



The New Democratic Federalism for Europe

**FUNCTIONAL, OVERLAPPING AND
COMPETING JURISDICTIONS**

BRUNO S. FREY

and

REINER EICHENBERGER

**STUDIES IN FISCAL FEDERALISM AND
STATE-LOCAL FINANCE**

General Editor:
Wallace E. Oates

The New Democratic Federalism for Europe

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General Editor: Wallace E. Oates, *Professor of Economics, University of Maryland and University Fellow, Resources for the Future, USA*

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Preface

The purpose of government is to fulfil the needs of the citizens and of the population at large as best as possible. Good government reflects the diversity of wishes and the differences in demand among persons and geographical areas.

Two institutions have proved to be excellent in fulfilling this task: federalism and direct democracy. However in present countries these beneficial institutions are either little used, or in some countries not used at all. This also holds for the newly emerging Europe. In fact, the European Union (EU) is hardly democratic (the well-known 'democracy deficit') and weakly decentralized.

This book proposes an institutional arrangement which strengthens the existing aspects of federalism and direct democracy, and which will be able to cope with future problems arising in Europe. This proposal is termed FOCJ (Functional, Overlapping and Competing Jurisdictions).

In Part I of this book, the idea of FOCJ is presented. Chapter 1 introduces the basic concept. The advantages of FOCJ are discussed in Chapter 2. Chapter 3 analyses how the concept can be successfully implemented. A comparison is made between FOCJ and the traditional concepts of federalism in Chapter 4, and Chapter 5 contrasts them to related theoretical proposals and historical and contemporary real institutions.

In Part II, the concept of FOCJ is applied to Europe. Contrasts are made between FOCJ and today's institutional structure of the EU and other constitutional proposals (Chapter 6). Chapter 7 discusses the advantages of FOCJ over today's federal elements and regional policies of the EU, and analyses how FOCJ can be institutionalized in the EU.

Part III extends beyond the EU. FOCJ provide a fruitful mechanism to incorporate the EU into world politics and to solve some of the pressing problems of integrating those countries which lie on the eastern and southern border into European politics (Chapter 8). In Chapter 9, the concept of FOCJ is applied to developing countries and is shown to help solve many of the problems in these countries, too. Chapter 10 provides a short summary of the arguments.

To keep the book easy to read, we have refrained from quoting

literature all over. Instead, the end of each chapter provides suggested further reading for the particular issues discussed.

The ideas contained in this book have been presented at a large number of workshops and conferences all over the world. We have benefited from intensive and repeated discussions with our scholarly friends, Charles Beat Blankart, Lars Feld, Gebhard Kirchgässner, Friedrich Schneider and Hannelore Weck-Hannemann. We also received useful comments from European economists concerned with the constitutional prospects on our continent, in particular Peter Bernholz, René Frey, Jürgen von Hagen, Henner Kleinewefers, Dennis Mueller, Dieter Schmidtchen, Hans-Werner Sinn and Roland Vaubel. We received useful insights from the Network on Enlargement and new Membership of the European Union (NEMEUE). The 'impartial spectators' from America have been most helpful in shaping our thoughts: Gordon Tullock, James Buchanan, Bob Cooter and Daniel Rubinfeld. Finally, we acknowledge the help provided by our co-workers Iris Bohnet, Felix Oberholzer-Gee and Juerg de Spindler. Margaret Ho was responsible for editing the manuscript and improving the writing. We are grateful to all of them.

PART I

The Idea



1. Functional, Overlapping and Competing Jurisdictions (FOCJ)

1.1 THE BASIC CONCEPT

Benevolent attempts to inform politicians and governments of how to undertake the 'right' policy must necessarily fail: all too often the interests of government (which is composed of selfish individuals) are in conflict with the interests of the citizens. Politicians have little reason to hold back their own interests. Elections, taking place only once every four years, are not able to sufficiently restrict politicians' selfish behaviour. Therefore the institutional conditions have to be designed so that stronger incentives are imposed on politicians and governments to fulfil citizens' preferences. This can only be achieved by strengthening the *political* competition at all levels of government. Strong political competition makes governments suppliers of policies that take care of citizens' demands and thus increase welfare – no less than economic competition makes suppliers of goods and services take consumers' wishes into account. Nevertheless political competition has often been disregarded, especially in today's EU. There is a wide consensus that a 'democracy deficit' exists at the European level. This gap could be bridged and large welfare gains could be attained if the market for government services were opened for competitive public jurisdictions focusing on the production of particular services instead of yielding power over a particular territory.

The concept of a new federalism proposed here is called FOCJ (Functional, Overlapping and Competing Jurisdictions). It allows the emergence of political bodies whose size corresponds to the tasks to be fulfilled. Examples are functions such as education, public transport, waste water treatment, public security or defence. The geographic extension of a FOCUS (as the singular of FOCJ is to be called) is driven by the present and future physical extension of a problem rather than by historical, more or less randomly established, boundaries.

FOCJ are characterized by four properties:

1. A FOCUS is determined by the goal or function to be fulfilled. Its size has to match its task.
2. FOCJ are overlapping, that is, each function requires a corresponding geographical extension.
3. FOCJ compete for communes and citizens, and they are subject to democratic political competition. Popular referenda, and possibly citizens' meetings, may be used for that purpose in addition to the normal representative political institutions.
4. FOCJ are jurisdictions with the power to raise taxes with which they finance the expenditures needed to fulfil their functions.

FOCJ emerge because they are desired by the citizens as they can be well monitored and controlled by them. The concept is based on ideas received from 'public choice', 'constitutional economics' and various elements of the 'economic theory of federalism'. It differs completely from the existing federalism of the EU and from various reform concepts, in particular, the principle of subsidiarity. FOCJ bear some similarity to a European integration proceeding with 'different speeds' and 'variable geometry' whereby integration can take place in a differentiated way – a concept vigorously rejected by most European politicians.

The traditional economic theory of federalism takes the extension of jurisdictions as a given. The analysis is concerned with which activities are allocated to what levels of government; the existence of an optimal degree of centralization is presumed. This study breaks with this concept. The 'optimal degree of centralization' varies according to functions and changes over time. In addition it is taken into account that decisions made in the current politico-economic process systematically tend to lead to over-centralization because many political actors have a self-interest in a strongly centralized state. The concept of FOCJ is, therefore, process-oriented: FOCJ form an adaptable federal network of governmental units that depend closely on citizens' preferences and adjust to the 'geography' of problems – as long as the citizens dominate the formation process of the FOCJ.

The *fifth freedom* suggested here goes beyond the four economic freedoms (the free mobility of goods, services, labour and capital) and is based on a constitutional decision. The European Constitution or a related treaty must provide the lowest political units (the communes), and possibly also individual citizens, with a guarantee of participation in FOCJ. The citizens must have the right to decide for themselves whether their commune should join a particular FOCUS, and what its

constitution should look like. At the same time they must have the right to leave the jurisdictions they belong to either totally or with respect to particular functions. When they decide to exit they must receive a tax rebate corresponding to the cost of the services they no longer consume. The emergence of FOCJ must not be blocked by the existing political institutions. Every citizen and commune must be able to place a formal complaint with the European Constitutional Court if they feel that the foundation of FOCJ is hindered.

In the following section the four characteristics of FOCJ are discussed more extensively.

1.1 FOCJ are Functional

Jurisdictions perform their activities more efficiently the closer the match between the consumers and those who pay for services, that is, the smaller the 'spillovers' are, the more these units are able to exploit 'economies of scale', and the more closely the supply can be adapted to the demand exerted by the citizens. The various public services (for example parks, schools, waste treatment plants, national defence and so on) extend very differently over physical space and have different degrees of scale economies (or diseconomies). Moreover demand varies strongly over space because it depends on several factors which can differ strongly according to location. As a consequence it is efficient when not all services are provided by the same governmental unit but are instead supplied by specialized functional jurisdictions adjusted to the corresponding tasks. In FOCJ functions are not defined in a technical way but in a manner relevant to citizens. Thus a FOCUS does not necessarily specialize in fire fighting in a narrow sense, that is, by putting out existing fires. Rather it will pursue an integrative approach by combining fire prevention (for example through government intervention), fire fighting (by the fire brigade), and reducing the utility losses caused by fires (by public and private insurance).

1.1.2 FOCJ are Overlapping

FOCJ that perform different tasks overlap. A citizen is, therefore, a member of several jurisdictions. FOCJ, moreover, need not have a monopoly of supply for a particular function. Several FOCJ providing the same functions may offer their services in a particular geographic area. This kind of overlap extends the choice set of citizens and strengthens competition among the suppliers of public services. Such overlapping, non-contiguous jurisdictions contrast with the traditional

notion of federal and national states which presume the geographical unity of the state. The two kinds of overlap just sketched reinforce each other.

1.1.3 FOCJ are Competitive

The governments of FOCJ are subject to two mechanisms forcing them to cater to the preferences of their members: the option for citizens and communes to *exit* FOCJ establishes competition similar to markets, and in addition their *voting rights* establish political competition. Exit from FOCJ does not necessarily require geographic mobility; citizens or communes may switch membership without moving physically. The threat of exit is, therefore, particularly effective. The importance attributed to exit in our concept of FOCJ strongly contradicts the prevailing concept of national and federal states which prohibits exit. Secession has indeed often been prevented by brute force, the American civil war (1861–65) or the Swiss Sonderbundskrieg¹ being pertinent examples.

The European treaties so far do not contain any concrete conditions for exiting the EU, nor do they specify the division of jurisdictions at lower levels (nations, states, Länder, provinces, regions and so on). The concept of FOCJ and of the fifth freedom could fill this gap in the future European Constitution. Exit should be restricted as little as possible in order to strengthen competition between governments. The exact conditions for exit can be regulated by contract among the members of a FOCUS, which would then have the nature of a constitution. For entry, in contrast, a FOCUS must be allowed to ask for a price. As is the case in 'clubs', entry cost may serve as prices for the use of public goods and for internalizing the cost of external migration. Such explicit prices are more efficient than mobility restrictions and regulations such as 'zoning laws' which lead to higher real estate rents and prices. Entry prices also serve to capture the consumer rents of the people and communes entering the FOCUS. This also provides the governments of a FOCUS an incentive to offer attractive services to potential members. It should not be feared that such entry prices will be set strategically and at too high a level because the competition among FOCJ calls for prices that are in line with the value of the corresponding services.

Under realistic conditions, exit is not sufficient to secure efficiency. As long as individuals have no political rights the governments have considerable discretionary power and can deviate from the preferences of the citizens. Thus FOCJ guarantee political competition by their

democratic institutions. The citizens can elect the legislative and the executive of the various FOCJ they belong to. In addition they should also have access to direct-democratic instruments to control government. This allows them to participate in agenda-setting in the political process (the right for initiatives) and to demand a vote on the decisions taken by the government (the right for referenda). These popular rights lead to a better fulfilment of citizens' wishes in the political process. When the citizens have the right to initiate propositions, the institutional details of a FOCUS need not be determined by a higher governmental level. The citizens themselves can create the democratic institutions of the various FOCJ they belong to.

1.1.4 FOCJ are Jurisdictions

A FOCUS is a formal political unit with powers to regulate and to tax. The membership of a FOCUS can be defined in two different ways. In the first case the smallest political units, normally the communes, may be the members. In that case an inhabitant of a commune automatically becomes a citizen of those FOCJ to which his or her commune belongs. Exit is possible only by leaving the commune. In the second case an individual citizen can decide freely whether he or she wants to be a member of a particular FOCUS. An example are FOCJ for the supply of basic education, which may well have individuals as members. Individual or communal membership may be the more appropriate solution, depending on the function. A strong form of individual choice opportunities may undermine public redistribution schemes. If desired, redistribution and a minimum level of public services can be guaranteed by a higher political unit. Membership in a FOCUS offering the public service in question can be made obligatory, and the quality may be prescribed. Citizens can be given the option of choosing which school-FOCUS to enter but in order to ensure that people without children contribute to school taxes, every citizen must be a member of some school-FOCUS. In order to prevent the founding of school-FOCJ without services and taxes (designed for citizens without children), minimum service levels can be prescribed.

1.2 ADVANTAGES OF FOCJ

Based on the four main characteristics discussed above FOCJ have various advantages over traditional forms of public organization.

Strengthening the democratic instruments and exit options helps the

citizens to express their demands and to effectively control the government. The concentration of a FOCUS on one or at most a few public services makes it easier for the citizens to evaluate efficiency and to compare it to other FOCJ. As many public services have a relatively small number of users, most FOCJ are likely to be smaller than many of today's jurisdictions which further reduces the information problem. The easier it is for individuals to exit, the more political information transforms itself into a private good, and the stronger are the incentives of the citizens to acquire knowledge about the political issues at hand. This in turn improves the functioning and efficiency of the democratic institutions.

FOCJ strengthen the ability of governments to fulfil citizens' preferences. Due to their spatial flexibility FOCJ are able to exploit economies of scale and minimize spillovers, that is, services unpaid by the users. The public services can, therefore, be supplied at a particularly low cost. If the benefits of a particular function spread over a large area and falling average cost prevails, FOCJ can adjust. Thus, for example, a FOCUS for defence might embrace large parts of Europe and even countries beyond.

The tax autonomy of FOCJ gives strong incentives to use the financial means in an economic way. FOCJ will, therefore, not automatically produce the services offered themselves but concentrate more on their provision. If it is less expensive they will rely on outsourcing, that is, they will buy the service from the cheapest supplier. In this respect FOCJ help to strengthen markets and to redress the public sector. But the concept of FOCJ does not just amount to privatization. In the case of FOCJ, the decision to produce privately develops endogenously as a result of the incentives the governments of FOCJ face. Privatization is not imposed from outside and is, therefore, less subject to ideological vagaries.

The concentration of a FOCUS on one public service does not only result in the advantages of specialization. FOCJ are a means to open political markets which are otherwise strongly dominated by the cartel of politicians, the *classe politique*. Competent outsiders have a chance to offer their services. While in today's jurisdictions most politicians are above all generalists catering for a multitude of services, in contrast, the government of a FOCUS will be run by specialists in a particular function. The narrower tasks to be fulfilled in FOCJ allow many political posts to be occupied part time or by volunteers, which further opens political markets. The functional focus on particular tasks also helps groups devoted to one theme to enter the political process. They no longer have to try to gain political power over many different issues

but can instead concentrate on issues they really care for. Ecologically oriented parties, for example, need no longer take a position on foreign policy but can fully devote themselves to a FOCUS concerned with the natural environment. A minority (for instance, an ethnic group) which disagrees only with some aspects of government policy relevant to them can establish a FOCUS devoted to these special public activities. A particular advantage of such a *partial* exit is that fewer trade restrictions are erected than when a new jurisdiction is founded which cares for all activities. In this respect FOCJ are an institution of 'market-preserving federalism'.

The fifth political freedom strongly changes the nature of the national states. FOCJ do not destroy them but establish new alternatives. FOCJ will only fulfil those public services delegated by the citizens because they are able to provide them more cheaply and more consonant to the citizens' wishes. The national states will still perform those functions which they provide more efficiently. The primacy of the national state over lower level units (provinces, Länder, regions, communes) is, however, ended.

1.3 CLAIMED DISADVANTAGES

As mentioned above the strengths of FOCJ have been stressed. Now some of the (presumed) weaknesses are discussed.

1.3.1 Exit is Costly

When individual citizens and whole communes leave a FOCUS, there is not only a (welcome) allocation effect but income distribution may be negatively affected. Exit will, therefore, never be agreed to by all persons involved. In some cases serious political and even military conflict may result. When FOCJ are founded it is, therefore, necessary to set the procedural rules under which exit takes place. In contrast to what is often feared, the experiences with exit, new foundations and mergers of communes and even whole cantons in Switzerland and of various types of jurisdictions in the USA, demonstrates that in most cases these changes take place in a democratic and peaceful way. These jurisdictional changes are, of course, preceded by long political negotiations whose efficiency is determined by the legal and institutional rules existing. The fifth freedom suggested here will be more effective when the various jurisdictions are forced by constitutional decree to indicate their 'tax price menu'. These menus show how much tax

revenue is needed to perform a particular public service. These tax prices can then be used to calculate the tax rebates granted when a citizen or commune leaves a jurisdiction.

1.3.2 Citizens are Overburdened

In a federal network of FOCJ every person is a citizen of many jurisdictions. It may be thought that the many elections and referenda in the various FOCJ may overburden the citizens who then react with political abstinence. This fear is unwarranted. First, a low rate of vote participation is not a problem as such. Rational citizens do not vote as long as they are satisfied with the services provided by the (FOCJ) governments. The same holds if they have no clear preferences among the alternatives offered to them. In contrast citizens with particularly strong views as well as those dissatisfied with the government's activities are more likely to participate politically. What matters is that the citizens react when they dislike what the persons in charge of the FOCJ offer.

Second, in a network of FOCJ the citizens find it easier to evaluate the public services provided. Today, it is nearly impossible to compare the services between jurisdictions because there is a large amount of cross-subsidization between the various departments and public services offered, and public bookkeeping is difficult to comprehend. In contrast, when FOCJ exist, the citizens automatically see the tax prices of the various public services. Third, the citizen's scope for participating in the political process in the case of FOCJ should be compared to their implicit abstinence in the traditional system. Many dimensions of services which in FOCJ are highly visible and can be easily evaluated, are hidden in today's jurisdictions where a voter must simultaneously evaluate all dimensions. Finally, the task of making political decisions can be made easier by new institutions which emerge for that purpose. For example, the timing of the various elections in various FOCJ can be synchronized. Delegates of the citizens may be active in several FOCJ, and in referenda the citizens may follow the recommendations offered by the parties and interest groups they trust.

1.3.3 Co-ordination is Needed

It often proves useful to co-ordinate the activities of various FOCJ but co-ordination is not necessarily good as such. It often benefits governments and politicians to establish cartels and to exploit the voters. In a network of FOCJ the need for (welfare-enhancing) co-ordination is reduced because they emerge exactly in order to minimize spillovers

and to use economies of scale. As long as there are spillovers between FOCJ there are incentives to adjust accordingly the extension of the respective FOCJ or to found new ones. FOCJ can thus be interpreted as democratic and competitive mechanisms of co-ordination. As changes in size are always costly, not all externalities between FOCJ will be internalized. However, from a comparative point of view, it should be noted that externalities also exist between the administrative units in traditional all-purpose jurisdictions. There are, for instance, many aspects which must be co-ordinated between the ministry of transport and the ministry of the environment. The question therefore arises in which system are there stronger incentives to negotiate and when are the bargaining costs smaller. The public officials in the various ministries have only weak incentives to co-ordinate their activities. They dislike the fact that their discretionary power is reduced by effective co-ordination. Bureaucrats in traditional ministries are, moreover, not dependent on following the citizens' wishes. In contrast politicians in FOCJ are given strong incentives to negotiate with other governments because their re-election and the chance of having referenda approved directly depends on citizens' satisfaction with their policy. As long as the citizens desire more co-ordination, it is likely to be supplied by the governments of FOCJ. There is a close analogy between the co-ordination among FOCJ and among firms. The latter is an everyday phenomenon typical for markets as the newer industrial organization literature shows. Some of the ideas discussed there, for example, the development of industry standards, can be transferred to the concept of FOCJ.

