

Chapter 7

Summary and directions for future research

In this book, I have analyzed the political economy effects of policy centralization. In the Introduction to the thesis, I have argued that centralization of policy making involves a trade-off between on the one hand efficiency gains of pooling resources and internalizing externalities, and on the other hand the political incentive costs. For we already know much about the efficiency effects, I argue that to evaluate better at what layer of government to allocate decision making power, we have to study the political economy effects of that choice.

To link the chapters in this book to the existing literature, the Introduction provides an overview of the political economy models that are used in this thesis. First, I have discussed the median voter approach, which is extended to strategic delegation. I use the concept of strategic delegation in Chapters 2, 3 and 4. Second, to take account of the role of special interest groups, I have discussed the common agency model, used in Chapter 5. Lastly, probabilistic voting was introduced to analyze policy making in a representative democracy.

7.1 Main findings

Chapter 2, coauthored with my supervisor Robert Dur, sets off with an observation. At the centralized level of policy making, for example in the EU, there is overspending in some policy domains and underspending in others. By using strategic delegation of policy making, Besley and Coate (2003) argue that the common pool problem may induce the median voter in the member states to delegate policy making at the centralized level to a representative who is a lover of local public goods. We show that if a sufficiently large part of the cost of local public goods is not shared at the federal level, this causes the median voter in the regions to delegate to a politician who has weaker preferences for these public goods than herself. In this way, the median voter free-rides on the spill-over effects of policies in other regions at low local cost. As a result, in the symmetric equilibrium the centralized provision of local public goods is too low. Examples of such policy domains may include those concerned with the environment, policing heavy crime, and caring for asylum seekers.

In the remainder of Chapter 2, we argue that in the case of delegation to public goods lovers, co-financing of local public goods may reduce overspending. We argue that with co-financing the median voter discounts that delegation also increases spending by the local government, which reduces the incentive to appoint public goods lovers. For example, in the EU such rules exist for regional development funds, where national governments should match grants from Brussels. On the other hand, policies that entail non-shared cost should be subsidized at the federal level. This reduces the free-riding incentive for national policy makers to delegate to conservatives, as this would also reduce the flow of subsidies from the federal level.

Chapter 3 analyses psychological externalities (in the form of envy) that policy makers in one region or group may impose upon the citizens of neighboring regions or groups. As a result, decentralized provision of these ‘conspicuous’ public goods may be too high. Potentially, a centralized legislature may internalize these negative externalities. However, in a model with strategic delegation we argue that the median voter in each jurisdiction may

anticipate a reduction in local public goods supply and delegates to a policy maker who cares more for public goods than she does herself. This last effect mitigates the expected benefits of policy centralization.

The main message of this chapter is that centralization may dramatically change the outcome of the political process. When countries are engaged in policy competition, citizens anticipate socially inefficient outcomes. For this reason, they have an incentive to vote for moderates, so as to not steer up the conflict. By contrast, when policies are coordinated, we show that voters have an incentive to delegate policy making to hawks, so as to obtain the upper hand over rival groups. Hence, the potential benefits from centralization are mitigated by changes in the type of the selected policy maker.

In Chapter 4, I focus on environmental policy making. Here, policy makers can use tax instruments to influence pollution in an industry that is characterized by Cournot competition in the world market. In line with other studies, I find that decentralized policy making by social planners triggers a ‘race to the bottom’, for each policy maker has an incentive to increase the competitiveness of its industry. Then, I show under which conditions this race to the bottom may be enhanced by political economy effects. I show that when the median voter cares little for the environment relative to firm profits, she selects a policy maker who cares even less for the environment than she does herself. By doing so, she commits to low taxes on pollution. This is beneficial, because when the foreign median voter also cares for profits, she sets a higher tax level, so as to avoid a large drop in the world market price.

In addition, I argue that when a median voter cares much for the environment, she has an incentive to delegate policy making to a person who cares more for the environment than she does herself. The intuition for this result is that delegation serves as a commitment to higher home pollution taxes. When the foreign policy maker also cares for the environment, this induces her to set higher taxes to avoid a large increase in the production of the foreign firm. As a result, the loss in profits of the domestic industry is compensated for by a cleaner local environment at a relatively small loss in international competitiveness.

The chapters on strategic delegation uncover two important political economy elements of centralization. First, in contrast to what is assumed by many, the political economy mechanisms in a decentralized policy making setting may actually be welfare enhancing. In addition, policy cooperation may disappoint because it is not able to overcome the coordination failure among local median voters of separate political jurisdictions. A way to solve this coordination problem may be to merge the political jurisdictions themselves.

