

Chapter 1

Introduction

1.1 Motivation

Currently, centralization of policy making is at the forefront of the political debate. As a first example among many, at the time of writing the member states of the European Union after long and sometimes bitter debate have derailed the ratification process for the European Constitution. Some like the EU to be more federalist, others argue that it should return powers to the member states. For a second example, in the Netherlands the centralized nature of the political system is open to debate. Opponents to the current system of a single centralized proportional election argue that politicians should partly be elected on a regional basis, so as to give parties more incentives to take notice of the demands of the common people. In the US, the recent tropical storms have revived with vengeance the debate on the allocation of powers between the federal government and the individual states. Certainly, risk sharing between US states creates cost saving. However, in case of emergency, do rich Northerners care enough for poor Southerners?

With respect to the costs and benefits of centralization, many of the trade-offs are well-known. In his seminal contribution on fiscal federalism Oates (1972) argues that common policies create economies of scale and internalize spill-overs. These benefits come at the cost of uniformity of policies for jurisdictions with heterogeneous policy preferences. Clearly, this trade-off is

only applicable when the public good can not be differentiated across regions. A prominent example is defense spending, but it is hard to come up with many more examples of public goods that in theory can not be differentiated. Hence, when public goods can be adjusted to meet local preferences (roads, libraries, and the classical swimming pool), the trade-off as described by Oates does not exist. In that case centralized policy making would always be superior when compared to decentralized policy making.¹

An important problem of centralized provision goods is that it may create adverse political incentives when policy makers are not social planners. Hence, the *execution* of policy is likely to generate socially inefficient outcomes. The motivation for this thesis is to contribute to the understanding of the nature of these policy making failures.

To give an example, cost-sharing of local public goods creates a common pool problem. Consider a dinner with friends. Everybody agrees that cost-sharing is most efficient, as it reduces check out time. However, we are well aware that cost-sharing creates an incentive to order more luxurious food, for the marginal cost of doing so are lower than when each pays for his own meal. Thus, the central trade-off is between the efficiency gains from saving on check out time on the one hand and overspending on the other hand.²

When public goods can be differentiated across regions, the question whether to centralize policy making boils down to a trade-off between the efficiency gains from centralization (economies of scale, spill-overs) on the one hand and the political incentive costs on the other hand. In general, citizens seem to be well aware of this trade-off. To take up the EU discussion in the Netherlands as introduced in the first paragraph, few people question that in theory the EU is better placed to perform a wider set of policy tasks. The main problem is whether the execution of these policies will be efficient. Critics in the Netherlands point to the lack of transparency of EU institutions, the presumed democratic deficit that gives policy makers too much discretion, and to the corruption associated with EU subsidies. All these are

¹The claim extends to the centralization of regulation if differentiation between regions is possible.

²In a field experiment conducted in a restaurant, Gneezy et al. (2004) provide evidence that individuals spend considerably more when forced to split a common bill.

political failures.³

1.2 Aim and scope

The aim of this thesis is to get a better understanding of how centralization affects the efficiency of policy making. To analyze this, the chapters in this thesis deal with political incentive problems. The chapters have in common a set of assumptions on the institutional setting in which centralized policy making takes place. First, the centralized policy making setting is modeled as a legislature consisting of local representatives. For this reason, the models are most applicable to loose federations such as the EU, where there is no (strong role for a) federal executive. In addition, the political process is set up as an agency problem, where citizens within a member state of the federation act as principals to their political agent. In this set up, centralization affects the incentives for the principals. As I will treat preferences as given, this means that centralization alters the constraints on policy making, for example through cost-sharing.

Two elements of the models developed in this thesis are worth mentioning. The first – that may not be too restrictive for the taste of most economists – is that all actors (including voters) are fully rational and maximize their individual utility. Readers who believe that this assumption is too restrictive may consider the outcomes of the thesis as benchmark cases. In addition, all chapters assume perfect information, which indeed may seem restrictive to economists as well. Clearly, it is well worth exploring how imperfect information affects the results. In the concluding chapter, I discuss some papers that deal with centralization issues when some actors are imperfectly informed.