1.3.4 Intensive Preferences are Difficult to Reveal

The functional separation among FOCJ renders vote trading and therewith a welfare-enhancing revelation of intensive preferences more difficult. In traditional jurisdictions, groups with strong preferences for particular public services can trade their vote with groups particularly interested in other public services. However vote trading does not necessarily increase welfare. It is beneficial for the participants but disadvantageous for those groups left out. According to the vote trade paradox, an exchange of votes can worsen the utility of all participants when public activity also involves redistributive effects (which is the rule).

Preference intensities can to some extent also be revealed in popular votes and in elections for positions in FOCJ. Intensive preferences raise vote participation and make it more likely that a citizen casts his or

her vote in favour of the preferred alternative. Moreover an individual can allow himself or herself to take into account the particularly intensive demands of other persons, as its influence on the result of a vote is small. Finally, minorities with intensive preferences can establish a FOCUS designed to care for their special interests.

1.3.5 Redistribution is Impossible

An important critique of FOCJ argues that in such a network, income cannot be redistributed because the recipients of higher incomes evade the respective taxes by exiting to a FOCUS with low tax rates and little support for the poor. This argument is also relevant for traditional federalism. New empirical research has, however, established that redistribution is also feasible in strongly decentralized states. Thus a considerable part of redistribution in Switzerland takes place at the level of cantons and even communes. One of the major reasons that redistribution is feasible at this level is due to the stronger local identity of citizens in strongly decentralized political systems. A strong local identity supports the inclination to redistribute income in favour of the disadvantaged members of the community, and to bear the respective taxes. (Small) communities even foster co-operative behaviour, as has also been argued by Bowles and Gintis (1998). The mobility of persons and firms is, therefore, lower than normally assumed. In the EU, for instance, mobility between the member states is rather low. Only five per cent of EU citizens live outside their mother country.

If the possibility of redistribution is considered to be too small by the citizens, a higher-level political unit (such as the government of the EU) can be granted limited power for redistribution by constitutional consent. Alternatively a special FOCUS designed to redistribute income may emerge; in order to survive it needs to establish barriers to exit and entry. After all the existing national states and lower units are undertaking redistribution on the basis of democratic decisions by the citizens; the same outcome may be expected to emerge in the case of FOCJ – provided the electorate is satisfied with the redistribution process taking place.

1.4 PROCEDURE

Our proposal of functional, overlapping and competing jurisdictions with a large amount of autonomy may appear radical at first sight. Its chances of realization seem rather small under present conditions in

Europe. It is certainly true that FOCJ deviate strongly from federalism as it is practised today, for example, in Germany or Austria. As the Länder, and also the communes, have only very restricted taxing power, they depend on central government to a large extent.

The arguments in this study are developed in the following way. Chapter 2 develops the strength of FOCJ with respect to decentralization and democratization. Chapter 3 discusses how FOCJ can be implemented. Chapter 4 compares FOCJ to theoretical federalism and deals with the alleged problems. Chapter 5 looks at the already existing 'bastard' FOCJ, that is, governmental units which share one or several of the characteristics of FOCJ.

Part II of the study is more specifically devoted to FOCJ in Europe. Chapter 6 discusses federalism as it exists in Europe today, and Chapter 7 analyses how FOCJ can be applied in Europe.

Part III looks at how the concept of FOCJ can be used beyond Europe. Chapter 8 considers the relationships of Europe with the rest of the world. Chapter 9 shows how FOCJ can be of great use in developing countries. The study ends with general conclusions (Chapter 10).

NOTES

1. The Sonderbundskrieg in 1847 brought the conservative Catholic cantons in the centre of Switzerland against the progressive (radical) Protestant cantons. The attempt at secession by the Catholic cantons was prevented by the Protestant army which proved to be victorious in several battles.

SUGGESTED FURTHER READING

The institutions of the EU are the subject of many books. See, for example, Marks, Gary, Fritz W. Scharpf, Philippe C. Schmitter and Wolfgang Streek (1996), *Governance in the European Union*, London: Sage.
Nugent, Neill (ed.) (1997), *The European Union*, 2 vols, Aldershot: Dartmouth.

Factual aspects of the EU are collected in
Roney, Alex (1998), *EC/EU Fact Book*. 5th edn, London: Kogan Page.

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Jones, Robert A. (1996), *The Politics and Economics of the European Union*, Cheltenham: Edward Elgar.
Tsoukalis, Loukas (1997), *The New European Economy Revisited*, Oxford: Oxford University Press.

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Føllesdal, Andreas and Peter Koslowski (eds) (1998), *Democracy and the European Union*, Berlin: Springer.

An analysis of European unification on the basis of Constitutional Economics is provided in

Mueller, Dennis C. (1997), 'Federalism and European Union: a Constitutional Perspective', *Public Choice*, **90**, 255–80.

Vibert, Frank (1995), *Europe. A Constitution for the Millennium*, Aldershot: Dartmouth.

Various contributions are collected in

Vanberg, Viktor and Richard Wagner (eds) (1996), 'Europe: A Constitution for the Millennium', *Constitutional Political Economy*, Special Issue, **7**, 253–338.

Strongly committed to the position of Friedrich von Hayek is the analysis by Streit, Manfred and Stefan Voigt (1997), 'Towards ever closer union – or ever larger?', in Dieter Schmidtchen and Robert Cooter (eds), *Constitutional Law and Economics of the European Union*, Cheltenham: Edward Elgar, 223–47.

The possibility for simultaneously sustaining tax competition, public goods and income distribution is shown in

Kirchgässner, Gebhard and Werner W. Pommerehne (1996), 'Tax Harmonization and Tax Competition in the European Union: Lessons from Switzerland', *Journal of Public Economics*, **61**, 66–82.

The idea of FOCJ was conceived in

Frey, Bruno S. and Reiner Eichenberger (1995), 'Competition among Jurisdictions. The Idea of FOCJ', in Lüder Gerken (ed.), *Competition among Institutions*, London: Macmillan, 209–29.

Some aspects of FOCJ were previously discussed in

Casella, Alessandra and Bruno S. Frey (1992), 'Federalism and Clubs: Towards an Economic Theory of Overlapping Political Jurisdictions', *European Economic Review*, **36**, 639–46.

The concept has been further developed in

Frey, Bruno S. and Reiner Eichenberger (1996), 'FOCJ: Competitive Governments in Europe', *International Review of Law and Economics*, **16**, 315–27.

2. The advantages of FOCJ

2.1 DECENTRALIZATION

2.1.1 The Benefits of Federalism

The economic theory of federalism, in line with modern economics in general, is based on methodological individualism and sees the goal of political and economic activity in fulfilling individual preferences as much as possible. This applies in particular to the wishes of citizens as consumers of public services and as taxpayers.

The economic theory of federalism reaches a clear conclusion: federal, that is, decentralized, are superior to centralized states. A federal state has three decisive advantages over a unitary state, provided the federal units (provinces, Länder, cantons, communes and so on) have sufficient autonomy and can raise their own taxes to finance their expenditures.

(a) Citizens' preferences are better met

In all societies individual demand for goods and services supplied by the state varies regionally. These differences are as a result of heterogeneous preferences caused by tradition, culture and language, as well as different economic conditions.

In order to meet these divergent preferences, public supply must be regionally differentiated. Lower level political units are best able to fulfil this task. They are better informed about the preferences of the local population. Even more importantly, local politicians have an incentive to provide the corresponding supply efficiently because their re-election and subsequent political survival depends on the satisfaction of local voters. Centralized states, in contrast, tend to undertake uniform programmes that do not take into account the geographically diverse demands of the citizens. Public schools and their educational programmes, for example, are often standardized over the whole country. If schools make pupils study only one foreign language or even none, regions where tourism is important are put at a disadvantage because the inhabitants would be better off knowing another language (for

instance, English or Japanese), or different languages. With strong centralization, even politicians acting at the local level are often not concerned with local issues as their career essentially depends on getting along well with the party headquarters and the politicians in the capital city.

(b) Supply is low cost

Government activities in all developed economies have reached very large proportions, a fact which is reflected in the share of public expenditures in national income, the share of public officials in total employment, the dependency of a significant portion of the population on redistributed income or the share of income going to taxation. In view of this, it is important for the government to behave in an efficient way. In federal states the mechanisms of entry and exit provide local governments a strong incentive to produce public supply at the lowest cost possible. Individuals and firms dissatisfied with the relationship between the supply and cost of public services threaten to move into another jurisdiction where this relationship is more favourable. Exit and entry create competition between the various suppliers of public services, and induce them to act efficiently. Mobility is, of course, not without cost. The entry and exit mechanisms sketched, however, do not require the full mobility of all citizens and firms. A small amount of mobility suffices to force politicians to consider the voters' demands. As on normal goods markets and the stock exchange, the marginal trader drives the price towards the equilibrium.

(c) Innovations are favoured

Chances for innovation are higher in decentralized states for several reasons. First, it is simply more likely that a majority of the population of one of the many small local jurisdictions favours a certain innovation than the population of the entire country. Second, innovations under decentralization can be undertaken on an experimental basis within those jurisdictions where the conditions for success are most conducive and where the respective innovations are most desired. Third, such voluntary innovative experiments have higher success rates than when they are imposed from above. Fourth, a particular local jurisdiction finds it less risky to introduce new ideas with respect to the provision of public goods or taxation because the consequences are limited and can be controlled and influenced more easily. If the innovation proves to be a failure, not much is lost. Fifth, a successful innovation, on the other hand, will soon be imitated by other local units and will thus diffuse over the whole country. In order to trigger an innovative process,

the initiators must have a large enough advantage. This precondition is fulfilled in local jurisdictions where the success (or failure) can easily be attributed to the corresponding politicians.

2.1.2 FOCJ and Decentralization

How do functional, overlapping and competing jurisdictions fare with regard to the advantages of decentralization? It will be argued that FOCJ constitute an extreme form of federal decentralization and, therefore, are able to exploit the advantages of decentralization to the fullest extent possible.

(a) Supply differentiation

The functional orientation of FOCJ, as well as the strong political competition induced by exit and entry and by direct democratic rights, produces a differentiated policy caring for the citizens' demands. If a particular FOCUS finds it difficult to meet heterogeneous demands, a new FOCUS will emerge to meet the corresponding local wishes. Supply differentiation need not be performed by one jurisdiction but will be the outcome of the diversity between public suppliers. This process can be illustrated with the example of the supply of publicly provided schools.

Consider the situation in which some parents desire a broad education, and other parents a more specialized education concentrating on a few subjects (for example, mathematics and the natural sciences). Even if the two conceptions of a desirable education for children diverge it is not necessary to solve the problem by reaching an unhappy compromise. Rather a portion of the parents can establish a new school-FOCUS. Their exit from the previous school-FOCUS reduces their tax burden. The corresponding tax opportunities can partly or wholly be used to finance the new school-FOCUS. Usually the parents dissatisfied with the old educational supply need not take the initiative to organize the new school-FOCUS themselves. This task will be performed in most cases by political entrepreneurs. The coexistence of a new and an old school-FOCUS in the same locality produces sound competition. It allows parents (and children) to compare the performance of the two school-FOCJ and to choose the one appropriate for themselves. In the case just mentioned it would also be possible to establish a private school. However, competition can only be considered fair if the parents exiting do not have to pay the taxes of the original school-FOCUS. This does not happen under present conditions. In many countries the cost

of sending children to a private school cannot be deducted from taxable income.

(b) Cost reduction

Easy exit and entry opportunities and well-established democratic participation rights give strong incentives to the managers of FOCJ to provide public services at low cost. Compared to traditional concepts of federalism based on geographic mobility, competition between the various suppliers of public services is more intensive in FOCJ. Dissatisfied persons and firms can join another FOCUS without having to change their location. This holds, of course, only if production conditions allow multiple suppliers to coexist. This is the case in the school example discussed above. Because of economies of scale, multiple supply is likely to be more difficult in other cases, say the provision of fresh water. However, even in these cases, the concept of FOCJ should be upheld. On one hand, free market entry is not noxious in the presence of large economies of scale. It is just not often made use of. On the other hand, new technological developments often allow new forms of competitive supply. In particular this is possible when the supply of the infrastructure for a natural monopoly (for example the water or railway network) is separated from the supply of the service. The latter can well be provided by several FOCJ standing in competition with each other.

(c) Innovation

For two reasons, FOCJ are even better equipped than traditional federal jurisdictions to pick up and put innovation into reality. First, they are flexible units which are established when needed, therefore, they increase the incentives as well as the opportunities for politicians to implement innovations. Second, FOCJ are discontinued when their services are no longer demanded as more citizens and communities exit and the tax base shrinks. This is an important aspect of FOCJ as it frees resources from unproductive use. It contrasts well with traditional types of government which have the unhappy tendency to keep extending their influence.

2.2 DEMOCRATIZATION

2.2.1 The Benefits of Direct Democracy

There is a large body of literature comparing the functioning of direct and representative democracy. In the context of FOCJ, two aspects are

of central importance, referenda as a means of restricting the cartel of politicians in power, and the role of information as a crucial part of the political process.

In the following the essence of direct democracy is identified with the popular referendum, that is, the option of citizens to reject decisions taken by the politicians (obligatory and optional referendum in the narrow sense), and to influence the political agenda by using initiatives. While the expression 'direct' democracy is used for simplicity, it means more precisely 'semi-direct' democracy, that is, we presume the existence of an elected parliament and executive making most decisions. What matters is that these decisions are not final and not unique but that the citizens may intervene directly in the political process when they feel that their interests are not being catered to.

(a) Referenda against politicians' cartels

Rent-seeking theory argues that representatives have a common interest in forming a cartel to protect and possibly extend political rents. Referenda and initiatives are a means to break the politicians' coalition against the voters. Initiatives require a certain number of signatures and force a referendum on a given issue. They are a particularly important institution because they take the agenda-setting monopoly away from the politicians and enable outsiders to propose issues for democratic decision, including those that many elected officials might have preferred to exclude from the agenda. As has been shown in public choice theory, the group determining which propositions are voted on and in what order has a considerable advantage because it decides to a large extent which issues will be discussed and which ones will be left out.

Referenda, obligatory or optional, enable the voters to state their preferences to the politicians more effectively than in a representative democracy. In a representative system, deviating preferences with regard to specific issues can only be expressed by informal protests, which are difficult to organize and to make politically relevant. If no immediate action is taken, voters have to wait until election time. Then, however, it often proves impossible to express specific demands on substantive issues. Foregone, unpopular decisions most often cannot be reversed without incurring high cost. Moreover it often makes little sense to punish the government, as the opposition would not have done better or acted differently. In a direct democracy, in contrast, citizens may regularly participate in political decisions and are less dependent on the proposals of the government or the opposition.

There is ample evidence that the interests of the political élite do not always correspond with voters' preferences. A significant example took

place in September 1992 when the citizens of Switzerland turned down two proposals seeking to increase the salaries and the staff of Swiss Members of Parliament. Both issues would clearly have been to the benefit of the elected officials, and both issues would have become law without Swiss voters taking the optional referendum.

It seems obvious that while politicians may try to secure benefits for themselves, taxpayers are not always ready to pay for such expenses. Privileges, however, do not always appear in the form of direct income for the representatives, but may also be seen in higher status or prestige. Many more illustrations from the history of democracy in Switzerland can be adduced here. Particularly interesting are the cases of two referenda on Switzerland joining international organizations or agreements: the United Nations (UN) in 1986 and the European Economic Area in 1992.

The political élite strongly supported the two proposals: all major political parties, all pressure groups, including both employers and trade unions, a huge majority of the Members of Parliament and the executive branch were all strongly for them. However the popular referendum in 1986 on Switzerland joining the UN resulted in a rejection by 76 per cent of the voters; similarly, in 1992, 50.3 per cent of the population and a majority of the cantons (16 out of 23) voted against Switzerland becoming part of the European Economic Area.

These two examples of the citizens voting differently from the public officials in power are not exceptional: in 36 per cent of the 316 referenda held in Switzerland between 1848 and 1997, the will of the majority of the voters differed from the opinion of the Parliament. Thus, in a representative system, the decision by the Parliament would have deviated from the people's preferences in 36 per cent of all cases where referenda were held.

Econometric cross-section studies for Switzerland and the USA, moreover, reveal that political decisions with regard to publicly supplied goods correspond better with the voters' preferences when the institutions of direct political participation are more extensively developed. Because it is the individual taxpayers and not the elected officials *per se* who have to bear the costs of government activities, it is not surprising that public expenditures are *ceteris paribus* lower in communities where the taxpayers themselves can decide on such matters.

Taxpayers respond to politicians' performance with a high tax morale if they are satisfied with policies in their community. This can be shown for Swiss cantons which have different institutional options for citizens' political participation. In some cantons, referenda and initiatives can be taken on virtually all issues, whereas others grant these options only on

special issues and under special conditions or rely completely on the institutions of representative democracy. It has been econometrically shown that the more direct democratic institutions are, the less tax cheating takes place. Compared to the mean of all cantons, almost 8 per cent (that is, about CHF 1600 per taxpayer per year) less income was concealed in cantons with a high degree of direct political influence. In contrast, in cantons with a low degree of direct participation and, therefore, low tax morale, the mean income undeclared exceeded the mean for all cantons by roughly CHF 1500.

Directly democratic institutions do not have tangible effects only on the behaviour of government and the population. It has also been shown that per capita income in Switzerland tends to be higher in cantons with a high degree of direct political participation, that is, where the population can directly decide on taxes and on the budget. On average, and again holding other possible influences on per capita income constant via a multiple regression, such strong direct democracy is found to produce an economic performance which (depending on time period and estimation technique) is between 5 per cent and 18 per cent higher than in cantons with representative democratic decisions on tax and budget matters. By using various econometric techniques it has been shown that the institution of direct democracy indeed leads to high real per capita income (and not the reverse which could also make sense).

Referenda do not only serve to break up the politicians' coalitions by destroying their monopoly on agenda-setting, but they also induce more competition in yet another respect: they provide information and stimulate communication.

(b) Referenda against information asymmetries

Economics is the science of choice, a choice between known alternatives. These alternatives, however, have been shaped and defined by a process of verbal exchange. This discourse among the citizens puts new issues on individuals' agendas, raises their perception, and communicates the arguments in the media. Information is offered free of charge – information that is not only relevant to the issue in question but also to an evaluation of the performance of politicians, parties and interest groups.

Besides information, communication may also enhance people's willingness to accept the decisions made by a referendum. They feel more responsible for whatever the result of the referendum may be because the process and the rules made them part of the decision. In a representative system, however, it is not difficult to shift the responsibility on to the actual decision-makers, the politicians. The more removed these agents are from the principals, the easier it is for them to pass the buck

on to someone else. Thus the very indirect system of the EU makes it easy for national politicians to blame the Commission for any decision that may endanger their re-election. This means that politicians in EU-member countries can make even more decisions that deviate from the will of the people than is the case within non-member countries.

The market is a discovery mechanism. The same could be said about discourse. By talking to one another, people discover the means of fulfilling their preferences. By relating to other people's positions, they find out where they stand. In economic terms, it could be said that communication changes the production function to fulfil individuals' preferences.

The Swiss experience shows that people's demand for discussion varies, depending on the importance of the issue in question. Some referenda motivate intensive and far-reaching discussions that lead to a high rate of voter participation (for example, the proposal to join the European Economic Area witnessed a participation rate of 79 per cent, while the average turnout between 1985 and 1992 was only 42 per cent). Referenda considered to be of little importance by the voters engender little discussion and low participation (as low as 25 per cent).

Even though a political decision is formally taken by a referendum, the issue in question does not disappear from public discourse after citizens have cast their vote. The referendum clearly reveals how the citizens feel and who and how large the minorities are. Groups dissenting from the majority are identified; their preferences become visible and part of the political process. A post-referendum adjustment process to account for the losers is often observed.

