

**Ignorance, Competition, and Jurisdictions: How Jurisdictional Competition can foster  
Learning and Discovery about Citizens' Needs**

Author Note

Mirian F. Breuer, Master's Student at the Department of Political Economy, King's College London. Contact: 14 Halmere Road, London SE5 9LN, United Kingdom, +44(0)7552554179, mirian.breuer@kcl.ac.uk.

Abstract (150-250 words)

In this paper I shall analyze how officials with “imperfect” knowledge can learn about their constituents’ needs. Introducing “imperfect” knowledge, in the sense that individuals have subjective perceptions and local knowledge is dispersed, give rise to two knowledge problems. I shall show that these knowledge problems are solved in a system of market competition, where its institutional properties of easy exit and entry allow for a high degree of learning. It follows a comparative institutional analysis in which I highlight the considerable higher costs of exit and entry in jurisdictional quasimarkets compared to genuine markets. The absence of easy exit and entry considerably limits the learning properties of jurisdictional competition – it makes it hard for officials to learn about their constituents needs. I will argue that high costs of exit and entry in jurisdictional quasimarkets are the result of, on the one hand, “natural” (economic) barriers (such as network effects), and on the other hand, “artificial” (non-economic) barriers (due to political or constitutional restrictions). I suggest the following two “design principles” which reduce the “artificial” barriers to effective jurisdictional competition: firstly, overlapping organization of jurisdictions, and secondly, jurisdictional entrepreneurship (in a system of clubs).

Key Words: knowledge problem, competition, exit & entry, jurisdictions

**Ignorance, Competition, and Jurisdictions: How Jurisdictional Competition can foster Learning and Discovery about Citizens' Needs**

How can officials know what their constituents really want? This is a challenging question when one considers individuals lacking “perfect” knowledge. Human’s ignorance and the role of the institutional environment to foster individual learning represent important insights, which experienced increased academic attention in the last decades (North, 1990; Mantzavinos, North, & Shariq, 2004; Ostrom E. , 2005; Pennington, 2011). I shall capture both points in this paper by answering the above question.

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. In section 1, I shall show that these “imperfections” in humans’ knowledge give rise to two knowledge problems – the ‘communication’ and the ‘discovery problem.’ This will also raise the related question which institutional environments facilitates learning most effectively. The two institutional arrangements I shall consider are genuine market competition (section 2) and jurisdictional ‘quasimarkets’ (section 3) (Boettke, Coyne, & Leeson, 2011).

In section 2, I focus on market competition. My thesis is that genuine markets’ easy exit and entry help to overcome both knowledge problems. In section 3, I shall turn the attention towards jurisdictional competition. First, I shall analyze the institutional differences between market competition and jurisdictional competition based on the easiness to exercise exit or entry. I will claim that besides “natural” (economic) barriers to exit and entry, jurisdictional quasimarkets are often featured by a high level of “artificial” (non-economic) barriers (political or constitutional rules). I suggest that in order to improve the learning properties in the provision of jurisdictional services, jurisdictional competition should be characterized by overlapping organization and jurisdictional entrepreneurship (in a system of clubs).

**1. Problems of a Politico-Economic Order: The Knowledge Problem(s)**

In the following, I shall explain what I mean by (i) subjective perceptions, and (ii) dispersed local knowledge, and demonstrate how these ‘unavoidable imperfections [...] of knowledge’ give rise to two ‘knowledge problems’ (Hayek F. A., 1945, p. 530; Kirzner, 1992) – the ‘communication’ and the ‘discovery problem.’

(i) Individuals’ knowledge is subjective: According to Hayek ([1948] 1958b), individuals’ perceive the world from their very own point of view. Thus, their perceptions and beliefs can differ from the objective data.<sup>1</sup> This simply allows that individual can err when they make 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.<sup>2</sup> As per Skarbek (2009, p. 417), ‘[l]ocal 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.’ According to Hayek (1945), local knowledge is the relatively more important kind in most politico-economic affairs.<sup>3</sup>

Following Hayek (1945), local knowledge is dispersed. To put it with Caldwell (2004, p. 213) ‘different people have access to different data.’ Local knowledge ‘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 F. A., 1945, p. 519). Its

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

<sup>2</sup> 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.