³The Eurobarometer biannually measures the sentiments of EU citizens on the functioning of the European Union. In its Spring 2005 survey, when asked to identify three priorities for the EU, 39 percent of respondents in the Netherlands called for better information on the decision making process, which is far more than the percentage of respondents choosing issues such as ‘combatting poverty’ and ‘fostering peace and stability’. Other important choices were the ‘improvement of democratic rights of individuals in the EU’ and ‘reorganization of EU institutions to make them more transparent’.

The chapters in this book are positive in the sense that, given the assumptions, they aim to uncover the mechanisms through which centralization may lead to failures in policy making. Wherever possible, I have formulated these mechanisms as hypotheses that can be falsified by empirical analysis. However, in this thesis I only make a limited attempt to confront theory with data. To defend this, it should be borne in mind that the object of the study (inefficiency in policy making) is difficult to observe. Certainly, there is much anecdotal evidence on political failure. However, hard systematic data are mostly missing. One could resort to studying the relation between centralization and policy *outcomes* such as overspending and corruption, but then one treats the political mechanism through which these come about as a black box.⁴

Even if empirical evidence on the effects of centralization is missing, when the assumptions are judged not to be overly restrictive, the models can be used for normative analysis. I will do so where appropriate. These recommendations will take the form of institutional arrangements. A follow-up question, beyond the scope of this book, is whether these institutional arrangements will be chosen by rational actors. In the concluding chapter, I will briefly discuss some work that deals with such endogenous political institutions.

1.3 Relation to the literature

In this thesis, I will use three agency set-ups to examine the effects of centralization: strategic delegation by the median voter, elections with probabilistic voting, and lobbying. In the following three subsections, I briefly discuss the key papers for these three settings and in particular pay attention to why agency problems lead to inefficient policy outcomes.⁵ In addition, by dis-

⁴In the empirical part of chapter 6, I try to open the black box slightly by analyzing how electoral rules shape policy making.

⁵In this section, I only discuss a few selected papers in order to clarify the main conclusions of this thesis and relate them to other work. The introductions to each of the individual chapters contain more references to related literature. Moreover, recently some excellent books have been published that survey the literature in more detail. Mueller's

cussing different policy making settings, I will motivate why I use more than one agency set up.

1.3.1 Strategic delegation

Strategic delegation of policy making can best be discussed in relation to the median voter theorem. The median voter theorem states that policies in a direct democracy are in line with the preferences of the median voter. The intuition is that when the policy-space is one-dimensional and voters choose the policy alternative that is closest to their most preferred policy (which is called ‘Euclidian’ voting), the only policy proposal that obtains an overall majority against any other proposal is the one preferred by the median voter. As is well-known, the result that policy outcomes favor the median voter extends to Down’s (1957) model of two-party electoral competition, which is a stylized version of representative democracy.

Besley and Coate (2003) introduce strategic delegation to show how an inefficiently high supply in public goods supply arises when two regions jointly decide on the production of these goods. In each region preferences for local public goods are heterogeneous and there is a citizen with median preferences who would win a decentralized election. When decision making is centralized, Besley and Coate show that the median voter has an incentive to strategically delegate policy making to a citizen with stronger preferences for public goods than her own. Strategic delegation serves as a credible commitment to a policy stance in centralized bargaining. Given the preferences of the policy maker in the other country, delegation to a citizen which stronger preferences for the public good increases the local supply of which the costs are shared with the other region. Hence, what drives the result is that centralization creates a common tax pool that can be tapped by misrepresenting local preferences.

(2003) textbook discusses the main theories in public choice. Recent contributions to the field of political economics are dealt with in Persson and Tabellini (2000). Drazen (2000) discusses many of these in relation to macroeconomic policy making. Grossman and Helpman (2001) focus on the role of special interest groups in the policy making process.

In which policy making settings will strategic delegation be relevant? Clearly, it is when member states (voters or their local policy maker) elect the agent who represents them at the centralized level. One crucial assumption is that appointed policy makers once in office are not constrained by their principals. Hence, in this model the policy stance of the delegate can not be contracted by the median voter, for the agent does not care for re-election or monetary rewards. Thus, the only parameter that is relevant for the principal are the policy preferences of the agent. In many international organizations, once appointed the agent has such freedom to follow her own preferences. Moreover, in some cases the rules of the centralized legislature explicitly state that the agents should not pursue the interests of their principals. This, for example, is the case for the European Commission. Hence, in settings where delegates have considerable power, the crucial stage for the median voter is to select a person with the right preferences.

