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2 A proposal for a new dynamic federalism in Europe

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The coming together of Europe is a fascinating and wonderful development. It seeks to overcome the perennial strife between the European nations whose worst manifestations were the two world wars of the last century. It should also solve the ongoing civil wars of long duration and bitterness that still plague this continent: in the former Yugoslavia, Ireland, the Basque country and Corsica. European history is not just a catalogue of belligerent behaviour. Europe can be proud of its achievements in the arts, sciences, and in its way of life. The basis of it all is *diversity*: a Scot is unlike a Sicilian, a Breton unlike a Bavarian, and an Andalusian unlike a Åland islander, and so on.

The vision developed in this chapter is based on these two basic ingredients: the future Europe has to be peaceful, and maintain its diversity. The proposal of democratic decentralised jurisdictions drastically differs from the European Union existing today. In particular, it emphasises the citizen in the political process, and proposes to decentralise the political process to the functionally most appropriate level. The proposal thus seeks to redress the two well-known and often lamented shortcomings of the European Union: its 'democratic deficit' and its 'decentralisation deficit'. The proposal in this chapter also differs markedly from other reform plans, seeking to mitigate the two deficits, which are currently being discussed.

The favoured answer to the democratic deficit is said to lie in further strengthening the European Parliament. But this measure does not necessarily engage the citizens of the European Union (EU) more fully in the political process. Rather, it may even increase the distance between the citizens and the decision-making body (Strasbourg or Brussels are even more remote than the national capital). Moreover, the concentration of over 600 professional politicians tends to invite the formation of yet another '*classe politique*', now at the European level, similar to the 'Eurocrat' counterpart of national bureaucrats.

The current plan to mitigate the 'decentralisation deficit' does not fare any better. It invokes the principal of subsidiarity, something that is ineffective as long as the regions of Europe financially depend on Brussels and the central governments of their nations. Political decentralisation requires the power to tax at lower echelons of government. And only then are they induced and able to balance the

benefits and costs of public expenditure. Only then is there fiscal responsibility, and only then will politicians be motivated to use scarce resources for the benefit of the citizenry at the grass-root level.

The vision proposed here is quite radical, and perhaps difficult to accept, but not outlandish:

1. The proposal of democratic decentralised jurisdictions is based on concepts central to economics, and in particular to the economic theory of federalism (Bird 1993; Breton 1996), for example, 'fiscal equivalence', 'voting by foot' or 'clubs'. However, they are combined in new ways, yielding a different type of federalism.
2. The proposal can be put into reality. Indeed, there are pertinent examples in history. Most importantly, the proposal can be introduced gradually.
3. The proposal does not require the dismantling of the nation states forming the European Union. Though nationalism has done enormous harm to Europe in the twentieth century, it is still a powerful force, and there is little sense in directly attacking it. But what is proposed is that there should be other jurisdictions besides it, and that the nation's right of existence has to be demonstrated by its effectiveness to efficiently care for the preferences of the population.

The proposal should not be understood to be a wholesale critique of the European Union. Rather, European integration has been very successful in opening markets within its confines. The four freedoms of liberal trade with respect to goods, services, capital and labour have been achieved to a considerable degree. Though protectionist tendencies still exist and make themselves felt almost daily, the European Union can be proud of having achieved a free market covering almost the whole of Western Europe.

The European Union is, however, not just a success story, but also one of failure. A flawed concept of Europe has increasingly taken over, and the unification process has taken a wrong turn. While these tendencies have accumulated over time, they have become dominant recently. This mistaken concept of Europe consists in identifying integration with *homogenisation* and *harmonisation*. There are hundreds of laws and directives in the European Union working in this direction. But the essence of Europe is its diversity. The strength of Europe is its wide variety of ideas, cultures and policies. Diversity, and not unity, has been the crucial element of Europe's rise in history and continues to be so. A homogenised Europe loses its *raison d'être*, and will lose its economic and political role.