<sup>3</sup> In the economic context, a change in the price (price increase) of a commodity leads to individuals’ adjustments by making use of their particular knowledge. For instance, by using their knowledge about subjectively perceived close substitutes which are cheaper.

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dispersed, subjective and contradictory character renders it impossible to centralize and aggregate this local knowledge.<sup>4</sup>

These two “imperfections” of humans’ knowledge – its subjective and dispersed character – make them face two knowledge problems in society,<sup>5</sup> which I shall call the ‘communication problem’ and the ‘discovery problem.’

The ‘communication problem’ is related to the subjective nature of individuals’ knowledge, which raises the question of how individuals can learn about their wrong perceptions – how these mistakes can be *communicated*. That encompasses the problems of how officials/entrepreneurs learn about both their constituents’/consumers’ current real needs. The ‘communication problem’ represents a lack of coordination of current information. In this situation, the full potential of present ‘coordinatedness’ is not yet achieved.<sup>6</sup>

The ‘discovery problem’ is related to the dispersed nature of local knowledge, which gives rise to the question of how individuals can learn about and make use of the other’s dispersed local knowledge of others’ – how this local knowledge can be *discovered*. How can we enable and motivate the discovery of new and better ways to satisfy constituents’/consumers’ needs? The extent and seriousness of this problem is not known in advance. Individuals are thus not automatically aware of the missed potential gains, in case they have not achieved them.

### **2. Market Competition as a Communication and Discovery Procedure**

In the former section, I presented the two knowledge problems in a general context. In this part, I shall introduce both ‘communication’ and ‘discovery problem’ in the sphere of market competition. The attention will first be directed towards the ‘communication problem’ and

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<sup>4</sup> ‘... [T]he sort of knowledge with which I have been [T] 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 F. A., 1945, p. 524)

<sup>5</sup> 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’.

<sup>6</sup> 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 a result of their needs).

how *consumer exit* provides a solution to it. Subsequently, I shall focus on the importance of *entrepreneurial entry* to remedy the ‘discovery problem’ in markets for private goods.

### **2.1 Exit: free prices and the ‘communication problem’**

Individuals’ subjective knowledge (section 1) creates the possibility of making mistakes. In fact, entrepreneurs are often ignorant about what consumers really want and err in deciding what and how much to produce. As Kirzner (1992, p. 154) notes, entrepreneurs often commit ‘over-optimistic mistakes.’ The result of their flawed plans is a discoordination between their and their consumers’ preferences (first knowledge problem).

In order to solve this discoordination caused by wrong beliefs (over-optimism), the relevant agents (here: entrepreneurs) need a *communication mechanism* which enables them to learn about the underlying economic realities (what their customers’ preferences really are). In markets, the price system constitutes such a mechanism. It represents a process of trial-and-error learning (Hayek F. A., [1948] 1958a, p. 100; 1978), which mainly operates by negative feedback in form of disappointment and regrets (Kirzner, 1992).

If an entrepreneur has committed (over-optimistic) mistakes, her profits will not reach the expected figures. Disequilibrium prices and the resulting profit and losses ‘alert market participants’ whether they are doing right or wrong (Kirzner, 1992). Losses (or lower profits) are the most powerful feedback. Their negative feedback give rise to disappointment (not the profit entrepreneurs’ hoped for) and regret (wished they had changed their plan in advance). The price mechanism communicates to entrepreneurs that they have to adjust.<sup>7</sup>

The price mechanism of competitive markets induce a process of error elimination (Caldwell, 2004, p. 213), allowing for more beneficial outcomes over time (Alchian, 1950; Kirzner, 1992). Errors become eliminated either because entrepreneurs who experienced a loss

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<sup>7</sup> However, these adjustments in order to ‘survive’ in the marketplace are left to themselves. They adjust by making use of their unique knowledge.

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want to change their plans (motivated by disappointment and regrets) or because entrepreneurs with bad plans become replaced by ones with better plans (Alchian, 1950).

How does this feedback mechanism come into existence? It is the *consumer's exit*. Consumers' choice to buy another seller's product or stay to buy close substitutes instead, will change the demand-curve for a particular good and thereby affect prices.