Switzerland again provides a suitable example. In 1989, a popular initiative demanded that the Swiss army be completely dismantled. To many Swiss this was considered an attack against one of the most essential, almost sacred institutions of the country. The *classe politique* was solidly against the proposal, and some generals threatened to retire if the initiative was not overwhelmingly rejected. (They expected a share of no-votes close to 90 per cent.)

The referendum outcome was surprising to almost everyone. One-third of the voters (and a majority among the young male voters eligible for service) voted for the dissolution of the army. After a short period of shock several parties suggested changes in the army to make this institution more acceptable among the population. These changes, which were considered impossible to achieve before the referendum, were put into effect within a short time. A major innovation was the introduction of civilian service as a substitute to the until then mandatory regular service in the army. This change of individuals' preferences, the position

of the parties and the government, and of the military élite, seems to have been induced by the discourse that accompanied the previously hotly discussed referendum on the dissolution of the army.

2.2.2 Criticism of Referenda

Democracy is not concerned with end states; solutions are not simply adopted but developed. In the course of the direct democratic process, information is produced and preferences are shaped – in the sense that voters are confronted with political issues they have not considered before, and which they learn to evaluate according to their basic values. Sceptics, however, worry about the intellectual capability of the citizens to cast votes on complicated, technical issues. This task, they argue, should be left to an élite.

Following the individualistic view and taking individuals' preferences as the normative base for evaluation, such a charge is unacceptable. Compatibility with the citizens' preferences is valued higher than any possible technocratic brilliance. The voters, moreover, need not have detailed knowledge on the issues, but rather on the main questions at stake. These, however, are not of a technical nature but involve basic decisions (that is, value judgements), which a voter is as qualified to make as a politician. It has even been argued that politicians are a group particularly ill-equipped to make such decisions because, as professionals, they spend most of their life in sessions and commissions, and meetings and cocktail parties, and, therefore, know much less about reality than ordinary people.

This argument only holds, of course, if voters are given the opportunity to make their choices seriously. As has been pointed out for California, this is not always the case. In November 1992 a Los Angeles voter was allotted 10 minutes in the ballot booth to make over 40 different electoral choices, varying from state-wide propositions to local judgements; in 1990 the total was over 100.

Such obviously ill-founded provisions, however, not only prevent direct democracy from functioning effectively but also prevent voters from making serious electoral choices and, thus, might even lead to worse outcomes in a representative democracy. It is, furthermore, not clear why the citizens are trusted to choose between parties and politicians in elections but not between issues in referenda. If anything, the former choice seems to be more difficult because electors must form expectations about politicians' actions in the future.

It is not argued that there is no room for a political élite, for a parliament and a bureaucracy in a democracy. They are indispensable

for providing information, working out the details and assessing the consequences of the various political issues at hand. This technical expertise of the representatives must be weighed against the human competence of the citizens – a process which seems to have led to a recent trend in Europe: important political issues are referred to the population even in representative democracies. This can be witnessed by the popular referenda on entry into the EU and the EC held in the Scandinavian countries, Austria and the UK, or on the Maastricht Treaty in Denmark, France and Ireland.

Critics also point out that well-organized interest groups might utilize direct democratic procedures for their own benefits. It cannot be denied that resourceful and financially potent parties and pressure groups are better able to start initiatives and engage in referendum propaganda than poor and disorganized interest groups. Of course there remain disparities in individuals' and groups' capacities to influence the government. Again there is no sense in the impossible aspiration of creating a totally egalitarian democracy where every citizen is a citizen legislator. However, it is always true that rich and well-organized groups wield more power.

Thus, the important question is not if there are any disparities, but under which institutional arrangements or rules, organizational and financial advantages play a more important role. It is argued that lobbying is the more successful, the less democratic a system is, because even with no elections, as in dictatorships, interest groups do have some means of influence. For the EC, it has been argued that pressure groups are able to exert more power than in the former nation states exactly because the EC is less democratic than its member states. On the other hand, the experience of Switzerland shows that even if pressure groups and the political class are united, they cannot always have their way, particularly on important issues.

2.2.3 Direct Democracy in FOCJ

It is to be expected that the members of FOCJ will choose to have as much direct participation as possible because (besides exit and entry) it constitutes an effective means of controlling the managers or politicians in the daily running of FOCJ. However the use of referenda will be restricted when there are high costs of undertaking them. Another restriction may be the danger of crowding out the politicians and managers' intrinsic motivation when the controls are too extensive. However, these are only a restriction for the *use* of referenda but not for constitutionally established participation rights as such. As the Swiss

experience of various governmental levels shows, the citizens can be attributed the good sense to design constitutional rules that prevent them from undertaking so many referenda and initiatives that the costs mentioned become relevant. In addition, especially larger FOCJ will find it useful to establish a parliament with the task to set directives and to monitor the executive. Small FOCJ normally do not require a representative body because the task can be performed by the voters either in an assembly or by polls.

Even in small FOCJ there is, however, a danger that the politicians or managers in charge may form a coalition against the voters and pursue a policy that is not in the interest of the latter. The formation of a cartel is facilitated by the politicians knowing each other and being in close and daily contact. The same holds when FOCJ are run by managers who tend to substitute technocratic considerations for the demands of the citizens.

Direct participation will be the more extensive, the easier it is, and the larger the incentives are for politicians to deviate from citizens' preferences. For example, when politicians can derive direct benefits from a given policy (most prominent examples are increases in taxes and, therefore, disposable funds, the pay of politicians, and decisions that favour relatives or friends who will then reciprocate). Deviating policies are also more likely, the more ideologically laden the issues are, as may happen with education. The same is likely to occur when the cost of providing public services are difficult to calculate and put into perspective, or when costs can be shifted to other persons (this is, for example, true when road repairs are undertaken at low visible, that is, monetary, cost but part of the burden is shifted to motorists who have to incur long waiting times and other inconveniences).

A higher degree of popular participation can be achieved by widening the range of issues on which the voters have a say, making more decisions subject to an obligatory referendum, and facilitating initiatives and optional referenda by reducing the number of signatures needed to make them happen.

It is sometimes argued that the need for extensive participation of the citizens tends to be lower in more technically oriented FOCJ. An example would be fresh water provision. However not only the quality of the service but more importantly, cost, may also vary. As empirical research has established, for instance, in the case of refuse collection, cost efficiency is better, the stronger economic and political competition is. Thus, even for more technical FOCJ, it is important to firmly establish popular participation rights. This is also shown by the technocratic 'special districts' or (in German-speaking countries) 'Zweckverbände'

which tend to become more and more secluded from outside political control. As a result they may be efficient in a purely technical sense but increasingly deviate from the citizens' preferences.

FOCJ perform well-defined tasks, and the institution of direct democracy, therefore, promotes a focused discussion. The citizens who are affected by the policy of a FOCUS are, therefore, well informed, which enables a useful discussion before the respective referenda. The politicians are forced to communicate with the citizens and convince them of the advantages of the solutions they propose.

It may be argued that this may well be true for a particular FOCUS, but the citizens get confused because they belong to a large number of different FOCJ. This is not necessarily so. Look at private consumption: while there is a larger incentive for citizens to keep themselves informed about the benefits and costs of private goods, it nevertheless shows that individuals manage to evaluate a large number of goods and services well. As in the case with private goods, the citizens do not have to be always fully informed. What matters is that they are able to use their political participation rights when they feel dissatisfied with the public provision of a particular FOCUS. Citizens can also resort to (virtual) delegation by relying on specialized personnel and institutions offering them advice. These can be political parties but often this task will be supplied by the market.

It can, for instance, be imagined that newspapers or consumer journals report on the quality and cost of public services, that is, they compare the efficiency of competing FOCJ. Today, such comparisons, although they already partly exist, are of very restricted use for citizens because in most countries, the latter cannot interfere directly in the supply process. Rather they have to evaluate an extensive bundle of experiences and proposed policies at election time. In contrast information provided about the relative efficiency of FOCJ may be of great interest to the citizens. If, for instance, a report discloses that a particular school-FOCUS provides good education at reasonable prices, while another FOCUS does not, parents with children in the respective schools will react by resorting to initiatives and referenda. If they are not successful, they can still incur the cost of leaving the FOCUS and sending their children to another school.

Not only actual direct public participation itself, but also the mere threat of an initiative or referendum, is effective in making politicians improve public provision. Consequently the usefulness of direct democracy should not be evaluated by the number of initiatives and optional referenda undertaken, nor by the share of citizens participating in the vote. If the citizens are satisfied with the public services compared to

feasible alternatives, there is no need to engage themselves in the political process. Only when they feel that the supply could be improved is it important that they respond by using their direct democratic rights.

SUGGESTED FURTHER READING

The Economic Theory of Federalism is presented in
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Oates, Wallace E. (1991), *Studies in Fiscal Federalism*, Aldershot: Edward Elgar. 'Symposium on Fiscal Federalism', and in various articles in the *Journal of Economic Perspectives*, 11 (Fall, 1997), 43–92.

Analyses of direct democracy are given in
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Cronin, Thomas E. (1989), *Direct Democracy: The Politics of Initiative, Referendum and Recall*, Cambridge, MA: Harvard University Press.

Empirical aspects of direct democracy are emphasized in
Butler, David and Austin Ranney (eds) (1994), *Referendums. A Comparative Study of Practice and Theory*, Washington: American Enterprise Institute.

Gallagher, Michael and Pier Vincenzo Uleri (eds) (1996), *The Referendum Experience in Europe*, London: Macmillan.

The importance of communication for democracy is stressed by
Dryzek, John S. (1990), *Discursive Democracy: Politics, Policy and Political Science*, Cambridge: Cambridge University Press.

Elster, Jon (ed.) (1998), *Deliberative Democracy*, Cambridge: Cambridge University Press.

Economic analyses of the performance of direct versus representative democracy are found in

Feld, Lars P. and Marcel R. Savioz (1997), 'Direct Democracy matters for Economic Performance: An Empirical Investigation', *Kyklos*, 50 (4), 507–38.

Kirchgässner, Gebhard, Lars P. Feld and Marcel Savioz (forthcoming), *Modern, erfolgreich, entwicklungs- und exportfähig: Die direkte Demokratie der Schweiz*.

The effect of direct democratic institution on tax morale is analysed in
Frey, Bruno S. (1997), 'A Constitution for Knaves Crowds Out Civic Virtues', *Economic Journal*, 107 (July), 1043–53.

3. FOCJ implemented

How can FOCJ be realized in practice? Before this question can be answered it is necessary to specify in greater detail the nature of these jurisdictions.

3.1 THE MEMBERS OF FOCJ

Whether communes or individuals may form FOCJ depends on the specific circumstances. As public jurisdictions serve to supply particular services – either public goods or goods with marked external effects – the natural starting point is for communes to constitute the FOCJ members. These *collective FOCJ* may then decide whether they wish to allow individuals to establish their own FOCJ. Such *individual FOCJ* may take many different forms. On one extreme we have FOCJ comprising many individuals who provide collective goods and services for its members; on the other extreme there are ‘FOCJ’ composed of only one person in which case we have the normal private good provision without any collective element.

It may be helpful to illustrate these options with a practical example. Consider old age pensions. One possibility is for various communes to come together in order to exploit the economies of scale of running a pension system, and thus establish a collective pension FOCUS. The people living in the member communes are automatically part of the pension system. They have democratically decided to let themselves be forced to contribute the necessary premium.

Another option is that communities themselves do not establish a pension FOCUS but decide to leave this decision to the individual citizens. In this case membership may be obligatory or optional. Obligatory means that a regulation exists stating that all individuals have to belong to *some* such FOCUS and that the general nature of the old age provision is determined. But everyone is free to choose which old age FOCUS to belong to. The respective FOCJ then find themselves in a competitive situation. They have an incentive to keep administration costs low in order to attract customers. If membership in individual

pension FOCJ is optional, some individuals may not belong to any old age FOCUS at all; if membership is obligatory, it may happen that some of the respective FOCJ are 'empty' in the sense that they are only pretending to provide services but are charging correspondingly low premia. It is, therefore, possible that the citizens of a country decide on a minimum service level. In contrast an unregulated situation will be chosen in a democracy if the citizens are convinced that they themselves will sufficiently care for their own future. The same holds when each individual establishes his or her own pension 'FOCUS', that is, buys old age insurance with a private company or even decides to make the necessary investments by himself or herself.

3.2 EXTERNALITIES AND FOCJ

The decisions on whether FOCJ are composed of communes or individuals, whether membership is obligatory or optional, and how FOCJ are regulated, have to be taken in the *political process*. It is, therefore, not possible to fix *ex ante* and from the outside how FOCJ are to be established. Such a constructivist approach would be misguided because it assumes that it is possible to identify and evaluate all the preferences and constraints of the actors concerned. It is, however, possible to identify the conditions under which FOCJ would emerge more collectively, or more privately oriented. The crucial factor is the extent of 'publicness' of the goods and services in question, that is, the extent to which *externalities* affect other individuals and groups.

Externalities are *socially determined*, although it is, of course, possible to provide a formal definition of what an externality is. For the purpose of this study, it can be defined as the extent to which an activity of a FOCUS imposes costs or benefits on persons outside the FOCUS. The larger these externalities are, the more biased are the decisions of the FOCUS. In the simplest case, that is, without any reaction from those affected by externalities, a FOCUS provides too many goods and services when it imposes part of the cost on outsiders (negative externality). On the other hand it provides too little if outsiders also benefit from its services (positive externality).

The essential question is *what* is considered to be an externality. This is not a technological issue but depends on the evaluations of the individuals concerned. History teaches people that these evaluations may drastically change over time, and from one location to another. Consider, for instance, noise. There are societies (in Europe one may think of Italy) where noise is a normal ingredient to life, and may even

be welcome. In other societies, especially in Northern Europe, noise is considered to be an intrusion into one's private life and, therefore, offensive. If historians (and novelists, see Süskind, 1985) are correct, smells were considered natural centuries ago and were not necessarily taken as a cost to others.

The same holds for smoking. Only a few years ago, smoky air was considered to be a normal facet of social life, and it seems that some of the 'revolutionaries' of 1968 and thereafter enjoyed discussing and arguing in smoke-filled rooms. This evaluation has changed dramatically over the last few years – and not solely because of the health consequences (they were generally known much earlier). Many more examples could easily be provided. This holds in particular to issues concerning redistribution and justice both of which are basically determined socially. Thus the sight of the poor and beggars is today considered by many to be a cost. However, in earlier times and societies, giving alms to beggars was an opportunity for people to perform good deeds, and consequently placate their gods. Begging, therefore, caused a *positive* externality.

The extent to which individuals are thought to be responsible for externalities, and are expected to protect themselves against externalities caused by others, also varies strongly according to conditions. When a car is left unlocked in a big city, most people will blame the owner when his or her car is stolen. This, however, need not be so in a rural setting.

These examples clearly show that externalities are not technologically but rather socially determined. There are no inherent properties of a good or service producing external effects, therefore, citizens have to use the political process to determine what is to be considered to be an externality. In other words, the *property rights* have to be politically established. The question then is which political institutions are to be used for that purpose? This is a *constitutional issue*. The idea of FOCJ, or more generally of the decentralization of political power, is that the political decision on 'what is an externality' is best taken at the level of FOCJ. They emerge such that those involved feel that they are covering the most suitable territory to minimize spillovers to other jurisdictions.

3.3 REGULATION AND PROVISION

Public regulations determine what goods and services are to be provided by a jurisdiction. Who is most capable of providing regulations that are in the best interests of the citizens? It is argued in this study that FOCJ

are better able to do so than the central state. FOCJ are subject to comparison and competition with other jurisdictions. The central state, in contrast, assumes a monopolistic position with respect to its inhabitants. Its decisions can only be controlled by 'voice', that is, democratic mechanisms. This privileged position makes it profitable for rent-seeking activities by organized pressure groups. The interests of consumers, taxpayers and other weakly organized groups tend to be neglected in this rent-seeking struggle.

Regulation includes *standard setting* which is an important task of governments. Contrary to what is often thought and claimed, the co-ordination and unification of standards need not be imposed from above, in particular by the central state. Often more effective standards emerge from below, as in our case through the activities of FOCJ. The popular idea that standard setting is the task of the central government is based on the notion that it knows what standard is best for the citizens. This state of information rarely obtains. In general standards have to be set in an uncertain environment where it is not a priori known what is most efficient. Imposing *some* standard from above may well result in a bad choice. That the standard chosen by the central government should not be accepted as given is clearly visible when one compares the widely different national standards imposed for the same issues. While national conditions may indeed vary, it seems unlikely that they differ as much as the national standards do. Consider, for example, the large differences in regulations existing between countries when it comes to the exchange of foreign currency by tourists. It is obvious that in some countries this simple transaction is regulated in different but very costly ways.

With regard to many standards, it is preferable to allow *evolution* to take its course. But evolution requires alternatives which are provided in a competitive setting in which various FOCJ provisionally adopt standards. After some searching it will become clear as to which standard is the most efficient. As federalism based on FOCJ is flexible, the other FOCJ will switch to this more efficient standard. Co-ordination thus takes place from below. There are certainly cases of 'lock-in' to a particular standard but it is only in extreme cases that a later switch to a more efficient standard is made too costly to be undertaken.

The co-ordination of regulations and standards via competitive FOCJ acknowledges the basic uncertainty existing when new tasks arise. The search period during which there is no common standard, and corresponding transaction problems arise, is a cost only *ex post facto* but not *ex ante* when it is unknown which is the most appropriate standard from the point of view of the citizens.

3.4 WHERE ARE FOCJ ADMITTED?

FOCJ take public decisions pertaining to their functions in their own hands. It may well be imagined that at a later stage there will be an extensive web of FOCJ of many different sizes and which takes care of many different tasks. At the beginning, however, it makes sense to start from existing conditions in which there are (normally) three levels of multi-purpose governments: the central state, the regions (states, Länder, cantons) and the communes.

It could now be envisaged that an extension of the range in which FOCJ are admitted according to three stages:

1. FOCJ may substitute for all those functions which are now performed by *existing jurisdictions*, provided they observe the ruling governmental regulations with regard to the provision, as well as the production, of the publicly supplied good or service. In this case, the effect of FOCJ must necessarily be limited to the reduction in the cost of provision, and even there the limitations are severe.
2. FOCJ may become active in all those functions, and is bound only by the regulations existing *somewhere* else in the *nation* or in the *EU*. This is the principle established by the 'Cassis de Dijon' ruling but is applied here to government goods and services instead of private goods. This basic norm of opening the political markets is likely to lead to major effects of FOCJ. They may, for instance, provide school services in Germany according to the laws existing in France. The scope for FOCJ is greatly extended because there are a large variety of regulations for any function between parts of federal states, and particularly so between nations. This extension of the 'Cassis de Dijon' principle enshrined in the Maastricht Treaty from the private to the public sphere is a logical step in strengthening political competition. It may, at first, seem somewhat surprising but it already exists in some areas. In many countries, for example, foreign national states run schools according to their own laws, and attendance is not normally restricted to nationals of that country. There are French 'licées' in several German cities which are organized according to the French curriculum. In particular, teaching is in French and the final examination is the French 'baccalauréat', and not the German 'Abitur'.
3. The final opening allows FOCJ to establish their own regulations and the consumers of the respective services to judge them. A school-FOCUS may, for example, decide to offer an education programme with heavy emphasis on language and communication

skills, or with a special 'philosophy' of learning. This is, of course, exactly what private schools try to do (such as the Rudolf Steiner or Montessori schools). In the scheme suggested here, public schools organized in FOCJ may do the same. The scope could again be greatly extended. Competition with regard to both output and cost, as well as the variety of publicly provided schooling, would increase.

