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10. A Europe of variety, not harmonization

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The integration of Europe is a fascinating and wonderful idea. One of the major ideas is to overcome the perennial *strife* between the European nations (whose worst outcomes were the two World Wars in the twentieth century). Moreover, the integration should help to solve the ongoing civil wars of long duration and bitterness that still plague this continent: in former Yugoslavia, Ireland, the Basque country and Corsica.

But Europe has not only a history of belligerence. It can be proud of its achievements in the arts, sciences, and the way of living. The basis of it all is *variety*: a Scot is unlike a Sicilian, a Breton unlike a Bavarian, and an Andalusian unlike a Prussian.

The idea developed here is based on *four* basic ingredients. The future Europe has to be:

- *peaceful*,
- *democratic*,
- *diverse*, and
- *productive*.

Our proposal of democratic decentralized jurisdictions differs drastically from the European Union existing today. In particular, (1) it emphasizes the role of citizens in the political process, and (2) decentralizes 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 *democracy deficit* and its *decentralization deficit*.

Our proposal also differs markedly from the various reform plans currently discussed to mitigate the two 'deficits'. Some seek to strengthen the European Parliament. But this measure does not necessarily engage the citizens of the EU more strongly in the political process nor does it really give them much more influence. Rather, it may even increase the distance between the citizens and the decision-making body (Strasbourg or Brussels are even more remote from the citizens of Europe than are the national capitals from their respective

national citizens). Moreover, the concentration of over 600 professional politicians in the European parliament tends to invite the formation of yet another 'classe politique', now at the European level (similar to the Eurocrats among public employees).

The current plan to mitigate the 'decentralization deficit' is not more promising. The principle of subsidiarity is ineffective as long as the regions of Europe financially depend on Brussels and on the central governments of their nations. Political decentralization requires the power to tax for the lower levels of government. Only then are they induced and able to balance the benefits and cost of public expenditures. Only then is there fiscal responsibility, and only then are the politicians motivated to use the scarce resources to the benefit of the citizens in the lower governmental units.

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

1. The proposal of democratic decentralized 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 as well as today. Very importantly, the proposal can be introduced in *marginal* steps.
3. The proposal does not require the dismantling of the national states forming the European Union. Though the nationalism going with the concept of a nation has brought enormous harm to Europe in the twentieth century, it is still a strong force, and there is not much 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 as 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 and services, and capital and labour have been achieved to a considerable degree. Though protectionist tendencies are still existing 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 only a story of success but also one of failure. A wrong 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 homogenization and harmonization*. There are hundreds of laws and directives in the European Union working in this direction. But the essence of Europe is its *variety*. The strength of Europe is its wide range of different 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 homogenized 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 role: it allows suppliers to specialize 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: the competition between governments was successfully restricted by the various European treaties and institutions. No steps have been undertaken to actively institutionalize competition between governmental units at all levels. Welfare can be improved substantially by promoting competition between newly emerging jurisdictions that are organized along functions instead of territories.

The *fifth freedom* here suggested allows for such *functional, overlapping competing jurisdictions*. They will be called by their acronym FOCJ (one such jurisdiction will be 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* (Frey, 1983; Mueller, 1996) which ensures that the emergence of FOCJ is not blocked by existing jurisdictions such as direct competitors or higher level governments. The European Constitution must give the lowest political units (communes) a certain degree of independence so that they can engage in forming FOCJ. The 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.

Section 10.1 specifies the concept of FOCJ and puts it into theoretical perspective. Section 10.2 evaluates FOCJ and discusses how the problems related with this type of jurisdictions may be overcome. Section 10.3 points out historical precursors, and Section 10.4 presents today's examples of FOCJ. In Section 10.5 the concept of competitive federalism is contrasted to other proposals. Section 10.6 offers concluding remarks.

