

NO-SUBSIDY MANTRA OF GOVERNANCE TO ATTAIN THE MOST EFFICIENTLY COMPETITIVE ECONOMY

Sankarshan Acharya*

Abstract

This paper proves the existence of a practically implementable system of governance necessary to attain the most efficiently competitive economy without the arduous collection of private information on individual preferences through a central planner. This governance is constituted with tenets: (a) adoption of only known commonly agreed rules like (i) common civil codes of conduct and (ii) penalties for robbery, killing and usurpation of public and private wealth and (b) an irrevocable mandate to frame any new commonly agreed rule that may be discovered in future or to repeal or amend any prevailing rule which may be ascertained in future to be preferentially catering to subsets of people. The only feasible available norm for common agreement to set rules is self-sufficiency of each group like the households and companies. Self-sufficiency or no-subsidy mantra is defined by the net surplus (production minus consumption) of a group being greater than the transfer from the public exchequer to the group. **

Keywords: Governance, ompetitive Economy, No-subsidy Mantra

* University of Illinois at Chicago - Department of Finance, 601 South Morgan Street, Room 2431, Chicago, IL 60607-7124, United States

E-mail: sacharya@uic.edu

** I am grateful to Professor Oleg Bondarenko for generous discussions and comments. I have argued in various memos to government leaders that cutting government subsidies would enhance efficiency. But this paper offers an economic theorem to prove that the no-subsidy (self sufficiency) mantra of governance is necessary to attain the most efficiently competitive economy.

I. Introduction

After the first version of this paper was distributed among top political leaders on September 9, 2011, the *no-subsidy mantra of governance* emerging from this paper seems to have spread around the world, especially, in USA, Europe and India.¹⁶ The Indian government has mulled the idea of public funding of elections and to block private black money in polls.¹⁷ The US President has stressed the necessity of no-subsidy and many Republicans have expressed agreement to remove subsidies even to corporations.¹⁸ The European Union has talked about trading tax to recover the cost of government guarantees (subsidies) to financial firms.¹⁹

This paper is consistent with and complementary to my research on first-best efficient resolution of the financial moral hazard problem,

which was first mimeographed at the Board of Governors of the Federal Reserve System, Washington, D.C. in 1991. This research has evolved into *Economically Efficient Constitutional Governance* obtained within a general equilibrium dynamic model of a game among leveraged firms with potentially asymmetrically informed stakeholders maximizing their net-worth while the government ensures free markets and trading with a constitutional rule to protect the net-worth generated by the players through trading and arbitrage equilibrium pricing.²⁰ The goal of first-best policy research is to beget first-best status for principals (citizens) in a society. During and after the 2008 financial catastrophe, the U.S. Congress has adopted major policies implied by the first-best policy research, namely, offering safe central government banking facility to \$3.5 trillion of previously uninsured money market funds and bank debts, and newly requiring the bank holding companies to have minimum capitals on a consolidated basis. The Congress has found through the Financial Crisis

¹⁶ <http://pro-prosperity.com/No-government-subsidy-economic-efficiency-competitiveness.html>

¹⁷ <http://pro-prosperity.com/Stop%20Private%20Funds%20in%20Elections.html>

¹⁸ See <http://pro-prosperity.com/Democrats%20and%20Republicans%20agree%20to%20stop%20subsidies.html>

¹⁹ <http://pro-prosperity.com/European-Union-Subsidy-Surplus-Trading-Tax.html>

²⁰ See Acharya, S. (2010), "*Economically Efficient Constitutional Governance*," at <http://www.pro-prosperity.com/Research/moralhazardliberty.pdf>

Inquiry Commission that the financial catastrophe of 2008 was manmade due to a failure of the agents (financial industry guardians, experts and regulators) who were supposed to serve the best interests of the principals (citizens).²¹ Unlike in this research, the current paper does not assume the existence of a constitution. It rather finds a constitution which is necessary to achieve first-best efficient equilibrium for the principals of a society.

If one nation is efficiently competitive, others need to progress towards efficient competitiveness for survival, if not for prosperity amid stability among people.²² The *most efficiently competitive economy* produces the most using the lowest possible costs of input. This paper shows that only by constituting a system of governance based on commonly agreed rules can a nation achieve the most efficiently competitive economy. This result does not assume the existence of any given constitution like the ones adopted by democracies in the real world. It rather characterizes a novel constitution which is proved to be necessary to attain the most efficiently competitive economy.

Philosophers, economists, political leaders and common people have struggled since time immemorial to propound better and better rules of governance. Democracy is considered to be the worst form of governance, except that nothing better exists. Democracy, guided by a constitution, has become the loadstar of governance in the developed world.

As the developed world prospered, other nations adopted constitutional democracy to follow suit. But the economies of well established constitutional democracies (USA and European nations) are now floundering due to an erosion of their competitiveness measured by massive trade deficit, public debt and unemployment. Perpetual trade deficit is an indicator of a nation unable to export as much as the imported goods and services it needs for its sustenance. Increasing public debt is an indicator of a government not operating within the tax revenues it can collect. Rising unemployment despite persistent trade and budget deficits shows a failure to harness workers to produce as much goods and services for exports as the nation needs to import for its survival. These are indicators of erosion of efficiency and competitiveness.

The predicament of constitutional democracies sharply contrasts the growing competitiveness and efficiency of a non-democratic China governed by a single-party system.