Integration should serve to foster this variability. It should set the rules under which the strength of the manifold components of Europe can develop. Opening up economic markets for free trade is exactly such a beneficial rule: it allows suppliers to specialise in the production of differentiated goods and services following the law of comparative advantage. However, no such open and competitive market for politics has been established. On the contrary: competition between

governments was successfully restricted by the various European treaties and institutions. No steps have been undertaken to actively institutionalise competition between governmental units at all levels. Welfare can be improved substantially by promoting competition between newly emerging jurisdictions that are organised along functions instead of territories. The fifth freedom suggested here allows for such *functional, overlapping competing jurisdictions*. They will be called by their acronym FOCJ (any one jurisdiction is called FOCUS). FOCJ form a federal system of governments that is not dictated from above, but emerges from below as a response to citizens' preferences. This fifth freedom requires a constitutional decision (B.S. Frey, 1983; Mueller, 1996) which ensures that the emergence of FOCJ is not blocked by existing jurisdictions such as direct competitors or higher levels of government. The European Constitution must give the most basic political units (communities) a certain degree of independence so that they can engage in forming FOCJ. Citizens must be given the right to establish FOCJ by popular referenda, and political entrepreneurs must be supported and controlled by the institution of popular initiatives. The FOCJ themselves must have the right to levy taxes to finance the public services they provide.

The first section specifies the concept of FOCJ and puts it into theoretical perspective. The next section evaluates FOCJ and discusses how the problems related to this type of jurisdictions may be overcome. The third section points to historical precursors, and the following section presents contemporary examples of FOCJ. In the fifth section the concept of competitive federalism is contrasted to other proposals. The final section offers concluding remarks.

The proposal: FOCJ

The federal units proposed here have four essential characteristics. They are as follows.

- *Functional (F)*: the new political units extend over areas defined by the tasks to be fulfilled;
- *Overlapping (O)*: in line with the many different tasks (functions) there are corresponding governmental units extending over different geographical areas;
- *Competing (C)*: individuals and/or communities may choose the governmental unit they wish to belong to, and they have the political right to express their preferences directly via initiatives and referenda;
- *Jurisdictions (J)*: the units established are governmental, they have powers of enforcement and can, in particular, levy taxes.

FOCJ are based on theoretical propositions advanced in the economic theory of federalism. They nevertheless form a governmental system completely different to the one suggested in that literature. While the economic theory of federalism

analyses the behaviour of given political units at the different levels of government, FOCJ emerge in response to the 'geography of problems'.¹ The four elements of FOCJ are now related to economic theory as well as to existing federal institutions, pointing out both similarities and differences with existing concepts.

Functions

A particular public service, which benefits a certain geographical area, should be financed by the people living in that locality; there should be no spillovers. Different governmental units can cater for regional differences in the populations' preferences or, more precisely, to its demands. To minimise cost, these units have to exploit economies of scale in provision. As the latter may strongly differ between functions (say, between schools, police, hospitals, power plants and defence), there is an additional reason for uni-functional (or few-functional) governmental units of different sizes. This is the central idea of 'fiscal equivalence' as proposed by Olson (1969) and Oates (1972). This endogeneity of the size of governmental units constitutes an essential part of FOCJ. However, fiscal equivalence theory has little concern with decision-making within functional units. The supply process is either unspecified, or it is assumed that the mobility of persons (and of firms, a fact rarely mentioned) automatically induces these units to cater to individual preferences.

Overlaps

FOCJ may overlap in two respects: (i) FOCJ catering to different functions may overlap; (ii) two or more FOCJ for the same function may geographically intersect (a multitude of school FOCJ may exist in the same geographical area). An individual or a political community normally belongs to various FOCJ at the same time. FOCJ need not be physically contiguous, nor have a monopoly over a certain area. Thus, this concept completely differs from archaic nationalism with its struggle over territory. It also breaks with the notion of federalist theory that states that units at the same level should not overlap. On the other hand, in that respect it is closer to Buchanan's (1965) 'clubs' which may intersect.