The discussion makes it clear that FOCJ can only fully bear fruit if stage (3) is reached. The idea of FOCJ cannot produce all the beneficial consequences described above if they are kept within the straitjacket of existing local, and even national and EU regulations.

3.5 DECISIONS ABOUT REGULATIONS

The politicians representing existing jurisdictions have a strong incentive to suppress FOCJ as is always the case with potentially more efficient competitors. Consequently the decision about the scope of FOCJ, and especially what regulations they have to observe, may not be left to these politicians. If so, they would either prohibit FOCJ, or would at least enforce strict observation of the regulations from all sides. It can be confidently predicted that stage (1) distinguished in the previous section would not be transgressed.

The decisions about the scope of FOCJ must, therefore, be taken outside the existing '*classe politique*'. The appropriate solution is to rely on *popular referenda* by the citizens. One of the crucial characteristics of direct democratic devices is that they circumvent the entrenched interests of the politicians and administrators deriving rents within the established forms of government. In referenda, the citizens take only the basic – or constitutional – decisions about the extent of liberalization they wish to see in the various functions of government, that is, how far these markets should be open for competition, and what general rules have to be observed. The politicians and administrators presently active in the governmental structure do not only prepare the propositions to be put to the vote but are also invited to participate in the discussion preceding the vote. But they may not monopolize it in a free society. In particular individuals and groups who expect to benefit from FOCJ have a chance to publicize their views. What matters is that the final decision is in the hands of the citizens and communes. If the political establishment blocks options by, for example, rigging the proposition to the disadvantage of FOCJ, the citizens should have the right to start *popular initiatives* to prevent, or to correct, such biases.

The use of referenda to decide constitutional issues is a process-oriented approach. It is not possible to determine *ex ante* what kind of results will emerge. Provided the process has been fair and the rules adhered to, the referendum outcome has to be accepted. It will be the result of a benefit-cost calculation of the citizens and other actors involved in the referendum process. The cost of a differentiated set of regulations to prohibit negative spillovers between jurisdictions will be compared to the advantages of opening political markets via relaxing regulations. It should be kept in mind that having less differentiated governmental regulations does not lead to uniformity but rather to more variability in the public services supplied by FOCJ.

An aspect the citizens will certainly seriously consider is minority rights. It may happen that by a majority vote a commune decides to join a FOCUS that provides public services that are disagreeable, or even adverse, to a minority of its citizens. Clearly such a suppression of minority rights may also occur when the commune in question supplies the public good or service itself. However it may be argued that this is perceived to be more acceptable. In the case of FOCJ a new kind of discrimination of the minority may be instituted¹. In order to prevent the possibility of such a *new* discrimination of minorities, voters may decide that such groups, or even individuals, have the right to consume the public good or service under the 'old' conditions, that is, the governments are required to offer the same services as before, and citizens who want to consume them pay the same tax prices as before. Within the framework of the new type of federalism proposed here, this means that a FOCUS is established with the old supply and the old tax prices. The citizens are then able to always choose between the old situation and the new FOCJ which have emerged. If the competition among the new FOCJ works, they will be able to offer either a better product, or lower tax prices, or both. Most citizens will then switch to the FOCJ if it is indeed Pareto-superior.

Such a system of competition between the existing government supply and (new) FOCJ will work except when there are major economies of scale in the provision of the services. This may lead to a 'lock-in' at a suboptimal situation. It should, however, be taken into account that the emergence of more efficient FOCJ has repercussions on the provision of public services in the old setting. A new equilibrium will arise in which both institutions coexist, and in which the supply of public goods and services by All Purpose Jurisdictions (APJ) is more efficient than it previously was.

NOTES

1. It is sometimes claimed that direct democracy, which is more important in FOCJ than under the already existing governmental institutions, tends to suppress minorities. The empirical evidence is far from convincing. While Gamble (1997) asserts that this holds for referenda in the USA, Frey and Goette (1998) find that the civil rights of minorities fare particularly well in referenda in Switzerland.

SUGGESTED FURTHER READING

The problem of externalities is analysed by

Coase, Ronald H. (1960), 'The Problem of Social Cost', *Journal of Law and Economics*, 3 (October), 31–44.

The basic issues of the theory of regulation are analysed in

Stigler, George J. (1971), 'The Theory of Economic Regulation', *Bell Journal of Economics and Management Science*, 2, 3–21.

New developments in the theory of regulation are portrayed in

Laffont, Jean and Jean-Jacques Tirole (1993), *A Theory of Incentives in Procurement and Regulation*, Cambridge: MIT Press.

Hägg, T. Goran P. (1997), 'Theory on the Economics of Regulation: A Survey of the Literature from a European Perspective', *European Journal of Law and Economics*, 4 (December), 337–70.

The evolution and intended setting of standards is discussed in

Farrell, Joseph and Garth Saloner (1988), 'Coordination through Committees and Markets', *Rand Journal of Economics*, 19 (2), 235–52.

Grindley, Peter (1995), *Standards, Strategy and Policy: Cases and Stories*, Oxford: Oxford University Press.

4. FOCJ compared

No institution is in all respects optimal; each one has its strengths but also its weaknesses. This also applies to the concept of FOCJ. For that reason it is important to compare FOCJ to institutions designed to deal with similar issues and to perform similar tasks instead of identifying the non-optimal aspects and leaving it at that. This procedure constitutes the essence of the *comparative institutional approach* which has proved to be successful in economics for a considerable number of years.

First FOCJ are compared to the theoretical alternatives of federalism proposed in the literature (section 4.1). FOCJ are then examined with regard to how they deal with particular problems and compare how alternative institutions cope with them (section 4.2).

4.1 COMPARISON TO THEORETICAL FEDERALISM

The economic theory of federalism has developed diverse models dealing with particular aspects of federalism. In various aspects, the idea of FOCJ can be considered to be a further development as well as an integration of these various models or building stones.

4.1.1 Spatial competition

A model developed by Tiebout (1956) focuses on the competition between jurisdictions triggered by the mobility of the citizens. The analogy to democratic competition is sought by calling this process 'voting by foot'. This model deals exclusively with the 'exit and entry' mechanism. Governmental units can be seen as enterprises offering public services in exchange for tax revenue. A citizen is assumed to move without incurring any cost to that jurisdiction which offers the most advantageous combination of services and taxes to him or her. As a result of competition, perfectly responsive governmental units are led to fulfil the citizens' preferences effectively, and to offer public services

at the lowest possible cost. Under these restrictive conditions it can be shown that local public goods are provided efficiently.

The concept of FOCJ also emphasizes competition between public units and uses it to provide the necessary incentives to politicians and managers to take care of the citizens' preferences. In contrast to the 'voting by foot' model, the governments of FOCJ do not have a monopoly of supply over a particular geographical area but various public suppliers may compete against each other in the same area. As a consequence the citizens do not have to move geographically when they switch from one public supplier to another. While the assumption of costless mobility for the citizens is obviously unrealistic in Tiebout's model, it is much more appropriate for FOCJ. Hence mobility will *ceteris paribus* be stronger in a net of FOCJ, and competition between jurisdictions more intensive.

Another difference to 'voting by foot' is that the geographical extension of FOCJ is not predetermined but adjusts to the extent of spillovers and economies of scale. This fact provides another advantage of FOCJ over the Tiebout concept: other things being equal, FOCJ are able to provide a given public service at lower cost because there are less inefficiencies due to a non-identity of consumers and taxpayers, and the size of production can be chosen so that economies of scale can be exploited and average cost minimized.

Yet another difference is that Tiebout's governments provide the whole set of public services demanded by the population (they are APJ) while FOCJ are restricted to one function each. They can, therefore, exploit the advantages of specialization and the corresponding cost savings.

Finally, Tiebout assumes that the competition via mobility suffices to bring about a public supply conforming to the wishes of the citizens. Political competition via elections and referenda, which in FOCJ plays a crucial role, is implicitly considered to be superfluous. This is correct in a model with costless mobility and perfect competition between governmental units which are taken to be 'black boxes' without lives of their own. As these assumptions certainly do not apply in reality it seems reasonable to complement competition via mobility by competition via democratic institutions as envisaged in FOCJ.

Our concept of FOCJ attributes a crucial role to competition via exit and entry but puts it into a more realistic setting. FOCJ work, and do so even more efficiently without having to make the strongly restrictive assumptions of the Tiebout model.

4.1.2 Exit and Voice

The concept of competition by mobility has been joined with political competition by Hirschman (1970). He coined the corresponding terms 'exit' and 'voice' which have become common currency in economics. Voice may take place within (elections and referenda) or outside (illegal, demonstrations, uprisings, revolutions) a constitutionally regulated framework. Originally Hirschman looked at exit and voice as substitutes. On the basis of the insights gained from the breakdown of the German Democratic Republic (GDR) he changed his views: the two mechanisms may well support each other (Hirschman, 1993). When a government is forced to tolerate exit (as was the case with the government of the GDR in the form of emigration through Hungary to the West), the citizens remaining in the country tend to interpret it as a sign of weakness. Voice in the form of demonstrations is then considered to be more effective and less dangerous than before which leads to mass participation. This in turn may induce the police to tolerate the demonstrations (as it did in the last days of the GDR).

The concept of FOCJ builds on both exit (and its correlated entry) as well as on voice in its institutionalized variant. The two forms of competition are mutually reinforcing. It is taken for granted that the threat of exit is not sufficient to force the governments of FOCJ to fully meet the citizens' preferences. As a result of decisions and transaction costs, citizens may be unwilling to leave the FOCJ they presently belong to. Though it suffices that exit is undertaken by a few 'marginal' citizens, the barriers to switching may still be so large that governments of FOCJ enjoy considerable discretionary power. This may especially happen when members of FOCJ are composed of communes rather than individuals because an implicit, and even explicit, coalition among the various politicians involved may not be excluded. Political competition via elections and referenda then helps to further reduce politicians' discretionary power.

4.1.3 Clubs

In the economic theory of federalism, clubs are private institutions that provide their members with public goods. The respective services are thus freely available to all club members but not to those outside the club, that is, they have a local dimension. The optimal club size in terms of members is reached when the marginal cost caused by an additional member corresponds to the marginal utility of the consumption made possible by this additional entry. This model according to Buchanan

(1965) postulates a club size corresponding to the extension of the public good in question. The number of club members is a control variable as only those who are ready to pay the corresponding marginal cost are admitted.

The club concept is closely related but not identical to FOCJ. It is also emphasized that a FOCUS provides for one particular public good or service, and in particular, that its size adjusts to the economic conditions revealed by benefits and cost. 'Local' public goods are also considered in the sense that members of FOCJ may enjoy their benefits while outsiders do not. However the term 'local' does not necessarily mean small scale; some FOCJ (an example is defence against outside aggression) may extend over a large area (in the case of defence, for example, certainly beyond the national states and even beyond Europe, as the North Atlantic Treaty Organization (NATO) shows).

In contrast to Buchanan's clubs, FOCJ attribute a large role to the formal political participation rights of the citizens. Clubs are private; their membership is based on a private contract while FOCJ are public jurisdictions with the constitutional power to impose taxes.

4.1.4 Fiscal equivalence

This idea focuses on the requirement that an optimal allocation presumes that those benefiting from a public service should also pay for it. If public services can be consumed without paying, or alternatively, if citizens have to pay for public services not consumed by them, biased decisions result. Fiscal equivalence (Olson, 1969, 1986; Oates, 1972) minimizes these spatial external effects or spillovers. For every public good there is a different optimal size because their benefits and costs normally extend over different areas. Fiscal equivalence requires overlapping areas of supply.

This concept is again closely related to FOCJ where fiscal equivalence also leads to overlapping jurisdictions. Fiscal equivalence does not, however, spell out the aspects of spatial competition, the dynamic adjustment processes by exit and entry, nor political participation rights.

4.2 COMPARATIVE PROBLEM SOLUTION

In the following, three problem areas are discussed where the institutional conditions tend to lead to inefficiency in the allocation of resources. The way FOCJ cope with these problems is compared to how alternative institutions do so.

4.2.1 Spillovers

Citizens paying taxes for public services they do not consume, or enjoying public services to whose provision they do not financially contribute, is a recurrent problem with the organization of states. The present arrangement where historically given governmental units have a monopoly in the supply of a large variety of public services tends to lead to large spill-ins and spill-outs. Even if the size of the governmental unit had been adjusted in the (distant) past to minimize spillovers, it is most unlikely to hold when times have changed (the benefits and costs of a public good have shifted over space), and when there is more than one public good.

This statement can be illustrated with the case of the national state. Even if it were true that the particular size of a nation was reasonably well adjusted to the extension of the benefits and cost of the public goods then relevant, conditions have changed since. Just consider the examples of defence, natural environment and trade policy, for which the existing national states in many respects are too small. Decisions made by any one national state have strong positive or negative spillovers on other nations. It is no accident that in all three areas attempts have been made to reach collective agreements at a supranational level. For defence, European co-operation has been sought (with little success so far) and NATO has been founded which now extends far beyond the countries at the border of the Atlantic. To prevent unwelcome climate changes, co-operation has been sought via international treaties, such as the Rio Convention. A mutually beneficial move towards free trade has not only been successfully undertaken in the European Free Trade Area (EFTA) and much more so in the EU, but also on a worldwide level by the General Agreement on Tariffs and Trade (GATT) and now by the World Trade Organization (WTO).

These efforts to reduce spillovers go well beyond national states, and in several respects reduce their sovereignty. The various supranational treaties and associations may be interpreted as a step in the direction of FOCJ: they tend to be (at least initially) focused on one function, and they overlap. However several of these supranational organizations have become multifunctional (especially the EU), and they tend to make competition difficult by claiming a monopoly, and by making exit and entry difficult (again the EU is a pertinent example). Moreover almost all of these supranational organizations lack strong democratic features and taxing power.

Reality also shows that existing nations tend to break up when spillovers are too large. Then minorities hope to be better able to solve their

problems without intervention from the existing central government. Former Yugoslavia, Czechoslovakia and the Soviet Union are examples, but similar tendencies exist also in Belgium, Spain (Basque Lands and Catalunya), France (Corsica), Italy (Padania), or Canada (Québec). This adjustment in size also points in the direction of FOCJ but the resulting new governmental units are, of course, far from FOCJ: they are not functional, not overlapping and often not competitive.

FOCJ are an *institutional* way to vary the size of public jurisdictions in order to minimize spillovers. A change in size is, therefore, a normal occurrence. Neither are FOCJ so slow and often ineffective as the cooperation between nations discussed above, nor accompanied by bitter strife as is often the case when countries threaten to, or actually do, break up.

4.2.2 Economies of Scale

When the average cost of *production* falls with size (economies of scale) or rises with size (diseconomies of scale), it is efficient to adjust the respective production outfit (plant). This does not mean, however, that the size of the jurisdiction using the respective product has to adjust. Indeed it normally makes sense to divorce production from provision. A jurisdiction in charge of the supply of a given public service may well source out the production, that is, buy the required goods or services from a producer located elsewhere.

What matters are the economies (or diseconomies) of scale in the *provision* of public services. Most often the optimal size from that point of view differs from the optimal size with regard to production. Often the cost of production exhibit economies of scale while geographical differences in demand and the cost caused by spillovers merit small jurisdictions. This trade-off must be faced. As a result of the competition enforced by exit and democratic participation rights, the politicians and managers in charge of a FOCUS have an incentive to evaluate and take into account the respective cost. In contrast, traditional jurisdictions identified with a particular territory find it difficult to solve these problems. The effort to exploit the economies of scale in *production* by establishing special districts or (as they are aptly called) 'Zweckverbände' is a step in the direction of FOCJ. But these new units are typically purely administrative, that is, they lack democratic legitimacy, and cannot raise their own taxes to finance the expenditure.

4.2.3 Public Goods

The concept of FOCJ relies on the idea that many, if not most, public goods are local. Thus it is possible to draw the borders of a FOCUS so that non-members and, therefore, non-payers are excluded from the use of the services provided. There are but a few public goods where such exclusion is not feasible. It is even argued that most public goods are best provided in small units because this best caters to the heterogeneous preferences of citizens. A large number of FOCJ are expected to be rather small, even smaller than today's communes. Many of the public services, for example, can be provided on the level of city quarters or even blocks.

Within a FOCUS the public good objective behind many public services requires citizens to agree collectively to pay taxes which finance these services. FOCJ are, therefore, governmental units with the power to impose taxes. This feature distinguishes FOCJ from a purely private provision of public services. Admittedly many public services could be privatized (examples are schools, electricity or telephone companies), others do have significant public good characteristics, that is, non-payers cannot be excluded. An example is, for instance, police services providing order and security which everyone living in a respective area benefits from. The concept of FOCJ, therefore, differs from the suggestion of privatizing public services. As it has already been pointed out the public good motive also requires that a citizen has to be forced to belong to *some* FOCUS that provides a particular service but he or she is free to choose among the FOCJ active in this function. A pertinent example is elementary school which benefits all citizens, and not only those with children of that age.

SUGGESTED FURTHER READING

More general aspects of competition among states, governments and other political units are discussed in

Gerken, Lüder (ed.) (1995), *Competition among Jurisdictions*, London: Macmillan.

The effects of spatial competition are surveyed in

Dowding, Keith, Peter John and Stephen Biggs (1994), 'Tiebout: A Survey of the Empirical Literature', *Urban Studies*, 31 (4-5 May), 767-97.

The concept of exit and voice has been developed by

Hirschman, Albert O. (1970), *Exit, Voice and Loyalty*, Cambridge, MA: Harvard University Press.

Hirschman, Albert O. (1993), 'Exit, Voice, and the Fate of the German Democratic Republic', *World Politics*, 45 (January), 173–202.

The role of clubs is analysed in

Cornes, Richard and Todd Sandler (1996), *The Theory of Externalities, Public Goods, and Club Goods* (2nd edn), Cambridge: Cambridge University Press.

Economies of scale in local public government production are analysed in

Hochman, Oded (1990), 'Cities, Scale Economies, Local Goods and Local Governments', *Urban Studies*, 27 (1), 45–65.

The problem of interregional spillovers is analysed from a theoretical perspective by

Wellisch, Dietmar (1994), 'Interregional Spillovers in the Presence of Perfect and Imperfect Household Mobility', *Journal of Public Economics*, 55 (2 October), 167–84.

5. Bastard FOCJ

FOCJ may appear radical compared to how decentralization of government looks like in reality today, or to the traditional economic theory of federalism. However, as was noted in the previous chapter, the economic analysis of various models such as voting by foot, clubs or fiscal equivalence has traced elements of our concept of FOCJ. The aim of this chapter is to examine three theoretical proposals which similarly propose the concept of decentralization on a general level (section 5.1) and then consider manifestations of FOCJ-type jurisdictions both in history (section 5.2) as well as in present times (section 5.3).

5.1 THEORETICAL PROPOSALS

Elements of FOCJ can be found in various other proposals for a new organization of the state and of society. In the next section three of these contributions are examined.

