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Public Choice: A Survey

Charles B. Blankart

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Abstract

Public Choice is the merger between political science and economics. In the introductory sections of this survey it is investigated what we can expect from the logic of public choice. How far is it able to produce consistent results? Is public choice consistent with liberty? What can be done to reconcile these core principles? In the later, more applied sections, several forms of democracies in unitary and federal states are investigated. The dynamics of public choice are considered in the theory of the political business cycle. The survey ends with some thoughts on public choice in the euro crisis.

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Charles B. Blankart
Tristanstraße 17d
Germany – 14109 Berlin
charles@blankart.net

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Public Choice: A Survey

by
Charles B. Blankart
Humboldt-University Berlin and University of Lucerne
CESifo and CREMA

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Public Choice is the study of politics with the use of economic methodology. It is the synthesis of political science and economics. The political science part of public choice has a much longer history than its economic complement. Political science started about 2.500 years ago and culminated with Herodotus (489-452 BC) and Aristotle (384 BC – 322 BC) in Greece. Both philosophers investigated alternative forms of government, in particular monarchy, oligarchy and democracy. While Herodotus pleaded for direct democracy to make decisions on issues and for lot toselect magistrates, Aristotle was more skeptical about democratic voting compared to monarchy or oligarchy. The economics part of public choice dates back to Adam Smith's Wealth of Nations (1776) and is therefore only about 230 years old.

Voting: Comparison of Goods and Political Markets

The merger between politics and economics into public choice was very productive. It now encompasses a very large field of problems from the theory of voting to the analysis of the euro crisis. Modern public choice started with Harold Hotelling (1929) who found that two parties who maximize votes in competition adjust their platforms in such a way that they both meet the median voter preferences. Josef A. Schumpeter (1950) has compared political party leaders to political economic entrepreneurs. The concepts of Harold Hotelling and Joseph A. Schumpeter have been merged and formalized by Duncan Black in his median voter model (Black 1948). In a second work entitled *The Theory of Committees and Elections (*Black 1958) Black investigates the outcomes of different voting methods and the degree to which they can represent individual preferences. One of these results is the Condorcet-Paradoxon of cyclical preferences. Based on this work, Kenneth Arrow (1951, 1963) showed in *Social Choice and Individual Values* that there is no way to aggregate ordinal individual preferences to a collective ranking that is consistent without being dictatorial.

More in detail, Kenneth O. May (1952) found that, under two alternatives, the sum of yes (+1) and no (-1) will generate a group decision function which is a simple majority rule if and only if it satisfies the following four conditions:

1. decisiveness (i.e. no ambiguity)
2. positive responsiveness (of the outcome when the pros or the cons increase)
3. anonymity (among ballots of voters)

4. neutrality (on particular issues) (Mueller, 2003, 133-136).

If we add transitivity as an additional condition it follows from May's theorem that no voting rule will satisfy all five conditions, not even the simple majority rule. In particular, decisiveness may be violated which would mean that the outcome may be no more unambiguous.

Neutrality means that all issues are of the same importance; anonymity that all individuals are equally affected. Dropping these two conditions opens a multidimensional issue space and hence opportunities for trading votes (logrolling) between issues of unequal importance and between individuals with different intensity of preferences. Decisiveness will break down and majority rule will lead to cycling. A further consequence of this analysis is that logrolling opens no escape from Arrow's impossibility theorem (Bernholz, 1978).

Under these new conditions another set of very strict conditions has to be met to restore a stable outcome of majority rule. Charles Plott (1967) has shown that a majority rule equilibrium exists if it is a maximum for one and only one voter while the other voters are evenly paired off so that any change improving the position for one individual is balanced by another individual being made worse off (s. Mueller 2003, Blankart and Fasten 2011).

