YRJÖ JAHNSSON LECTURES

The New Systems Competition

Hans-Werner Sinn

Blackwell Publishing

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Yrjö Jahnsson was Professor of Economics at the Helsinki University of Technology between 1911 and 1936. In 1954, his wife Hilma Jahnsson established, in accordance with her late husband's wishes, the Yrjö Jahnsson Foundation. The purpose of the Foundation is to promote Finnish research in economics and medical science, and to support Finnish institutions of research and education.

In the field of economics the Foundation is the most important source of private research funding in Finland. It supports the work of individual scholars and institutes by awarding them scholarships and grants. It organizes scientific seminars and workshops in the field of economics and medicine. And it invites internationally renowned economists to Finland to give lectures.

In 1963 the Foundation launched a special series of the Yrjö Jahnsson Lectures, which are organized in Helsinki every two or three years and which are published. Up to the end of 1996 no fewer than five of the economists who have served as lecturers in this series have been awarded the Nobel Prize in economics.

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Contents

Table and Figures

Table

Figures

Preface

This book contains the material of the Yrjö Jahnsson Lectures which I presented in January 1999 in Helsinki. I am very grateful for the honour of having been invited to contribute to this famous series whose published results have not only had a significant impact on the course of economic thought but have also influenced my personal development as an economist ever since my student days in Münster and Mannheim. That I would be asked to deliver these lectures one day would never have crossed my mind. I am grateful to the foundation and the Finnish colleagues for the hospitality they offered to me and my wife during the lectures.

The lectures are about systems competition in the sense of competing for mobile factors of production rather than the traditional yardstick competition. While a substantial body of literature has developed on the problem of tax competition, my interest centres on a broader set of competitive instruments, including government expenditure, environmental regulation, labour standards, quality standards and even competition rules. There is such a thing as the competition of competition rules, for example.

One topic which I had wanted to include in the lectures but failed to handle satisfactorily at the time was the competition of banking regulation. In the light of the Asian banking crisis, I found this topic sufficiently important not to submit the manuscript before I had managed to add a chapter. However, due to my new obligations as president of the Ifo Institute, I did not succeed in doing so until the summer vacation of 2001. Writing the chapter was fun, and I do not regret having waited.

I have been interested in systems competition ever since my inaugural lecture as honorary professor at the University of Vienna in 1988, because I doubted the frequent claims of my fellow economists from the German Scientific Council of the Ministry of Economics that systems competition could be a construction principle for the European Community. Since then, I have published a number of policy and theory articles on various facets of the topic, including, for example, a report for the German Monopoly Commission. I have conducted graduate courses on systems competition at the University of Munich and in the Dutch doctoral programme at the University of Groningen. I also presented a number of seminars on related topics at various European universities, and I circulated earlier versions of the manuscript among my colleagues and students. This is the time to thank all those who participated in the lively discussions of my often controversial propositions and who gave many useful comments, suggestions and counter arguments which have helped me sharpen the argument. In particular, I am grateful for the comments I received from the very knowledgeable and lively audience that attended the Yrjö Jahnsson lectures.

I can only single out a few people who assisted in this publication. I received useful comments on the banking chapter from Vesa Kanniainen, on the chapter on competition laws from Klaus Schmidt, and on various other aspects of the book from Ronnie Schöb, Marcel Thum and Alfons Weichenrieder. Technical assistance as well as useful comments on the content I also obtained from Regina von Hehl, Juli Irving-Lessman, Marko Köthenbürger, Robert Koll, Paul Kremmel, Claudio Thum and Frank Westermann. This is the first of my books for which I am indebted to my IBM laptop rather than my secretaries for an excellent typing job, though now the blame for the remaining errors rests firmly on my shoulders.

Gauting, January 2002
Hans-Werner Sinn

1

Competition Among States

The New Systems Competition[1]

In a broad sense, the competition between systems has ended. The enormous economic power of the capitalist market economy forced communism to its knees: the discredited central planning system has left the stage of world history.

In a more narrow sense, the competition between systems is just beginning. Not all market economies are the same. Today many different varieties can be found all over the globe: market economies with planning elements as in France, quasi-night watchmen systems as in the USA, liberal corporate systems as in Japan, competitive socialist systems as in China, and social market economies as in Germany and the Scandinavian countries. Only time will tell which of these different systems will survive and how the remaining systems will evolve.

