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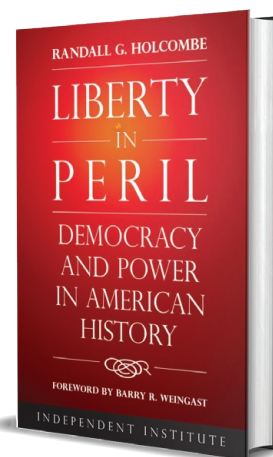
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# A Utopia?

## *Government without Territorial Monopoly*

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BRUNO S. FREY

**W**e normally take it for granted that each government has a particular territory and that each territory belongs to a particular government. Yet this identification of government with territory need not be the case. In important instances, it does not hold.

*Multiple Governments Associated with the Same Territory.* In the classic case, several governments claim the same territory. Sometimes the borders are ill-defined or the ownership disputed—perhaps they have been for centuries. Historically, this situation has led to innumerable wars. Such wars often seem to reflect a collective failure: the individuals and groups involved—in particular, the leaders of the military-industrial complex and the politicians playing the nationalist tune—find it individually rational to fight for territories, but from the point of view of society, it is difficult to see what is really gained. The same conclusion often holds for the winners of a territorial war as for a government that engages in and subsequently loses that war. The winners, too, spend valuable resources for military purposes, but in many cases they would be better off not owning the conquered territory.

- Land is often unproductive, and the farmers receive subsidies, putting a heavy burden on the economy and society. Germany provides a good example. The

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Nazis urgently sought “Raum im Osten,” claiming that the German population could not otherwise be sustained. But look at Germany now. It has experienced a *Wirtschaftswunder* within a territory that was (even after the reunification) and still is smaller than that of 1933. Obviously, no additional territory was needed. One could even argue that the Federal Republic would be better off if the Saar had decided to join France instead of Germany because the Saar relies on large subsidies from the rest of Germany.

- It is often advantageous for society as a whole not to own territories that contain certain industries, especially steel making or shipbuilding, which often continue to operate only by receiving large subsidies.
- Even the acquisition of a territory with important natural resources is not necessarily advantageous. Often the extraction of certain natural resources, such as coal, must be heavily subsidized. Owning a territory with oil resources may be, but certainly need not be, an advantage. Many oil-rich states have low—some of them, very low—income per capita. Prominent examples are Venezuela and Nigeria. A major reason why richness in oil does not translate into richness of the population is that pervasive rent-seeking activities are induced. Those activities may be so large that the resulting resource waste is larger than the advantage of having the natural resources.

An important case of several “governments” or “nations” claiming authority over the same territory relates to ethnic groups. The present conflicts in the former Yugoslavia and the former Soviet Union, as well as many in Africa and other parts of the world, are examples. According to Small and Singer (1982), between 1916 and 1939, no less than 80 percent of the wars occurring in (what is now called) the Third World sprang from ethnic conflict. After 1945, this proportion rose to 90 percent. Overall, not less than 75 percent of international wars are related to conflicting ethnic-group claims over territory.

In sum, the quest for territories in which many governments have engaged and still engage is often, if not normally, a bad deal from the point of view of society as a whole.

In contrast, a federal state in which several governments are in charge of the same territory—the central government, the provinces, states or *Bundesländer*, and the communes or other local governments—is a propitious institution.

*Governments without Territory.* Many different quasi-governmental organizations (QANGOs) perform functions similar, if not identical, to the functions performed by states. Examples include international organizations, such as the United Nations or the International Court in The Haag. They are made up of member countries, but they have no monopoly power over a territory. The number and importance of such “virtual” governments have increased greatly. There are now at least 350 intergovernmental international organizations, with far more than one

hundred thousand employees. A more extensive definition, based on the *Yearbook of International Organizations*, yields more than 1,000 intergovernmental units (Frey 1997).