Another way to achieve an equilibrium outcome is by narrowing preferences. But how narrow must preferences be in order to achieve stable outcomes? The answer given by Gerald Kramer (1973) is devastating: Only when individuals have identical indifference maps can cycling be avoided. While individuals have non-crossing personal indifference curves, it is far from probable that interpersonal indifference curves are non-crossing. It follows that interpersonal consistency can only be expected if decisions are made by unanimity. But with unanimity preferences are simply juxtaposed and not really aggregated. An aggregation of preferences leading us to a social welfare function in the sense of Abram Bergson (1938) or Paul A. Samuelson (1947) indicating what is good and what is bad for the society is not possible. This again shows the importance of Arrow's impossibility theorem. A conclusion of these results is that we should not rely too much on the rationality of collective choice. In fact, we should rather avoid voting processes in favour of markets where preferences are maximized individually by exchange.

So far I have restated the normative standpoint of public choice and individual values. From a positive point of view, however, inconsistencies of voting open quite different perspectives. They provide political entrepreneurs incentives to engage in politics and to compete for votes. From this viewpoint, Antony Downs developed his vote maximization hypothesis. In his book *"An Economic Theory of Democracy"* (1957) Downs followed the lines of the two party model by Hotelling and Black and showed, in addition, that political agents maximize votes just as private consumers maximize utility. Hence the paradigm of individual utility maximization known from market economy should be extended to political agents in particular to party leaders who can be considered as competitive vote maximizers. Under carefully specified conditions, such as single peakedness and one-dimensionality, cycling can be avoided. Ideally again the median voter preferences will be pursued although special interest groups may affect voters' information and hence distort the voting outcome.

In the pure Downsian model both parties supply the same program and chance decides which party comes to power. Individuals, however, ignore how close parties are at the median. If they believe that parties' positions are off the median, the probability that an individual's vote is decisive for the election outcome is very small and not worth the personal costs of voting. Nevertheless people vote. This is the "paradox of voting" first found by Downs (1957).

The Downsian conditions of a voting equilibrium are, however, very restrictive. Peter Coughlin and Shmuel Nitzan (1981) asked the question: Is it possible to find a voting equilibrium under more than one-dimensional preferences? They found that under deterministic preferences even small changes in a platform will motivate voters to reallocate their votes so that cycling again occurs as soon as a party transgresses the yes/no threshold of a voter's preferences. Cycling can, however, be avoided when voters and parties are both incompletely informed about each others' reactions so that only the probability of a yes or no changes when a party modifies its program, and voters therefore adjust their voting decisions probabilistically in each direction. Under these conditions again a stable median voter outcome may emerge.

The Economic Logic of Voting Rules

The above authors do, however, not explain the economic reason of voting rules. In practice we observe that simple majority rule is by far the most popular voting rule. Already the ancient Greeks referred to simple majority rule when they discussed democratic governance. The ostracism held in Athens in 482 BC on whether the commander and statesman Aristides the Just should be sent to exile was quite self-evidently made by simple majority rule (Blankart and Fasten 2011). But why? The frequent use of simple majority rule compared to other less than unanimity rules is barely accidental. Simple majority is the smallest majority which cannot be reversed by a counter coalition when only one issue is at stake (see the above section on voting). Since the odds were against Aristides, it was clear that he had to go into exile. Decisiveness is an important condition for consistent collective decision making. But as soon as several options are at stake (e.g. Aristides could also simply be excluded from politics in Athens), simple majority rule loses the advantage of decisiveness. For, at that point, counter coalitions containing another blend of issues could be proposed, and majority rule equilibrium would become indecisive.

This problem of the theory of majority rule was resolved eventually by James M. Buchanan and Gordon Tullock in their book *The Calculus of Consent* (1962). The authors asked the question of an optimal majority rule in a more general way: What decision rule would a group of settlers choose, behind the veil of ignorance concerning their own future wealth position, but in full knowledge of the qualities (e.g. of cycling) implicit in less than unanimity rules? They found that although full unanimity would be desirable from an individual point of view, decision making cost may suggest a less than unanimity rule (though not necessarily a simple majority rule) for the post-constitutional stage of a society while the choice of the rule itself is made by unanimity. So a unanimous decision is made on the constitutional level and a less than unanimity rule will be applied on the post-constitutional stage of the ongoing political process. Hence the unanimity principle is preserved even if the post-constitutional decisions are made by less than unanimity.