The old systems competition between communism and capitalism was aimed at gaining economic, cultural and, most importantly, military dominance, and took the form of mutual observation, imitation and innovation while the borders were closed. In the new systems competition, the goal of military dominance has lost importance, and a new element has been added to the competitive process that fundamentally changes its nature. This element is the international migration of people and capital as a reaction to national policy decisions. The migration response of production factors makes states behave like firms which

[1] A variant of this section has appeared as Sinn (2001).

compete for customers by offering them attractive combinations of tax prices and public goods. In the old systems competition, relocation decisions were excluded by the Iron Curtain and other means of tightening the national borders. In the new systems competition, location decisions will be the central driving force for national policy reforms. The factors of production are complements and cannot operate without one another. Whoever controls the political process in a country will have to make sure that not only the factors he owns are treated well by the state but also those factors that are mobile internationally and whose escape would have adverse repercussions for the domestic economy as a whole.

The difference between the old and the new systems competition can be clarified by alluding to Albert Hirschman's (1970) theory of institutions which emerged from his personal experience as a socialist youth leader who managed to escape the Nazi regime. Hirschman argued that people have three options to cope with unattractive institutions or states: 'exit, voice and loyalty'. Voice and loyalty were the forces that were characteristic in the old competitive process. Exit is the special feature added in the new form of systems competition. If exit had been easier at the time when Hirschman fled, many more people would have left Germany, and history might have taken a different course.

Today, there is a widespread fear in social welfare states that private companies will use the exit option. While goods and financial capital have been moving freely across borders for some time, real capital is now following. More and more firms are transferring their operations to countries with low wages and taxes to hold their own in the increasingly intensive international product and cost competition. The more liberal the trade relations and the lower the relative transportation costs, the easier the relocation becomes, for it is no longer necessary to choose a production site in the neighbourhood of marketplaces. Cross-border mergers contribute to reducing the cost of relocation decisions. Once a multinational company is established, it can easily shift capital and tax bases between the countries where it operates. The New Economy, too, will facilitate relocation decisions. Virtual firms that employ people in different parts of the world and connect them via the Internet can be moved to low-tax countries without moving matter and without incurring any particular relocation cost. The Organization for Economic Cooperation and Development published an extensive policy report under the title *Harmful Tax Competition. An Emerging Global Issue*

(OECD, 1998) in which they spelled out a large number of legal and economic problems resulting from the increased mobility of international capital. The issue has, indeed, become more pressing in recent years and needs both analysis and policy actions.

By comparison, labour markets are far from perfect, since many people are reluctant to cross cultural borders and ignorant about living conditions in other countries. However, things are changing even here. More and more people from all income categories are starting to move, looking for better living conditions elsewhere in the world. There is a host of top managers who are willing to work abroad or are expected to do so by the multinational corporations that employ them, guest worker flows are normal phenomena in the European Union and elsewhere in the world, and many retired people decide to spend their pensions in low-cost countries. In terms of languages spoken, some Mediterranean islands are undergoing changes in their national identities, and construction sites in northern Europe have become veritable Towers of Babel.

One special aspect of globalization is the migration of poor people from the less developed economies to the more developed ones. The time when lack of knowledge and transport costs hindered such migration is long since past. Global television coverage and increasing hordes of tourists are spreading the news about the prosperity of the Western industrial countries even to the most distant Himalayan villages, and the prices that the illegal transport organizations charge for transferring people from the Third World to the First World are falling fast because controls have weakened and air traffic has become cheaper. Ships full of Kurdish refugees land on Italian coasts, planes with Tamil asylum seekers land at German airports, and desperate refugees from the former Soviet Union risk their lives by swimming across the Oder at night to enter Germany undetected.

As will be explained below, the migration flows will probably increase multifold when eastern Europe joins the EU for then the right of residence will be granted to those who wish to work abroad. Extensive migration can be expected in Europe as the pressure built up over decades of communist dictatorship is suddenly released.

The increasing mobility of people, goods and factors of production will put the countries of the world under severe competitive pressure. Competition is no longer over advancing a largely self-sufficient economy to a position of economic strength, social peace or military superiority by means of clever internal policy measures. The strategies of Bismarck, Stalin or Reagan are no longer in demand. The leaders of every country must now consider what influence their national institutions can exercise on the cross-border transfer of economic activities. Taxes, expenditures, social transfers, public goods, regulation systems, legal systems and many other things affect the location decisions of people and production factors just as much as do wages and other economic factors which are not directly influenced by the government. No government can permit mobile capital to be driven away because of the unusual design of its institutions any more than it can permit its institutions to attract the world's poor. Like a private firm, a government competes for good customers and must try to ward off the bad ones.

In the late 1960s the city of New York implemented a very generous social assistance programme to help its poor and check the negative social implications of poverty. It soon became clear that the programme could not be maintained since it attracted the poor from all over the United States and imposed a huge burden on the municipal budget. The programme had to be limited to prevent the city from going bankrupt.[2] The city government had to learn the hard way that it could not act against the forces of systems competition.