Is the single-party governance crucial for the stronger economic results in China as compared to the stagnant economies of constitutional democracies? If so, why didn't the single-party governance in the former Soviet Union produce economic miracles similar to those of China?

Whether China has undervalued its currency to gain a competitive economic advantage is really moot as the developed constitutional democracies deliberately kept their currencies strong to grow economically with lower costs of inputs in terms of Chinese goods and services.

The constitutional democracies' punditry is now pondering over sacrificing "democratic freedom" to compete with a non-democratic China. Is the freedom in a constitutional democracy the true cause of floundering national competitiveness and efficiency? What about the prevailing wisdom that freedom motivates people to work harder and that only hard-working people can make a nation competitive and prosperous? Diverse answers to such bewildering questions have only confounded the guardians and thinkers who have hitherto considered superiority of constitutional democracies.²³

No one has yet uncovered any common factor which could explain, satisfactorily, how the developed constitutional democracies immensely prospered to become the envies of other nations, how their economies are now floundering, how a single-party rule ushered an era of prosperity for the Chinese while a similar single-party system caused economic collapse and disintegration of the former Soviet Union.

This paper presents a novel constitution to establish a system (commonly agreed rules) of governance to harness the productive strength of people in order to attain the most efficiently competitive economy. I have argued later that the only feasible available norm for common agreement to set rules is self-sufficiency of each group like the households and companies. Self-sufficiency is defined by net surplus (production minus consumption) of a group being greater than the transfer from the public exchequer to the group.

II. Devolved Central Planning in Constitutional Democracies

The economists have offered a general equilibrium theory in which a Central Planner (Walrasian Auctioneer) can attain the most preferred allocation

21 See Acharya, S. (2011), "Begetting first-best efficient status for principals," at [http://www.proprosperity.com/Begetting%20first-best%20status%20for%20principals%20\(citizens\).html](http://www.proprosperity.com/Begetting%20first-best%20status%20for%20principals%20(citizens).html)

22 See Acharya S. (August 15, 2003) "Optimal Governance for Prosperity amid Stability: A New Economic Philosophy for Democratic Capitalism," available at <http://proprosperity.com/Research/Prosperity%20Amid%20Stability%20-%20A%20New%20Economic%20Paradigm.pdf>

23 See, for example, Friedman, Thomas L. (August 6, 2011), "The Whole Truth and Nothing But," New York Times, available at <http://www.nytimes.com/2011/09/07/opinion/friedman-the-whole-truth-and-nothing-but.html?ref=opinion> and Pesek, William (August 7, 2011), "China in Time of Millionaires Frustrates Neighbor" Bloomberg News, available at <http://www.bloomberg.com/news/2011-09-06/china-in-time-of-millionaires-frustrates-neighbor-william-pesek.html>

of resources if people reveal their private information about their preferences.²⁴ The fundamental idea behind central planning is that once people are guaranteed to receive their most preferred allocations of resources, they will remain motivated to work as hard as possible to make their economy the most efficiently competitive. But individuals in the real world have incentives to misrepresent the truth about their preferences in order to attain better allocations of resources from the Central Planner. The experiments of Central Planning in the Soviet Block economies have, therefore, failed.

Constitutional democracies are decentralized economies. They appear to operate antithetically to the centrally planned economies. Yet, they too have failed to establish the most efficiently competitive economies, as the current turmoil indicates.

Constitutional democracies have successfully devolved the central planner's power to elected political representatives. The elected representatives gather the information on preferences of their constituents for goods and services to make allocations of resources centrally in Parliaments or Congress or state legislatures. Such decentralized private information collection and resource allocation system can be called devolved central planning with the elected representatives of people collecting their constituents' private information on preferences and allocating resources accordingly. Devolved central planning is definitely better than pure central planning. This is perhaps why the devolved central planning in constitutional democracies has lasted for centuries.

Despite early success, decentralization or devolution cannot, by its design, attain the most efficiently competitive economy. Devolved central planning cannot avert the same fundamental problem that is associated with any central planning due to individuals having the incentive to misrepresent the truth about their preferences for goods and services even to their elected representatives. The elected representatives may perform their duties effectively to vote for rules to help their constituents usurp more resources than the efficient allocation attainable through the arduous gathering of true individual preferences. Yet, the devolved central planning designed in constitutional democracies cannot achieve the most efficiently competitive economy.

Nevertheless, people have willy-nilly accepted the constitutional democracy as the best feasible form of governance because (a) it is practically impossible for a single central planner to gather private information about individual preferences to attain the most efficiently competitive economy, (b) most centrally planned economies have collapsed, and (c) not better system of governance has emerged yet.

The Chinese economic success has now raised ambivalence towards the long-cherished

constitutional democracies and about exploration for a new system of governance which is capable of achieving the most efficiently competitive economy.

III. How to Attain the Most Efficiently Competitive Economy?

A unique path is presented here to attain the most efficiently competitive economy without central planning and without collecting private information on individual preferences. The path is simply to establish a *progressively reforming system of governance*—which starts with only known commonly agreed rules and which operates with an irrevocable mandate to adopt any new rule or to amend or repeal any prevailing rule, if necessary, to fulfill any freshly discovered common longing of people in future.