The effectiveness of the (negative) feedback mechanism of consumers' exit results from the relative low exit costs in competitive markets. Market competition is featured, from a consumers' perspective, by a great number of suppliers the same or similar goods – *overlapping supply*. This overlap creates the low cost exit environment. High exit costs hamper consumer's exit, the movement of free prices is thereby also hampered and prices communicate less clearly about consumers' preferences. Blurred price signals make it difficult for entrepreneurs to learn about their consumers' "real" preferences. Therefore, the higher the exit costs in a market, the more difficult it is to solve the 'communication problem.'

### **2.2 Entry: profit-opportunities and the 'discovery problem'**

In markets the 'discovery problem' concerns with both entrepreneurs' search for new products and production procedures.

Since entrepreneurs, which risk to introduce a new production procedure or a new product, are only in possession of bits of the relevant knowledge, their success is not certain. Entrepreneurs' limited knowledge make them underestimate the profit opportunities of unachieved coordination – it gives often rise to 'over-pessimism' (Kirzner, 1992, p. 168). Thus, the intensity of entrepreneurial experimentation and the discovery of new products or production procedures is likely to be lower than desirable.<sup>8</sup>

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<sup>8</sup> On the first glance, this finding shares some similarities with the "market-failure" argument regarding information and innovation, for instance to find in Arrow (1962).

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In the case of the discovery problem there is no automatic feedback mechanism which informs entrepreneurs of their over-pessimism.<sup>9</sup> However, the profit opportunities arising from unexploited coordination gains give entrepreneurs a motivation to experiment and innovate.<sup>10</sup> Some entrepreneurs, alerted by their local knowledge, may spot these pure profit opportunities.

However, the fact that some individuals are more alert than others – local knowledge is neither equally dispersed nor random (Pennington, 2011; Skarbek, 2009) – directs the attention towards the importance of *entrepreneurial entry*. Individuals need to be free to enter markets as entrepreneurs, since with them the currently needed local knowledge enters, too. One cannot assume that the present entrepreneurs are the ones with the required local knowledge (otherwise this gap would probably not exist in the first place).

If a discovery is desired is, again, signaled by profit and loss. The successful new innovation, rewarded by high profits, will be imitated by the competitors and spread over the whole market. Pure entrepreneurial profit is the driving force of experiments, discoveries, and innovations. Entry of local knowledge enabled by entrepreneurial entry their prerequisite.

Humans' imperfect cognitive abilities call for an institutional environment which foster learning. The competitive market provides such an institutional setting.

### **3. Jurisdictional Competition as a Communication and Discovery Procedure**

In this section, I discuss the two knowledge problems in the context of jurisdictions. I will view a jurisdiction as the provider of governance and public services. Jurisdictions will be considered as 'enterprises offering local services in return for taxes' (Frey, 2009, p. 7; Tiebout, 1956). That is, jurisdictional units will be characterized (and defined) by their functions rather

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<sup>9</sup> 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, c.f. Kirzner (1973; 1979; 1992)).

<sup>10</sup> 'Today's inefficiency is tomorrow's profit opportunity.' (Boettke, Coyne, & Leeson, 2007, p. 133)

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than their attachment to a territory (Frey, 2001). In section 3.1, I will highlight the major differences between the jurisdictional ‘quasimarket’ and the ‘genuine market’ in economics by having recourse to the formerly used categories *exit* and *entry* (Leeson, 2011; Boettke, Coyne, & Leeson, 2011). In the subsequent section 3.2, I shall focus on how jurisdictional quasimarkets should be “designed” in order to induce effective competitive forces.

### **3.1 Economic markets versus jurisdictional ‘quasimarkets’**

Despite the considerable differences between ‘genuine’ economic markets and ‘quasimarkets’ in jurisdictional services, I claim that the latter can be also analyzed in terms of exit and entry. The provision of jurisdictional services entail considerable “natural barriers” for easy exit and entry (such as, spillovers or network effects). However, there are also considerable “artificial” barriers to competition.

**Exit:** Consumers of jurisdictional services (citizens) are assumed to have heterogeneous preferences (this parallels the market case). However, due to the imperfections of individual’s knowledge, one cannot presume that officials have (always) the right perceptions of what their constituents’ heterogeneous preferences are – it reflects the ‘communication problem’ the jurisdictional officials face.