The effects of systems competition are not always so readily evident, however. Often the migration responses are so slow that a long period of time can elapse before a country is forced to react to a policy move of another country. In 1982 the Wassenaar agreement on wage moderation was made in the Netherlands, and in 1986 the United States enacted its policy of tax cut cum base broadening. It took Germany more than 15 years and a number of spectacular relocation decisions to understand what had happened and to consider copying these reforms. In the light of these observations, the reader should be warned

[2] In John Lindsay's first term as Mayor of New York City (after 1965), social welfare spending grew from 12.5% to 23% of total city expenditures (Glaeser and Kahn, 1999, p. 124). The increased spending went primarily to low-income groups, mostly black and Puerto Ricans; eligibility was lowered and benefits were increased (Shefter, 1985, p. 86). The city became very attractive for this segment of the population, which immigrated to New York from all over the United States.

Since the tax base eroded (also as a result of the economic downturn between 1973 and 1975), and since insufficient effort was made to get permission from the state and federal levels to raise taxes, the city's debt increased rapidly, and in 1975 the banks refused to include city securities in their portfolios. As a result, the city had to implement drastic spending cuts to regain its credit standing.

not to interpret the theoretical results of this book from the angle of day-to-day politics. It may take many decades before the forces analysed here become visible.

The long time span is a potential problem from an international policy perspective, for if there is something wrong with systems competition, if it does not work in the same way as private markets do, then it will be difficult to implement timely corrective measures such as mutual international agreements on political conduct or the development of international political structures and institutions. The sluggish reactions of national policies could make a trial and error process in the development of international institutions extremely costly. When unpleasant implications of systems competition become visible, it may be too late for countervailing policy measures. Therefore, theoretical studies are indispensable. They give an early warning of some problems, alert politicians and help them take precautionary actions.

The Selection Principle

Many economists place much faith and hope in the forces set in motion by systems competition. They praise this type of competition as a disciplinary device that will shape a better Europe. Some of them, mostly in the tradition of Hayek and Schumpeter, argue that competition per se is a good thing because it is an ‘exploration and invention device’ and brings about ‘creative destruction’. Others refer to Adam Smith’s Invisible Hand and the Main Theorem of Welfare Economics that establishes the Pareto efficiency of competitive equilibria under certain conditions. Still others simply overlook the potential fallacy of aggregation, confusing national with international optimization constraints.

It is undoubtedly true that the word ‘competition’ rings positively in the economist’s ear. However, this does not decide the matter, since the rules of the game under which systems competition takes place are very different from those under which a market economy functions. Where are the well-defined property rights and where is the price vector that makes the plans of different agents compatible and clears the markets? There may be analogies, but to work them out is anything but a trivial exercise. Even market economies will not, in general, be Pareto efficient when there are increasing returns to scale, external effects, information asymmetries or other violations of the assumptions underlying the Main Theorem of Welfare Economics. How can it be taken as self-evident that systems competition would not suffer from such problems? Approaching the problem of systems competition with semantic intellectual exercises leads nowhere. Migration competition has its own adaptive mechanisms which need specific analysis.

Models of systems competition with assumptions tuned to efficient competition between states can now be found in the literature. These models go far beyond the semantic exercises of the Hayekian economists, because they define the exact conditions under which the Invisible Hand would work in systems competition.[3] This is without doubt an intellectually attractive venture, but whether the models really depict the essentials of systems competition is debatable.

The reason for the doubts is to be found in what I have called the *Selection Principle*.[4] The Selection Principle says that governments have taken over all those activities which the private market has proved to be unable to carry out. Because the state is a stopgap which fills the empty market niches and corrects the failures of existing markets, it cannot be expected that the reintroduction of the market by the back door of systems competition will lead to a reasonable allocation result. Instead, it must be feared that the failures that originally caused the government to take action will show up again at the higher level of government competition.

There are a number of examples of the kind of fears that the Selection Principle gives rise to, and this book studies some of them. If the state has taken over the production of goods with increasing returns to scale because private markets tend to result in ruinous competition, must not ruinous competition between states be feared? If the state has stepped in as an insurer where private insurance markets have not been established because of adverse selection processes, will there not be an adverse selection between insurer states, too? If the state regulates the product quality of private firms or makes regulations about bank solvency because it wants to prevent lemon markets from appearing, will there not be a lemon market between the states in which the states neglect their regulatory responsibilities? And finally, if the state

[3] Optimistic views of fiscal competition are held, e.g., by Richter (1994, pp. 223–430), Wellisch (1995) or Oates and Schwab (1988, pp. 333–54). For a thorough overview and useful extensions of the existing literature see Wellisch (1999).