Religious organizations, of which the Roman Catholic Church is a good example, constitute another case of virtual governments. The Roman Catholic Church has a monopoly over a tiny territory in Rome, but its importance derives from a completely different source—namely, the allegiance of its members. To some extent, it performs activities similar to those of normal governments (for example, it pursues a foreign policy), and it even levies taxes. On a much smaller scale, the “sovereign” Order of Malta, which even has ambassadors in several national capitals, is another example. Perhaps more relevant today are sports organizations—such as the FIFA, the international football association—some of which have huge resources at their disposal. They also undertake certain government-like activities: they impose rules on their members, have a foreign policy, distribute development aid, and so forth. The same description applies to some cultural associations and international-action groups, such as Greenpeace, unconnected to a territory.

The most important virtual governments without territory are profit-making global firms. The more traditional ones still own plants located in specific countries, but the digital revolution has created a rapidly increasing number of knowledge firms in the new economy. Their only significant capital consists of human resources and ideas, and they are not attached to any particular territory. Only the public sectors of very large countries can match the cash flows of the largest international companies. Such firms perform governmental functions in the sense that they influence the daily lives of their employees at least as strongly as states do (for example, they impose a language to be spoken and rules to be followed), and they negotiate on an equal footing with national states.

I am well aware that international organizations, churches, and global firms do not fit the traditional legal definition of a government. Such units are not identical to governments. Bear in mind, however, that the traditional definition of government is based on the primitive notion that governments by their very nature have a territorial monopoly. The purpose of the present discussion is to question that notion from the point of view of social science and economics. From this radically different viewpoint, it becomes clear that there are indeed *multiple governments on a given territory* and that there are also *governments without territory*. Increasingly, the territorial monopoly of ordinary governments is threatened by nonterritorial units of the sorts I have identified. Much of the literature on globalization has been motivated by the fear that territorial national governments have lost significant power relative to global firms. In my view, many other global actors, such as international-action groups or sports associations, pose a similar “threat.” But, in contrast to many writers on globalization, I do not believe that the power of territorial states is vanishing; rather, relative power is shifting to nonterritorial governments.

In this article, I advance a practical, constitutional proposal based on the notion that there are significant governmental units whose major characteristic is not their territorial extension but their function. The constitutional proposal allows for the emergence of governmental organizations that I call *Functional, Overlapping, Competing Jurisdictions* (FOCJ). Their territory is variable, and they do not have a territorial monopoly over it. Rather, within a given territory, they compete with other such FOCJ.

## Federalism and Political Competition

The basic idea of federalism is that individuals' preferences can be satisfied better by decentralizing government activity. The goods and services offered by government can be geared more narrowly to citizen demands, which differ from place to place because of geographical and physical characteristics (for example, as between mountainous regions and plains, or rural areas and cities); ethnicity, culture, and traditions; economic structure (for example, the relative importance of agriculture, industry, and services); and social structure (for example, income distribution and the proportion of families with young children or with retired persons). Such differences obviously lead to varying demands for public activity, such as public expenditure for education or social services. In a purely technocratic conception of politics, such spatially varied demands can be met by a centralized government, but that view utterly neglects human behavior and essentially assumes an omniscient and benevolent planner. A long time ago Adam Smith ([1776] 1980) rejected such presumptions theoretically for the economy, and more recently F. A. Hayek rejected them for society as a whole. In practice, such hubris has been demonstrated to have dire consequences, as attested by the downfall of the centrally planned East Bloc economies. In the political sphere, decentralization has clear informational advantages because local politicians know more about local needs and constraints. Even more important are the incentives motivating local political decision makers to care about the wishes of the local voters who elected them.