Chapter 5 analyzes the effects of centralization on lobbying behavior. I argue that when policy is the outcome of legislative bargaining by delegates from the member states, lobbying expenditures may well decline. The reason is that, due to the common pool effect, national policy makers become allies of local special interest groups. As a result, these interest groups are able to reduce their payments to the local policy maker. In addition, by endogenizing lobby formation, I show that as influencing policy making becomes cheaper, more groups become engaged in lobbying.

Chapter 6 turns to electoral competition where two parties announce trade policies with the goal of winning a centralized election. In a country, each district produces a good, for which it uses locally specific capital. I argue that in this setting electoral rules matter for trade policy making. In the theoretical part of the chapter, I show that when countries have a majoritarian electoral system this results in a more protectionist trade policy when compared to countries that have a proportional system. In the empirical part of Chapter 6, I provide evidence that in a cross section of 62 countries this hypothesis is supported by the data.

7.2 What is missing?

To derive these results in theoretical models, I have used assumptions that may be judged restrictive. To start, I have analyzed the effects of policy centralization in a setting where there is perfect information on the preferences of citizens. However, there is a large literature that deals with the relation between centralization and information transmission. One traditional

argument against centralization (Oates 1972) is that when jurisdictions are heterogeneous, there may be imperfect information on local preferences for public goods at the federal level. More recently, it has been argued by various authors that voters are less informed about federal policies than they are on local policies.¹ In this case, centralization may reduce the information on the performance of policy makers, which in turn distorts their incentives to achieve the common good.

In addition, I have dealt with symmetric equilibria in which districts have an identical economic structure. A weak point of the thesis is that in practice problems of centralization typically arise when jurisdictions are heterogeneous. For example, small members may be preyed upon by large member.² However, deriving game-theoretical equilibria when agents are heterogeneous agents is notoriously difficult, worth future research.

When discussing decentralized versus centralized policy making, I have treated these institutional settings as exogenous. However, one may also study the question whether centralization will be chosen, and hence is an endogenous choice variable. In the models of this thesis this issue is dealt with only casually, as we implicitly assume that when the adverse political economy effects of policy centralization are not too large, jurisdictions may want to centralize policy making for efficiency reasons. However, the choice whether to centralize policy is also a political process, and should be treated as such. Still in a rather normative setting, Aghion et al. (2004) and Alesina and Spolaore (2003) make progress in this direction.

7.3 Directions for future research

To end this thesis, I become engaged in the hazardous activity of spending some words on where the large field of the political economics of federalism may and should be evolving. I start by noting that when studying policy centralization I have used standard political economy models. In turn, most of these standard models have been developed in microeconomics, more in

¹See for a survey of this issue Lockwood (2005)

²See for an extensive discussion of these issues Alesina and Spolaore (2003).

particular in labor economics and industrial organization. I expect two developments to be particularly useful for the study of policy centralization. First, there are now many studies that take account of heterogeneity of the policy makers' ability (Caselli and Morelli 2004). In this setting citizens are imperfectly informed about the ability of policy makers and face the problem of selecting the most competent one. Hence, can one think of political processes in which centralization improves the information on candidate quality? One example may be that centralization sometimes improves benchmarking of local policy performance. In this way, centralization may increase yardstick competition (Besley and Case 1995). A case in point is fiscal policy in the EU, where the European Commission publishes regular reports which score the fiscal performance of countries. In addition, there has been a fruitful cooperation between economics and psychology to provide more insights in what motivates people. For example, good politician may in this case not be judged only on their policy making ability, but also on their motivation to hold office (see for more on this issue e.g. Beniers and Dur 2006).

For a second direction, currently there is renewed interest in the political economy of decentralization. The World Bank has even created a learning program for civil servants on why decentralization works. The main reason may be that nation building by the allied forces after the Second World War has created too few countries so that preferences of citizens are not aligned, to put it mildly. Alesina and Spolaore (2003) argue that recently these internal conflicts are pushed to the limit because of global free trade, for this reduces the economic benefits of the nation state relative to the political cost of preference diversity.

An important research direction is to find more empirical evidence on the political economy effects of centralization. In the subsequent chapters of this thesis, I have discussed some empirical studies, however, more is needed. One problem in the empirical literature is that centralization itself is endogenous, for especially rich countries choose to dissolve policy making powers to regions (Panizza 1999). To overcome this problem, it is worthwhile to study the effects within one country, such as Besley and Case (2003) and Baqir (2002) do for the US.

Lastly, although there seems a consensus that the negative political economy effects of centralization are important, the efficiency gains of centralization (economies of scale and the internalization of policy externalities) in some cases may still dominate. Hence, it can be worthwhile to develop a second-best theory of policy centralization. When, from a theoretical and empirical perspective, we know what works in policy centralization and what goes wrong, these insights then can be used to develop better centralized political institutions.