My research so far has presumed that individuals have a common preference (longing) for prosperity amid stability.^{25 26} I have till now argued (without offering any proof) that only by adopting those rules which fulfill the common longing of people and by rejecting other rules that cater to specific groups, can a society enhance its competitiveness and prosperity. The progressively reforming government presented here is subconsciously embedded in these arguments. One needs to formally prove, however, that a progressively reforming system (rules) of governance eventually attains the most efficiently competitive economy.

Any real-world constitution (like that of USA) is a set of rules or principles used by legislatures to shape the laws of governance. The theorem presented here does not presuppose the existence of any constitution as given. The theorem rather sets the tenets for the constitution including a mandate for the government to attain the most efficiently competitive economy. In other words, the constitution of a progressively transforming government is presented below as a theorem. The proof is about the existence of such a system of governance that achieves the

²⁵See Acharya S. (August 15, 2003) "Optimal Governance for Prosperity amid Stability: A New Economic Philosophy for Democratic Capitalism," available at <http://proprosperity.com/Research/Prosperity%20Amid%20Stability%20-%20A%20New%20Economic%20Paradigm.pdf>

²⁶In the real-world of asymmetry of information, the Arrow-Debreu paradigm for first-best (efficient) outcomes cannot obtain as all states cannot be priced (which makes the markets incomplete). This is why there emerged a slew of papers on second-best outcomes, which deviate from the first best. The deviation from inefficiency is due to the asymmetry. I have proved in another paper how free trading and non-interference by governance can resolve the inefficiency due to moral hazard induced asymmetry in the banking industry (Acharya, S. (2010), "An economically efficient constitutional governance," <http://proprosperity.com/Research/moralhazardliberty.pdf>). The current paper proves that progressively reforming governance (with a no-subsidy norm) can result in first-best outcomes (at least in the limit) in every sector.

²⁴ See, for example, "General Equilibrium Theory," available at http://en.wikipedia.org/wiki/General_equilibrium_theory

most efficiently competitive economy and that is practically implementable without the necessity of gathering private information or even the devolved central planning.

Theorem Part A. Constitute a system of governance as follows:

(A1) Adopt only those rules (and all such rules) that are commonly agreed by all individuals.

(A2) Do not spend any resource on central planning to gather any private information of individuals like their preferences or demands for goods and services.

(A3) Do not interfere in individuals' determination of their own demands for goods and services based on their own preferences subject to their own constraints stemming from their own endowments (budget and skills) and to all adopted government rules. In other words, allow individuals total freedom to make their own choices subject to their own constraints and to commonly agreed rules of governance.

(A4) Keep the markets free for exchange of goods and services among individuals.

Under this system of governance, individuals achieve the allocation of goods and services exactly as they prefer subject to their own constraints (like endowed resources and skills) and exchange their surplus in the free markets for creation of the same public goods as the central planner if the latter can collect all private individual information on preferences and demands.

Theorem Part B: Consider a system of governance constituted on tenets A2, A3 and A4 stated above and with A1 replaced by the following tenet:

B1. The government is initially founded on (a) only the known commonly agreed rules like penalties for robbery, killing and usurpation of public and private wealth and (b) an irrevocable mandate to adopt any new commonly agreed rule discovered in future or to repeal or amend any prevailing rule which is ascertained in future to be preferentially catering to special groups of people, e.g., capital market and banking rules that facilitate traders to wangle away private wealth surreptitiously and to usurp public funds when their gambles fail.

This system of governance may not attain the most efficiently competitive economy at its inception because all the commonly agreed rules may not be known at the start. But the system will ultimately attain the most efficiently competitive economy, despite the initial hurdle of identifying all the commonly agreed rules at once. This system of governance also does not need to gather private information about individual preferences.

Proof of Part A: Economists have already proved that if a central planner (Walrasian Auctioneer) can gather all the private information on every individual's preferences (or on every individual's preferred demands for goods and

services), it can allocate the available resources efficiently to attain the most efficiently competitive economy. The Walrasian Auctioneer basically (a) achieves for the individuals whatever the latter can do for themselves to maximize their utilities and (b) generates the maximum possible social surplus (after fulfilling individual demands) to create public goods preferred by all individuals. The problem with the Walrasian equilibrium is that it is not implementable in the real world because individuals will have the incentive to misrepresent their private information to garner more resources than that the Central Planner will allocate based on optimization.

The rules stated in (A1) are commonly agreed by all. They do not restrict an individual's choices. Furthermore, the government does not interfere in the individual choice process by rule (A3). The individuals can freely exchange their surplus in the unrestricted markets by rule (A4). Each individual can thus attain the same allocation as the central planner can achieve through a costly process of gathering private information on individual preferences. The government in the theorem avoids such arduous private information gathering by rule (A3). The common good that the central planner can create by gathering all the private information must be compatible with common preferences of individuals. The government in the theorem can use the free markets established by rule (A4) to generate the same surplus to create the same common goods as preferred commonly by all individuals. The government founded by principles (A1) through (A4) can thus attain the most efficiently competitive economy.

Proof of Part B: It might be impossible (in the ancient times as well as now) to ascertain all the commonly agreed rules to found governance as stated in Part A of the theorem. But a government can be founded on only known commonly agreed rules. The initially adopted rules may not include the entire set of commonly agreed rules, some of which may be discovered after the government has been established according to principle B1. At its inception, this government may not succeed in attaining the most efficiently competitive economy because it may not have adopted all possible commonly agreed rules that human knowledge can discover over time.