The *Calculus of Consent* penetrates, however, much deeper into the heart of public choice than this superficial optimization reveals. The subtitle of the Calculus makes clear that the authors want to grasp the *Logical Foundations of Constitutional Democracy* (1962), or the political foundations of a free society (p. v). Freedom is the absence of coercion. Hence politics should be organized in such a way that coercion is minimized which would be the case if all political decisions are made by unanimity. Here Buchanan and Tullock refer to Knut Wicksell (1896) who in his book *Finanztheoretische Untersuchungen* also pleaded for unanimity as a guarantee for liberty.

Wicksell was a political “enfant terrible” in Sweden’s conservative political scene of 19th century. As a politician Wicksell rejected any political compromise on voting, but as an economist he was much more moderate. He arrived at a proposal on collective decision making based on the economic principles of quid pro quo. His reasoning is based on two inequities he observed in Sweden: first, that a democratic majority imposed its will on a minority and second that a small number of franchised wealthy citizens imposed taxes on a large number of disenfranchised poor. To restore legitimacy, Wicksell proposed two changes: First, general franchise should be introduced and no one should be excluded from the voting rights; and second, in order to prevent that under the new rule the majority of the poor ruled over the minority of the rich, decisions should be made by unanimity. Basically Wicksell required that nobody’s preferences be outvoted.

Wicksell builds the bridge between Adam Smith’s principle of exchange in the market and exchange in politics. He shows that contracts can be made in the private sphere of markets as well as in the political sphere of public goods. His idea of contracts on public goods was quite revolutionary for how could it be possible to reach consensus in a popular assembly? Negotiation costs would be too high. True, but consensus guarantees that eventually only those decisions are made whose overall benefits exceed its overall costs (though potentially unanimous decisions may be rejected because negotiation costs are too large). As soon as unanimity is attained, the decision is enforced and everybody has to pay her agreed sum on tax contribution. Free riding is not possible.

Wicksell emphasizes that, under his principle, the costs of a public good are distributed according to the benefit principle among all citizens and that it is not necessary to resort to the “ability to pay” principle. This latter principle is silent as to the size of the public budget, and therefore may lead to non-unanimous and hence imposed decisions. Wicksell believes, however, that in practice the tax shares according to the benefit principle come close to the tax burdens according to the ability to pay principle (but not vice versa).

Wicksell did not think of direct voting on the floor by the citizens. He thought that voting should take place in the National Parliament, the Swedish Riksdag of which Wicksell was a representative. But his unanimity principle could also work, perhaps work even better, at a regional or local level than on the national level of government provided that some caveats are observed. It must be prevented that extra-jurisdictional voters vote on intra-jurisdictional issues and vice versa or, to put it differently, it must be ensured that the principle of institutional congruency is applied, i.e. that the circles of the regional beneficiaries coincide with the circles of the decision makers and the circles of the tax payers. We shall return to institutional congruency in the section of fiscal federalism.

Are there limits to the unanimity principle? Unanimity is always advisable if different choices are conceivable. If settlers disagree on the form of government, e.g. if some want a republic and others a monarchy, it is better if one group emigrates to another place than if they jointly take majority decisions in one place. If on the other hand individuals randomly brought together are locked in a room and exit is impossible, it is better to take a majoritarian decision giving both sides an equal chance to win Douglas W. Rae (1969) and Michael J. Taylor (1969).

Unanimity is also problematic if it conflicts with liberty. Amartya Sen (1970) has shown that giving up liberty for gains of trade may be in conflict with some basic principles of a free society. The conflict appears even more when unanimity is replaced by majority rule or democracy and when democracy is defined as a unanimity up to ½ of the society (as an approximation to unanimity). If seen from this point of view one cannot say that a democratic society is always a free society, or that a free society is always a democratic society. The majority may vote to abolish the basic liberties.

Federalism, Competition and Public Choice

The public choice theory of federalism has two fathers: Charles M. Tiebout (1956) and Wallace E. Oates (1972). Tiebout argues that local communities are comparable to competitive profit maximizing firms. They provide places to live complemented by local public goods in exchange for taxes. Individuals chose among these places offered by local communities, they vote with their feet, so that eventually a Pareto optimal allocation may be achieved. Note that individuals have to reveal their preferences for local public goods when they choose the local community where they like to live. Again institutional congruency is an important requirement that this process works.

