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3

**Debate:**  
**Metropolitan Governance**  
**Today**

*Michel Bassand*

*Daniel Kübler*

Introduction: Metropolization and  
Metropolitan Governance

*Bruno S. Frey*

*Reiner Eichenberger*

Metropolitan Governance for the  
Future: Functional Overlapping  
Competing Jurisdictions

*David Lowery*

Metropolitan Governance Structures  
from a Neoprogessive Perspective

*Christian Lefèvre*

Metropolitan Government Reform in  
Europe: Current Trends and  
Challenges

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## **Metropolitan Governance for the Future: Functional Overlapping Competing Jurisdictions**

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### **Problems with Cities**

Effective metropolitan governance is hindered by spillovers. Central cities provide many public services that also benefit neighboring communities. Examples are arts

institutions, private and public transportation infrastructure, as well as the rising payments to social security beneficiaries who migrate to the cities. Because the city populations carry the full cost of these allocative and redistributive activities, but reap only part of the benefits, fiscal equivalence does not hold: the cities produce positive externalities.

City governments face a dilemma. If they produce the optimal amount of the respective public services as seen from the citizenry of the whole metropolitan area, they get into fiscal stress. If they restrict service supply, under-provision of government services results, which causes the competitiveness of the whole metropolitan area to shrink.

This dilemma can only be solved by internalizing the spillovers and re-establishing fiscal equivalence. Only if the people who benefit from a certain service are identical with the people who pay the cost of, and decide on, the respective service, are there no distorting incentives towards under- or over-provision.

Today's political discussions on getting incentives right concentrate on four solutions:

1. *Amalgamation.* Cities are integrated with neighboring communities.
2. *Centralization.* Some of the functions supplied by the cities are shifted to higher level jurisdictions, e.g. the cantons, "Länder" or regions, or even the national government.
3. *Delegation.* The provision of the respective services is delegated to newly formed, specialized administrative units, e.g. in Switzerland and Germany to "Zweckverbände", or to public stock companies.
4. *Reimbursement.* The cities are reimbursed for their expenditures by the communities benefiting from the services or by a higher governmental level.

However, these four approaches are not effective in reinstalling fiscal equivalence, but suffer from severe drawbacks.

*Amalgamation* may serve to internalize some of the *technical* externalities among communities, but it also increases the *fiscal* externalities within the enlarged jurisdictions. The geographical area, and thus the optimal service area for each government service, is different. The larger a jurisdiction becomes, the better the benefits of far-reaching services are internalized. However, the negative fiscal externalities of the services with geographically concentrated benefits grow as the production costs are spread over the whole citizenry of the enlarged jurisdiction. The beneficial effects of amalgamation via the internalization of technical externalities tend to hold for some new governmental tasks (e.g. for those concerning the environment) which are at the center of political attention. In contrast, its negative effects via the creation of new budgetary externalities are mainly attached to old functions with highly localized benefits, (e.g. to education or the construction and maintenance of communal roads), the effective provision of which is taken for granted but not much debated. Thus, the benefit-cost ratio of amalgamation is often overestimated and politics, accordingly, biased. Amalgamation is also troubling in other respects. The increasing size of a governmental unit tends to raise, rather than lower, costs, and it causes the physical and mental distance of the citizens to the public decision-makers to rise. Moreover, amalgamation is often accompanied by

weakening the direct-democratic institutions. Therefore, the citizens find it more difficult to express their preferences, and the public officials and politicians therefore have more discretionary leeway.

*Centralization* suffers from similar problems. It may account for some differences in the geographical impact of government services, but it is still not flexible enough. It is only accidental that the benefits involved with a certain government service stop at the boundaries of the higher level government. With most services, heavy positive or negative spillovers remain after centralization. Again, the democratic say of the citizens is often reduced.

*Delegation* is more flexible than centralization and amalgamation. Many cities are involved in ten or more such administrative units, and the size of the units can be adapted to the geographical area of each service. However, today's delegation institutions are plagued by two major problems. First, there are almost no direct-democratic and representative-democratic institutions within the administrative units. The decision makers are delegated by politicians of the member-communities, often via two or three delegation steps. This is in sharp contrast with the accepted wisdom that democratic competition is a prerequisite for good governmental performance (Mueller 1997). It obviously reduces to a minimum the decision makers' incentives to care for the demands of the citizens and to provide the services effectively. Second, the cost of the services produced is not charged in a direct and clearly visible form to the citizens, but shared among the member-communities' general budgets. Moreover, the contributions of the communities are often bound by long term contracts, so that the citizens have almost nothing to decide upon.