Wisdom has already dawned on humans millennia ago-when Krishna propounded a commonly agreed rule of governance (called Dharma) in Gita to even wage wars, if necessary, to punish those who usurp others' hard-earned wealth. This rule of governance (Dharma) is commonly agreed by all humans then and now. Even the usurpers do not like to have their wealth grabbed by the more powerful people. Millennia later, the Americans waged a war to attain independence in order to prevent usurpation of their hard-earned wealth and dignity. It was as if they replicated the wisdom Dharma of Gita by scripting a modern constitution to bestow individuals

with rights to their hard-earned properties (including their discovered knowledge), liberties, lives and beliefs and to pledge a common resolve (preference) to protect such rights. The modern (American) constitution has become the lodestar for founding governance based on commonly agreed rules everywhere around the world.

It may be practically impossible for a society to discover all the commonly agreed rules at inception of their government to attain all the virtues of the most efficiently competitive economy. But any society can found its governance on only the known commonly agreed rules and with an irrevocable mandate to progressively adopt any newly discovered commonly agreed rules in future or to reform and repeal any prevailing rule, if necessary, to attain the common longings of people.²⁷ Such progressive governance will ultimately create the most efficiently competitive economy without the need to gather private information on individual demands for goods and services.

Corollary to the Theorem The devolved central planning via elected representatives-as practiced in a constitutional democracy-will fail to achieve the most efficiently competitive economy unless the rules of governance are as stated in the theorem.

The theorem on attaining the most efficiently competitive economy²⁸ crucially depends on the existence of a norm to determine commonly agreed rules.

A norm for determining a commonly agreed rule is to make the government transfer (subsidy) to a group (e.g., a company or body of individuals) less than the surplus generated by the group. The surplus is defined as the output minus consumption of the group. This norm attains self-sufficiency of every group through generation of more surplus than any government subsidy received as incentives or seed money to work and produce.

The only other alternative to the self-sufficiency norm is to grant net-subsidies (transfer exceeding surplus) to some groups. But this will not be agreed to by the groups excluded from the net-subsidy schemes. Net-subsidies for all groups are not feasible. Granting net-subsidies to some groups may be feasible, but will not be a commonly agreed.

Individuals will need to have a common agreement for the self-sufficiency norm if they wish to have a civilized coexistence through governance run

with commonly agreed rules. They can then achieve the most efficiently competitive economy.

A society that cannot reach a common agreement for the self-sufficiency norm, because of too many net-subsidy seekers, will become unstable and chaotic. A government can be founded with rules to satisfy some groups, but it will eventually become chaotic and unstable because many of these rules will likely contradict each other and, certainly, impose enormous burden on those who generate net surplus by those who usurp net subsidy. Any governmental attempt to satisfy every individual or group is impossible and hence futile. Such societies will not attain the most efficiently competitive economies.

The system of governance characterized by the theorem will obviously not satisfy everyone. But it is the unique, practically implementable system of governance which can achieve the most efficiently competitive economy needed for civil coexistence and survival, if not for prosperity amid stability of a society.

Governance defined in the theorem induces every group to produce as much as possible and to generate as much surplus as it can. But whenever a group seeks government subsidies (transfers), the surplus generated by the group minus the transfer must remain positive, under the self-sufficiency norm needed to make the economy the most efficiently competitive. This economy will always generate a positive total surplus to avoid trade imbalance, which is an indicator of competitiveness. The nation will be self-sufficient.

The current political rivalry in the US involving subsidies (like government transfers made to Social Security, Medicare, Medicaid or Banking Firms) can be easily resolved through this theorem if there is an agreement about making the economy the most efficiently competitive. Economies, which desire to boost consumption but unable to generate surplus, can do so only by exploiting their natural resources or selling off national assets.

The self-sufficiency norm would be equivalent to President John F. Kennedy's call to "think what you can do for your country, not what the country can do for you," if country means public exchequer comprising collected tax revenues and newly minted/borrowed funds. A shrinking public exchequer (rising budget deficits) indicates that the country is drifting away from the most efficiently competitive state of the economy. Such drift increases the burden on the net-surplus generators by the net-subsidy takers, which amounts to color-blind latent slavery that is antithetic to what President Abraham Lincoln had wished to accomplish in USA.

The theorem on attaining the most efficiently competitive economy is likely to excite Hayek in his grave to declare victory, but freeze Keynes.²⁹ The

27 See Acharya, S. (September 2010), "Constitutional System of Money and Finance," available at <http://pro-prosperity.com/Research/Constitutional-Monetary-Finance-System.pdf>

28 Revisions of this paper are available at <http://pro-prosperity.com/Research/Governance-and-Most-Efficient-Competitive-Economy.pdf>. To avoid confusion over semantics, the term in the first version of the paper "commonly preferred rule" has been replaced with "commonly agreed rule."

29 See Nasar, S. (September 13, 2011, Bloomberg News) "How to Prevent Economic Crises," <http://www.bloomberg.com/news/2011-09-13/hayek-keynes->

Keynesian monetary infusions worked for seventy years since the war-ravaged world accepted the currency minted by the victor (USA) to supply net-surplus to net-subsidy recipients in USA.³⁰ But adherence to the Keynesian philosophy has retrogressed the American economy away from its most efficiently competitive status.