1.3.2 Swing voters

Probabilistic voting theory states that in elections not all voters are equally likely to swing the ballot towards one of the candidates or parties. The reason is that some individuals have a strong ideological bias for one of the candidates or parties and thus are less responsive to policy proposals of other political parties or candidates for office. Dixit and Londregan (1996) develop a model where regions differ in their ideological bias towards one of two parties. Voters with a low ideological bias are more easily pulled towards the party that offers them financial benefits. Consequently, when parties effectively compete for swing votes in a centralized election, policies are biased towards regions that have a low ideological bias. Persson and Tabellini (1999) extend this analysis by arguing that a majoritarian electoral rule magnifies inefficiencies in local public goods supply when districts differ in the amount of swing voters. The reason is that when parties only have to win swing districts, this effectively eliminates opposition to excessive public goods supply from voters in electorally safe districts.

To illustrate the inefficiencies that may arise under probabilistic voting,

consider a country consisting of three regions where there is a Christian democratic party and a Socialist party. Suppose that the Christian party is strong in the country side and the socialists are strong in the industrialized coastal region. Strong means that in these two regions there is a strong ideological bias towards one of the parties. Further, there is a city in the middle that has no bias towards one of the parties. In that case, both parties commit to low supply in the coastal and rural area, and both will promise to deliver a high supply for the city. However the parties do not commit to zero supply in the coastal and rural area, as this would give the other party the opportunity to win votes for the national assembly in these regions. Overall, when taxes are the same for all citizens, the rural and coastal regions will be net losers with inefficiently low supply of public goods and the middle region will be a net winner with inefficiently high supply.⁶

Following Persson and Tabellini (1999), what would happen when the centralized legislature has members who are selected in regional elections? Suppose that the party leadership designs the policy platforms and the legislature implements the policy of the winning party. In that case, as there is a strong bias in preferences, the Christian democratic party wins the seat in the countryside and the socialists win the seat in the coastal region. Hence, effectively there is only electoral competition between the two parties in the swing district. But then both parties commit to supply no public goods at all to the coastal and to the rural area, as this would reduce their chance of winning votes in the swing city region. Consequently, regional representation in a centralized legislature increases the inefficiencies in local public goods supply when parties are organized nationally.

It is appropriate to use the probabilistic voting model when there is representative democracy and a nation-wide election. Such centralized elections are absent in most international organizations, including the EU. Hence, probabilistic voting models are best used when analyzing issues of centralization within nation states and strong federations.

⁶Note that decentralized policy making will be politically efficient, as in that case the two parties will have to please the local median voter.

1.3.3 Lobbying

Another important deviation from the median voter theorem occurs when some citizens have an incentive to form a lobby to influence policy making. As a prominent example, Olson (1965) argues that small groups of citizens with similar preferences may overcome the free-riding problem to organize into a pressure group. He argues that policy is biased in favor of such small and well-organized groups.⁷

To study how lobbying affects policy choice, many papers use the Grossman and Helpman (1994) common agency set up. In this model, in the first stage each lobby offers a contract to a policy maker, where payment is contingent on the policy maker's action. In the second stage, the policy maker implements a policy that maximizes his own utility. Grossman and Helpman assume that the policy maker maximizes an objective function that has as arguments social welfare and contributions by lobbies. Because the utility of lobbies is part of social welfare and these groups provide contributions to the political agent, policy will be biased in favor of organized groups.

Building on the Grossman-Helpman model, Persson and Tabellini (1994) argue that the common pool effect of centralization may induce the member states to engage in lobbying. In their model, the member states lobby a single policy maker in the center to supply public goods to their citizens. In that case, lobbying may cause overspending on local public goods. Bardhan and Mookherjee (2000) extend this model to investigate the relative capture of the center versus that of local government by developing a lobby model that incorporates electoral competition between two parties for swing votes. They show that, as electoral competition between parties for swing votes is stronger at the centralized level, this weakens the incentives to use policy favors for special interest groups as a means to generate funds for attracting uninformed voters.

Lobbying can be important in a pre-election and in a post-election setting.

