PART TWO

The Optimal Number of Governments

According to the usual economic formulation, corporations are hierarchies bounded by markets (Coase 1937; Williamson 1995). Small firms require less hierarchy and more markets, whereas large firms require more hierarchy and fewer markets. For example, an automobile manufacturer can buy tires for its cars from another corporation or make tires in a subsidiary. Buying tires involves two firms using a market, whereas making tires involves one firm using hierarchical organization. The relative efficiency of buying or making a private good depends on the relative efficiency of markets and hierarchies. The optimal hierarchy in firms and the optimal number of markets pose the same problem.

Just as the private sector consists of markets and hierarchies, so the public sector consists of governments and hierarchies. In democracy, the citizens elect their government, so democratic states are hierarchies bounded by elections. Centralized states require fewer governments and more hierarchy, whereas decentralized states require more governments and less hierarchy. For example, the national assembly can direct the ministry of education to provide schools for all localities (centralized), or boards elected in each locality can provide local schools (decentralized). The relative efficiency of centralized and decentralized states depends on the relative efficiency of hierarchies and elections. The optimal depth of hierarchy and the optimal number of governments pose the same problem.

Part 2 applies the principles of voting, bargaining, and administering to the problem of the optimal number of governments. Chapter 5 concerns relations among governments. In theory governments facing zero transaction costs will bargain to efficient agreements. This is true regardless of the organization of intergovernmental relations. In reality the organization of associated governments affects the outcomes of bargaining among them. Governments can associate on the basis of unanimity rule or majority rule. Unanimity rule causes holdouts, which weaken the bargaining position of governments that gain most from collective action. Conversely, majority rule enables a majority to shift costs to the minority, which weakens the bargaining position of governments excluded from the governing coalition.

The consequences of majority rule depend on the scope of elected government. The constitution can prescribe separate governments for separate purposes, or the constitution can prescribe multipurpose governments with broad purposes. To illustrate, a constitution can separate the school board from the town council, or the constitution can merge them. Narrowing the scope of each government tends to replace bargaining over multiple issues with majority rule over each issue (median rule).
Having discussed unanimity rule, majority rule, and the scope of each government in chapter 5, we turn to chapter 6, which concerns competition among governments. For local public goods, a legal framework of free mobility causes governments to compete for residents, which can promote efficient government. Even without mobility, the right of communities to contract freely with governments ideally increases the efficiency by making governments compete with each other. The ability of citizens to correct the legislature by ballot initiatives and referenda can also increase the pressure for efficient administration. As electronics reduce the transaction costs of conducting elections, direct democracy will become an increasingly attractive supplement to legislatures.

Chapter 7 turns to administration. Whereas equals negotiate, subordinates follow orders. Specifically, governments in an association negotiate, whereas subordinates in a unitary state obey. An association of governments requires multiple elections, whereas a unitary state requires a steep hierarchy and few elections. Too deep administration dilutes democratic purposes and gives too much discretion to administrators, in which case the constitution should replace hierarchies with elected governments. Conversely, too many elections can drain the reservoir of civic spirit that animates voters, in which case the constitution should replace governments with hierarchies.