would challenge the federal’s government monopoly and create a more contestable market. This would ‘prevent the central government’s ability to overawe the lower governments’ (Weingast, 1995, p. 4).

However, the potential for exit would be incomparably greater if also smaller units, such as communities or even single individuals’, had the right to secession.¹⁰ If an individual could proclaim to form his or her own “community,” exit costs would be very low, and strong competitive forces would be induced. The respective jurisdictions would receive prompt and clear feedback in

⁹ ‘[T]he need for competition is nowhere greater than in fields in which the nature of the commodities or services makes it impossible that it ever should create a perfect market in the theoretical sense.’ (Hayek, [1948] 1958a, pp. 103-104)

¹⁰ For a related discussion see Vanberg (2000).

cases where they are not sufficiently satisfying their citizen's preferences since the citizens' would secede in groups or individually. As a result, there could be temporarily 'empty communities' (Tiebout, 1956, p. 421), that is, analogous to the market where a company's failure to satisfy consumers leads to the absence of consumers.¹¹

The actual provision of jurisdictional goods is often organized in bundles. Jurisdictions do not only offer particular kinds of goods but rather a broad range of public services. They are multi-function units. Even if the citizens were free to choose their favored jurisdiction, it is hard for them to judge the jurisdiction's performance, since they have to compare the whole bundle of services of one jurisdiction with the whole bundle of others'. Jurisdictions, which are specialized on some functions – functional jurisdictions –, would allow a citizen to compare only these services of different jurisdictions where his or her preferences are currently insufficiently satisfied.

Further, as Frey (2009, p. 12) mentions, functional jurisdictions would enable the use of new and more knowledge, since it 'may also open up the politicians' cartel to competent outsiders.' Whereas 'all-purpose jurisdictions attract people with broad and non-specialized knowledge to become politicians', functional jurisdictions have a greater need to involve experts and individuals with the relevant knowledge to enter (especially when they fear that citizens can easily exercise exit).

The overlapping supply in the market creates a low exit environment that makes market competition so powerful in solving the communication problem. However, overlapping organization of jurisdictional service is mostly regarded as a waste of resources. As Ostrom et al. (1961) show, for the case of local governments, a 'polycentric' organization – a system with 'many centers of decision-making which are formally independent of each other' (Ostrom, et al., 1961, p. 831) – can be an effective mean to resolve problems in the provision of jurisdictional market.

In Frey's (2001; 2009, p. 10) conception, an overlapping organization of jurisdictional services implies two things. Firstly, jurisdictions may intersect with regard to their *functions*. For instance, one jurisdiction provides bus services and another offers train services (both intersect in the provision of public transport). Secondly, jurisdictions may intersect with regard to their *territory*. That is, two or more 'school jurisdictions' offering the same services in the same area (Frey, 2009, p. 10). Following this approach of organizational overlapping, jurisdictions would both lose their *functional* and *territorial* monopoly.

¹¹ From an exclusive focus on exit costs this seems to be desirable, since low exit costs increase the effective working of its communication signals. Since, jurisdictional goods are often featured by problems with excludability, individual secession could create free-rider problems. In the presence of non-excludable spillovers there exists a trade-off between the gains from solving the 'communication problem' and the costs of free-riding

Due to the overlaps, citizens can choose among jurisdictional services without changing their place of residence. This lowers the costs of exit considerably and makes citizens' exit a credible threat for jurisdictions. 'Voting with the feet' becomes a stronger mechanism and is more likely to discipline jurisdictions. They must now fear that citizens will exit if their preferences are not sufficiently met. The overlap enables sufficient diversity in the supply of public services and governance. Individuals will join exactly the jurisdictions that offers the best combination of taxes and public services (Tiebout, 1956).¹² The multiplicity of jurisdictions or clubs providing public services gives rise to strong competitive forces.¹³ The easy exit, due to overlaps, is an 'important means to make one's preferences known to governmental suppliers' (Frey, 2009, p. 12).

The functional and territorial monopoly of (most of the) jurisdictions represent strong "artificial" exit barriers, and, thereby, barriers to competition as a remedy for the 'communication problem.' The right to secede, provision of jurisdictional service according to their functions, and, most importantly, the overlapping organization of these services are a way to bring the quasimarket in jurisdictional services closer to a 'genuine market' in public services and governance (Leeson, 2011, p. 302). A maximization of the 'poly-ness' of the "market" in jurisdictions minimizes the exit costs (Leeson, 2011, p. 304), and, thereby, maximizes the competitive forces necessary to solve the 'communication problem.'

Jurisdictional entrepreneurship within a system of clubs

The dispersion of local knowledge causes a great deal of that local knowledge to lie fallow for society. This is partly because bits of local knowledge are not needed at every point in time, but also because in many social affairs entrance of new ideas is blocked. A competitive environment that allows for entry and entrepreneurship (in a broad sense) represents an institutional environment capable of mitigating the discovery problem.

A primer source of high entry costs in the jurisdictional quasimarkets is the functional and territorial monopoly. Potential competitors have no access to this market, or only to parts of the market, or only under acceptance of very high costs, or both. Jurisdictions are neither really independent from higher-level jurisdictions, nor do they have (extensive) power to tax or to provide particular services.