The economic theory of federalism has focused on four important theoretical elements (see Bird 1993; Inman and Rubinfeld 1997; Oates 1972, 1977, 1999):

- *Fiscal Equivalence*. Each jurisdiction should extend over space so the recipients of the benefits and the taxpayers correspond as closely as possible. Spatial external effects—positive spillovers where nonpayers benefit from public services, and negative spillovers where outsiders are burdened with costs—are thereby avoided. The various public activities are to be assigned to the most appropriate government level (see Oates 1972; Olson 1969, 1986).
- *Clubs*. These institutions offer public goods—that is, goods from whose benefits nobody can be excluded—only to their members. The optimal size of a club is

reached when the marginal utility received corresponds to the marginal cost induced by an additional member. A club therefore has a limited spatial extension, and the only persons admitted are those who are prepared to bear the marginal cost they impose (see Buchanan 1965).

- *Voting with the Feet.* Citizen mobility creates competition between jurisdictions. Public jurisdictions can be regarded as enterprises offering local services in return for taxes. The citizens migrate to jurisdictions that have the most favorable relationship between services and tax prices. The induced competition forces the jurisdictions to take the citizens' wishes into account and to supply services at the lowest possible cost. The same considerations apply to the locational decision of firms (see Tiebout 1956).
- *Exit and Voice.* Besides choosing among various jurisdictions, citizens may also participate in the political decisions of the jurisdictions to which they belong by voting in elections or referenda (see Hirschman 1970, 1993). They may also make themselves heard by protests, demonstrations, strikes, and uprisings. Initially, exit and voice were seen as substitutes. A citizen who chooses to leave a jurisdiction has little incentive to take the trouble to protest. However, under certain conditions, the relationship may be complementary. Thus, when the German Democratic Republic (GDR) government had to grant exit to its citizens (via Hungary to the West), that action was generally interpreted as a sign of weakness of the communist regime. As a consequence, demonstrations were perceived to be less dangerous and more promising, and they grew into a mass movement (the so-called "Monday Demonstrations"), eventually forcing the resignation of the regime.

Most countries today, especially the large ones, have a federal constitution. Prominent examples include the United States and Canada in North America; Mexico, Argentina, and Brazil in Latin America; Germany and Russia in Europe; and India in Asia. Recently, some formerly highly centralized countries, such as Spain and the United Kingdom, have shown strong tendencies toward decentralization. Centralized countries, such as France or the Netherlands, have become the exception, but one should also note that federalism has been undermined by the central government in many countries, including the United States and Germany. "Federal" countries exhibit vastly different degrees of decentralization and of competencies attributed to lower levels of the governmental organization. For federalism to work satisfactorily, two crucial conditions must be met.

First, the subunits must have the power to tax citizens for the functions they perform. This power forces them to balance the benefits and costs of government activities. At the same time, it gives the subunits a certain degree of independence from the central government. This requirement is not met in most "federations." As a conse-

quence, local politicians engage in widespread rent seeking with the central administration. They have to please the political decision makers at the center to obtain funds. Once funds are granted, subunit politicians have few incentives to refrain from spending them completely because such funds have the character of a free good. The politicians' rent seeking also encompasses subsidies to cover budget deficits. Such an institutional arrangement fosters fiscal irresponsibility at the local level. Because such irresponsibility is a direct consequence of the high degree of centralization, it does not occur when the local politicians have the power to balance revenues and expenditures in their own jurisdiction. If it turns out that they are incapable of doing so, the citizens will throw them out of office.

Such ejection suggests the second crucial condition for a well-functioning federalism. The local politicians must be elected by the citizens of their jurisdictions, not by a larger electorate, and they must certainly not be appointed by the central government. This requirement aligns the politicians' incentives with the wishes of the local population.

Most presently existing federal governments do not meet these two requirements or do so only to a small degree. Therefore, they cannot attain the properties of a "civic society" with multiple horizontal networks carrying out the wishes of the population. For that reason, I advance here a proposal for a new type of a federalism that combines the four aspects of federalism discussed earlier: (1) it meets the condition of fiscal equivalence by creating a network of multiple and overlapping governmental units; (2) it is based on well-defined members and boundaries according to the public functions to be performed, and thus is comparable to a club; (3) it is competitive by allowing exit and entry of members according to the voting-with-the-feet mechanism; and (4) it adds political competition via elections and referenda and thus includes institutions favoring voice.