5.1.1 Flexible Integration

In its booklet 'Making sense of subsidiarity: how much centralisation for Europe?', the Centre for Economic Policy Research (CEPR, 1993) mentions briefly the possibility of overlapping jurisdictions but does not further pursue the idea. The option of an institutionalized secession is pointed out, an aspect that has also been emphasized by Buchanan (1991), the European Constitutional Group (1993) and Drèze (1993). The subsequent booklet titled 'Flexible integration: towards a more effective and democratic Europe' (CEPR, 1995) distinguishes between a 'common base' and 'open partnerships'. The latter are functionally oriented.

The proposals advanced by CEPR are similar to FOCJ with regard to its functional orientation and the possibility of voluntary participation. The concept of federalism in the form of FOCJ establishes a common base including free trade, basic individual and political rights, and the right to found new FOCJ. Involuntary redistribution pro-

grammes in the manner of the EU are not envisaged. Among FOCJ there are likely to be activities that reduce social inequality but their nature and extent would have to be determined in the context of a special redistribution-FOCUS.

There is also a marked difference between the concept of flexible integration and FOCJ with regard to political competition. The CEPR is geared to the traditional notion of representative politics; the relevance of direct democracy in revealing and fulfilling individual preferences is overlooked. The central importance of the financial independence of the political units, that is, their competence at raising taxes, is disregarded. The concept of 'flexible integration' thus differs greatly from the idea of functional, overlapping and competing jurisdictions here championed.

5.1.2 Demarchy

In his book *'Is Democracy Possible?'*, Burnheim (1985) advances two proposals with regard to institutions.

1. *Functional autonomy.* Burnheim suggests that newly formed autonomous and functionally specialized agencies make most of the decisions that now lie with centrally controlled, multifunctional jurisdictions. Only those persons with 'legitimate material interests' should have the power to decide. The proposed agencies co-ordinate themselves through negotiation. As such decentralized negotiations sometimes fail, it is necessary to install an arbitration court. The individual agencies have limited competence and consequently differ from the existing jurisdictions ranging from national states to communes which are not subject to such limitation.
2. *Statistical representation.* Elections and popular referenda should be substituted with the old principle of selecting politicians by lot. Burnheim strongly emphasizes this random, or statistical, selection which he calls 'demarchy'. The elements of functional autonomy and of statistical representation are bound to lead to an erosion and even elimination of the state. Burnheim judges such a development to be desirable as he strongly rejects today's centralized state with its absolute monopoly of power and its subjection to organized interest groups. Burnheim's desire to do away with present arrangements becomes particularly clear when he argues for the elimination of private property in land and 'big' capital (which is only loosely connected with his institutional proposals).

Functional units which are only concerned with *one* task as well as the co-ordination achieved by vertical negotiations are also elements of FOCJ. In contrast Burnheim does not discuss the competition among units via mobility (entry and exit). He even rejects popular referenda as an institutional form of the direct participation of citizens. The agencies suggested do not have an independent power to impose taxes but unlike FOCJ receive their financial means from higher-level jurisdictions. While Burnheim hopes that the state 'dies', the concept of FOCJ desires the existing governmental units to remain provided the population judges them to constitute the adequate units for a particular function. Even the national state may remain as far as it can prevail in free competition with the various FOCJ.

5.1.3 Sociological Federalism

Tullock (1994) proposes the establishment of private units which supply the otherwise publicly provided services such as security, water, electricity and gas, refuse collection and education. He considers the rapidly emerging condominiums and 'gated communities' which are separated by a wall from the (inimical) environment and are fully privately organized, to be a good example for the future. Private units are democratically organized in the sense that decisions are taken by the home owners of a gated community by a popular assembly. The community is administered by an elected manager who can be dismissed at any time. Exit takes place by selling the property while entry is restricted by regulations and depends, moreover, on the consent of existing members. Gated communities are in competition with each other; a potential home owner can choose between a large number of different gated communities.

A typical feature of these private communities is the high degree of regulation. Thus regulations govern how the house has to look, how large the garden must be, where and how the car may be parked and to which extent noise may be produced. The various gated communities tend to be socially and racially homogeneous and this facilitates life within the community while increasing the differences to the outside world.

Tullock's idea of 'sociological federalism' (as he likes to call this new type of federalism) shares various features with FOCJ. Both allow the establishment of 'political' units and are characterized by competition in the form of entry and exit as well as democratic participation rights. Gated communities, however, are multifunctional units and do not overlap. This sets them apart from FOCJ. Because of the problems

connected with the provision of public goods, FOCJ are public jurisdictions whose members often consist of communes. To evade social, racial or religious discrimination, the common base includes constitutional guarantees regulating entry into FOCJ. The FOCJ system is more open than that of gated communities because FOCJ overlap in a great many respects and they do not lead to the strong separation of socio-economic strata.

5.2 FOCJ-TYPE INSTITUTIONS IN HISTORY

Nowhere have FOCJ been put into practice in a pure form. However, various features of this concept of federalism have proved to be fruitful in the past. We will discuss some important examples here. The main goal is to demonstrate that FOCJ are no utopian idea which cannot exist in reality. Rather it is possible to draw on a lively tradition which has partly been buried in many countries by the age of nationalism and centralism.

5.2.1 Antiquity

Decentralized and overlapping political units have been an important characteristic of European history. One of the main theses of the New Economic Historians (North and Thomas, 1973; North, 1981) contends that the disunity of Europe was its very advantage. The great variety of institutions of all kinds and levels – with regard to religion, language, geography, law, regions, economy, professions and so on – have been crucial for the success of European civilization. Europe's geography with its many cross-cutting rivers, lakes and mountains favoured the founding of a large number of independent states. Somewhat to the surprise of non-economists, many social scientists and historians (Hayek, 1960; Jones, 1991; Weede, 1993) attribute the rise of Europe to this diversity and to the resulting competition which provoked technical, economic and artistic innovations.

The blooming of antique culture is a result of the multitude of city states. The states of early and classical Greece stood in intensive competition with each other, but also with the Phoenician states and their colonies, in particular Carthage. The outcome was the typical forms of European culture such as epics, lyrics, drama, philosophy, natural sciences and historiography. In contrast to what is often thought, the Roman empire was built on a polycentric order up to AD 300. Law was created by a decentralized mechanism which resulted from the

distribution of power between the emperor, the senate and the regional and local authorities. Over a long time, in the provinces various types of legal systems, and even courts stood in competition with each other. The Romans took care not to destroy local traditions; they resisted from putting their subjects under unnecessary pressure and endeavoured to respect the ideas of liberty and autonomy of the local population. The move towards an increasing unification of laws observable since the dynasty of Severus (AD 193–211) up to the reforms by Diocletian (AD 284–305) was not imposed by force but was the result of competition in which Roman law proved to be more attractive than other legal systems (Bürge, 1995).

5.2.2 Medieval Times

During the Middle Ages Europe was characterized by many centres of power. Between the states there was intense competition in political, economic and military respects. The European rulers were forced to support economic development and to win the support of their subjects in order to achieve higher tax returns and to build up stronger armies. International competition forced the rulers to restrict their power within their countries and to admit variety which was conducive to innovation (Bernholz, 1996).

Centralization does not rarely lead to a decline. It ended, for example, the advantage of the Chinese in many fields when the unified empirical state was established (Rosenberg and Birdzell, 1986; Pak, 1995). The unification of Italy and Germany in the nineteenth century, which is often praised as a great achievement, not only led to positive (for example the creation of a free market) but also negative consequences. The stimulating competition between the many small and even minute states ended and was followed by many brutal wars between the national states. Some small countries such as Liechtenstein, Luxemburg, Monaco, San Marino and also Switzerland were able to evade the unification and at the same time experienced a phase of economic prosperity. Today they are among the richest countries in the world.

The historical account sketched so far emphasizes the fruitfulness of variety and competition for economic, technical and cultural development. This highlights a crucial feature of FOCJ. The political units mentioned are, of course, not FOCJ but there are historical examples for such jurisdictions which are more similar to FOCJ. The strong ethnic and religious differences in Poland between Catholics, Protestants and Jews could be mitigated by jurisdictions organized according to functional and not geographic principles (Rhode, 1960; Haumann, 1990).

The Hanse which prospered between the twelfth and sixteenth century was not a governmental but a functional unit offering rules and institutions for trade. It consisted of geographically discontinuous areas and extended, among others, over Lubeck, Bremen and Cologne (today German), Stettin and Gdansk (today Polish), Kaliningrad (today Russian), Riga, Reval and Dorpat (today Baltic), and Groningen and Deventer (today Dutch). Moreover London (English), Bruges and Antwerp (Belgian) and Novgorod (Russian) were established trading posts or associated members.

5.3 FOCJ-TYPE INSTITUTIONS TODAY

In two countries, Switzerland and the USA, there are local administrations which are closely related, though not identical, to FOCJ. They work well and again serve to show that the kind of federalism suggested by FOCJ can exist in reality.

5.3.1 Swiss Communes

Switzerland is characterized by a strong variety of political institutions. In addition to 26 cantons in a population of roughly seven million people there are approximately 8000 communes, as shown in Table 5.1.

Table 5.1 Types of communes in Switzerland, 1996

Commune type	Number
Political communes	2940
Citizen communes	1519
School communes	516
Church communes	
Catholic	1455
Protestant	1100
Corporations	309
Fractions	78
Further types of commune	73
Total	7990

Source: Based on Wohlfahrtstätter (1996, Table 1, p. 26). The numbers are partly based on estimates.

The 2940 'political communes' constitute the most important form. They consist of Swiss citizens living within the commune; they are thus traditional jurisdictions based on a territorial area.

Political communes have a considerable amount of autonomy within cantons and could maintain their position well over time (in 1848 there were 3203 political communes, that is, only about 10 per cent more than today). They have quite far-reaching rights to impose their own taxes, including individual and corporate income and wealth taxes yielding large revenues. The pluralism of communes is supplemented by 5000 overlapping, functional special communes, as shown in Table 5.1.

The 'citizen communes' are self-administered legal jurisdictions on a personal basis. They grant communal citizenship on which the cantonal and Swiss national citizenship are derived, that is, the Swiss are always citizens of a particular commune and never of Switzerland as a whole. The citizen communes moreover administer the common property of the citizens, which most often consists in large plots of land. 'School communes' exist in six cantons. They take care of education for one or several political communes (or parts of communes). They are organized as jurisdictions according to the public law and, in some cantons, have the power to impose income and wealth taxes. These taxes are determined at a citizens' meeting and are sufficient to make the communes financially independent. Every Swiss adult is automatically a member of that school commune in whose territory he or she lives.

The Catholic and Protestant churches have an official status in almost all cantons. Church membership is independent from Swiss citizenship but one is bound by the territory a person lives in. Entry conditions may be set by the various religions but exit is free.

The 'corporations' existing in 10 cantons are organizations similar to communes and have a very old tradition. They cannot raise taxes but can own land (in particular in the form of commons on the Alps and property to build on). Membership is a precondition to citizenship and can be acquired by descent, marriage or decree.

Among the 'fractions' and 'further types of communes' listed in Table 5.1 are above all the 'civil communes' in the canton of Zurich which take care of local tasks which the corresponding political communes do not fulfil. Examples are the distribution of electricity, gas and water or street lighting. They have their own budget and can raise charges.

In 1994 and 1995, the communes raised about 34 per cent of the total income and wealth taxes, the cantons 44 per cent and the federal (that is central) state only 22 per cent, of which a substantial part has to be passed on to the cantons. Tax rates differ between cantons, for example, the canton of Zug has less than half the tax rate of the canton of Jura.

The tax rates also differ greatly within each canton. In 1997, for instance, in the canton of Zurich, the city of Zurich as well as some small communes added a tax rate of 131 per cent over the cantonal tax, while the neighbouring communes of Zumikon added 88 per cent, and the 'tax paradise' Maur (about 10 km away from Zurich), 85 per cent only.

In addition to all these types of communes the *associations of communes* (for example, 'Zweck-' and 'Gemeindeverbaende' are of great importance. Since 1980, not less than 216 such communal associations have been formed. Their total number is unknown, but obviously it is large. For example, in the canton of Zurich (with a population of about 1.2 million), there were 178 associations in 1994, and in the canton of Aargau (population about 0.5 million) there are today 159 such associations. Ninety-three per cent of the Swiss political communes belong to at least one such association, and often to several. On average the communes take part in six communal associations. More than 40 per cent of the communes, for example, participate in associations caring for canalization, hospitals and nursing homes, as well as refuse collection. The communal associations have a public status, are functionally oriented and extend over a geographic area suited for the provision of the respective service. The citizens are free to establish such associations. The communal associations, however, do not have the power to tax, and there is rarely direct participation of the citizens in decision-making.

As this short survey shows FOCJ in the pure form do not exist in Switzerland. However the communes often share particular characteristics with FOCJ (Wohlfahrtstätter, 1996).

- (a) The *functional* requirement is met in all types of commune except in the political communes which are multifunctional. Many of these jurisdictions cannot be instituted freely by the citizens due to the restrictions imposed by cantonal law.
- (b) Some jurisdictions *overlap* into other communes. There is an overlap within the same function in the case of church communes which provide the same service in the same region.
- (c) Thus there is *competition* which also applies to those communal associations which compete with individual political communes. Individual exit as a further element of competition is possible without geographic mobility for church communes, corporations and citizen communes. Collective exit without geographic mobility is possible in the case of communal associations and most special communes. There exists market-like competition for church communes, communal associations, citizen communes and several

special communes. Political competition via direct democratic participation is fulfilled in all types of commune with the exception of communal associations.

- (d) A *jurisdiction* in the sense of the power to tax exists in all communes except citizen communes, corporations and communal associations. The church communes have only limited power to tax as membership is voluntary.

In summary, Switzerland has an enormous variety of public jurisdictions but there are no FOCJ. School, civil and special communes are in nature close to FOCJ as they have (limited) competition via exit (induced by mobility) and overlap functionally. Communal associations are quite similar to FOCJ as they concentrate on specific public services and independently adjust their territorial extension to the requirements of fulfilling their task. They lack, however, direct democratic participation as well as the power to impose taxes. Church communes are most closely related to FOCJ. Though they have no enforcement power, they allow citizens to easily compare their services and are in a market-like competition (for the competition within and between religions see, for example, Ekelund *et al.*, 1996).

5.3.2 The USA

The 'special districts' fulfil a great number of functions with regard to education, environmental protection, transport and police. They play an increasingly important role in the US federal system (ACIR, 1982, 1987). As an econometric study by Zax (1988) documents, special districts are a particularly efficient form of local government because (as FOCJ) they can adjust their size to correspond with the respective economies of scale for each function. For various functions (for example fire protection or rest and park areas) there are autonomous special districts which are organized in a direct democratic or representative democratic way and these hold the power to tax. Moreover, there are dependent special districts whose managers are delegated by the member communes. Consistent with the view here suggested, the former are significantly more efficient as shown by Mehay's (1984) analysis.

5.3.3 Other Countries

Associations of communes to fulfil specific tasks may also be found in countries beyond Switzerland and the USA. In Germany they are aptly called 'Zweckverbände' (that is, task associations). In Italy they are

known as 'consorzi' and are used for various functions in particular in the northern part of the country. Thus there are 'consorzi per le acque' (water associations), 'per l'università' (for the university) or 'per le strade' (for the roads). However, they are bureaucratic units without the power to tax. They are functionally oriented in the way FOCJ are, but in other respects they deviate fundamentally from the democratically controlled FOCJ.

SUGGESTED FURTHER READING

Theoretical proposals similar to FOCJ have been advanced by Burnheim, John (1985), *Is Democracy Possible?: The Alternative to Electoral Politics*, Cambridge: Polity Press.

Tullock, Gordon (1994), *The New Federalist*, Vancouver: Fraser Institute.

The importance of variety and competition for economic growth and the rise of Europe have been worked out by

Bernholz, Peter, Manfred E. Streit and Roland Vaubel (eds) (1998), *Political Competition, Innovation and Growth. A Historical Analysis*, Berlin: Springer.

Jones, Eric L. (1981), *The European Miracle* (2nd edn), Cambridge: Cambridge University Press.

Jones, Philip (1997), *The Italian City-State: From Commune to Signoria*, Oxford: Clarendon.

Rosenberg, Nathan and L.E. Birdzell (1986), *How the West Grew Rich. The Economic Transformation of the Industrial World*, London: I.B. Tauris.

A survey of the Swiss system of government and its communes is given in Steinberg, Jonathan (1996), *Why Switzerland* (2nd edn). Cambridge: Cambridge University Press.

Klöti, Ulrich, Peter Knöpfle, Hanspeter Kriesi, Wolf Linder and Joannis Papadopoulos (1999, forthcoming), *Handbuch zum Politischen System der Schweiz*, Zürich: NZZ-Verlag.

The American special districts are discussed, for instance, in Foster, Kathryn A. (1996), 'Specialization in Government. The Uneven Use of Special Districts in US Metropolitan Areas', *Urban Affairs Review*, 31 (3), 283–313.

Nuun, Samuel and Carl Schoedel (1997), 'Special Districts, City Governments, and Infrastructure. Spending in 105 US Metropolitan Areas', *Journal of Urban Affairs*, 19 (1), 59–72.

Zax, Jeffrey S. (1988), 'The Effects of Jurisdiction Types and Numbers on Local Public Finance', in Harvey S. Rosen (ed.), *Fiscal Federalism: Quantitative Studies*, Chicago and London: University of Chicago Press, 79–106.

PART II

FOCJ for Europe

6. Federalism in today's Europe

6.1 THE EUROPEAN UNION (EU)

6.1.1 The Three Bodies

The unification of Europe is in principle based on the idea of federalism and decentralization though it contains strong elements of a centralized state. Each member state has a fixed number of seats and votes in the most important institutions of the EU – the European Commission (EC), the Council of Ministers and the European Parliament (for the European Court with its 15 judges elected for six years, such quota do not formally exist but are effective in practice).

Table 6.1 provides a survey of the weight of the individual members in the European institutions mentioned above.

The *European Commission* is a supranational unit whose members are required to act in the interests of the EU as a whole. They may not follow any orders by the national governments. They are elected with the approval of the governments of the member countries and they must be confirmed by the European Parliament. Once elected, the governments cannot recall them. The fact is that the members of the commission tend to follow their national rather than any other country's interests.

The present 20 Commissioners are elected for four years. The five largest countries – Germany, the UK, France, Italy and Spain – delegate two members each, all other countries one each. The EC acts as a unity; if a vote is necessary, the rule is a simple majority. The president is *primus inter pares* and does not have any special decision powers.

The EC must guarantee that the law and the political decisions of the EU are correctly applied. It can take legal action against member countries which violate them, and often does so. The EC also has the duty to strengthen European integration and, therefore, has the right to undertake appropriate activities.

The *Council of Ministers* is the most important legislative unit in the EU. It is not a standing body but an assembly of the national ministers

Table 6.1 The weight of the member states in the institutions of the EU, 1998

Member country	Population (1995) (million)	Members in the Commission	Votes in the Council of Ministers	Seats in the European Parliament
Germany	81.9	2	10	99
UK	58.5	2	10	87
France	58.1	2	10	87
Italy	57.2	2	10	87
Spain	39.2	2	8	64
Netherlands	15.5	1	5	31
Greece	10.5	1	5	25
Belgium	10.1	1	5	25
Portugal	9.9	1	5	25
Sweden	8.8	1	4	22
Austria	8.1	1	4	21
Denmark	5.2	1	3	16
Finland	5.1	1	3	16
Ireland	3.6	1	3	15
Luxemburg	0.4	1	2	6
Total	372.1	20	87	626

Source: Jones (1996, p. 64).

responsible for the respective policy areas. If, for instance, a decision on agricultural policy is to be taken, the national ministers of agricultural affairs participate. Of course these national ministers pursue their national interests. The presidency of the council changes in a fixed sequence after six months in order to prevent the domination of any country.