The theorem has serious implications for global economies to eliminate all government funded net-subsidy schemes. A practical way out of the quagmire facing the American economy, implied by the theorem, is to stop transfer of net-subsidies from the public exchequer to schemes like Social Security, Medicare, Medicaid, Military, etc. Distributing the social security contributions with the accumulated interest, calculated like the U.S. Internal Revenue Services levies interests on tax deficiency, to every individual will be consistent with the self-sufficiency norm. More critically, all unconstitutional and inefficient rules (especially those governing the banks and financial markets) that transfer net-subsidies from the public exchequer should be repealed forthwith to revert the economy towards the most efficiently competitive state.³¹ As a compensation for losses suffered due to such rules (and to boost the economy), the government should initiate a zero net-subsidy program to refinance all non-delinquent highly rated home mortgage loans through Fannie, Freddie and Federal Reserve.³² Doing so will facilitate elimination of the tax subsidy on home mortgage interest.

The system of governance characterized by the above theorem will obviously not satisfy everyone. But it is the unique, practically implementable government which can achieve the most efficiently competitive economy needed for civil coexistence and survival, if not for prosperity amid stability, of a society.

Governance defined in the theorem induces every group to produce as much as possible and to generate as much surplus as it can. But whenever a group seeks government subsidies (transfers), the surplus generated by the group minus the transfer

must remain positive, under the norm needed to make the economy the most efficiently competitive. This economy will always generate a positive total surplus to avoid trade imbalance, which is an indicator of competitiveness. The nation will be self-sufficient.

The current political rivalry in the US involving subsidies (like government transfers made to Social Security, Medicare, Medicaid or Banking Firms) can be easily resolved through this theorem if there is an agreement about making the economy the most efficiently competitive. Economies, which desire to boost consumption but unable to generate surplus, can do so only by exploiting their natural resources or selling off national assets.

The system of governance in the above theorem is not necessarily a democracy with multiple political parties as in the real world of constitutional democracies. This government is, however, characterized by a "constitution" with the principles or rules A1 (or B1), A2, A3 and A4 as stated above. By the time a government-starting with principles A2, A3, and A4 and B1-attains principle A1, the economy will have become the most efficiently competitive.

The theorem also shows that a democratic form of governance with multiple political parties—as prevailing in the real world—is neither necessary nor sufficient (a guarantee) for a society to attain an efficiently competitive economy.

The theorem indicates that a society with a single-party system of government can credibly guarantee individual freedom by adopting rules A1 through A4 (and B1 initially) to achieve the most efficiently competitive economy. One cannot say whether China has achieved this status. But a single-party government can eventually be more liberating than the real world constitutional democracies creating vast swathe of financially bonded households. This possibility should be a serious cause for concern to the pundits and guardians of constitutional democracies who may have either remained complacent about superiority of their system or simply propagated such superiority to cover up the actual erosion of freedom (due to transgression of the basic tenets A1 through A4 and B1) in order to perpetuate their hegemony over wealth and governance. It should be considered serious because the constitutional democracies with their devolved central planning can no longer claim supremacy of their economies without being most efficiently competitive.

The real world constitutional democracies were founded on commonly agreed basic rules like punishing robbers and killers. As long as they progressed forward to be governed by the commonly agreed rules, they prospered immensely. They became envious of the regimes in the former Soviet Block which failed due to their dogged adherence to central planning which could not gather all the private information on individual preferences to achieve the most efficiently competitive economies.

and-preventing-economic-crises-commentary-by-sylvia-nasar.html

³⁰ See Nasar, S. (September 19, 2011, New York Times), "Keynes: The Sunny Economist," for a well-articulated article in support of Keynes. The Keynesian philosophy-professed through such opinion pieces-is oblivious of the latently growing economic inefficiency due to ever increasing supply of fiat money. A sanguine picture painted by media, consistent with sunny Keynesian philosophers, cannot forever suppress the truth about the economic inefficiency ballooning under the veneer of "economic growth," concocted through unconstitutional padding of inefficient groups in a society.

³¹ See Acharya, S. (December 2010), "An Economically Efficient Constitutional Governance," <http://pro-prosperity.com/Research/moralhazardliberty.pdf>, and Acharya, S. (September 2010), "Constitutional System of Money and Finance," <http://pro-prosperity.com/Research/Constitutional-Monetary-Finance-System.pdf>

³² I had made this suggestion in memos sent to the US Congress and President in 2008.

China could have also failed if it stayed on the path of central planning. China adeptly amended its course of governance by electing local leaders based on their skills to solve problems by fathoming the common preferences of people. These local leaders allowed the Communist Party of China to gather the necessary information about common preferences like the desire to make profits and accumulate wealth. The CPC then allowed creation of profit making ventures and accumulation of wealth by individuals. China continued some of its Central Planning based on such common preferences via new rules of law. All the Chinese political leaders belong to the same CPC. They prevent formation of rival political parties to maintain stability. But the CPC picks leaders from multiple contestants based on their skills to solve common problems facing people. The CPC does not ordinarily entertain individual complaints unless they pertain to common problems or existing rules, though not perfectly so because the leaders still receive uncommon largesse from the government. China has produced top ten political leaders as qualified engineers and has become the manufacturing hub of the world. No other nation has chosen an engineer to be its top leader at any time.

The crucial factor in the Chinese economic success is governance based on common preferences (though imperfectly), as opposed to pandering to special groups through ever increasing sets of laws in constitutional democracies.