## A Network of Competing Jurisdictions

The federal units I propose are called FOCJ according to the acronym of their essential characteristics:<sup>1</sup>

- *Functional* (F): the new political units extend over variable areas, corresponding to the tasks or functions to be fulfilled;
- *Overlapping* (O): corresponding with the many different functions are governmental units extending over different geographical areas, which necessarily overlap;
- *Competing* (C): individuals or communities may choose which governmental unit they want to belong to, and they have political rights to express their preferences directly via initiatives and referenda;

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1. The concept is the result of joint work with Reiner Eichenberger. See Frey and Eichenberger 1995, 1996, 1999.

- *Jurisdictions* (J): the units established are governmental; they have enforcement power and can levy taxes.

FOCJ form a governmental system that differs in an essential way from the one suggested in the economic theory of federalism. That theory pertains to the behavior of given political units at the different levels of government, whereas FOCJ emerge in response to the geography of problems.<sup>2</sup>

### *Functions*

A particular public service that benefits a certain geographical area should be financed by the people living in that area; there should be no spillovers. The different governmental units can cater to differences in the populations' preferences or, more precisely, to the citizenry's demands. To minimize cost, these units have to exploit economies of scale in production. That such economies differ greatly between functions (for example, between education, police protection, health care, power, and defense) provides an additional rationale for unifunctional (or few-functional) governmental units of different sizes. This *endogeneity* of the scope of the governmental units constitutes an essential part of FOCJ.

### *Overlaps*

FOCJ may overlap in two respects: first, FOCJ catering to different functions may overlap; second, two or more FOCJ catering to the same function may overlap (for example, a multitude of school FOCJ may serve 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 differs completely from nationalism and its recurrent fighting over pieces of land. It also breaks with the criterion of federalist theory that units at the same level may not overlap.

### *Competition*

The heads of FOCJ are induced to conform closely to their members' preferences by two mechanisms: the individuals' and communities' capacity to *exit* mimics market competition, and 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 (the singular of FOCJ) can be discontinued without changing one's location.

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2. The general idea of FOCJ may be found in Montesquieu 1749. Burnheim 1985 also discusses several elements. In economics, Tullock 1994 has suggested a related idea. Casella and Frey 1992 discuss the concept and refer to relevant literature. Centre for Economic Policy Research 1995 develops the idea of *flexible integration*, in which all members of the future European Union would have to participate in a "common base" comprising the four freedoms as well as the transfer programs and may opt to enter "open partnerships."



Exit is not restricted to individuals or firms; 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 participates in only a restricted set of FOCUS activities.

For FOCJ to establish competition between governments, exit should be restrained as little as possible. In contrast, entry need not necessarily be free. As for individuals in Buchanan-type clubs, jurisdictions and individuals may be required 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 decide democratically whether a new member would pay an adequate entry price and thus would be welcome.

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

### *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. First, the lowest political unit (normally the community) and all corresponding citizens automatically become citizens of the FOCJ to which their community belongs. In that case, an individual can exit only via mobility. Second, individuals may freely choose whether they want to belong to a particular FOCUS, but while they are its citizen, they are subject to its authority. Such FOCJ may be nonvoluntary in the sense that an individual 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, although 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, regardless of whether one has children. Regarding FOCJ's providing functions with significant redistributive effects, a minimal regulation by the central government may provide that—for example, citizens without children may not join school FOCJ that in effect do not offer any schooling and therefore have correspondingly low (or zero) taxes.

### **Strengths of FOCJ**

FOCJ compare favorably to traditional forms of federalism with respect to the governments' incentives and capacities to satisfy the heterogeneous preferences of individuals. Owing to the concentration on one functional area, the citizens of a particu-

lar FOCUS have better information on its activity and therefore can more easily compare its performance with that of other governments. Because many benefits and costs extend over only a limited geographic area, FOCJ would often be small, which would also be helpful as voters make their evaluations. The exit option provided by the existence of overlapping jurisdictions would also provide an important means of making one's preferences known to governmental suppliers.