The Council of Ministers constitutes an intergovernmental body. It differs in two respects from national legislatures. Its members are delegated by the government and are not elected by popular vote. Moreover the decisions are taken unanimously provided the European Treaty does not stipulate a qualified majority. A qualified majority requires 62 of the total 87 votes; thus, a blocking majority is 26 votes. However an overruled national government can resort to the 'Luxemburg compromise' of 1966, according to which every country has a veto vote if an issue is of 'foremost national interest'. There are no criteria for this

'foremost national interest'. The existing rules and vote distributions (Table 6.1) clearly favour the small member countries.

Since 1979 the *European Parliament* has been directly elected for a period of four years. It represents the population of the member countries, not the voters of the EU. The small nations are again overrepresented. Decisions are taken by simple majority, only the dismissal of the EC requires a two-third's majority. The competence of the European Parliament is quite restricted compared to national parliaments or to the EC and the Council of Ministers.

6.1.2 Subsidiarity

The principle of subsidiarity was established in the Maastricht Treaty in 1992 and refined in the Amsterdam Treaty which was signed in 1997 and is effective in 1999. Subsidiarity stipulates that the EU should only become active in a certain area if the member countries are less capable of taking actions. The EU, moreover, should not extend beyond what is strictly necessary in order to reach the goals established in the EU treaties. Political decisions and responsibilities are to be taken at the lowest possible governmental level. This would at the same time restrict and relieve the workload of the institutions of the EU. Subsidiarity thus seems to strengthen the federal element in the EU.

However, the EC, as expected, interprets the principle of subsidiarity to its own advantage and turns its logic on its head. As soon as a problem can be approached at the European level, or if there are any problems at the national level, the EC takes it for granted that it must intervene. Moreover it does not accept that subsidiarity limits the competencies accorded to it; it takes subsidiarity to deal only with how *common* competencies are to be divided up.

The EC tends to interpret the competencies exclusively given to it in a very broad way. In a legalistic definition its competencies are restricted to trade policy and the protection of the seas. The EC considers itself to be responsible whenever the four freedoms – the free movement of goods, services, capital and labour – are touched. It thus not only considers the removal of restrictions to these freedoms to fall within its competencies, but also all policy areas connected with the four freedoms such as trade policy, competition policy, agricultural policy and transport policy.

This clearly makes the EC claim a very wide area of policy. The principle of subsidiarity proves to be much too general to counteract the increasing centralization at the European level. The Amsterdam Treaty does not change this fact. It only stipulates that the EC, while

extending its fields of activity, is bound to argue that the extension of its tasks is consistent with the principle of subsidiarity. However this is not a strong constraint to centralization. There is hardly a government activity for which it cannot be argued that it causes some transnational spillovers or overcharges at least one national government. Therefore the EC can always argue that centralization is compatible with the subsidiarity principle. Moreover there is no institution which is in charge of judging the soundness of the EC's arguments. However even a strict interpretation of subsidiarity would not be sufficient to give Europe a really federalist structure because in many of today's (and future) member states, governments at lower levels are insufficiently developed and, in particular, do not have the tax bases to finance their own expenditures.

6.1.3 Tendencies for Centralization

The EU has in many areas taken over competencies from the member countries. The tendencies to centralize are most marked in the following policy areas:

- internal trade and factor mobility;
- industrial and research policy (in particular telecommunication, energy and other public service areas);
- competition policy (the country competencies are restricted to aspects which do not touch on trade between EU members, and only applies for unimportant activities);
- agriculture (the instruments for price supports and structural programmes take place in the context of the Common Agricultural Policy (CAP). They benefit mostly the farmers living in the North and occupies roughly 50 per cent of the EU budget);
- environment (the EU has issued directives with regard to atmospheric pollution, dangerous chemicals, water pollution, the protection of flora and fauna, noise emissions and animal experiments which strongly restrict member countries);
- trade policy (the EU has largely exclusive competencies with regard to custom treaties. A large number of bilateral and multilateral treaties have been concluded, for example, with the USA, Japan and EFTA and a common external tariff has been established);
- transport policy (the EU has fixed entry conditions and prices for suppliers of road transport and controls air traffic regulations);
- monetary policy (the Economic and Monetary Union (EMU) and

the common monetary unit (Euro) was mainly decided by the EU);

- social policy (the Social Charter has now been accepted by almost all member countries; the European regulations in general are less extensive than the national laws but a large number of directives to set minimum standards and to harmonize the conditions for health and security have been issued);
- redistributive policy (the Structural Fund and the Cohesion Fund support infrastructure and transport projects with the goal of helping the poorer nations of the EU. In 1993 Greece and Ireland, for instance, received almost 3 per cent of their GNP via such supports (outside the Common Agricultural Policy and the Social Fund). For Portugal, this share reached 3.7 per cent of BIP (Centre for Economic Policy Research 1993, p. 26)).

As illustrated in Table 6.2, centralization tendencies in the EU are not so much reflected by the number of public officials (it more than tripled from approximately 5000 in 1970 to 17 000 in 1990), or by the budget (it increased from 0.54 per cent of the GNP of the six EC countries in 1975 to 1.28 per cent of GNP of the 12 EU countries in 1994). Rather increasing centralization can be seen in the number of interventions. Table 6.2 shows the number of decisions of the European Court which grew almost eight times from 240 in 1970 to 1780 20 years later.

Table 6.2 Centralization tendencies in the EU

	1970	1980	1990
Number of employees with the EC	5000	11000	17000
Number of judgments by the European Court	240	830	1780
Number of interest groups with the EU	309	410	3000

Source: Molle (1994) and CEPR (1995, p. 27).

Perhaps an indirect indicator is even more revealing. The more important the decisions taken by the EU, the greater the number of interest groups seeking to influence them and, indeed, their number increased from approximately 300 (1970) to 3000 (1990). This indicates

that this rent-seeking is now of a large magnitude. In particular the rapid increase over the last decade clearly reflects a shift of power towards the EU.

6.1.4 Comparison to FOCJ

'Federalism' as practised in today's EU differs strongly from the concept of FOCJ. The Maastricht Treaty has fixed the *acquis communautaire* stipulating that no member country may renounce particular parts of the legal framework which forms the basis of the EU. In particular new members must completely accept the *acquis communautaire*. There are two areas where some flexibility is allowed because a common policy has proved impossible to achieve. Exceptions to the treaties such as those concerning the EMU, the Protocol of Social Policy, or the Schengen Treaty concerning border controls, have been granted reluctantly, only. Thus the UK and Denmark have opted out of the EMU, and Sweden has also decided not to join for the time being.

Opting out is generally seen by European politicians and public officials as damaging the spirit of Europe. Concepts related to FOCJ such as 'variable geometry, multi-track, multi-speed, two-tier, hard-core, concentric circles' or as 'Europe à la carte' always evoke fierce opposition. In a system of FOCJ, in contrast, functional units not covering everyone are taken as a welcome expression of heterogeneous demands among Europeans.

The Amsterdam Treaty which is due to come into effect in 1999 is often interpreted to allow more flexibility for member countries. However the treaty asserts that the *acquis communautaire* cannot be touched. Flexibility refers to further steps of integration only. Thus a majority of member countries are allowed to engage in closer union, provided no other member vetoes such a step. This is, of course, a far cry from the concept of FOCJ where those jurisdictions which desire to co-operate or to (partially) disintegrate are free to do so.

6.2 CONSTITUTIONAL PROPOSALS

Various people have advanced concrete ideas for a future European Constitution in which federal elements play a major role. They go beyond constitutional proposals which essentially strengthen federalism in the EU by doing away with elements which hamper the working of federal institutions. The new proposals endeavour to overcome the vague definitions of subsidiarity by explicitly and clearly stating the com-

petencies of each level of government. Equally the existing confusion caused by the increasingly complicated web of tax and transfer payments should be clarified.

The possibility of a regulated *exit* of member countries from the EU plays a central role in Buchanan's (1991) constitutional proposal. The right to secede should guarantee that the European government adheres to only those activities which its citizens desire. Today's EU does not formally envisage exit. It could be argued that it is difficult to conceive that the European institutions or member countries would forcefully prevent the exit of a country, let alone a group of countries. However secession would inflict great harm on the EU and would inflict huge cost because procedural rules are lacking. Thus, exit is highly improbable and thus does not constitute a constraint to EU policy. Although Buchanan focuses on the exit option in his constitutional proposals, he somewhat surprisingly does not apply his own theoretical model of clubs (Buchanan, 1965) to this context. For this reason Buchanan's proposal differs greatly from our concept of FOCJ.

To our knowledge only one constitutional proposal for Europe deals with the functional separation of tasks. Teutemann (1992) proceeds, however, quite differently from FOCJ by suggesting a European Parliament in which *individual chambers are responsible for the various functions*. These functions are allocated by experts or by the government. The citizens have no say in this respect. Teutemann's innovative proposal is embedded in a rather constructivist and technocratic tradition. It is not to be expected that these parliamentary chambers are well suited to make decisions on the various functions which correspond to the voters' preferences.

The constitutional proposal of European parliamentarians (in the so-called Herman Report of the European Parliament, 1994) accepts the existing federal and geographic division of the EU and almost exclusively suggests changes to *parliamentary institutions*. In particular the number and structure of chambers and the national voting rights must be adjusted to changing conditions. As is to be expected in a report which must suit the differing interests of parliamentary groups, only marginal changes to existing institutions are proposed.

The European Constitutional Group, among whose members are Peter Bernholz, Roland Vaubel and Frank Vibert, goes in many respects farther than the Herman Report. Important goals are the openness of the EU, the removal of inner frontiers and barriers, as well as the protection of cultural variety. These goals are to be reached by a competitive system of taxes, laws and social security. The centre of the EU has to fulfil two essential tasks: a common foreign and defence policy

and the free mobility of citizens, goods and services, and capital. Free competition, not only with regard to the exchange of goods but also with regard to social programmes (labour market, social security), stands at the centre of this constitutional proposal. An independent European Central Bank is responsible for price stability. The proposal of the European Constitutional Group regulates some issues in depth and thereby tends to determine outcomes, and not rules. Thus it stipulates that the budget of the EU must be in balance, and public expenditure may not exceed a certain percentage of GNP. Every state which makes a net contribution to the EU budget has a veto right.

With regard to institutions, the Group proposes a legislature composed of two chambers. The chamber of parliamentarians is composed of 175 members and has the right to control new laws, to initiate new laws, to approve the budget and international treaties as well as the entry of new members (the latter with a qualified majority of at least 80 per cent of the votes). The members of this parliament are selected from the members of the parliaments of the member states. The second chamber, the Union Chamber, has the right to initiate laws, decide on laws and the budget, monitor their execution and control the activities of the executive, that is, of the EU administration. Its members are directly elected and may serve a maximum of two terms of five years.

The proposal of the European Constitutional Group intends to strongly restrict the competencies of the EU. It wants to confine them to the execution and support of the decisions of the European Council which is composed of the heads of governments or heads of state of the member countries.

As the proposal is outcome-oriented (by fixing, for instance, the maximum budget size), its main goal is to set limits on the European state, but not to strengthen the participation of the citizens or of federalism. Thus one of the chambers of parliament is not directly elected and direct democratic elements in the form of popular initiatives and referenda are missing. The idea of FOCJ proposed here is process-oriented in contrast. Only a few general institutional rules are fixed; in particular FOCJ may form freely and may raise their own taxes. As far as possible, material aspects remain unregulated. As the decisions in FOCJ are made in a democratic way, they are to be accepted and should not be limited or even determined from outside. It is difficult to see what the legitimacy for such an outside interference is based on.

Another important proposal for a European Constitution has been worked out in the context of the Centre for Economic Policy Research (CEPR, 1995), as has already been briefly discussed in Chapter 5. The main task of the authors (among them Mathias Dewatripont, Francesco

Giavazzi, Jürgen von Hagen, Torsten Persson, André Sapir and Guido Tabellini) is to combine greater flexibility with greater political integration. They propose a 'flexible integration' starting from policy areas instead of countries. The Common Base has to be observed by all the members of the EU. It contains well-defined goals of policies, the most important of which is the unified market. It is not restricted to a guarantee of the four economic freedoms but also contains transfer programmes, the Structural Fund and CAP which serve to make the common market politically acceptable. Moreover the measures to harmonize capital taxes and to co-ordinate monetary policy also belong to the Common Base to be included in the European Constitution.

While participation in the Common Base is mandatory, member countries can choose to participate in those Open Partnerships from which they hope to benefit. The policy areas include the common currency and the Social Charter. The report does not envisage that member countries which are not (yet) ready to participate may co-determine what these Open Partnerships look like. Conversely particular Open Partnerships may prescribe 'rules of good behaviour' to other EU countries. Thus, for example, no monetary policy may be undertaken which would lead to competitive devaluation of currencies.

The constitutional proposal designed by the CEPR shares some characteristics of FOCJ, in particular the focus on functions or policy areas. The same holds for the basic rules which have to be accepted by all. The concept of FOCJ presumes, however, a much smaller set of conditions to be included in this base, namely above all the four economic freedoms and the fifth political freedom to freely form new overlapping jurisdictions. Programmes for redistribution and standardization imposed from above are inconsistent with FOCJ. If such programmes are desired by the citizens, corresponding FOCJ will emerge. However neither co-ordination nor redistribution needs to be prescribed by any higher authority. Neither is it necessary nor desirable to fix the competencies of the various levels once and for all. The constitutional proposal by CEPR seeks to add content to the otherwise rather empty concept of subsidiarity, but the report puts much less weight on the major advantages to be gained by decentralization and the direct participation of citizens than does our proposal of FOCJ.

SUGGESTED FURTHER READING

The federal elements in the EU and the European Nation States are discussed, for example, in

Hesse, Joachim Jens and Vincent Wright (1996), *Federalizing Europe? The Costs, Benefits, and Preconditions of Federal Political Systems*, Oxford: Oxford University Press.

Vaubel, Roland (1995), *The Centralisation of Western Europe. The Common Market, Political Integration, and Democracy*, London: Institute of Economic Affairs.

The extent of decentralization of government in the various EU-member countries is analysed in

Goldsmith, M.J.F. and K.K. Klausen (eds) (1997), *European Integration and Local Government*, Cheltenham: Edward Elgar.

The concept of subsidiarity has been widely discussed. See, for example, Centre for Economic Policy Research CEPR (1993), *Making Sense of Subsidiarity. How much Centralization for Europe?*

Feld, Lars P. and Gebhard Kirchgässner (1996), 'Omne Agens Agendo Perficitur. The Economic Meaning of Subsidiarity', in Robert Holzmann (ed.), *Maastricht: Monetary Constitution without Fiscal Constitution?*, Baden-Baden: Nomos, 195–226.

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A politico-economic analysis of the tendencies for centralization in the EU is provided by

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7. FOCJ in Europe

In this chapter the concept of how FOCJ can be applied to Europe is examined. In particular how far the policy of the EU strengthens federalism and especially the regions (section 7.1), and the conditions necessary for the emergence of FOCJ (section 7.2) are analysed. It then evaluates what opportunities exist for a stronger federalism, and in particular, for the concept of FOCJ within the EU (section 7.3).

7.1 FEDERALISM AND REGIONALISM IN THE EU: THE PRESENT STATE

7.1.1 EU Policy

Regional policy is an important task in the EU and is actively undertaken. Its major goal is to reduce disparities in income levels between the member countries and to subsequently achieve a 'harmonic development'. While this goal already forms a part of the preamble of the Roman Treaty, not much was undertaken until the mid-1970s mainly because the European Agricultural Fund used up a considerable part of total expenditures. In 1975 a European Regional Development Fund was established. Its main purpose was to support the national governments in their respective regional policies. After a reform in the 1980s income criteria for potential recipients were fixed. An effort was made to stimulate rather than to substitute national investments. The Single European Act of 1985 strengthened the commitment to an active redistribution policy among the various parts of the EU (article 130A). In 1988 Structural Funds were introduced, several of which are explicitly geographically oriented. The corresponding financial means are granted to the regions only indirectly through the mediation of the national governments, that is, the regions must rely on their governments and cannot pursue an independent policy. The Structural Funds are attributed after extensive consultations with the national governments of the member countries. However the EU Commission makes an effort to establish direct relationships with the regions of Europe. As a result

of the Maastricht Treaty, a Committee of Regions was formed for the purpose of establishing contacts.

Several Structural Funds of the EU are devoted to cross-border regions. In 1990 an initiative was started with the goal of overcoming the national as well as the EU borders and to establish a network for closer co-operation.

As it has become clear from this short discussion, the regional policy in the EU is top-down and works by handing out monetary transfers. No effort is made to encourage the regions to develop from the bottom. This is reflected in the fact that it is mainly the national governments which determine the distribution of the funds while the interests of the local population are of little concern. The regional policy in the EU is not directly rooted in any democratic process, and it does not intend to develop political structures at a decentralized level. The contrast to our concept of FOCJ thus could not be larger.

7.1.2 Regional Activities

Several associations have expressed the demand of the regions to be heard in the political process within and beyond the EU. It started in 1971 with the Association of European Border Regions which in 1985 led to the foundation of the 'Assembly of European Regions' comprising today of about 300 members from 23 countries. In the EU, the regions gained formal influence with the Maastricht Treaty when the Committee of the Regions (COR) was established. This is an advisory body of 222 representatives from local and regional authorities which provide consultation on matters affecting regional interests and before decisions are made on regional matters. Policies concerning education, culture, public health, trans-European networks and economic and social cohesion, and according to the Amsterdam Treaty, employment, environment and transportation policies must all be consulted on. In these organizations of the regions the term 'region' does not refer to a particular geographic area but rather to the administrative districts below the national state, that is, the German or Austrian 'Bundesland', the Italian 'regione', the Spanish 'region autónoma' or the Swiss 'canton'. However, these units differ greatly with regard to size and responsibilities although their competencies and especially their tax autonomy are heavily restricted almost everywhere.

In Austria and Germany, which are at least formally federal countries, the Länder can pursue their own policies within the constitutional provisions. The limits imposed are, however, rather strong. In this instance, as elsewhere, the power to tax is decisive. The Austrian and

German Länder have no tax autonomy but live mainly from the transfers and the tax shares they receive from the central government. As a result the politicians at the Länder have a marked central orientation as they try to get as many financial means as possible from the federal government by lobbying.

Italy has 20 regions of which the two large islands of Sicily and Sardinia and three border regions have a special status. There are even demands for a cross-border 'European region Tyrole' to be composed of South Tyrole, Trentino and the Austrian Bundesland Tirol. The Italian Regions (so far) have only limited financial independence in terms of their own power to tax. There are continuous efforts to gain more financial autonomy but it is doubtful whether the central authorities in Rome will be prepared to make a decisive step in this direction. It would constitute a major break from the concept of a highly centralized national state that has been cherished since the unification.

Alsace in France which in the past was at times German and at other times French has always taken a special position. Savoy with its present-day departments Savoie and Haute-Savoie has also asked for more autonomy from Parisian centralism. The announcement of a 'sovereign state' in 1996 was not to be taken seriously but showed that regional demands gained in importance. In Corsica the movement towards regional autonomy even makes use of terrorist means.