The Tiebout model remains in the domain of private supply and demand. Migration between local communities is equivalent to shopping around for private goods. The implicit assumptions are that, within a local community, public goods are provided at decreasing returns to scale though not necessarily under piecemeal exclusion (as immigrants pay an access tax). So competition may establish an optimal allocation of resources.

The Tiebout mechanism generates important adjustment processes. First, local communities will specialize in particular services and hence induce citizens with similar preferences to cluster in specialized local communities. Second, as far as the market is a discovery process (Hayek 1968), local jurisdictions under competition will search for new products and processes, hence dynamically improve the quality of local public services. Third, competitive federalism is a laboratory for new ideas (Wallace Oates' "laboratory federalism" Oates 1999). Fourth, federalism may crowd out inefficient bureaucratic and Leviathan solutions (Weingast, 1995); and fifth, federalism may bring a local community on a steeper growth path (Feld 2010).

Tiebout, public choice and the multilevel constitutional contract

The pure Tiebout model does not provide for public choice. Local governments work in the same way as markets work. They find the efficient solution themselves. Public choice is not only not necessary, it would even interfere with the market and destroy Tiebout's efficiency. Public Choice is required, however, where individuals are not fully mobile between local communities. Suppose that the 100.000 inhabitants of jurisdiction J, which consists of two local communities A and B with 55.000 and 45.000 inhabitants respectively, are debating the introduction of a progressive school system X or a conservative school system Y, see table 1.

Table 1: Collective choice of school system X and Y

	Options	
	School system X	School system Y
Inhabitants of A	20.000	30.000
Inhabitants of B	35.000	15.000

All Inhabitants	55.000	45.000

Source: Wagner (1983), Blankart (2011)

If the jurisdiction J votes as an entity the progressive school system Y will be chosen. The preferences of 55.000 voters will be fulfilled, while 45.000 inhabitants are outvoted. If the inhabitants of A and B vote separately, however, the A inhabitants would choose the conservative school system Y, while the B inhabitants would opt for the progressive school system X. As can be seen only 35.000 inhabitants are outvoted: this is a clear advantage of decentralized voting (under the assumption that the inhabitants in A are equally concerned about school systems as those in B). Note that with the same overall, but another inter-local, distribution of votes, both communities might vote for the progressive school system so that decentralized decision making does not seem necessary. This outcome is, however, not an argument against decentralized decision making for how could one know that an aggregated vote is enough if not by decentralized voting? Therefore it is more reliable to start with decentralized government before centralized solutions are considered. This insight has been anchored in Oates' decentralization theorem:

„For a public good — the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or the respective local government — it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions." (Oates 1972)

The primacy of decentralized decision making is also anchored in the subsidiarity principle proposed by pope Pius XI in his Encyclica „Quadragesimo Anno" (1931). The principle says that what the individual or the smaller community can do should not be allocated to the upper level. The burden of the proof for centralization is at the larger political level. The subsidiarity principle is also embedded in art. 5 EU of the Treaty of Lisbon: "The use of Union competences is governed by the principles of subsidiarity and proportionality." The subsidiarity principle is closely linked to the principle of institutional congruency mentioned above. Only when the voters of a jurisdiction bear the full costs of a public service they can calculate rationally whether it is worthwhile to increase taxes for an additional public good or vice versa to decrease taxes. Voting has been introduced in the example of table 1 because voting with one's feet is often not enough to generate efficiency of public good provision. Tiebout's competition by migration suffers from several deficiencies such as mobility costs. But so does the political process. Political entrepreneurs are not necessarily interested in either the subsidiarity principle or in the principle of institutional congruency. When they believe that they can obtain power by destroying subsidiarity and institutional congruency they will not hesitate to do so and to justify ex post their policy.