These restrictions represent severe "artificial" limitations of entry in jurisdictional markets. In order to increase the competitiveness, lower political units, such as communes, need to have

¹² 'Variety in service levels among various independent local government agencies within larger metropolitan community may give rise to a quasi-market choice for local residents in permitting them to select the particular community [...] that most closely approximates the public service levels they desire.' (Ostrom, et al., 1961, p. 838)

¹³ '[C]ompetition among producers of public services in a metropolitan area [...] may produce substantial benefits by inducing self-regulating tendencies with pressure for the more efficient solution in the operation of the whole system.' (Ostrom, et al., 1961, p. 838)

the freedom to form their own jurisdictional units, enter new jurisdictional markets (with regard to new functions, and new territories), and collect fees or levy taxes in order to finance their services (Frey, 2009).

Open markets allow for the entry of new local knowledge. Due to the dispersion of local knowledge, ‘there is no assurance that others will identify the same profit opportunities’ (Skarbek, 2009, p. 417). The (high) entry barriers in jurisdictional markets prevent the entrance of particular local knowledge. In order to realize jurisdictional gains of a higher coordination (solving jurisdictional discovery problems), entry barriers should be minimized. Again, economic limitations will certainly be in place, particularly network effects, which may naturally limit the number of jurisdictions (Leeson, 2011, p. 304), and thereby also the degree to which discovery problems can be solved. Facilitating jurisdictional entry may not be as easy and effective as in genuine markets, but it can at least help to realize some of the so far undiscovered jurisdictional gains.

In order to solve, or at least mitigate, the jurisdictional ‘discovery problem,’ the “artificial” barriers to entry need to be removed. Easy entry is a necessary step for creating a competitive jurisdictional market. The sufficient step, however, is to enable entrepreneurship also in the arena of jurisdictions.

In markets, profit-opportunities motivate for entrepreneurship. The prospect of profit motivates alerted individuals to discover new input-output combinations. The price-mechanism and the resulting profit and loss are an important tool to realize the gains of a ‘higher level of coordination’. However, these are usually either absent, or only weakly developed in jurisdictional quasimarkets.

A way to mimic or rather to ‘establish a genuine market in governance,’ which also incentivize and motivate for entrepreneurial discovery, would be to replace the ‘system of government’ by a ‘system of clubs’ (Leeson, 2011, p. 302). In such a system, clubs provide jurisdictional services. Jurisdictional clubs have owners and they earn profits from the members of their clubs (Leeson, 2011, p. 303). Moreover, individuals are free to join (if the club owners accept them as members) or to leave the respective jurisdictional club. As per Leeson (2011, p. 303), ‘in the system of clubs governance suppliers are residual claimants on revenues they generate through constitutional compliance.’ Thus, the club-owner’s revenues depend on his or her constituents’ (members’) preferences.

In a system of clubs, the opportunity of satisfying (some) constituents’ preferences better than any rival club – and, thereby, the chance of realizing profits – motivates the jurisdictional entrepreneur’s discovery. The number of new members and the respective revenues from membership fees reflect the economic market’s profit-and-loss-signals.

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Jurisdictional entrepreneurship would, thereby, not only help to mitigate discovery problems, but also allow individuals to conclude as heterogeneous ‘governance contracts’ reflecting their heterogeneous preferences. As Leeson (2011, p. 303) remarks, in this scenario individuals do not enter the same constitutional contract as in Buchanan’s (1975) *Limits of Liberty*, but a ‘variety of different constitutional contracts – as many as “the market will bear.”’

However, as Buchanan (1965, p. 13) notes, the efficient organization of clubs applies only to ‘arrangements where “exclusion” is possible.’ Thus, the existence of externalities, which cannot completely be internalized, produces inefficiencies in the ‘system of clubs’ (Leeson, 2011, p. 307).

Externalities are doubtlessly an important point challenging the superiority of a club system. Two responses to that. Firstly, these inefficiencies due to spillovers might be compensated by the gains the system of clubs creates through solving the ‘discovery problem.’ Secondly, the constant discovery initiated by genuine competition in jurisdictional services in a club system, may enable the discovery of solutions for externality problems. Alerted jurisdictional entrepreneurs might find a way to internalize the spillovers if it seems profitable to them.

An opening of jurisdictional markets by allowing the small units (such as communes or individuals) to form new jurisdictional entities would remove the “artificial” barriers to entry. A jurisdictional system of clubs would come close to a genuine market in jurisdictions and suggest that it may allow for a comparable degree of solving the ‘discovery problem.’

The provision of public services faces severe “artificial” barriers to the discovery of procedures of competition. The communication existing knowledge and discovery of new knowledge is thereby crucially hampered. A political reform aiming at minimizing the “artificial” (that is, political) restrictions on exit and entry would allow for a greater extent of learning and would help to rescue as much of competition’s knowledge-problem-solving properties. Hayek’s insights provide a fruitful and inspiring source for further work on jurisdictional competition.

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