⁷Becker (1983) is the first to model policy formation as a fight among special interest groups. He shows that policy is biased in favor of small and efficiently organized groups. However, he adds that competition among lobbies may also benefit society, for it provides incentives to use efficient instruments for redistribution.

In the election campaign, parties may need funds to communicate their policy positions to the electorate. To generate funds, the party leadership faces a trade-off between on the one hand pleasing the electorate at large and on the other hand pleasing the lobbies. In a post-electoral setting, the incumbent may also care for reelection so that he faces the same trade-off as parties in a pre-election stage. In addition, the acceptance of funds can also be motivated by a desire for private consumption of the incumbent.

A loose interpretation of the Grossman-Helpman model is that there is an implicit exchange between policy makers and lobby groups: policy makers and lobby groups simply exchange something that is of value to both of them and is costly to produce. For example, the policy maker needs information on a policy domain that only a lobby group can supply. To provide this information, the lobby must incur research and organization costs. If the lobby provides the information, the policy maker is willing to bias legislation in its favor.⁸

1.4 A short overview of the chapters

In this thesis policy making in the center is modeled as a political process where individual member states are engaged in various political tactics to obtain a larger slice of the cake, so as to shift the costs of local public goods to other jurisdictions. The main purpose of chapter 2, coauthored with my supervisor Robert Dur, is to extend and generalize the Besley and Coate (2003) model. In this chapter we argue that the variation in policy outcomes under centralization across several domains can be explained by the cost structure of common policies. When costs are shared, the Besley and Coate story applies and we observe overspending, for delegates are policy lovers compared to the median voter. By contrast, when there are unshared cost at the local level of centralized policies that citizens try to avoid – the ‘not in my backyard’ principle – median voters strategically delegate policy making to a politician who values local public goods less than the median voter herself. As

⁸There now is a large literature on informational lobbying. See the paper by Potters and van Winden (1992) and the survey of the literature in Grossman and Helpman (2001).

a result, there is underspending on local public goods. Hence, a combination of the common pool incentive to obtain local public goods for low cost (which causes delegation to ‘lovers’) and the free-riding effect where citizens try to avoid unshared costs (which results in delegation to ‘conservatives’) explains the variance of common spending across policy domains at the centralized level.

Chapter 3, that draws on a paper with Colin Jennings, deals with policy rivalry. In this chapter, citizens care for the relative supply of public goods compared to other regions. We argue that in a decentralized policy making setting, the median voter delegates to a policy maker with weaker policy preferences to those of her own, so as to reduce the spending on public goods in the other country. By contrast, when the regions coordinate public goods supply, this incentive disappears and the median voters delegate to public goods lovers. The model in chapter 3 may well explain the failure of policy coordination in situations where groups in society are antagonistic towards each other, such as in the conflict in Northern Ireland.

In chapter 4, I analyze why we fail to observe a race to the bottom in environmental policy making in developed countries. I argue that when citizens care much for the environment, they have an incentive to shift production to the other country by increasing environmental protection at home. They do so by appointing relatively green politicians. However, for poor countries where the median voter cares little for the environment compared to the profits of the home firm, I argue that strategic delegation results in a more severe race to the bottom.

Chapter 5 studies how centralization alters lobbying behavior. In contrast to earlier work in this area, I show that centralization may reduce lobbying expenditures. I argue that centralization provides stronger incentives for local policy makers to supply public goods to domestic interest groups. For this reason, the policy maker becomes an ally of national special interest groups, who anticipate this and, hence, offer a smaller contribution. In this chapter, I also discuss the effects of enlargement of unions on lobbying and consider the incentives of centralization on lobby formation.

Chapter 6 shifts the attention to electoral competition for swing voters. In

this chapter two parties compete for the majority in a centralized legislature. The instrument to gain votes is to announce a tariff structure for three regions that each produces a geographically distinct product. First, I show that when jurisdictions are unitarian states, all citizens would opt for free trade. Then, I demonstrate that centralized policy making results in protection for at least one of the three products. Further, along the lines of Persson and Tabellini (1999), I then discuss the effects of different electoral rules, where I derive the hypothesis that countries with a majoritarian electoral rule have higher protection. I provide some empirical evidence in favor of this hypothesis. Chapter 7 draws up the main conclusions of the thesis and speculates on the future of the field.