The main cause for floundering of economies in constitutional democracies is that groups of individuals (lobbyists) have influenced the elected officials to adopt rules of governance which facilitate unconstitutional and economically inefficient usurpation of private and public wealth.³³ This has led to an unstable concentration of wealth. The rules that allow unconstitutional usurpation of private and public wealth transgress A1 through A4 and B1 stated in the theorem above. Transgression of the rules of the theorem by the real world constitutional democracies has made their economies less competitive and less efficient. The wealth so concentrated is not due to hard work. It has stemmed from a myriad of uncompetitive, unconstitutional and inefficient rules of governance. The constitutional democratic economies have now become unstable because the concentrated wealth is nothing but the net debt surreptitiously laden on the truly hard-working individuals who produce globally competitive goods, services and knowledge to prop their national currency, security and stability. Insurmountable debt is a disincentive for hard-work. As the constitutional democracies really turned unconstitutional and wealth (credits) gravitated to a few, the indebted people stopped working hard to keep their economy

competitive and inefficient. This is the cause of underlying instability in the economies of constitutional democracies.

The above conclusions do not imply that China has become a virtuous invincible society. But China will remain formidable as long as it is governed by the CPC based on commonly agreed rules of law while the constitutional democracies perpetuate their prevailing systems for special interest groups through unconstitutional and economically inefficient usurpation of private and public wealth.

The common longing of people is to ensure that their hard-earned wealth is not usurped, even surreptitiously. Why is this so? Wealth stems from labor. Labor connotes dignity of a human. No one likes to surrender hard-earned dignity. Systemic failure of a society to avert usurpation of hard-earned wealth causes a financial depression among hard-working people, those who produce globally competitive goods (like food and knowledge) and services (like public service, teaching and defense). Insufficient production of globally competitive goods and services causes national trade imbalance, lowers the value of national currency and impoverishes people relative to their counterparts in other countries. Widespread financial depression (Great Depression) causes poverty, social instability and chaos. Depressed people stop working hard and, thus, eviscerate their society. Usurpation of hard-earned wealth makes a society vulnerable to (financial or military) subjugation by external forces. It is suicidal (treasonous) for a society to perpetuate a system of governance that fosters, and/or fails to avert, usurpation of hard-earned wealth. The common longing of people is, therefore, to institute a system of governance which not only preserves their dignity but also makes their society strong (at least not suicidal).

The Communist Party of China is the center of Chinese power, which operates with a constant fear of being uprooted by people. On the other hand, the de facto centers of power in constitutional democracies are unfortunately not the democratically elected representatives. They are the special interest groups and the regulatory bodies implanted to mastermind perpetuation of unconstitutional and economically inefficient rules of governance to grow their wealth and power without being visible to the voters. These de facto centers of power have willy-nilly caused erosion of competitiveness of the nonpareil constitutional democracies and made their economies unstable. They are rarely, if ever, unseated from power because they have a complete financial spell over the leaders of every political party and hue. The elected political leaders do not tell this truth to people.³⁴

³³ See Acharya, S. (September 2010), "Constitutional System of Money and Finance," available at <http://prosperity.com/Research/Constitutional-Monetary-Finance-System.pdf>

³⁴ See, for example, Friedman, Thomas L. (August 6, 2011), "The Whole Truth and Nothing But," New York Times, available at <http://www.nytimes.com/2011/09/07/opinion/friedman-the-whole-truth-and-nothing-but.html?ref=opinion> and Pesek, William (August 7, 2011), "China in Time of Millionaires Frustrates Neighbor" Bloomberg News, available

The biggest obstacle facing constitutional democracies is financial dependence of the elected representatives on the de facto centers of perpetual power. To survive, if not to thrive, constitutional democracies need urgently to adopt a new rule to let the government fund elections and to prevent private funds from controlling elections and policies. Only then will principles A1 through A4 and B1 come into being (through the new leaders emerging from government-funded elections) to achieve the most efficiently competitive economies within the constitutional democracies.

IV. First-best Efficiency

To gain more intuition about how the theorem in the previous section yields the first-best efficiency: Just imagine that whatever first-best equilibrium level of welfare achieved by the Walrasian auctioneer with all information on private preferences and constraints is *exactly* will be the same level of equilibrium welfare that the individuals in my economy can achieve themselves with the same constraints. But the individuals in my economy do not have to share their private information with the Walrasian auctioneer. Furthermore, the cost of information collection is zero in my economy. One can write a maximization problem with all utilities and constraints in either case to show that the two constrained optimization problems are identical and will achieve the same welfare in equilibrium, except for the absence in my economy of the cost of gathering information by a Walrasian auctioneer. Introducing extra math notations to show this equivalence does not enlighten any further.

The theorem will be useless, however, if there did not exist a *commonly agreed norm* to set the rules. The phrase *commonly agreed* in this paper is the same *unanimously agreed* in the literature on social choices. I have used the term "*commonly*" because it stems from my research on *common longing of people for prosperity amid stability*.³⁵

This paper has actually presented a *commonly agreed norm* to set commonly agreed rules in the real-world. This norm is defined by "no net transfer" or "no net subsidy" to any group of individuals or companies from the public exchequer. The public exchequer comprises taxes and money created or printed and borrowed, directly by the government or via the central bank. We have argued earlier how this norm will be commonly agreed to resolve problems like the US social security. The source of first-best

efficiency is this norm in a progressively reforming system of governance.