Competition

The heads of FOCJ are induced to conform closely to their members' preferences via two mechanisms: the individuals' and communities' option to exit, mimicking market competition (Hirschman, 1970), and their right to vote, establishing political competition (Mueller, 1989). It should be noted that migration is only one means of exit; often, membership in a particular FOCUS can be discontinued without changing one's location. Exit is not restricted to individuals or firms; as indicated earlier, political communities as a whole, or parts of them may also exercise this option. Moreover, exit may be total or only partial. In the latter case, an individual or community only participates in a restricted set of FOCUS activities.

Secession rights ought to be an important ingredient for a future European constitution, as advocated by Buchanan (1991) and the European Constitutional

Group (1993). This is in marked contrast to the prevailing system within nation states and federations where the right to secede is usually absent and prevented by force. Current European treaties do not provide for the secession of a nation from the European Union, and *a fortiori* for part of a nation.

For FOCJ to establish competition between governments, exit should be as unrestrained as possible. In contrast, entry need not necessarily be free. As in Buchanan-type clubs, jurisdictions and individuals may be asked to pay a price if they want to join a particular FOCUS and benefit from its public goods. The existing members of the particular FOCUS have to democratically decide on an adequate entry price for a new member.

Competition also needs to be fostered by political institutions, as the exit option does not suffice to induce governments to act efficiently. Citizens should directly elect the persons managing the FOCJ, and should be given the right to initiate popular referenda on specific issues. These democratic institutions are known to raise efficiency in the sense of catering to individual preferences; on elections, see Downs (1957) and Mueller (1989); on referenda B.S. Frey (1994).

Jurisdictions

A FOCUS is a democratic governmental unit with authority over its citizens, including the power to tax. Two forms of membership can be distinguished. First, all citizens automatically become members of the FOCJ to which their community belongs. In that case, an individual can only exit via mobility. Second, individuals may freely choose whether they want to belong to a particular FOCUS, but while they are its citizens, they are subject to its authority. Such FOCJ may be involuntary in the sense that one must belong to a FOCUS providing a certain function, say schooling, and must pay the corresponding taxes. An analogy here is health insurance, which in many countries is obligatory, but where individuals are allowed to choose an insurance company. The citizens of such a school-FOCUS may then decide that everyone must pay taxes in order to finance a particular school, irrespective of whether one has children. With respect to FOCJ providing functions with significant redistributive effects, a minimal regulation by the central government may be in order so that, for instance, citizens without children do not join 'school-FOCJ' which in effect do not offer any schooling and have correspondingly low (or zero) taxes. In this respect, Buchanan-type clubs differ from FOCJ, because they are always voluntary, while membership in a FOCUS can be obligatory.

An evaluation of FOCJ

Benefits

FOCJ compare favourably to traditional forms of federalism. Due to the concentration on one functional area, the citizens of a particular FOCUS have better information on its activity, and are in a better position to compare its performance with other governments. As many benefits and costs extend over a relatively limited

geographic area, FOCJ are often likely to be small. The exit option, which arises from the existence of overlapping jurisdictions, can guarantee that suppliers take individual preferences into account.

On the other hand, FOCJ are able to provide public services at low cost because they are formed in order to minimise interjurisdictional spillovers and to exploit economies of scale. When the benefits of a specific activity indivisibly extend over large areas, and there are decreasing costs, the corresponding optimal FOCUS may cover many communities, several nations, or even Europe as a whole. An example may be defence against outward aggression where the appropriate FOCUS may extend over the whole of Europe (and beyond the European Union).

The threat of exit by dissatisfied citizens or communities, and the benefit of new citizens and communities joining the FOCUS, gives an incentive to take individual preferences into account and to provide the public services efficiently. Another advantage of FOCJ is that they open up the politicians' cartel (*classe politique*) to functionally competent outsiders. While all-purpose jurisdictions attract persons with non-specialised knowledge into the political arena, in FOCJ, persons with a well-grounded knowledge in a particular functional area (say education or refuse collection) are successful.