[4] See Sinn (1997a, 1997b); for initial thoughts in this direction, see also Sinn, S. (1992).

imposes competition laws to hinder private monopolies, should we not expect competitive states themselves to have an interest in fostering cartelization in their national economies? An attempt will be made in this book to give a deeper and more precise meaning to the doubts expressed by the questions.

If the Selection Principle holds, then one can be optimistic about the working of the market economy because the market handles those allocation problems which it can handle. Almost by definition the market economy would perform quite well. On the other hand, it follows from the same argument that we have to be pessimistic about a 'marketplace' in which governments compete, because governments are coping with the rejects of the competitive process. Nothing could be more misleading than the usual conclusion by analogy from private competition to systems competition.

The historical selection of government tasks may also have come about partly by means of a competitive process. However, as explained above, this was not a systems competition forced by factor migration, but a process driven by the attempt to gain economic, cultural and military dominance. Such competition follows quite different laws from those which apply to migration-induced competition. Given the Selection Principle, it seems possible that the latter may destroy the results of the former.

The Selection Principle is in agreement with the rules and legal aspects of the development of the state as investigated in the traditional school of public finance as represented by Schäffle (1880), Sax (1887), Wagner (1876), Wicksell (1901), Lindahl (1939), Musgrave (1959) or Timm (1961), to mention only a few of the important figures. According to this school, the modern state necessarily accompanies the industrialization and urbanization which occurred as a result of the Industrial Revolution. It came into being primarily to remedy the intolerable state of affairs which characterized the end of the nineteenth century. The suffocating cities, the wretched living conditions of the proletariat, the poverty of the old, the catastrophic hygienic situations, and many other outrages resulted in a general need for government intervention in the market process which gradually, after various institutional and political impediments had been overcome, led to growing government participation. It was pressure of massive social problems that forced Bismarck to introduce his path-breaking reforms, and it was the power of the democratic majority vote that determined the further development of the modern state into a service provider for its citizens. Despite all its weaknesses and problems, the state must be seen as an instrument for meeting the collective responsibilities which the private market cannot fulfil. It is not a result of an error of history, it is history's logical consequence.

Inefficient Governments and Systems Competition

Although the useful role of governments in the development of modern societies seems obvious, the modern state admittedly suffers from severe deficiencies in its internal decision-making process, as was explained by Buchanan and Tullock (1962), Olson (1965) and other members of the public choice school.[5] In a distributional political struggle between small and large groups, the small groups are always stronger than the large groups because in small groups the value per capita is higher and it is easier for its members to overcome the internal free rider problem in starting a political action. Governments and parliaments therefore tend to concentrate on legal reforms which make gifts to the few and charge the many, and these tend to be tax financed expenditures that favour rent seeking subgroups of the society. The maximization of national welfare is often incompatible with these reforms.

There is some hope that systems competition will reduce this type of internal inefficiency because mobile factors of production will prefer the less inefficient states and force the governments to choose their policies in line with the national interest rather than the wants of special interest groups.[6] This hope follows the same logic as the view that private competition eliminates inefficient companies or forces them to act efficiently. Indeed, much can be said for this logic under ideal market conditions. Inefficiently managed firms have high average costs and are forced to match the lower costs of efficiently managed firms to

[5] The public choice school founded by James Buchanan and Gordon Tullock has a pessimistic view of government. Buchanan, the 'libertarian socialist' and dyed-in-the-wool Southerner, has a deep-seated aversion to the state. The family trauma of the lost Civil War and the self-sufficient life on the farm where he grew up made him see in the central government a presumptuous authority whose power needs to be restricted (see Buchanan and Musgrave, 1999).

[6] For a criticism of this view see Edwards and Keen (1996) who showed that systems competition may even exacerbate the political distortions.

stay in business. The Main Theorems of Welfare Economics probably also apply, if the managers selected by the market process are too stupid or selfish to actively implement the conditions for maximum profit but clever enough to understand that they will have to mimic successful competitors in order to survive.

The problem, however, is that internal efficiency does not imply allocation efficiency as such. Consider the example of environmental pollution to clarify the point. Without competition, a management with a romantic, nature-loving orientation could survive but under competition it has no chance. Businesses that maximize their profits and minimize their private operating costs will prevail, and these are the environmental polluters.