*Reimbursement*, although adaptable to different services, does not reinstall fiscal equivalence. It only brings about a formal identity of the citizens benefiting from, and the citizens paying for, a specific service, as it leaves all the decision power with the citizens of the reimbursed central city. Therefore, the preferences of the citizens of the reimbursing communities are geared to be systematically neglected.

According to the above discussion, today's approaches to internalize the inter-jurisdictional spillovers are not effective. They do not reinstall fiscal equivalence, but they tend to weaken the citizens' democratic influence.

The citizens therefore often put up a lot of resistance to these policy reforms. As the citizens often argue in terms of "historical identity", it is easy to attribute the opposition as being old-fashioned, and not being aware of the technological requirements of modern times. But behind this effort to cling to the historical communes may be the awareness that citizens find it much more difficult to control the politicians in the new, larger jurisdictions.

Therefore, we here advance an alternative institutional solution to the problems faced by municipalities. This proposal is called FOCJ, according to the initials of its four characteristics: Functional, Overlapping, Competing Jurisdictions.<sup>1</sup>

The next following section presents the basic idea of FOCJ. Thereafter, we deal with the strengths and claimed weaknesses of our proposal. The last section offers conclusions.

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<sup>1</sup> An earlier version is Frey and Eichenberger (1996), and the concept is more fully developed in Frey and Eichenberger (1999).

## The Proposal: FOCJ

The jurisdictions proposed here have four essential characteristics. They specialize in one or a small number of functions; they extend over areas defined by the functions to be fulfilled and thus overlap with units specialized in other functions; they compete for members and exhibit competitive democratic institutions; and they have enforcement power and can levy taxes.

FOCJ are based on theoretical propositions advanced in the economic theory of federalism. They nevertheless form a governmental system different to the one suggested in the literature. While the economic theory of federalism analyzes the behavior of *given* political units at the different governmental levels, FOCJ *emerge* in response to the geography of the problems of integration.

The four elements of FOCJ are now related to economic theory as well as to existing federal institutions, pointing out both similarities to and differences from existing concepts.

### Functions

A particular public service, which benefits a certain geographical area, should be financed by the people living in that area, i.e. there should be no spillovers. The various governmental units providing different functions can cater for regional differences in the populations' preferences or, more precisely, to its demands. To minimize costs, these units have to exploit economies of scale in production. As the latter may strongly differ between functions (e.g. between schools, police, hospitals, power plants and defense), there is an additional reason for uni-functional (or few-functional) governmental units of different sizes.<sup>2</sup> This is the central idea of *fiscal equivalence* as proposed by Mancur Olson and Wallace Oates. This endogeneity of the size of governmental units constitutes an essential part of FOCJ. However, fiscal equivalence theory has been little concerned with decision-making within functional units. The supply process is either left unspecified or it is assumed that the mobility of persons (and of firms, a fact rarely mentioned) automatically induces these units to cater for individual preferences.

### Overlaps

FOCJ may overlap in two respects: (i) FOCJ catering to different functions may overlap; (ii) two or more FOCJ catering even for the same function may geographically intersect (e.g. a multitude of school FOCJ may exist in the same geographical area). A political community normally belongs to various FOCJ at the same time. FOCJ need not be physically contiguous, and they need not have a monopoly over a certain area of land. Thus, this concept completely differs from archaic nationalism with its fighting over pieces of land. It also breaks with the notion of federalist theory that units at the same level may not overlap. On the other hand, it is similar in this respect to Buchanan's (1965) *clubs*, which may intersect.

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<sup>2</sup> If there are strong economies of scope dominating the economies of scale, a FOCUS (which is taken to be the singular of FOCJ) may cover more than one function.