A federal web composed of FOCJ certainly affects the role of nation states. They will certainly lose functions they presently do not fulfil according to the population's preferences, or which they produce at higher cost than FOCJ designed to exploit cost advantages. On the other hand, the scheme does not purport to do away with nations but allows for multi-national as well as small-scale alternatives where citizens desire them. Nation states continue in so far as they provide functions efficiently according to voter preferences.

Alleged problems

Up to this point the advantages of FOCJ have been emphasised. However, there are also possible problems that are now discussed.

Overburdened citizens

In a federal system of FOCJ, each individual is a citizen of various jurisdictions. As a consequence, individuals may be overburdened by voting in elections and referenda taking place in each FOCUS. However, citizens in a direct-democratic FOCUS find it much easier to politically participate as they have only to assess one or a few concrete issues at a time.

Overburdened consumers

An individual is confronted with a multitude of suppliers of public services, which could make life difficult. This is the logical consequence of having more options to choose from, and is similar to supply in the private sector. If citizens neverthe-

less find it to be a problem, a governmental or a private advisory service can be established which offers information and support to consumers.

'Need' to coordinate the activities of FOCJ

While co-ordination is obviously often needed, co-ordination between governments is not necessarily beneficial. It sometimes serves to build cartels among the members of the *classe politique* who then evade or even exploit the population's wishes (see CEPR, 1993; Vaubel, 1994; B.S. Frey, 1994). As far as welfare increasing co-ordination is concerned, its need is reduced because the FOCJ emerge in order to minimise externalities. If major spillovers between FOCJ exist, new FOCJ will be founded taking care of these externalities.

Redistribution

It may be claimed that all forms of federalism – including FOCJ – undermine redistributive goals. Moreover, the formation of FOCJ could be based on members' income. This fear is unwarranted, as long as redistribution is based on solidarity, or on insurance principles. A problem emerges when redistribution is a pure public good, and requires enforcement to prevent free-riding. However, recent empirical research (Gold, 1991; Kirchgässner and Pommerehne, 1996) suggests that substantial redistribution is feasible in federal systems.

Historical precursors

Decentralised, overlapping political units have been an important feature of European history. The competition between governments in the Holy Roman Empire of German Nations, especially in what is now Italy and Germany, has been intensive. Several of these governments were small. Many scholars attribute the rise of Europe to this diversity and competition between governmental units, which fostered technical, economic and artistic innovation (see Hayek, 1960; Jones, 1981; Rosenberg and Birdzell, 1986; and Weede, 1993). The unification of Italy and Germany in the nineteenth century, which has often been praised as a major advance, partially ended the stimulating competition between governments and led to deadly struggles between nation states. Some smaller states escaped unification: Liechtenstein, Luxembourg, Monaco, San Marino and Switzerland stayed politically independent, and at the same time grew rich.

The above-mentioned governmental units were not FOCJ in the sense outlined in this contribution but they shared the characteristic of competing for labour and capital (including artistic capital) among each other. However, history also reveals examples of jurisdictions even closer to FOCJ. The problems connected with Poland's strong ethnic and religious diversity (Catholics, Protestants and Jews) were at least partly overcome by jurisdictions organised along these lines, and not along geography (Rhode, 1960). The highly successful Hanse prospered from the twelfth to the sixteenth centuries, and comprised *inter alia* Lübeck, Bremen, Köln

(today German), Stettin and Danzig (today Polish), Kaliningrad (today Russian), Riga, Reval and Dorpat (today parts of the Baltic republics) and Groningen and Deventer (today Dutch). Furthermore, London (England), Bruges and Antwerp (today Belgian) and Novgorod (today Russian) were Handelskontore or associated members. It was clearly a functioning governmental unit providing trade rules and facilities that were not geographically contiguous.

Partial existence today

In two countries functional, overlapping and competing jurisdictions exist to some degree. They do not in all cases meet all the requirements of FOCJ specified above, but nevertheless show that democratic functional jurisdictions are viable.