In a democracy, one way of conveying citizens’ preferences is voting. Voters make a choice based on which party, candidate or program they prefer. However, voting means a choice over a very limited number of alternatives containing a broad range of issues. A voter might cast a vote for an ‘environmental’ party, which at the same time advocates higher taxes, though he opposes the party’s plan to increase taxes. The voter has no possibility to “divide” his or her vote, in contrast to markets. Thus, the officials of that party do not get the information that this vote is only a support for nature protection, not for tax increases. The ‘divisibility of voting [in the market] tends to make market choices finer and more articulate’ (Buchanan, 1954, p. 341).

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Competitive markets are characterized by a great *overlaps* of different suppliers and a manifold variety of goods, which yields both a ‘diverse choice set’ and low exit costs (Mantzavinos, 2010). Easy exit as in markets is absent in politics (Buchanan, 1995, p. 21). Political decision are mostly centrally conducted. The smallest unit is often the community.<sup>11</sup> The considerably higher degree of centralization in the quasimarket for governance implies its more monopolistic structure.

Monopolistic powers in jurisdictional “markets” are not only more often in place, they are even stronger than in ordinary markets. Not only particular public goods and services but often close substitutes are centrally organized, too. Furthermore, citizens are obliged to contribute to the services in form of taxes. The only way to “escape” from a particular jurisdictional markets (if individuals, or communes do not have the right to secede) is by changing their place of residence, which involves substantially high exit costs.

High exit costs render its feedback mechanism less effective. Individuals make less scope of exit, even though they might be very discontent with the services provided by their particular jurisdiction. The *lack of overlaps* and the *monopolistic structure* in jurisdictional quasimarkets undermine competitive forces. As I shall show, these barriers are partially “artificial,” that is, due to political restrictions.

**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)), and, secondly, a particular territory is not associated with

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<sup>11</sup> Consider the number of entrepreneurs who act within a community, which indicates the stronger decentralization of markets.

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more than two governments on the same level. That is, the services and authority of governments do usually not geographically intersect (Frey, 2009, p. 10).

However, jurisdictions (communities, federal states etc.) do not only have (almost always) a *territorial monopoly*, they are also in possession of a *functional monopoly*. For instance, in most countries lower jurisdictions, such as communities, have no or only a very restricted right to levy taxes. They are often not independent from the higher levels of government and not free to enter to their “business area” and compete with them.

The monopolistic structure of many jurisdictional markets represents strong entry barriers for new ‘jurisdictional entrepreneurs’ and, thereby, entry barriers to new local knowledge. Restraining entrepreneurship hampers experimenting, discoveries, and innovation. For instance, officials of a particular jurisdiction may realize that they could provide cheaper and more satisfying their services also to other territories, but they might not allowed to do so.

Jurisdictional services sometimes possess natural monopoly characteristics (this constitutes “natural” barriers to jurisdictional competition). 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, by political or constitutional implemented restrictions. As per Kirzner (1973), freedom of entry determines the markets competitiveness. Jurisdictions’ functional and territorial monopolies display, therefore, an exceptional potential for competitive forces.

### **3.2 “Design” of effective jurisdictional competition**

The strikingly higher exit and entry costs in jurisdictional “markets” makes it more difficult for officials to learn about citizens preferences. Following Frey’s (2009, p. 8) assessment that exit and entry are *the* important factors to create competitive jurisdictional markets, I will argue that one has to tackle the “artificial barriers.” I will propose two points which I consider

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as the prerequisites for effective jurisdictional competition: firstly the *overlapping organization* of jurisdictional services, and secondly the enabling of *jurisdictional entrepreneurship*.

**Overlapping jurisdictions:** Which services, restrictions (regulations) and kinds of governance are desired by citizens? This question is hard to answer for every official in charge since they mostly lack “perfect” knowledge of their constituents’ needs.