James M. Buchanan and Gordon Tullock focus in a landmark book, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (1962),³⁶ on constitutional democracy in an ethical context of consent. Kenneth Arrow's *Social Choice and Individual Values* (1951)³⁷ makes an excellent formulation of social choice theory. These and other works in the extant literature on political economy show how to make social choices from a moral or ethical point of view to enhance social welfare within the framework of a constitution and democracy. My paper neither needs nor assumes the existence of a constitution or democracy for a society. It rather finds the existence of a constitution (constitutional norm/rules) necessary to attain the most efficiently competitive economy for a society. The theorem shows that such an attainment does not need a democracy. Neither does a democracy obstruct attainment of the most efficiently competitive economy as long as the constitution is formed according to the theorem.

The Walrasian equilibrium is the first formally scripted benchmark of first-best or efficient outcomes for an economy. The Arrow-Debreu economic environment shows how every state of the economy needs to be priced to obtain first-best outcomes. In the real-world of asymmetry of information, the Arrow-Debreu paradigm for first-best (efficient) outcomes may not obtain as every state may not be priced, which makes the markets incomplete. The Walrasian idea of central planning to gather private information on preferences and demands for goods and services completes the market to obtain first-best efficient results.

To address the issue of asymmetry of information, a set of important papers on second-best outcomes in the extant literature show the existence of second-best (inefficient) outcomes, which deviate from the first-best efficiency results. The deviation from first-best efficiency is due to the asymmetry of information causing incomplete markets. These papers are important because even the second-best equilibrium in the case of asymmetry of information is not guaranteed. I have made an extensive citation of the extant literature on these important papers in a companion paper entitled, "Economically Efficient Constitutional Governance" within a general equilibrium math model.³⁸ I have proved in that paper how free trading and non-interference by government can result in efficient resolution of moral hazard induced by asymmetry of information in the banking industry.

at <http://www.bloomberg.com/news/2011-09-06/china-in-time-of-millionaires-frustrates-neighbor-william-pesek.html>

³⁵ See, Acharya, S. (2010), "Optimal Governance for Prosperity amid Stability: A New Economic Paradigm for Democratic Capitalism for Realizing a Common Dream – Free Market Economy," <http://pro-prosperity.com/Research/Prosperity%20Amid%20Stability%20-%20A%20New%20Economic%20Paradigm.pdf>

³⁶ Buchanan, James M. and Gordon Tullock (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.

³⁷ Arrow, Kenneth J. (1951, 2nd ed., 1963). *Social Choice and Individual Values*

³⁸ <http://pro-prosperity.com/Research/moralhazardliberty.pdf>

The equilibrium presented in the theorem of the current paper is first-best efficient. This should be obvious because it obtains the same equilibrium outcome as in the Walrasian equilibrium presented within the proof of the theorem. The difference between my theorem and that of Walras is that my theorem does not need gathering of private information. My theorem also circumvents the problems

associated with moral hazard and adverse selection which give rise to second-best (inefficient) outcomes.

For example, during the 2008 financial catastrophe, if the commonly agreed norm presented in this paper were the constitutional rule of governance, the public exchequer in the US would not have been used to bail out the bankers that caused a manmade financial crisis. The crisis was manmade due to failure of experts, especially those at the helm of the Federal Reserve, according to the Financial Crisis Inquiry Commission.³⁹

In the agency literature, the bankers are the agents of the principals, the citizens of society including stockholders of banks. This literature would consider bankers as having superior information to bestow only second-best (inefficient) outcome for principals and thus approve of continual transfer of subsidies to banks through bailouts and cheap money printed by central banks.

But if the commonly agreed norm of my paper were the constitutional rule of governance in place, the bankers would not have expected such bailouts and subsidies. They would have expected to have their assets to be auctioned in the free markets without the government or the central bank using public exchequer to buy those assets at higher prices that the free market economy could not offer. My norm would have thus prevented bankers from engaging in moral hazard ploys. The bankers under the commonly agreed constitutional norm of this paper would have been better capitalized and as risk-averse as others with expectation of equilibrium returns available in a free-market economy. They would not have engaged in reckless gambles, for example, like credit default swaps (put options) written on third-party mortgage backed securities. The commonly agreed constitutional norm would have thus fetched first-best (efficient) outcome for the principals.

This is how the theorem in this paper achieves the most efficiently competitive outcomes.

The economic environment of the theorem imposes no restriction on competition or on individual choice, except the commonly agreed rules. An efficiently competitive economic equilibrium is possible because of the uniformly

progressive system of governance, which is the novel contribution of this paper.

V. Evidence on Progressively Reforming System of Governance

The evidence presented here is anecdotal because no nation has a progressively reforming system of governance or rules or constitutional tenets as presented in the theorem above. The anecdotal evidence is based on recent elections and mass movements across the world.

Firstly, Mr. Barack Obama's election as President of USA was unprecedented. It showed that Americans wanted new leadership distinguished by integrity, truthfulness and efficiency to change the established system by adopting only commonly agreed rules and by repealing the rules that enriched special groups of people like the financial traders, bankers, health insurance industries and lobbyists. Mr. Obama's skin color and background as a community organizer may have thwarted many Americans in supporting his candidacy. But the precipitous decline in the stock market before the election in 2008 was a strike in favor of his candidacy. His opponent Mr. McCain even talked openly in a debate that the independent people would withdraw their support to Mr. Obama if the stock markets recovered before the election.

