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Listed response number 2 for Economics Discussion Paper 2010-6

Referee comments on:

"An Enabling Mechanism for the Creation, Adjustment, and Dissolution of States and Governmental Units," by Kjell Hausken and John F. Knutsen

The authors offer an amalgam of ideas, about formation and dissolution of governments, with non-zero territorial jurisdiction (where the government has some land ownership), combined to create mechanisms that aim at Pareto optimality. Their ideas, for designing their governmental decision making processes as well as determining the size of the governmental unit, are aligned with Charles Tiebout's "voting with your feet" and Ronald Coase's theory of the firm. Their definition of a governmental unit is one which has a territory, a function and a population (at least one). Exit from this governmental unit is free and entry may or may not be free depending on preferences of the population and the design of immigration policy. Competition between governmental units is assumed to be desirable (cooperation is not considered as possible alternative). There is nothing in the model that prevents governmental units from cooperating. In fact the assumption is that there would be quite a lot of cooperation as there is cooperation as well as competition among firms. Cooperation and competition are not opposites. In order to compete effectively, most firms are forced to cooperate, though not necessarily with direct competitors. The following has been inserted towards the end of section 5: "Competition between governmental units is assumed to be desirable, and usually occurs jointly with cooperation. Using the language of game theory, one example is coordination games where the players coordinate on a mutually preferably equilibrium. Other examples are mixed motive games such as the battle of the sexes or chicken game where players compete for their preferred equilibrium, but also coordinate to avoid outcomes which can be jointly disastrous. Zero-sum games, exemplified by dividing a fixed cake, cause competition and cooperation to be at odds with each other, but such games are not the most common societal games which usually involve joint competition and cooperation." The authors focus on the operational aspects of this competition versus the outcomes. The authors provide detailed definitions of various dimensions of the process and the conditions imposed on the process. However, the conditions imposed make it difficult to identify a viable functional pursuit for the government. We are not concerned about defining a priori what ought to be the functional pursuit or task of government. This is something for the inhabitants to decide, not economists. The authors provide two examples of governmental functions that presumably lend themselves to the design proposed by the authors: tax collection and garbage removal. In a sense, these characterize two extreme ends of public sector functions: the former is feasible only via a legal and constitutional authority (marginalized by the model's almost exclusive focus on markets and resident mobility) and the latter is a largely private function that is performed by governments, often in competition with private providers. Yes. The following has been inserted in section 3 after the examples of tax collection and garbage removal: "The design in this paper enables a government to choose any function that the inhabitants prefer, e.g. those functions present in our current societies, or a subset of these functions, or functions not common in our current societies. This inherent flexibility enables innovation in the provision of governmental services or functions including innovations in organization that may involve competition and cooperation."

A more detailed description of conditions imposed by their model on the creation and dissolution of governments that ignore some of the key constraints in performing such functions are:

(1) There are economies of scale in both the functional illustrations (given above) and once we consider larger bodies of domiciliaries, transaction costs are not zero in these functions (for example, administration and enforcement costs in the case of taxation have economies of scale). Transaction costs are never zero. The six words “absent decision making and transaction costs “ at the end of point 4 in section 7 have been removed to avoid confusion. The authors discuss this issue on page 22, but it’s unclear from this description as to how the community size will adjust to the optimum size and yet be Pareto optimal with respect to domiciliary preferences (unanimity or near unanimity within a particular territorial unit). The end of point 4 in section 7 has been rewritten as follows: “The design is Pareto optimal because those that have other preferences will leave. No a priori definition is imposed for “optimum size”, which follows as a consequence of the residents’ preferences.” The authors also do not discuss how the costs and benefits of the functions will be distributed across domiciliaries in the equilibrium situation and what form of taxation will be used to pay for the functions (these are some of the limitation of the Tiebout model as well). The end of point 4 in section 7 has been rewritten as follows: “As an example, taxes are decided by the domiciliaries. The actual distribution of costs and benefits across domiciliaries in equilibrium depend on the domiciliary preferences, and how domiciliaries move in and out of governmental units. This paper does not impose exogenous preferences on domiciliaries, and hence does not provide a mathematical formulation of the equilibrium.” The following footnote has been inserted: Because collective decision making is costly in itself, we do not expect all decisions to be by unanimity. Decision making that does not involve large external costs is likely to be delegated. The proposed model works on all costs and benefits, including external costs and collective decision making costs. This optimizes the tradeoff between the different costs and benefits as perceived by each domiciliary, and also optimizes for all domiciliaries.

(2) On page 15, the authors describe their proposed “adjustment mechanism,” as extending beyond the transfer of traditionally portable resources to traditional immovables, cultural barriers, etc. However, they don’t provide any illustration of how such “immovables” might be transferred in a costless way considering their proposed mechanism. The end of that paragraph has been rewritten as follows: “Although the exit costs are reduced, there is no such thing as a costless transaction. The cost of the transaction is part of what the individual has to consider.”

(3) In discussing their assumption 4, they consider the example of a fee for entry –a potential tool that can be used to create a barrier to entry for population considered undesirable. An entry fee would certainly not serve the interest of the poorer population seeking entry to the jurisdiction (a point not considered in item 8 on page 18). The following has been added to the end of item 8 in section 6: “Governmental units that require a fee for entry, in order to prevent free-riding e.g. on luxury public goods, likely exclude the poorest immigrants who instead transit to units with other characteristics including lower or no entry fees.” The following footnote has also been inserted: “Our current societies have huge problems in this regard. Some people, who want to leave their country, pay smugglers huge amounts and/or take huge personal risks in crossing borders illegally to countries they prefer.”

(4) It is also unclear how the adjustment mechanism proposed by the author is different from the Tiebout “voting with your feet” mechanism with the addition of zoning or other jurisdictional restrictions (analogous to the fee/immigration requirements in the present model) later used to salvage the Tiebout’s local government public goods provision model.

The following has been inserted at the end of the discussion of the Adjustment Mechanism in section 5: “The difference between the Adjustment Mechanism and Tiebout’s “voting with your feet” mechanism is that the latter does not enable the movement of what to most people is their most important capital asset i.e. their real estate (whether residential property or commercial or other real estate). The Tiebout mechanism has no mechanism for the release of assets tied to land from dysfunctional governmental units and the transfer of these real assets to more effective governmental units. The release of assets from non-competitive firms through the mechanism of “creative destruction” is a key driver of economic growth. Our mechanism provides for a similar release of assets from dysfunctional governmental units.”

(5) Finally, the applicability of the model proposed by the author to situations of violence and national defense is not convincing. **Has been rewritten.** National defense is an area involving huge economies of scale, whether defense is superior to attack (stated in the paper on page 24 –citing Clausewitz for this statements) is debatable and depends on the specific context and international sanctions (mentioned on page 24) typically work slowly. **The Clausewitz quote has been removed.** The authors assert (on page 24) that historical experience has shown that violent governments are more successfully dissolved than marginalized groups engaged in political wasteful processes (no explanations or citations are provided for this statement). **The following has been inserted related to that discussion: “As an example from WWII, Germany became a threat when it invaded neighboring countries, and Japan became a threat with the Pearl Harbor attack.”**