Because FOCJ are formed in order to minimize interjurisdictional spillovers and to exploit economies of scale, they would be able to provide public services at low cost. 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. Defense against external aggression may be a case in which the appropriate FOCUS would extend over the whole of Europe (even beyond the European Union).

The threat that dissatisfied citizens or communities will exit the FOCUS and the benefit gained when new citizens and communities join give the politicians in charge an incentive to take the preferences of the citizens into account and to provide the public services efficiently. FOCJ may also expose the politicians' cartel to competition by competent outsiders. Whereas all-purpose jurisdictions attract persons with broad and nonspecialized 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 would affect the role of the nation-states. They would certainly lose functions that they presently do not fulfill according to the population's preferences or that 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 national governments, and it allows for multinational as well as small-scale alternatives where the citizens desire them. Nation-states would remain to the extent that they provide functions efficiently according to the voters' preferences.

### **Alleged Disadvantages of FOCJ**

Four criticisms are often advanced against the proposal for establishing FOCJ.

*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 all the jurisdictions to which they belong. However, citizens in a direct-democratic FOCUS will find it much easier to participate in politics because they have to assess only one or a few concrete issues at a time.

*Overburdened Consumers.* In the FOCJ system, an individual is confronted with a multitude of suppliers of public services, which arguably makes life difficult. But this situation is the logical consequence of having more options available, and it is similar to supply in the private sector. If citizens find it to be a problem, a governmental or a

private advisory service could be established to offer information and support for the consumers' decisions.

*Need to Coordinate the Activities of FOCJ.* Although coordination is obviously often needed, coordination between governments in itself is not a good measure. It sometimes serves to build cartels among the members of the *classe politique*, who then evade or even exploit the population's wishes (CEPR 1993; Frey 1994; Vaubel 1994). As far as welfare-increasing coordination is concerned, its need would be reduced because the FOCJ would emerge in order to minimize externalities. If major spillovers between FOCJ occurred, the citizens dealing with those externalities would establish new FOCJ.

*Redistribution.* It has often been claimed that all forms of federalism, including FOCJ, undermine redistributive policies. This fear is unwarranted because the citizens can still express their solidarity toward persons with low income, in particular by establishing a FOCUS designed to effect redistribution. Moreover, they can still undertake redistribution to insure themselves against future loss of income. Only as far as redistribution is a pure public good and therefore must be enforced to prevent free riding may a problem arise. Recent empirical research, however, suggests that substantial redistribution is feasible in federal systems (Gold 1991; Kirchgässner and Pommerehne 1996).

## Examples of FOCJ in History and Today

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, was intensive. Many of those governments were small. Some scholars attribute the rise of Europe to this diversity and competition of governmental units, which fostered technical, economic, and artistic innovation (Hayek 1960; Jones 1987; Weede 1993). Although for a long time the Chinese were more advanced in many respects, their superiority ended with the establishment of a centralized Chinese Empire (Pak 1995; Rosenberg and Birdzell 1986). The unification of Italy and Germany in the nineteenth century, which has often been praised as a major advance, partially ended this stimulating competition between governments and led to deadly struggles between nation-states. Some smaller states preserved their political independence—Liechtenstein, Luxembourg, Monaco, San Marino, and Switzerland—and grew rich.

The governmental entities just mentioned were not FOCJ, although they shared the characteristic of competing with each other for labor and capital (including artistic capital). History does reveal, however, examples of jurisdictions similar to FOCJ. The problems connected with Poland's marked ethnic and religious diversity (Catholics, Protestants, and Jews) were overcome at least in part by jurisdictions organized to correspond with those features, not according to geographical boundaries (Haumann 1991; Rhode 1960). The highly successful Hanse prospered from

the twelfth to the sixteenth century, comprising among others Lübeck, Bremen, and 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 trade rules and facilities, but its components were not geographically contiguous.