The Selection Principle states that ideal market conditions tend to exist in private competition but not in competition between states, and this raises doubts as to the efficiency of systems competition even if national governments actively pursue a policy of national welfare maximization. For a similar reason as in the case of private firms, competition will force even the badly functioning governments to mimic their successful neighbours who managed to find better policy mixes with regard to the mobile factors of production, but such policy mixes need not be better from an international welfare perspective.

In this book it will be assumed that the behaviour of the individual country serves the goal of maximizing national welfare, given the behaviour of other countries. Despite, or better, because of the perfect achievement of this goal, systems competition turns out to be defective in a number of cases. As correct as the thesis that systems competition forces the nation state to seek national efficiency is, it does not follow from this that systems competition in itself is efficient.

The book does not assume benevolent politicians, but it abstracts from the distortions in the democratic voting process resulting from lobbying activities of the kind the public choice school has emphasized. It assumes a well-functioning democracy. Selfish politicians who want to be re-elected in a democratic voting process maximize domestic rents and choose policy moves that are Pareto optimal from a national perspective, for if they did not, they would be beaten by others who offer such policy moves. The focus is directed entirely on a study of the effective functioning and possible failures of systems competition when the competing countries themselves act rationally in the national interest. The name *systems economics* may be appropriate for this study area.

Systems Economics and the Hierarchy of Competitive Processes

Systems economics examines the functioning of systems competition under the idealized assumption that the national governments are not interested in the general welfare of all countries but in the well-being of their own citizens. Thus the methodological procedure of systems economics corresponds with the standard economic model used to analyse private allocation processes, which is based on the assumption of a rational individual choice by *Homo oeconomicus.*

Somewhat heroically the economist assumes that firms are capable of maximizing their profits and households are capable of maximizing their utility, disregarding the internal aggregation problems within these groups of individuals. These assumptions are not made because anyone believes that they are strictly true, but in order to avoid the danger of confusing failures in the rules of the game in which these groups participate with coordination failures inside these groups themselves. Problems in the internal organization of firms, deficiencies in the rules of conduct within a household or psychological inadequacies in people's minds are disregarded. This methodological constraint leads to policy recommendations that are free from dictatorial welfare objectives, satisfy the principle of methodological individualism and minimize the risk of calling for overdrawn government interventions. The analysis of coordination failures at lower levels of decision making is left to other disciplines including the economics of the family, business economics, psychology and sociobiology. Such failures are there, but they contribute little to the foundation of economic policy within a country.

A similar remark is appropriate for systems economics when the question is whether uncoordinated government actions lead to an efficient equilibrium. Here the national government is assumed to act like *Homo oeconomicus* in order to minimize the risk of fallaciously diagnosing a deficiency in systems competition and deriving an excessive demand for supra-national policy actions. It is true that there are failures within the political systems of the single countries involved, but once again such failures contribute little to the foundation of economic policy measures to be taken by centralized government bodies such as the European Parliament or the EU Council of Ministers.

The study of the internal deficiencies in the government sector can be left to the public choice school, which has specialized on this topic and which itself makes similar abstractions on a lower level of the decision hierarchy. The public choice school assumes that politicians are rational agents and private markets function well, leaving the analysis of mental deficiencies and market failure to other disciplines. The public choice theorist knows that the failures of the internal political competition can only be isolated when clever, maximizing politicians, households and firms are assumed, and the systems economist knows that failures of systems competition can only be isolated when clever, welfare-maximizing governments are assumed.

Similar remarks can be made about the business economist and the family economist who, using the principal agent model, derive internal rules which lead to the desired success of the firm or household under the assumption of clever, utility-maximizing employees or household members. The principal agent model does not attempt to find rules that make dull employees behave efficiently but, instead, rules which encourage smart employees to work harder, and it explains the economic behaviour inside the household, assuming that the household members are rational agents rather than assuming that they are dunces.

Systems economics studies the competition between states. The public choice school studies the competition between politicians within a single state. Economic theory studies the competition between households and firms in private markets. Business economics studies the interaction between the employees within a firm. And the economics of the family studies the interaction of household members. Each of these disciplines looks at the interactions between individual decision makers, abstracting from the deficiencies inside the aggregates which they call 'agents'. They all assume that the agents of their models behave rationally, and ultimately they attempt to find rules and constraints that ensure the emergence of collectively rational actions that are compatible with individual rationality on the part of these agents. The business economist looks for internal worker-incentive structures that ensure profit maximizing behaviour within the firm. The family economist tries to find social norms or legal rules for economic behaviour within the family that result in a Pareto-efficient intra-household allocation of resources and a rational behaviour of the household in the marketplace. The economist, here especially the public finance economist, tries to optimize the government laws and regulations so that households and firms interact in an efficient manner. The public choice theorist tries to find constitutional rules which ensure that the politicians