The overlapping supply in markets create the low exit environment which makes market competition so powerful in solving the ‘communication problem.’ Overlapping organization is mostly regarded as a waste of resources in the political sphere. However, as Ostrom et al. (1961) in the case of local governments show, ‘overlapping’ or ‘polycentric’ organization – a system with ‘many centers of decision-making which are formally independent of each other’ (Ostrom, Tiebout, & Warren, 1961, p. 831) – can be an effective mean to resolve problem 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, there is one jurisdictions which provides bus services and another which 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 based on “artificial” barriers.<sup>12</sup>

Overlapping supply allow citizens to choose among jurisdictional services without changing their place of residence. Consequently, costs of exit are considerably lower. ‘Voting with the feet’ becomes a credible threat. Jurisdictions must now fear that citizens will leave in

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<sup>12</sup> Jurisdictions could after all still be in a monopoly position e.g. due to network effects.

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case their preferences are not sufficiently met. The overlapping structure enables greater diversity in the supply of public services and governance. Individuals will join the jurisdictions which offers the best combination of taxes and public services (Tiebout, 1956).<sup>13</sup> The multiplicity of jurisdictions or clubs providing public services allow for easy exit and the arising of strong competitive forces.<sup>14</sup> Easy exit is an ‘important means to make one’s preferences known to governmental suppliers’ (Frey, 2009, p. 12).

The functional and territorial monopoly of (most) jurisdictions represents strong ‘artificial’ exit barriers, and, thereby, barriers to competition as a remedy for the ‘communication problem.’ The *overlapping organization* of jurisdictions is a way to transform the quasimarket into a ‘genuine market’ in jurisdictional services (Leeson, 2011, p. 302).<sup>15</sup> 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:** Due to the dispersion of local knowledge, a great deal of local knowledge lies fallow for society. This is partly because not at every point of time all bits of local knowledge is needed, but also because in many social affairs entrance of new ideas is blocked. A competitive environment which foster entry and entrepreneurship (in the broadest meaning) represents an institutional environment which allow to mitigate the ‘discovery problem.’

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<sup>13</sup> ‘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)

<sup>14</sup> ‘[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, Tiebout, & Warren, 1961, p. 838)

<sup>15</sup> Intermediate steps to increase the overlaps of jurisdictions would be a radical decentralization of political authority (Tiebout, 1956; Weingast, 1995), the right to secession to federal states or even lower political units (such as communes, or even individuals) (Buchanan, 1995; Vanberg, 2000), and the functional (not geographical) organization of jurisdictional (Frey, 2001; Frey, 2009).

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A primer source of high entry costs in the jurisdictional quasimarkets are (“artificially” granted) functional and territorial monopoly positions (section 3.1). Potential competitors have no or only limited access to this “market,” or only under acceptance of very high costs, or both. Jurisdictions are not completely independent from higher-level jurisdictions, since they do they not have (extensive) power to tax or to provide particular services. These restriction represents severe “artificial” entry barriers.

In order to increase the competitiveness, lower political units, such as communes, need to have the freedom to form their own jurisdictional units, enter new jurisdictional markets (with both regard to functions and territories), and collect fees or levy taxes in order to finance their services (Frey, 2009).

This raises the following question: Which should be the smallest unit allowed to enter jurisdictional markets? Shall an individual be free to provide (some) jurisdictional services (e.g. self-employed garbage disposal, or a school as a one-man education business)?

In a system of market competition, entrepreneurial entry allow for the entry of new local knowledge. Local knowledge is not randomly dispersed (Pennington, 2011; Skarbek, 2009). Thus, entry restrictions are relatively harmful, since ‘there is no assurance that others will identify the same profit opportunities’ (Skarbek, 2009, p. 417). The high entry barriers in jurisdictional markets may therefore prevent the entering of particularly needed local knowledge.

The necessary step to allow the greatest use of dispersed local (jurisdictional) knowledge is to minimize (“artificial”) entry barriers. However, again, economic limitations will certainly be in place, particularly network effects. This “natural” barriers may 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. The fact that the potential for entry might be smaller should not distract from the insight

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that there exist indeed a potential for more easily exit and thereby greater exploitation of 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 reduced. 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 making profit by finding new input-output combinations). The price-mechanism, profit and loss are important information mechanism to realize the gains of a ‘higher level of coordination. These are, though, either absent or only weakly developed in jurisdictional quasimarkets.

A way to mimic or rather to ‘establish a genuine market in governance’ which incentivize entrepreneurial discovery would be to replace the ‘system of government’ by a ‘system of clubs’ (Leeson, 2011, p. 302).