Despite his resounding success, Mr. Obama and his party were rudely shocked about losing the Massachusetts Democratic senate seat held for more than forty years by a stalwart Democrat. The independents who had voted for Mr. Obama en masse withdrew their support to him and to his party soon after observing (a) back-door negotiations of the Obama Administration with special interest groups like the health insurance industrialists and union leaders and (b) inaction to reform the rules governing banks and capital markets that caused the crisis of 2008.

The Financial Crisis Inquiry Commission has found that the financial crisis was manmade due to a failure of finance and economic experts in the industry, academy and regulatory agencies including the Federal Reserve Board. Yet the voters observed that the Obama Administration continued to depend conspicuously on the same failed experts.

The negative response of voters towards an Administration catering to special interest groups resulted in toughening of Mr. Obama's public stance towards Wall Street and departure of his top economic advisers. The popular anger against political favor to special interest groups prompted the Democratic Senate to withdraw its previously expressed support to President Obama's nominee to the post of the Chairman of the Federal Reserve Board. The Democratic Senate reluctantly voted for the current Chairman of the Federal Reserve to contain further erosion of public support to their

³⁹ See "Financial Crisis Inquiry Report, the Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," submitted by the Financial Crisis Inquiry Commission, pursuant to Public Law 111-21, January 2011, <http://www.gpoaccess.gov/fcic/fcic.pdf>

President if his nominee were rejected by his own party.

The inference here is not about the current Chairman of the Federal Reserve Board or any specific adviser to the President. It is about people detesting government rules and regulatory practices that enrich and empower special interest groups. Even the FCIC seems to have sided with the people to conclude that the regulatory agencies including the Federal Reserve Board failed to protect the common interests of people by causing a manmade crisis.

The Tea Party in the U.S. surfaced as a movement against the established rules serving special interest groups including unions and welfare recipients. Historically, leaders of many such movements have been eventually absorbed by the established power centers, which have succeeded so far to perpetuate their hegemony over power and wealth. But, given the success of popular movements elsewhere, the American power centers may preemptively accept the progressively reforming government in order to maintain an efficiently competitive economy, which is the source of their wealth and hegemony.

Popular movements have spread across the middle-east and India with people demanding to repeal government rules and practices that enrich special interest groups. They have achieved tremendous success. But no nation or movement has yet made an explicit referendum for the progressively reforming system of governance proposed in this paper. One cannot, therefore, make a conclusive claim that people across the world are really longing for this system of governance until they vouch for it based on a referendum. But the widespread protests all over the world indicate that people are opposed to government transfers to special interest groups.⁴⁰

VI. Conclusion

The theorem presented in this paper shows that only a progressively reforming system of governance can attain the most efficiently competitive economy. This system is also practically implementable via a self-sufficiency norm to set commonly agreed rules of governance. This norm is defined by a zero net-subsidy in any government scheme like the U.S. Social Security, Medicare and Medicaid. The theorem offers a practical approach to fulfill the common longing of people to maximize their welfare without hurting others, subject to constraints like individual endowments and skills and to the enacted commonly agreed rules of governance.

The anecdotal evidence presented here seems to support that people do not like rules that enrich and

empower special interest groups. For example, consider a government rule or practice that facilitates some people to usurp public resources or others' private wealth. The usurpers may like this rule at first blush. But will they like their wealth (including whatever they have usurped from others) to be wangled away by more powerful people or by future movements of people? The ousted authoritarian rulers did not anticipate, *ex ante*, that their rules and practices would cause popular movements. But the preference of the same authoritarian rules *ex post* (after they lost their usurped wealth and faced prosecution by popular movements) is obviously to not institute any government rule or practice that will let anyone usurp public or private wealth.

Thus, people including those used to usurping others' wealth do not ultimately (in the long run) prefer to establish a rule of governance which facilitates usurpation of public and private wealth. The people do eventually decipher even the most sophisticated system (rules of law) designed to usurp public and private wealth, recover the wealth from the usurpers, and reform the system to proscribe and punish even surreptitious usurpers of public or private wealth.

The anecdotal evidence presented in the paper is consistent with the premise of the theorem that people prefer establishment of only commonly agreed rules, as opposed to the rules (currently prevailing in the systems of governance worldwide) that enrich and empower only some special groups of people.

I have no doubt that people, globally, will ultimately see the truth about the need of a progressively reforming government, presented in the paper, to attain the most efficiently competitive economy. But I am afraid that even the leaders of the currently successful popular movements may resort to some "reformed" rules of governance to enrich "new" special interest groups that maybe lurking behind the rising masses of people. I have, in fact, written about such possibility to Mr. Barack Obama before he was elected the President of USA based on a popular movement on changing the established rules that cater to special interest groups.

It is hard to predict if Mr. Obama or any of his successors in USA or any leader in other nations can establish a progressively reforming system of governance or if China is having one. But I believe that people globally shall willy-nilly converge eventually towards this system because the truth (proven by the theorem) is that it alone can achieve the most efficiently competitive economy which is commonly longed by them.

⁴⁰ As Scorn for Vote Grows, Protests Surge Around Globe (September 28, 2011), New York Times, at <http://www.nytimes.com/2011/09/28/world/as-scorn-for-vote-grows-protests-surge-around-globe.html?hp>