10.1 OUR PROPOSAL FOR A EUROPE OF VARIETY

The federal units here proposed have four essential characteristics: they are

- *Functional (F)*, that is, the new political units extend over areas defined by the tasks to be fulfilled;
- *Overlapping (O)*, that is, in line with the many different tasks (functions) there are corresponding governmental units extending over different geographical areas;
- *Competing (C)*, that is, individuals and/or communities may choose to which governmental unit they want to belong, and they have political rights to express their preferences directly via initiatives and referenda;
- *Jurisdictions (J)*, that is, the units established are governmental, they have enforcement power 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'.²

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

10.1.1 Functions

A particular public service, which benefits a certain geographical area, should be financed by the people living in that area, that is there should be no spillovers. The different governmental units can cater for regional differences in the populations' preferences or, more precisely, to its demands. To minimize cost, these units have to exploit economies of scale in production. As the latter may strongly differ between functions (for example, 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 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.

10.1.2 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 (for example, 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, 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 in this respect similar to Buchanan's (1965) 'clubs' which may intersect.

10.1.3 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 (see 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 said before, 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 has been suggested as an important ingredient for a future European constitution (Buchanan, 1991; European Constitutional Group, 1993). The right to secede stands in stark contrast to the prevailing concepts of nation states and federations where this is strictly forbidden and often 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 for individuals in Buchanan-type clubs, jurisdictions and individuals may be asked 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 whether a new member pays an adequate entry price and thus is welcome.

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 should 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 (for elections, see Downs, 1957; Mueller, 1989; for referenda Frey, 1994).

10.1.4 Jurisdictions

A FOCUS is a democratic governmental unit with authority over its citizens, including the power to tax. According to the two types of overlap, two forms of membership can be distinguished. (i) 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. In that case, an individual can only exit via mobility. (ii) Individuals may choose freely 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 non-voluntary in the sense that one must belong to a FOCUS providing for a certain function, for example, to a school-FOCUS, 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 example, 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.

10.2 ADVANTAGES AND CLAIMED DISADVANTAGES OF FOCJ

10.2.1 Strengths

FOCJ compare favourably with traditional forms of federalism. One aspect concerns the governments' incentives and possibilities to satisfy heterogeneous preferences of individuals. 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 to other governments. As many benefits and costs extend over a quite limited geographic area, FOCJ are often likely to be 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 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 (even beyond the European Union).

The threat of dissatisfied citizens or communities to exit 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. Quite 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 broad and non-specialized knowledge to become politicians, 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 the 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 multinational as well as small-scale alternatives where they are desired by the citizens. Nation states subsist in so far as they provide functions efficiently according to the voters' preferences.

10.2.2 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

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.

Consumers are overburdened

An individual is confronted with a multitude of suppliers of public services, which is argued to 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 find it nevertheless to be a problem, a governmental or a private advisory service can be established which offers information and support for the consumers' decisions.

Coordination is needed

While coordination is obviously often needed, coordination 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; Frey, 1994). As far as welfare increasing coordination 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 taking care of these externalities.

Income must be redistributed

It is 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, a problem may arise. However, recent empirical research (Gold, 1991; Kirchgässner and Pommerehne, 1996) suggests that substantial redistribution is feasible in federal systems.

10.3 EXAMPLES IN HISTORY

Decentralized, 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 today's Italy and Germany, has been intensive. Many of these governments were small. Many scholars attribute the rise of Europe to this diversity and competition of governmental units, which fostered technical, economic and artistic innovation (see, for example, Hayek, 1960; Jones, 1981; Rosenberg and Birdzell, 1986; 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 organized along these features, and not along geography (see Rhode, 1960). The highly successful Hanse prospered from the twelfth to the sixteenth century, 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 functional governmental unit providing for trade rules and facilities and was not geographically contiguous.

10.4 EXAMPLES 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 they nevertheless show that democratic functional jurisdictions are viable.