US special districts

Single-purpose governments play a significant role in the American federalist system. Their number has increased more quickly than other types of jurisdictions (Zax, 1988). There are both autonomous and democratically organised as well as dependent special districts (say for fire prevention, recreation and parks). Empirical research suggests that the former type is significantly more efficient (Mehay, 1984). Existing jurisdictions tend to oppose the formation of special districts. In order not to threaten the monopoly power of existing municipalities, statutes in eighteen states prohibit new municipalities forming within a specified distance from existing municipalities; in various states there is a minimum population requirement and various other administrative restrictions have been introduced (Nelson, 1990). Empirical studies reveal that these barriers tend to reduce the relative efficiency of the local administration (DiLorenzo, 1981; Deno and Mehay, 1985), and tend to push local government upwards (Martin and Wagner, 1978).

Swiss communes

Many Swiss cantons have a structure of overlapping and competing functional jurisdictions that share many features of FOCJ. For example, in Zürich (with a population of 1.2 million, an area of 1,700 square kilometres, and tax revenue of CHF 2,800 million) there are 171 political communes (with a tax revenue of CHF 3,900 million) which in themselves are composed of three to six independently managed, democratically organised communes devoted to specific functions and raising their own taxes. Examples for such types of functional communes can be found in Zürich as well as in the cantons of Glarus and Thurgau (for the latter, see Casella and B.S. Frey, 1992). Cantonal bureaucracy and politicians have made various efforts to suppress this diversity of functional communes. However, most of these attempts have been thwarted as the population is satisfied with existing provision. The example from Switzerland – generally considered to be a well organised and administered country – shows that a multiplicity of functional jurisdictions under democratic control is not wishful thinking but has worked well in reality.

Comparison to other proposals

FOCJ differ in many crucial respects from other proposals for a future European constitution. One of the most prominent is Buchanan (1991) who stresses individual nation's right to secede but, somewhat surprisingly, does not build on Buchanan-type clubs. The European Constitutional Group (1993) focuses on the example of the American constitution, and presents constructivist proposals with respect to the houses of parliament and the apportioning of weighted voting rights amongst countries. Overlapping jurisdictions and referenda are not considered, and the exit option is strongly restricted. Other economists (such as Blöchliger and R.L. Frey, 1992; Schneider, 1992) suggest a strengthening of federalism in the traditional sense (i.e. with multi-purpose federal units) but do not envisage overlapping jurisdictions. Reports by the Centre for Economic Policy Research (CEPR, 1993, 1995) criticise 'subsidiarity' (as used in the Maastricht Treaty) as an empty concept arguing that good theoretical reasons must be provided for central government intervention. But the report does not deal with the institutions necessary to guarantee that policy follows such theoretical advice: The idea of overlapping, not geographically based jurisdictions is briefly raised (CEPR, 1993: 54–5), but is not institutionally or practically worked out, nor is the need for a democratic organisation and the power to tax recognised.

The proposal by politicians at the European level (Herman report of the European Parliament, 1994) mainly deals with the organisation of the parliamentary system and national voting rights, and to a substantial extent accepts the existing treaties as the founding blocks of the European constitution. The crucial idea of competition between governments is neglected; the report prefers to speak of the necessary 'co-operation' between governments – which in actual fact often serves to undermine the threat of competition.

FOCJ are also quite different from the regions envisaged in existing European treaties and institutions (see Adonis and Jones, 1991). A major difference is that FOCJ emerge from below while the 'European regions' tend to be established from above. Moreover, their existence strongly depends on the subsidies flowing from the European Union and the nation states (Sharpe, 1993). In contrast, the concept of FOCJ corresponds to Hayek's (1960) non-constructivist process view. One cannot, *a priori*, determine which FOCJ will be efficient in the future. This must be left to the competitive democratic process at the level of individuals and communities. The central European constitution must only make sure that no other governmental units, particularly nations, obstruct the emergence of FOCJ. In contrast to Hayek, however, the scheme allows for a (closely restricted) set of central regulations, as mentioned above. Moreover, Hayek measures efficiency by survival in the evolutionary process while efficiency is defined here in terms of the fulfillment of citizens' demands.