### Competition

The heads of FOCJ are induced to conform closely to their members' preferences by two mechanisms: while the individuals' and communities' possibilities to *exit* mimics market competition (Hirschman 1970), their right to *vote* establishes political competition. 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 political communities as a whole; parts of them may also exercise this option. For FOCJ to establish competition between governments, exit should be as unrestrained as possible, but if a negative external cost is imposed on the remaining members, an exit price has to be levied. Similarly, a price may be asked for joining a particular FOCUS. Competition also needs to be furthered by political institutions, as the exit option does not suffice to induce governments to act efficiently. The citizens should directly elect the persons managing the FOCJ, and may even be given the right to initiate popular referenda on specific issues. These democratic institutions are known to raise efficiency in the sense of caring well for individual preferences (Frey and Stutzer 2000; Kirchgässner et al. 1999).

### Jurisdictions

A FOCUS is a democratic governmental jurisdiction with authority over its citizens, including the power to tax. The lowest political unit (normally the community) is a member, and all corresponding citizens automatically become citizens of the FOCJ to which their community belongs. They have to carry the taxes to finance the public services provided by a particular FOCUS.

## The Advantages and Claimed Disadvantages of FOCJ

### Strengths

FOCJ compare favorably with attempts to solve municipal problems via integration. One aspect concerns the governments' incentives and possibilities to satisfy heterogeneous preferences of individuals. Due to the concentration on one or a few functions, the citizens of a particular FOCUS have better information on its activity, and are in a better position to compare its performance to other governments. As many benefits and costs extend over a quite limited geographic area, some FOCJ are small. The exit option opened by the existence of overlapping jurisdictions is also an important means to make one's preferences known to governmental suppliers.

On the other hand, FOCJ are able to provide public services at low cost because they are formed in order to minimize inter-jurisdictional 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.

The threat of dissatisfied citizens or communities exiting the FOCUS, and the benefit of new citizens and communities joining, gives an incentive to take individual preferences into account and to provide the public services efficiently.

### Claimed Problems

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

#### *Citizens are overburdened by the voting load*

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 two concrete issues at a time. The referenda and elections in the various FOCJ can be held at the same time, say three or four times per year, and the votes can be cast without problem by mail or E-mail.

#### *Citizens are cognitively overburdened*

The individual is confronted with a multitude of suppliers of public services, which is argued to make life difficult. However, FOCJ do not cause the dimensionality of politics to grow. Rather, they make it explicit. Evidence from private consumer markets tells us that citizens are able to cognitively master an incredibly broad array of supplies, if they have the appropriate information. However, FOCJ provide stronger incentives and opportunities for the citizens to be politically informed than traditional forms of government. Membership in FOCJ is decided at the local or even the private level, and the performance of functional units can be easily monitored by comparison and benchmarking. If citizens nevertheless fear that appropriate information is lacking, a governmental or a private advisory service can be established, which offers information and support for the consumers' decisions.

#### *Coordination is needed*

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 avoid or even exploit the population's wishes. As far as welfare increasing co-ordination is concerned, its need is reduced because the FOCJ emerge in order to minimize externalities. If major spillovers between FOCJ exist, new FOCJ will be founded to take care of these externalities.

#### *Income must be redistributed*

It is sometimes claimed that all forms of federalism – including FOCJ – undermine redistribution. Moreover, FOCJ are said to emerge on the basis of income. As far as redistribution is based on the citizens' solidarity or on insurance principles, this fear is unwarranted. Only as far as redistribution is a pure public good, and thus must be enforced to prevent free-riding, may a problem arise. But even then, FOCJ compare favorably to traditional forms of federalism, as they lead to less geographical segregation because the citizens can select their supplies without migrating. However, recent empirical research (Kirchgässner and Pommerehne 1996; Ashworth et al. 2001) suggests that substantial redistribution is feasible in federal systems. Moreover,

to the extent that redistribution is a pure public good, it will be delegated to higher governmental levels or, perhaps, to specialized, large-scale redistribution FOCJ.

### Concluding Remarks

A federal net of functional jurisdictions under democratic control is not a theorist's wishful thinking. This is shown, for example, by the success of American special districts (some of which are more similar to FOCJ than to delegated units like "Zweckverbände") and the school communes in the Swiss canton of Zurich, which are similar to FOCJ with respect to their functional orientation, their strong direct-democratic institutions, as well as their power to raise income tax. FOCJ are a viable alternative to municipalities attempting to solve their problems by integrating neighboring communes, shifting services to higher government levels, cooperating via dependent bodies and seeking reimbursement for the services provided.

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