In Belgium the Walloons and the Flemish seem to have drifted far apart. There is even a possibility that the national state may break up. The initiative derives mainly from the Flemish. Over the last 25 years they have achieved a regionalization of the central state. After increasingly extensive revisions of the constitution Flandria (Flandern), Wallonia and Brussels received an autonomous status, a parliament and a government with economic, cultural and even foreign policy competencies. Brussels, the capital of Europe, is in the uncomfortable position of an enclave (with up to 90 per cent French-speaking inhabitants) within the predominantly Flemish-speaking region of Flandria. Decentralization in Belgium is thus predominantly along 'ethical' (or at least language) lines.

In another classical central state, Spain, the regions have strongly gained in importance. In Catalunya and Galicia this special position has been reached mainly by peaceful means while terrorism played an important role in the Basque Lands. Violence has also occurred in the UK for decades: with regard to Northern Ireland, the hope for a peaceful and enduring solution has grown only recently. In contrast, no such regionalist tendencies exist in Scandinavia and the Netherlands.

7.1.3 FOCJ as a Solution

The discussion of federal and regional policy in the EU leads to four conclusions:

1. The regional policy pursued by the EU consists mainly in handing out subsidies. This has little to do with taking regional preferences into account. No effort is made to improve the citizens' possibilities to politically participate at the regional level, and it is unlikely that such efforts will prevail in the future because the national governments of the EU member countries have an interest to oppose it.
2. Within the EU there are three important regional conflicts, the Basque Lands, Corsica and Northern Ireland. They have occurred for years and all sides operate by the use of force. It could be said, in fact, that there are 'wars' taking place within the EU. The EU is in no way capable of offering a peaceful solution to these bloody conflicts, or even to mitigate them.
3. The peaceful regional movements have also little to do with the EU. They do not understand themselves as regions within the formal structure of the EU but largely endeavour to pursue their own course. The existing constitution of the EU offers them few options to reach their goal of greater local autonomy.
4. The EU is not necessary at all for establishing *cross-border associations*. Switzerland which stands outside the EU provides a good example. After rejecting entry into the European Economic Area by a popular vote in 1992, the cantons which lie at the border of the country have made efforts to overcome the isolation threatening them. Switzerland is at present linked to all its neighbouring countries via cross-border associations:
 - The 'Regio Oberrhein' previously known as the 'Regio Basiliensis'. It includes regional units in Germany, France and Switzerland;
 - The 'International Conference of the Lake of Constance' ('Internationale Bodenseekonferenz') composed of the Austrian land Vorarlberg, the German Baden-Württemberg and Bavaria, as well as five Swiss cantons;
 - The evolving 'Region Raetia' which connects the Swiss cantons Graubünden with the neighbouring regions in Austria and Italy;
 - The 'Regio Insubrica' with the Italian Varese, Novara and Como and the Swiss canton Ticino;

- The 'Conseil du Léman' consisting of the French Haute-Savoie and Ain and three Swiss cantons;
- The emerging 'Communauté de Travail du Jura' with the French Franche-Comté and four Swiss cantons.

The importance of these cross-border associations is not large so far. What matters is that their emergence takes place outside the formal, top-down structure of the EU.

The regional movements, associations and jurisdictions previously discussed have one thing in common: they refer to territories. The FOCJ which we suggest present an alternative way of establishing cross-border contacts. They are based on co-operation with respect to specific *functions*. Above all they do not require territorial separation from existing national states. Thus Corsica, for example, need not leave the French state in order to co-operate closely with Italian (or Spanish) local units with regard to particular functions or policy areas, most importantly, culture and language. A break with the 'motherland' which would unnecessarily evoke emotions and prevent solutions is evaded. It could be similarly envisaged that some Northern Irish communes forming jurisdictions with communes of the Irish Republic with regard to some functions, but with regard to other functions, may form jurisdictions with British communes and regions.

It is impossible to say *ex ante* what such FOCJ in crisis areas would look like because this must be left to the participants and cannot be determined from above and from outside. Rather the *preconditions* must be set to enable the emergence of such FOCJ. At present this is impossible because the respective communes have insufficient competencies to make such a step. In particular, they lack (sufficient) power to tax. Only if these preconditions are firmly established can it be hoped that a functional task (say refuse or waste water collection) is solved by forming FOCJ. It can well be expected that such concrete functions can be undertaken more successfully by FOCJ than by national states which tend to mix up functions with political, religious or ethnic ideologies. An analysis of wars has indeed revealed that the people affected were at least to some extent able to establish co-operation along functional lines. For instance, during World War I the soldiers spared each other's line of communication in order to safeguard the provision of food (Axelrod, 1984). In most wars, prisoners are exchanged (Frey, 1992, chap. 8), and a black market for trade in urgently needed goods emerges. It may even be hoped that such functional co-operation helps to reduce ideological barriers because the participants experience that their welfare is raised by cooperation. Of course,

one should not have too high an expectation; there is normally no easy solution to bloody conflicts. However it is certainly more promising to pursue the functional co-operation suggested here than to stick to the nationally oriented approach which has failed dismally in the past.

FOCJ are, of course, also useful under peaceful conditions. Again it is not possible to determine concretely which policy areas will be covered and what the jurisdictions will look like because this lies in the hands of the individuals and communes involved. However it is possible to think of a variety of FOCJ. An example is a FOCUS which provides language education for the children of communes in the Alsace and Baden on the left and right side of the Rhine. Whether such FOCJ will indeed emerge depends on the conditions for their establishment which we now turn to.

7.2 CONDITIONS FOR THE EMERGENCE OF FOCJ

As the concept of FOCJ is process-oriented, it is only possible to identify the conditions under which they can emerge, as well as the likelihood of them emerging. It cannot be determined a priori in which policy areas FOCJ actually form and how they perform their functions. Our proposal thus follows the Economic Theory of Constitutions which focuses on the process of policy decisions which in turn determine the outcomes.

It is useful to distinguish the conditions which we call the Common Base that FOCJ have to meet, and the conditions that are necessary for FOCJ to emerge.

7.2.1 Common Base

FOCJ require economic and political competition to perform properly. Only if the markets are open can FOCJ achieve the benefits discussed above, in particular, fulfilling the individual preferences of the local population. As it is true for all markets, many actors have incentives to subvert the free play of competition and to establish monopoly positions that damage others. For this reason the constitution must make sure that economic and political competition remains vigorous. A 'competition authority' has to be established which monitors whether the two kinds of market remain sufficiently open:

- (a) The *economic* markets must allow the entry of new competitors. In particular the four freedoms of the free movement of goods, services, capital and labour must be guaranteed.
- (b) The *political* markets must be based on the unconstrained competition for the votes of the citizens, that is, the basic human and democratic rights have to be ensured. The 'competition agency' must fix general rules that determine the maximum prices for entry into, and exit from, a FOCUS. If these prices are set too high, mobility is hindered and monopolistic positions appear. Prices are, however, necessary to ensure that citizens or communes entering or exiting cannot profit at the cost of others, as this would undermine the emergence of FOCJ. Each citizen should be prevented from failing to participate in the solidaric responsibility of providing particular public services. Individuals without children, as well as those whose children are no longer in education, for instance, must be forced to participate in the financing of general education. It is not sufficient to make the membership in a school-FOCUS obligatory. FOCJ may emerge which deal nominally with schools only, but which essentially offer no educational services, but correspondingly raise low taxes. In such cases an obligatory membership to a FOCUS with a (minimal) supply must be stipulated. The competition authority must have the power to intervene when these conditions are not met; a task which has to be formally included in the constitution. It would be wrong to assign the task to national, political or administrative authorities. They have an interest in making the life of FOCJ as difficult as possible, and preventing their emergence in the first place. Rather the institution charged with this task should be as objective as possible. One possibility would be the Constitutional Court (in the case of the EU, the European Court of Justice) though it somewhat tends to favour national over regional and local interests. Nevertheless such a Court is likely to fulfil the tasks of a 'competitive authority' more objectively than a national unit.

7.2.2 Freedom to Establish FOCJ

FOCJ can only emerge if a positive and a negative condition are met:

- (a) The *formation* and *functioning* of FOCJ must be *constitutionally guaranteed*. It should be possible for the units to incorporate themselves as jurisdictions with (limited) power of enforcement. Without any doubt the power to impose taxes is crucial in order

to provide services. This right will always be challenged by other jurisdictions at all levels (nations, provinces and so on) because they have to give up part of their tax base. It is, therefore, of great importance that the tax power of FOCJ – of the existing as well as of those that will only emerge in the future – is fully guaranteed.

Both individuals and communes (as the lowest political unit) should have the possibility of establishing FOCJ. Who the members are depends on the functions concerned. Thus it can well be conceived that individual citizens would form a FOCUS for a particular public school. In other policy areas, such as collection of waste water, communes would most likely come together to establish a FOCUS. The constitution should not fix in advance whether FOCJ are to be based on individuals or communes but should allow both types to form.

- (b) Existing governmental units at all levels may *not block* the emergence of FOCJ. This means that, in particular, the members of a FOCUS which newly provides particular public services need no longer pay the respective taxes in the former jurisdiction. The competition authority must force the suppliers to make the cost of provision known and to correspondingly reduce taxes for members who are partially exiting and entering a FOCUS. The potential competition by FOCJ gives the existing public suppliers an incentive to reveal the precise cost of providing their services. It is certainly advantageous to them to state the cost of a given service low in order not to make partial exit look too favourable. However the setback is that the other services become more attractive for exit as, of course, the various tax prices should sum up to the full tax.

The competition authority should enforce that the appropriate tax reduction for individuals and communes is granted. In order to make the market transparent and to further strengthen the incentives to reveal the true prices, it may be useful to enforce that the tax price for the various public services be revealed and applied to those not only exiting but to all citizens including those who newly enter. As a result existing suppliers lose the incentive further to grant too low a tax rebate to those exiting because they would at the same time lose tax revenue from their present and future members. It should, of course, be taken into account that the traditional political units will employ much 'creative bookkeeping' to put their new competitors at a fiscal disadvantage. The competition authority thus has no easy task to fulfil.

Again the Constitutional Court seems well-suited for the role of a

competitive authority. Because a large number of tax prices have to be monitored, it must rely on the support of a specialized agency such as the Court of Account which has the necessary economic knowledge.

7.3 PROSPECTS FOR FEDERALISM IN EUROPE

The chances for FOCJ to be part of the government structure depends strongly on the future of federalism in Europe, in particular, in the context of the EU.

The success of integration via the EU cannot be disputed, especially when it is compared to the demise of EFTA. The EU was economically very productive by achieving the four freedoms concerning the mobility of goods, services, capital and labour. The opening of these markets has raised the growth rate permanently. According to the few existing studies, integration has increased the growth rate by between 0.2 and 0.5 percentage points per year, although it is important to note that the growth impact of EU and EFTA membership has been about equal (Henrekson *et al.*, 1997). While such changes in growth do not appear to be very large, they have led to a marked rise in per capita incomes in the member countries in the long run.

With regard to employment, the EU's record is less favourable. The average unemployment rate in 1997 was around 11 per cent, with Spain far above 20 per cent, and Finland and Italy at the top with clearly above 12 per cent. Unemployment is also a serious problem in the core countries; France (around 12 per cent) and (West) Germany (around 9 per cent). The rates of unemployment should be compared with the current low rates in the USA (around 4.5 per cent) and Japan (around 4 per cent), but also with the comparatively low rates in the former EFTA countries.

The integration could be considered successful from the political point of view because it prohibited wars *between* the European nations. It is, however, also plausible that the causation runs in the opposite direction. It may well be that it was the absence of strong conflicts between the nations that allowed integration to take place. As it has been pointed out, the EU contributed little or nothing to prevent war-like conflicts *within* the member states. The terrorism existing in Northern Ireland, the Basque Lands and also in Corsica is still considered to be a purely national issue, a view that has not changed with the existence of the EU.

The insufficient democratic legitimacy of the EU is generally acknowledged. Moreover the support of the EU by the citizens of the member

countries is far from overwhelming. Table 7.1 gives an overview based on a Eurobarometer survey for November 1997.

Table 7.1 Evaluation of the EU in the various member states, November 1997

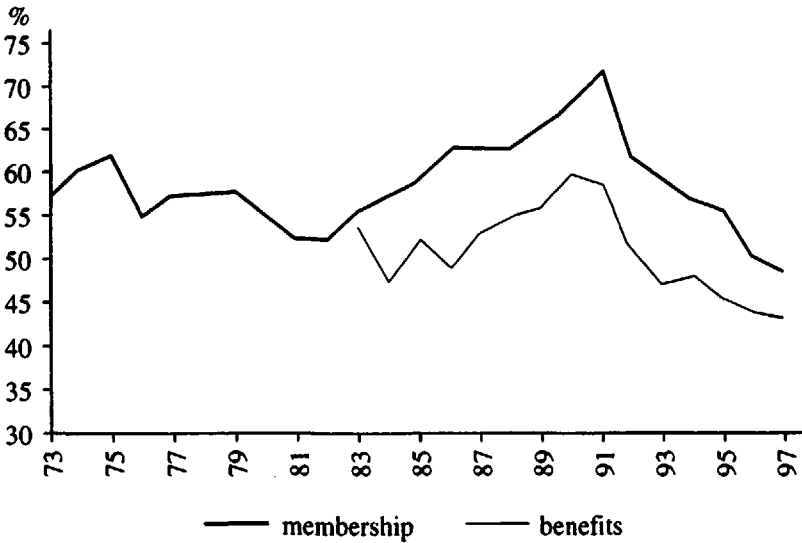
	EU membership is	
	a good thing (%)	a bad thing (%)
Ireland	83	3
Netherlands	76	9
Luxemburg	71	10
Italy	69	6
Greece	60	8
Portugal	56	6
Spain	53	9
Denmark	53	22
France	48	14
Belgium	42	18
Finland	39	25
Germany	38	15
UK	36	23
Sweden	31	46
Austria	31	24

Source: Eurobarometer no. 48, 1998.

This table reveals that in seven countries – France, Belgium, Finland, Germany, the UK, Sweden and Austria – less than half of the persons questioned considered ‘EU membership to be a good thing’. However it must also be said that in almost all countries – with Sweden as an exception – a smaller share considered the EU to be a ‘bad thing’. After 1991 the previously rising support for the EU drastically fell as two different indicators of the Eurobarometer reveal. Figure 7.1 shows this development for the time period from 1973 to 1997.

The indicator ‘membership’ captures positive answers to the question, ‘Do you find the membership of your country in the EU (Community), generally speaking, to be a good (thing), or a bad (thing), or neutral?’

The indicator ‘benefits’ measure positive answers to the question, ‘All considered, would you say that your country has had a net benefit from the membership in the EU (Community)?’ After 1991 the two indicators



Source: Eurobarometer 1974-98.

Figure 7.1 The development of the approval of the EU over time, yearly average, 1973-97

reveal a marked reduction in the approval of the EU. In fact both indicators fell to historical lows in 1997. This alarming trend is in no way confined to new members but holds for almost every member country. In Belgium, for instance, the positive evaluation of membership rose from 1981 to 1991 from 53 per cent to 73 per cent but fell until November 1997 to 42 per cent. In Germany it increased from 54 per cent to 68 per cent and decreased to 38 per cent, and in France it rose from 52 per cent to 67 per cent and fell to 48 per cent. It seems likely that this is due to the problems discussed above, which were made more acute with the Maastricht Treaty.

Such surveys are of limited use for various reasons. They may depend on short-run influences, and there is a tendency for superficial answers. Some of the questions are also not concrete enough so that the respondents may interpret them quite differently. For example when the common currency, Euro, was introduced, it was a disputed political issue; between 55 per cent and 60 per cent of the Germans were *against* the Euro. However only 10 per cent of the Germans found 'EU

membership a bad thing', despite the Euro being almost a necessary consequence of EU membership (at least for Germany). Such inconsistencies are also obvious for other EU countries where an average 35 per cent of the respondents rejected a common currency and somewhat more than 50 per cent supported it (Eurobarometer, 1992–95). Nevertheless there exists empirical evidence (Gabel, 1998) that the responses to Eurobarometer surveys are influenced by the utilitarian consequences of integration policy.

In addition to the 'democracy deficit', the wastefulness and lack of efficiency that occur within the large-scale redistributive programmes have often been criticized. The same holds for the increasing use of unnecessary and somewhat ridiculous regulations of the Eurocracy. One of the most crucial shortcomings of the EU is its neglect of federal structures. As has been shown the EU accords the individual nations a strong position. However the EU does not endeavour to strengthen the local and regional decision-making structures and interests. Even the European regional policy contributes little to improve this situation. On the contrary it may even worsen it because the regional policy proceeds top-down and increases the dependence of the lower levels of government.

FOCJ represent a *radical* alternative: they emerge from below and finance their activity themselves. They, therefore, do not depend on the goodwill of the higher levels of government but can pursue the interests of the local citizens. As has been demonstrated in Chapter 5, concepts similar to FOCJ have a long tradition in Europe. Above all the diversity which has always characterized Europe is taken seriously. More concretely FOCJ take up and extend the often discussed concepts of 'Europe à la carte', 'variable geography', 'concentric circles' or 'Europe of different speeds'.

FOCJ are a promising means of *integrating Europe further without having to sacrifice democracy and diversity*. They present a viable option to enlarge and to deepen European integration. In the following chapter, it is argued that the countries of Eastern Europe cannot possibly become members of the EU under the existing *acquis communautaire*. The income differences to today's member countries are far too large. The transfer necessary to effect an integration in the present style appears impossible to raise. The EU has thus the choice to either maintain its present structure or to exclude most of the East European countries. As an alternative the EU could allow a flexible integration in a way similar to FOCJ.

FOCJ may also help to deepen European integration. In contrast to the prevailing view, this is not understood to be an ever-increasing

harmonization (equalization) of social and economic policy but the goal instead is increased diversity. FOCJ could achieve this goal of increased integration by cutting across existing political boundaries, and in particular across national borders.

The new kind of federalism proposed here for Europe builds strongly on developed direct participation rights of the citizens. It can be interpreted as a third historic transformation of democracy. The first transformation occurred in the first half of 500 bc. The authoritarian rules of the Greek city states were transformed into democracies by citizens' assemblies. The second grand transformation took place at the end of the eighteenth century when large-scale countries became democracies that required a representation of citizens by parliamentarians. It is now time in a third transformation to accord citizens effective democratic participation. From this point of view the EU is moving in the wrong direction. The same holds for reform proposals which endeavour to strengthen the European Parliament and the European Court of Justice. FOCJ are a promising possibility of strengthening the direct participation of citizens in an effective way by transferring political decisions to the levels most appropriate for the respective problems.

SUGGESTED FURTHER READING

The regional policy of the EU is discussed in Commission of the European Communities (1991), *The Regions in the 1990s*, Luxemburg: Office for Official Publication of the European Community.

Scientific analyses are provided by Cappelin, Ricardo and P.W.J. Batey (eds) (1993), *Regional Networks, Border Regions and European Integration*, London: Pion.
Eskelinen, Heikki and Folke Snickars (eds) (1995), *Competitive European Peripheries*, New York: Springer.

The goals and activities of the European border regions are discussed in Association of European Border Regions (1991), *Linkage Assistance and Co-operation for the European Border Regions. Cross-Border Co-operation in Practice*, Gronau: Euregio.

The working of the European Court is the subject of Rasmussen, Hjalte (1986), *On Law and Policy in the European Court of Justice*, Dordrecht: Nijhoff.

The possibilities and shortcomings of courts of account are analysed by Frey, Bruno S. (1994), 'Supreme Auditing Institutions: A Politico-Economic Analysis', *European Journal of Law and Economics*, 1, 169-76.