10.4.1 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 organized as well as dependent special districts (for example, 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 18 states prohibit new municipalities within a specified distance from existing municipalities; in various states there is a minimum population size required and various other administrative restrictions have been introduced (see, for example, Nelson, 1990). Empirical studies reveal that these barriers tend to reduce the relative efficiency of the local administration (Di Lorenzo, 1981; Deno and Mehay, 1985), and tend to push toward local government (Martin and Wagner, 1978).

10.4.2 Swiss Communes

Many Swiss cantons have a structure of overlapping and competing functional jurisdictions that share many features of FOCJ. For example, in the canton Zurich (with a population of 1.2m, a size of 1700 km² and tax revenue of CHF

2800m) there are 171 political communes (with a tax revenue of CHF 39000m) which in themselves are composed of three to six independently managed, democratically organized communes devoted to specific functions and raising their own taxes. Examples of such types of functional communes can not only be found in the canton of Zurich but also in the cantons of Glarus and Thurgau (for the latter, see Casella and Frey, 1992). Cantonal bureaucracy and politicians have made various efforts to suppress this diversity of functional communes. However, most of these attempts were thwarted because the population is most satisfied with the public supply provided. The example from Switzerland – which is generally considered to be a well organized and administered country – shows that a multiplicity of functional jurisdictions under democratic control is not a theorist's wishful thinking but has worked well in reality.

10.5 COMPETING 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 nations' 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 respective voting weights of the various countries. Overlapping jurisdictions and referenda are not allowed for, and the exit option is strongly restricted. Other economics scholars (for example, Blöchliger and Frey, 1992; Schneider, 1992) suggest a strengthening of federalism in the traditional sense (that is, with multi-purpose federal units) but do not envisage overlapping jurisdictions. The report by the Centre for Economic Policy Research (1993, 1995) criticizes '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 raised (1993, pp. 54–5) but is not institutionally or practically worked out, nor is the need for a democratic organization and the power to tax acknowledged.

The proposal by European level politicians (Herman report of the European Parliament, 1994) deals mainly with the organization of the parliamentary system (the houses of parliament and the national vote weights) and to a substantial extent accepts the existing treatises 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 'cooperation' 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, for example, 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. It cannot *a priori* be determined from outside and from above which FOCJ will be efficient in the future. This must be left to the competitive democratic process taking place at the level of individuals and communities. The central European constitution must only make sure that no other government units, in particular the 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 here defined in terms of the fulfilment of citizens' demands.

'Subsidiarity' as proclaimed in the Maastricht Treaty is generally recognized to be more a vague goal than a concept with content (see, for example, Centre for Economic Policy Research, 1993, pp. 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 subunits 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 nations only are represented) and organized 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 legitimized 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 and 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 evokes 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.

10.6 CONCLUSIONS

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 successful?

The organization 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. p. 123ff.).

Secondly, 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 suppliers' power and increases citizens' influence by the newly introduced mechanisms of competition by exit and entry and by direct democratic elements. Both are regularly opposed by the *classe politique*. As politicians' discretionary room and therefore the rents appropriate are the larger, the higher the federal level, they favour a shift of competences in this 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 is the 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 steps. An obvious first application is the 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 grand pronouncements by heads of states or pompous conferences and meetings.

Another obvious scope for applying FOCJ is the integration of the countries of the ex-Soviet empire 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 'democracy' and 'decentralization deficit'.

NOTES

1. Blümlisalpstrasse 10, CH-8006 Zurich/Switzerland, Tel: +41-1-257 3731/30, Fax: +41-1-364 0366; E-Mail: bsfrey@iew.unizh.ch. The ideas developed here are the result of joint research with Professor Reiner Eichenberger of the University of Fribourg; see Frey and Eichenberger (1995, 1996, 1999).
2. Similar ideas can already be found in Montesquieu (1749). Burnheim (1985) mentions similar elements. In the economics literature related concepts have been proposed by Tuitlock, (1994), who calls it 'sociological federalism' (and Wehner (1992)). Casella and Frey (1992) discuss the concept and refer to relevant literature.

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