'Subsidiarity' as proclaimed in the Maastricht Treaty is generally recognised to be more a vague goal than a concept with content (see EPR, 1993: 19–23). Even if subsidiarity were taken seriously, it would not lead to a real federal structure because many (actual or prospective) members of the European Union are essentially

unitary states without federal sub-units of significant competence (examples are the Netherlands, France or Sweden). The 'regions' existing in the European Union (examples are Galicia and Cataluña in Spain, or South Tyrol and Sicily in Italy) are far from being units with significant autonomous functional and fiscal competencies.

The Council of Ministers is a European decision-making institution based on federal principles (but only nations are represented) and organised according to functional principles (or at least according to the corresponding administrative units). However, this Council is only indirectly democratic (the ministers are members of governments which are democratically legitimised by the representative system) and the deliberations are not public. Exit from the European Union is not formally regulated, and exceptions to specific aspects of agreements reached (as in the Maastricht Treaty concerning the European Monetary Union, the Protocol on Social Policy, or in the Schengen Treaty concerning the free movement of persons) are granted reluctantly. Indeed, they are seen as damaging the 'spirit of Europe'. Whether differential degrees of European integration are framed as models of 'variable geometry', 'multi-track', 'multi-speed', 'two-tier', 'hard core', 'concentric circles', or as 'Europe à la carte', it always elicits fierce opposition. In a system of FOCJ, in contrast, functional units not covering everyone are taken as a welcome expression of heterogeneous demands among European citizens.

Concluding remarks

In view of the major advantages of FOCJ the economist's standard question arises: if this type of federalism is so good, why is it not more in evidence?

The organisation of states today does not follow the model of FOCJ for two major reasons. An obvious, but crucial one, is that individuals and communities are prohibited from establishing such jurisdictions, and in many countries of the European Union, communities are not even allowed to formally collaborate with each other without the consent of the central government (see Sharpe, 1993, esp. 123ff).

Second, a system of FOCJ cannot be observed because it violates the interests of politicians and public officials at the higher levels of government. The emergence of FOCJ reduces the public supplier's power and increases citizens' influence via newly introduced mechanisms of competition by exit and entry, and by elements of direct democracy. Both are regularly opposed by the *classe politique*. As politicians' discretionary room and therefore the rents appropriable are the larger, the higher the federal level, they favour a shift of competencies in that direction, and oppose local decision-making, especially by FOCJ, wherever possible.

In the countries of the European Union (and elsewhere) a federal system of FOCJ will not arise if these barriers are not overcome. A necessary condition are new constitutional rules allowing the formation of FOCJ and giving citizens and governments the right to appeal to the Constitutional Court in case they are blocked.

FOCJ are a flexible concept. They can be introduced in small doses. An obvious first application would be functional units straddling communes situated on two or more member states of the European Union. Such FOCJ would make a substantial contribution to the coming together of Europe at a level directly benefiting the citizens. Such jurisdictions would contribute more to the emergence of a 'European spirit' than grandiose pronouncements by heads of states or sumptuous conferences and meetings.

Another obvious scope for applying FOCJ is the integration of the countries of the ex-Soviet bloc into Europe. At present, the European Union insists that these nations fully accept the '*acquis communautaire*' though their economic and institutional development differs drastically from those of the present member states. Even staunch supporters of the present European system have to accept that it is impossible to integrate these countries into the EU without changing its constitution. This would present an excellent opportunity to open up the EU constitution to overcome the democratic and decentralisation deficits.

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Note

- 1 Similar ideas can be found in by Montesquieu (1749). Burnheim (1985) mentions similar elements. In the economics literature a related concept has been pioneered by Tullock (1994), who calls it 'sociological federalism'. Casella and Frey (1992) discuss the concept and refer to relevant literature.

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