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PART III

Beyond Europe

8. Europe and the world

Europe today is divided into two: nations inside and nations outside the EU. If one looks at Western Europe, all the major countries are inside; the only exceptions are Switzerland and Norway (and some mini states such as Monaco or Liechtenstein). Competing institutions for economic integration such as EFTA or EEA have all become negligible. In Eastern Europe none of the former Soviet-dominated countries so far is a member of the EU. However at least 10 countries aspire for membership: the three Baltic states, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania and Bulgaria. There are also other countries that would like to become members. Turkey, for example, handed in its application several years ago, and Cyprus and Israel are also interested. But also the former parts of Yugoslavia and Belorussia, Ukraina and even Russia are seriously considering whether they should join.

It may even be possible that the EU will grow beyond Europe in the future. This does not only apply to Asia (with Israel, Cyprus and the larger parts of Turkey and Russia) but several countries in North Africa are also potential members. It cannot even be totally excluded that members of the North American Free Trade Association (NAFTA), Canada, the USA and Mexico, will join the EU.

The major obstacle to such an enlargement is the *acquis communautaire*, that is, the formal requirement of all new member countries to accept the basic 'constitution' of the EU. From today's point of view it seems most unlikely that several of these countries, in particular the USA, would be prepared to give up essential parts of their own constitution in order to become members. The *acquis communautaire* will also create great problems for the East European countries that stand a good chance of becoming members: Estonia, Poland, the Czech Republic, Hungary and Slovenia. In addition redistribution is an acute problem. If the *same* criteria were now used to govern the redistributive flows, the burden on existing EU members would be very large, and possibly too heavy to bear. Some present recipients of the harmonization flows within the EU would lose this privilege and would become net payers – a prospect they would not be particularly fond of.

EU politicians are, of course, well aware of the *fundamental trade-off* they face. If they adhere precisely to the *acquis communautaire* and the redistributive flows going with it, few, if any, new member states will be able to join. By not being part of the huge Western European free trade zone established by the EU, their economic development is strongly hindered. The exclusion may even increase political unrest in these countries, and a return to totalitarian planning is not unlikely. On the other hand if EU politicians are prepared to loosen the *acquis communautaire* and redefine the criteria for redistribution, integration may be possible but the nature of the EU would change drastically. EU politics thus finds itself in a most difficult position. It does not seem likely that the trade-off identified can be solved in a satisfactory way.

The major problem lies in the fact that the EU is organized along *nations* instead of along *functions*. Further integration within Europe and even beyond would be possible if the kind of variable and flexible federalism proposed here were adopted. In a system of FOCJ, each commune would choose according to which functions it wants to team up with other communes. A whole web of FOCJ would emerge. It might involve many functions within Europe, but some with strong ties bridging the continents. Clearly such an integration would differ from the one which the EU is based on because it would transcend existing national borders in a much more extensive way. At the same time the historically grown nation states may survive in a leaner but fitter shape if they fulfil useful functions.

If Europe is viewed from the point of view of this concept of federalism and integration, one immediately observes that functional units already exist which link the Europeans and beyond. Consider, for example, statistics and policy advice which are offered by the Organization of Economic Co-operation and Development (OECD) which includes non-European members such as Canada, the USA, Mexico, Japan, Korea or Australia. Another case is defence provided by NATO. Defence also highlights the overlapping nature of many functional units. On one hand, there are members of the EU (Ireland, Sweden, Finland and Austria) that are neither members of NATO nor members of the Western European Union (WEU), the European alliance for defence. Denmark, in contrast, is a member of NATO but not of the WEU. On the other hand there are members of NATO that are not in the EU – the USA, Canada, Norway, Turkey and Iceland.

Yet another example would be culture or sports whose transnational functions have been taken care of by virtually hundreds or thousands of organizations. An example is the European Football Association (UEFA) which organizes several important football events with locally

based clubs (that is, the nation states no longer play a role). Indeed some of these competitions such as the Cup-Winners' Cup, the Champions' Cup or the Champions' League, and even the UEFA Cup (with lower-ranking football teams) have become very prominent, and sometimes overshadow competition between national teams.

SUGGESTED FURTHER READING

The danger of a breakdown of the EU as a result of regional incommensurabilities and the impossibility of integrating the East European countries are discussed in

Hama, Noriko (1996), *Disintegrating Europe. The Twilight of the European Construction*, London: Adamine Press.

Newhouse, John (1997), *Europe Adrift*, London: Pantheon.

A lively discussion of the costs and benefits of Eastern enlargement of the EU is provided by

Baldwin, Richard E., Joseph F. Francois and Richard Portes (1997), 'EU Enlargement. Small Costs for the West, Big Gains for the East', *Economic Policy*, **24**, 125–70,

and several participants of an *Economic Policy* panel, most noteworthy being Rodrik, Dani (1997), 'Discussion on Baldwin, Francois, and Portes', *Economic Policy*, **24**, 170–72.

9. FOCJ and developing countries

The concept of FOCJ is not only suited for industrial countries. It can also be fruitfully applied to developing countries whose problems are mainly due to inadequate governmental institutions.

9.1 TOO MUCH AND TOO LITTLE GOVERNMENT

Economic growth in many developing countries is hampered by excessive government. The state tends to interfere in almost all activities and endeavours to regulate them minutely. The government sector which is often very large, employs a high proportion of the population outside agriculture. The administration tends to be more bureaucratic than in industrial countries. In addition, rent-seeking distortions are rampant (for instance public officials often receive much higher incomes relative to other occupations) and waste is pervasive. Many public employees do not really work in a productive sense, and some rarely show up for work. This combination of interventionism and bureaucracy stifles investment and innovation in the private sector.

As a result of this, *over-government* prevails in the developing countries. At the same time, however, many governments do not adequately fulfil the functions necessary for rapid economic growth. Most importantly they secure the property rights which are needed for private economic activities only insufficiently. Investors are faced with a high degree of uncertainty and are, therefore, reluctant to commit themselves in the long run. Instead of concentrating on productive endeavours, investors are devoting their time and money finding substitutes for the deficient property rights.

Governments in most Third World countries are inadequate in a second, quite different sense. They are far from meeting the wishes of the citizens; many are either strongly paternalistic or even dictatorial. Changes in government rarely consider the preferences of the ordinary citizens. Rather, they merely substitute one group of the reigning élite or military with another. While the preferences of the city dwellers – in particular of the capital – are at least taken into account as far as

to evade an uprising, the preferences of the population living in the countryside are almost totally disregarded. While some Third World countries are officially federal, central governments distance themselves from the fragmented local problems and demands, and consequently neglect them. Often interference by the central government actively destroys traditional, well-working production and distribution arrangements, in particular self-governing units.

Developing countries are thus faced with a paradoxical situation: at the same time there is 'over-government' (that is, interventionism which hinders economic progress) and 'under-government' (too few governments caring for the fragmented local problems). Our proposal of FOCJ can overcome this paradoxical situation as it allows for a large number of governments that are based on grass-roots local democracy to check government and prevent it from evolving into an oppressive and intervening bureaucracy. Of course the concept of FOCJ deviates strongly from existing developing plans. It is worth observing that a large part of the economic literature on development does not deal with the structure of government. The failures of government are duly noted, but proposals for overcoming the lacuna are rarely advanced. To just hope that the future will bring 'better politicians' is unfounded optimism. As Modern Political Economy has convincingly shown, politicians are not 'bad' or 'good' as such, but it is the political institutions which make them, or allow them to behave in a particular way. Government will only improve if the underlying institutional conditions are changed. This is exactly the aim of the proposal in this study: with FOCJ the basic governmental units are defined by the various functions which the state has to fulfil to enable development. These jurisdictions are formed according to the 'geography of problems', that is, by the citizens seeking to cope with issues they are confronted with. The new type of federalism – unlike most existing federal units – is not imposed from above (sometimes by the former colonial powers) but forms from below.

The local power to impose taxes as an essential ingredient of FOCJ will also prove decisive for developing countries. Whenever the central government allocates funds (as it is the rule in today's 'federal' developing countries), the lower level units become dependent on it, so that most of the advantages of decentralization are lost. Under these circumstances decentralization is not necessarily beneficial. In a system in which the finance is allocated by the centre, the lower units are liable to become fiscally irresponsible. Local authorities tend to borrow too much on the (normally correct) assumption that they will be bailed out by central government if they run into trouble. In Brazil, for example, the São Paulo region has accumulated a debt of \$40 billion, over 7 per

cent of the country's GDP (Tanzi, 1995). In contrast, if FOCJ have the power to levy their own taxes, the population would have to carry the cost of bad politics, therefore, governments have an incentive to observe the budget constraint and to behave in a fiscally responsible way.

9.2 BENEFITS OF FOCJ FOR DEVELOPING COUNTRIES

FOCJ produce major advantages over the existing form of government in developing countries:

- (a) They break the central government's effort to monopolize politics which would otherwise stifle economic development and oppress the citizens. FOCJ shift the political power to initiatives from below. Effective local governments become viable because they have authority over a particular government function, and may raise taxes to finance the respective expenditures.
- (b) FOCJ allow for combinations of various forms of political rules. They do not only blend federalism and democracy, that is, exit and voice, but also modern and traditional styles of governing such as meetings by village elders. Time-proven local ways of public decision-making are not dumped but are used and fostered in those areas in which they prove to be effective.
- (c) FOCJ solve the 'fundamental organizational dilemma' between an open polity and decentralized development at the local level: '... one of the necessary (though far from sufficient) conditions of a development state [is] a large degree of insulation that the development-minded decision-makers can have against the ravages of short-run pork-barrel politics and their ability to use the discipline of the market (...) against the inevitable follies of group predation' (Bardhan, 1993, p. 46). This insulation is made possible in a system of FOCJ by the establishment of new, growth-oriented development units which are, however, disciplined by economic and political competition.
- (d) FOCJ deal with another 'fundamental dilemma of government' (Montignola *et al.*, 1995, pp. 54–5). The state has to be strong enough to enforce legal rules and especially property rights which are prerequisites for economic development. At the same time government institutions have to be 'weak' in the sense of not exploiting the citizens, for example, by expropriating them without

compensation or taxing them excessively. FOCJ are able to convey credible limits against such exploitation because each FOCUS is self-financed and may go bankrupt, thus imposing a hard budget constraint. In a system of FOCJ individuals and firms do not face a monopolistic and therefore oppressive state, but may resort to substitutes.

- (e) There is an emphasis on local public production and efficient polycentric organization. This aspect has been much neglected in the literature.
- (f) The fiscal decentralization induced by FOCJ reduces the volatility in macroeconomic variables (for instance, in budget deficits and income growth).
- (g) The concept of FOCJ overcomes the fruitless contradiction of 'government versus market' which was typical of many of the writings on developing countries (Ostrom, 1990; Klitgaard, 1991). FOCJ mark a radical departure from much of the earlier literature on developing countries that emphasized the need for a strong, well-organized central state and bureaucracy to steer and support economic growth. They depart from the more recent exclusive emphasis on private property and free markets as the key to successful development. In both cases local governments needed for economic growth are neglected.

9.3 COUNTER-ARGUMENTS

Some people may consider the claim that FOCJ are also advantageous to developing countries to be too optimistic and naively neglect the specific conditions reigning there. In the following three related assertions which are often raised are refuted:

1. FOCJ do not meet with the traditions in developing countries which are neither federalistic nor democratic.

This historical critique is factually incorrect. The pre-colonial political system in developing countries was characterized by various forms of self-government though they, of course, did not meet the criteria of democracy which we are familiar with. Vestiges remain even today, but this traditional way of governing was on the whole destroyed by the authoritarian colonial rule. Post-colonial governments wanted to centralize as much power as possible in their hands and consequently destroyed traditional local rule.

2. FOCJ are unsuitable for developing countries.

The 'culturalist position' maintains that individuals in developing regions are basically different from Westerners and, therefore, need a different form of government, arguably a more authoritarian one. A popular version of this belief is that people in Third World countries lack the discipline and initiative to form FOCJ. The economic approach to human behaviour suggests the opposite causation. The lack of discipline and initiative observed is the *consequence* (and not the cause) of unfavourable institutional settings. Three types of empirical observations strongly support the economic view:

- (i) When individuals in developing countries shed the stifling restrictions imposed upon them by government bureaucracies, they become active and venturesome. Thus de Soto (1989) has shown for Peru that people who are passive within the confines of the highly regulated and inimical official sector become enterprising and energetic once they act in the unofficial or shadow economy. This observation does not only apply to Peru but also to all developing countries as casual observation (for instance, the dramatic changes in Asia) and scientific research show. Indeed the unofficial economy is extremely lively but has, of course, limits. The people who are active in it evade taxes and disregard public regulations, and become independent. Such an emancipation of the population from the (central) government is dangerous for the political class because it demonstrates that it is not needed, at least not for some purposes. As a consequence existing governments make strong efforts to clamp down on the unofficial economy (but, fortunately, often with little success). In contrast FOCJ constitute a means of reintegrating the shadow sector into the official economy without destroying its vigour.
- (ii) Empirical evidence shows that to the extent self-governance could be preserved, it often functions well and is even able to solve difficult common property resource problems (Wade, 1988; Ostrom, 1990; Ostrom *et al.*, 1993).
- (iii) Even experiences with an extreme form of democracy, popular referenda, are positive provided they are devoted to substantive issues and not simply plebiscites to support the authoritarian or dictatorial rulers (Rourke *et al.*, 1992). If citizens in developing countries are taken seriously, they do participate in political affairs (for Africa, for example, see Chazon, 1994; for Mexico, see Oberreuter and Weiland, 1994).

3. FOCJ worsen inequality.

Many people believe that central governments promote equality while federal systems make the rich richer and the poor poorer. Central governments are at best *formally* committed to an 'equal' provision of public services but in actual fact, there are huge differences in the services provided across the country – Ostrom *et al* (1993, p. 211) speaks of a 'myth of equality'. Typically the population in the capital is grossly favoured, in particular, by highly subsidized food, while the much poorer inhabitants in the rural areas are taxed (Bates, 1988). FOCJ redress such imbalances because they are based on decentralized decision-making and subsequently allow regional and local development of the natural and human resources to be made available.

SUGGESTED FURTHER READING

The interdependence between economy and polity in the process of development is analysed in

Diamond, Larry (ed.) (1994), *Political Culture and Democracy in Developing Countries*, Boulder: Lynne Rienner.

World Bank (1997), *The State in a Changing World. World Development Report 1997*, New York: Oxford University Press.

An economic analysis of the interaction between democratization and economic growth is provided by

Barro, Robert (1997), *Determinants of Economic Growth: A Cross-country Empirical Study. Lionel Robbins Lectures*, Cambridge: MIT Press.

The role of federalism for economic development is the subject of

Bird, Richard M. and François Vaillancourt (eds) (1999), *Fiscal Decentralization in Developing Countries* New York: Cambridge University Press.

Economic programmes and conceptions are the subject of

Frey, Bruno S. and Reiner Eichenberger (1994), 'The Political Economy of Stabilization Programmes in Developing Countries', *European Journal of Political Economy*, 10, 169–90.

Krueger, Anne O. (1992), *The Political Economy of Agricultural Pricing Policy. Vol. 5. A Synthesis of the Political Economy in Developing Countries*, Baltimore: Johns Hopkins Press.

The outdated confrontation of 'state vs market' is criticized in

Klitgaard, Robert (1991), *Adjusting to Reality. Beyond 'State versus Market' in Economic Development*, San Francisco: KS Press.

A careful theoretical and empirical analysis of self-government to overcome commons problems typical for developing countries is provided in

Ostrom, Elinor (1990), *Governing the Commons: The Evolution of Institutions for Collective Action*, Cambridge: Cambridge University Press.

Ostrom, Elinor, Larry Schroeder and Susan Wynne (1993), *Institutional Incentives and Sustainable Development*, Boulder: Westview Press.

The self-initiative of people in developing countries outside the official sector is emphasized by

Hernando de Soto (1989), *The Other Path: The Invisible Revolution in the Third World*, New York: Harper and Row.

10. Conclusions

This book was started with a conviction, which has been empirically well supported, that federalism and direct democracy are excellent institutions with which to induce government to meet the demands of the population. A concrete solution in the form of FOCJ has been suggested to promote decentralization and referenda (Chapter 1). FOCJ have great advantages over present arrangements as they are able to minimize spillovers which tend to distort government behaviour, to exploit the technically determined economies of scale of producing public services, and to provide local public goods efficiently (Chapter 2).

While FOCJ are able to deal with a wide range of public functions, the whole approach is process-oriented. It thus specifies how the necessary decisions are to be reached but it does not determine what functions are to be provided by what jurisdiction. The basic idea is to establish competition among jurisdictions as a 'fifth freedom' to complement the four freedoms of mobility of goods, services, capital and labour which are well entrenched in most countries and in the EU. Spatial competition requires the free entry and exit of communes and in some cases also of citizens. This freedom must be guaranteed by a constitutional 'market order' similar to the one which exists in economic competition. But FOCJ also rely on political competition effected by the direct participation of citizens in decision-making (Chapter 3).

Although the idea of FOCJ is new and perhaps unorthodox, it builds on well-established elements in modern economics: the theory of spatial competition, the notions of exit and voice, club theory and the concept of fiscal equivalence (Chapter 4). Moreover our proposal shares important traits with ideas such as flexible integration, demarchy and sociological federalism. FOCJ are a realistic proposal and its important aspects can already be observed in reality. Features of FOCJ can be found in history as well as today's Switzerland and the USA (Chapter 5).

In this study FOCJ are considered significant for the emerging constitution of the EU not least because the diversity of demands among the citizens and geographical units is even larger than within nation states (Chapter 6). The concept is also directly relevant to many of those European countries that are overcentralized, and leave few, if any,

decisions to the local electorate. 'Regionalism' as understood by EU politicians does not contribute to decentralization in a real way because European regional policy works from the top down. In particular regional subunits are not given the essential power to tax. In contrast FOCJ emerge from below and may decide on their own taxation laws. This procedure allows for greater variety and diversity. All this can be put into effect without endangering the great achievements of the European integration, free trade and free factor mobility (Chapter 7).

Over the coming years and decades, the EU will have to deal with the enlargement in the East. The former communist countries have completely different economic structures, needs, traditions and institutions, yet the EU seems surprisingly little prepared to meet this challenge. Clearly such integrations require major changes in the basic institutions and financing of the EU. FOCJ offer attractive properties to meet this challenge (Chapter 8). The concept is also well suited for developing countries that need, on the one hand, strong government in the sense of efficient institutions for the provision of public goods. However, on the other hand, they need less government with regard to public intervention in the economy and society. The argument is that FOCJ are well suited to balance these requirements (Chapter 9).

The idea of FOCJ is not driven by any particular ideology (except for the normative position that politics should function according to the citizens' preferences), and it does not suggest perfect, simple nor ready-made solutions. Nor does it require an all-or-nothing decision. It may sometimes appear surprising and perhaps even shocking but it allows for introduction on a step-by-step basis. The beneficial features of the concept already show even if it is only applied with regard to *some* functions and a *few* members. This does not mean that FOCJ emerge all by themselves. Even if political competition works well to the advantage of citizens, established politicians who see their power reduced will make an effort to block or at least undermine the concept. It is, therefore, necessary to openly and seriously discuss the proposal in order to make the advantages generally known and accepted by the population. In our (democratic) societies the citizens then have the means to effect FOCJ by rewriting the constitutions such that they may emerge.

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