In two countries, functional, overlapping, and competing jurisdictions currently exist, although they do not in all cases meet all the requirements of FOCJ.

In the United States, *special districts* play a significant role in the federalist system, and their number has increased substantially in recent decades. Although some of the special districts are dependent, others are both autonomous and democratically organized. According to empirical research, the latter type is significantly more efficient. Not surprisingly, existing municipalities make an effort to prevent the emergence of these more efficient governmental units. Thus, for example, in various states a minimum population size is required to establish such units and various administrative restrictions are imposed.

In Switzerland, a multitude of governmental units exist, some of which closely resemble FOCJ. In addition to the twenty-six cantons, there are roughly 8,000 communes of various forms. The most important are the 2,940 political communes that define citizenship—a Swiss is not citizen of the nation but of a political commune. These communes have considerable autonomy; in particular, they have wide-ranging authority to impose income and property taxes. As a consequence, the tax rates between neighboring political communes may differ greatly, inducing political competition between communes and bringing forth bundles of public services and taxes more favored by the citizens. Besides political communes, there are roughly 5,000 overlapping, functional special communes. The most important are school communes offering education for the children of one or several political communes. They are public jurisdictions that levy their own tax, whose rate is determined by a citizen meeting. The Protestant and Catholic churches have established other functional, democratic, and overlapping communes. A citizen may freely choose which one he desires to join, but once a member, he must pay the established tax. In addition to these and other types of communes are many thousands of “communal units” (*Gemeindeverbände* or *Zweckverbände*) founded by the communes to deal with specific tasks, such as maintaining canals, hospitals, and old people’s homes, and collecting refuse. These units, however, have no independent power to tax, and the citizens only rarely have direct participation rights. Although this short account of the Swiss federal system at the local level shows that FOCJ are a practical possibility, they have still not been developed to their full extent.

Completely different kinds of FOCJ have developed in cyberspace. An example is the Internet Corporation for Assigned Names and Numbers (ICANN), the body

that now administers Internet domain names.<sup>3</sup> It could well evolve into a global regulatory institution without any territorial boundaries. Although laws that govern business conduct are primarily country specific, the Internet acknowledges no such geographic borders, and net firms can move from one jurisdiction to another by switching the location of their servers. Although initiated by the U.S. government, ICANN is not a governmental institution; it is based on openness and collaboration rather than on closed procedural regulation. It seeks to establish wider legitimacy by holding democratic elections, relies on voluntary dispute-resolution channels, and adapts its policy to rapidly changing technology. This new kind of cyberspace body thus has several features of FOCJ: it is functional and overlapping; it allows exit and entry, and establishes democratic accountability; and it imposes prices (taxes) for its services. It is much closer to the FOCJ of my conception than to traditional forms of government.

## Conclusions

In view of FOCJ's major advantages, the economist's standard question arises: If this type of federalism is so good, why has it not been more successful?

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

Second, FOCJ conflict with the interests of politicians and public officials at higher levels of government. FOCJ would reduce the public suppliers' power and increase the citizens' influence by means of the newly introduced mechanisms of competition by exit and entry, and by virtue of the direct democratic elements—both of which the politicians in power regularly oppose.

A federal system of FOCJ will not arise unless those barriers are overcome. A necessary condition is the establishment of new constitutional rules allowing the formation of FOCJ and giving the citizens and the governments the right to appeal to the constitutional court if they are blocked.

Functional, overlapping, and competing jurisdictions break with the ingrained notion that a government must have a well-defined territorial monopoly, but the constitutional proposal advanced here is not utopian. It has significant support from related developments stretching back for centuries, and it is also in accordance with the emergence of virtual governments in the recent past.

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3. I am grateful to Lawrence Lessig for drawing my attention to this institution. See <http://www.icann.org> and Engel 1999 for a general discussion of legal and political aspects of the Internet.

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