In such a system, jurisdictional services are provided by clubs. 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, with widely overlapping jurisdictions (low exit costs, or high degree of citizen decision-mobility), an individual alerted by her particular local knowledge might see the opportunity to provide new jurisdictional services. The chance of realizing profits by satisfying (some) constituents’ preferences better than any rival club incentivizes the jurisdictional entrepreneur’s discovery. The number of new members and the respective revenues from membership fees mimic the economic market’s profit-and-loss-signals.

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Jurisdictional entrepreneurship would, thereby, not only help to remedy ‘discovery problems,’ but also allow individuals to conclude as heterogeneous ‘governance contracts’ as their 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 some inefficiencies in the ‘system of clubs’ (Leeson, 2011, p. 307).

This is doubtlessly an important point which challenges the superiority of a club system. Two responses to that: firstly, these inefficiencies due to spillovers need to be compared with the benefits from mitigating ‘discovery problems.’<sup>16</sup> Secondly, the constant discovery initiated by genuine competition in a club system may enable the discovery of solutions for externality problems. Alerted jurisdictional entrepreneurs might find new ways to internalize the spillovers, if it seems profitable.<sup>17</sup>

Opening jurisdictional “markets” by allowing small units (or individuals) to form new entities would remove the “artificial” barriers to entry.<sup>18</sup> A jurisdictional system of clubs would come close to a genuine market in jurisdictions and suggest that it may perform better in solving the ‘discovery problem.’

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<sup>16</sup> As I claimed in the beginning of this paper, the extent of ‘discovery problems’ are unknown to any individual in advance, an exact balancing is impossible. Nevertheless, I consider it as insightful to be aware of such a trade-off, even though it is to specify the exact terms of that trade-off. I tend to believe that the gains from mitigating ‘discovery problems’ often exceed possible costs due to spillover-inefficiencies.

<sup>17</sup> Or to put it with Ostrom et al. (1961, p. 836), ‘[i]nformal arrangements between public organizations may create a political community large enough to deal with any particular public’s problem.’

<sup>18</sup> As I mentioned earlier, the complete removing of all “artificial” barriers can create some costs, for instance, in form of free-riding or externalities which should not be neglected in considerations about a desirable system. In this paper, however, I limit my focus merely on the institutional environments’ ability to solve the knowledge problems. My intention is rather to highlight that remedy of knowledge problems create gains which are important to recognize.

### **Conclusion**

This analysis proceeded from the assumption that humans' are ignorant. Individuals' "imperfect" knowledge is considered to result from their subjective perceptions (which can diverge from the objective realities), and the dispersed character of local knowledge. These imperfections produce two knowledge problems on societal level: the 'communication' and the 'discovery problem.'

In section 2, I showed that market competition by its feature easy exit and entry provides the sufficient institutional environment to solve the two knowledge problems. Easy exit enables an effective trial-and-error learning with the result of error-elimination over time. Easy entry allow alerted entrepreneurs to exploit profit-opportunities through experimenting and discovery.

Section 3 covered the concept of jurisdictional competition, beginning with a comparative analysis of the institutional differences between genuine economic markets and jurisdictional 'quasimarkets' along the lines of exit and entry (section 3.1). Jurisdictional markets are characterized by both considerable higher exit and entry costs. This is caused by "natural" barriers (such as externalities, network-effects, and excludability-problems), but in part also because of "artificial" barriers, in form of political or constitutional restrictions (territorial and functional monopolies). In part 3.2, I suggested the following two "design principles" of how to reduce these "artificial" barriers: firstly, the overlapping organization of jurisdictions, and secondly, jurisdictional entrepreneurship, that is, granting lower political units independence and the right to form new, competing jurisdictions. Replacing the 'system of government' by a 'system of clubs' would allow to transform the 'quasimarket' for jurisdictional services into a 'genuine jurisdictional market' as much as possible (Boettke, Coyne, & Leeson, 2011; Leeson, 2011).

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A constitution which minimizes the “artificial” restrictions on exit and entry would allow a greater extent of individual learning, would rescue much of competition’s knowledge-problem-solving properties and, ultimately, help to mitigate the knowledge problems. Jurisdictional competition, with lower exit and entry costs, can help to make officials learn what their constituents really want. Thus, it might provide the necessary foundation for legitimate decisions in society.

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