Decentralized government is always in danger of being destroyed by ambitious politicians and therefore it needs to be protected by a constitution. The task of a constitution is to regulate central politics i.e. to give politicians the desired amount of discretion to assume central power. The theory of public choice has developed several models of central power. Three of which are of importance: the model of an association of states, the model of a federal state and the model of a unitary state (Blankart 2011).

In an association of states a motion to centralize an issue is adopted only if it obtains a “gross majority”, i.e. a majority in each member state according to its constitution. In a unitary state a “net majority” of all citizens, independent of their place of living, is sufficient to adopt an issue. A federal state usually requires a qualified majority in between a gross and net majority. The grid of these three institutions is useful to understand the European Union as an association of states, the United States or Germany as federal states. and France as a unitary state. Therefore prima facie a centralization of government is more likely in a unitary state than in an association of states. On the other hand, it may be more difficult to control the decisions of the executive committee in an association of states (which is usually not directly elected by the voters)than the actions of a directly elected national government in a unitary state (which is directly elected) so that an association of states is not exempt of the danger of over-centralization.

Which Form of Democracy?

Despite the caveats against voting expressed in earlier sections of this paper, it must be acknowledged that democracy is still the most reliable way to transmit individual wants into political action. But which form of democracy should be chosen? Two institutions are in competition: “Direct Democracy” and “Representative Democracy”. In a direct democracy the voters vote on issues, in a representative democracy the voters elect representatives who vote on issues. These polar cases, however, need to be defined more closely. A direct democracy means that a representative democracy is supplemented by direct voting of the citizens, and a representative democracy means that the parliament exclusively decides. In some representative democracies, the government is elected by the parliament, in others the government or the president is elected directly by the citizens. Though both democracies are representative, the latter are often called “presidential”.

Direct and representative democracies differ in the way how individual preferences are transmitted into political action. In representative democracies the elected members of parliament are confronted only at election time with voters’ preferences. During the the mandate after they have been elected and up to the next election they and their governments are shielded from voters’ preferences.. In a direct democracy, in contrast, politicians have less leeway to enforce their own ideas. They are checked occasionally on single issues and not only on the sum of their achievements at the end of their mandate. Therefore more compliance with voter preferences has to be expected in direct democracies than in representative democracies.

An important question is therefore who benefits from this leeway or vacuum in a representative democracy? Economists say that an economic vacuum is an economic rent for which different interest groups compete up to the point where their expected benefits equal their marginal costs. However, as the property rights are not allocated at the beginning of the process, politicians' leeway is similar to a common pool property. In equilibrium the total costs of rent seeking are equal to the total benefits and nothing is gained (theorem of the dissipation of rents, Tullock, 1980). Insofar as competition for rents is restricted rents do not fully dissipate and result in benefits for staff and bureaucrats within the government (Lüchinger, Meyer, Stutzer 2010). For these reasons interest groups have an important influence in representative democracies. But what about interest groups in direct democracies? In general it is said that the political influence of interest groups is smaller in a direct democracy than in a representative democracy for it is more expensive to convince millions of voters than a hand full of representatives (Kirchgässner, Feld, Savioz, 1999, p. 31-32).

Rent seeking is not without social costs to voters: what interest groups gain is lost by voters. Especially vaguely defined and blurred voter interests such as disguised taxes, general expenditures and public debt are likely to be neglected by politicians in parliamentary democracies in favour of interest groups' goals. Amilcare Puviani has observed this phenomenon more than a hundred years ago (Puviani 1903). In empirical studies it has been found that taxes, expenditures and public debt are significantly lower in direct than in parliamentary democracies (Kirchgässner, Feld, Savioz, 1999).

So far it seems that the transfer of individual preferences into political action is more truthful in a direct democracy than in a representative democracy but it depends on what is compared. A good direct democracy is always better than a bad representative democracy. But what is a representative democracy? In practice we observe two forms: a representative democracy can be either a pure representative democracy (PRD) or a pure two party system (PTP). PRD is aimed at representing citizens' preferences as truthfully as possible, PTP is aimed at voting on political issues (Blankart and Mueller, 2004)

In a pure representative democracy every citizen is regarded as a member of parliament. But as only a few citizens want to go to parliament, those who prefer to stay outside can transfer their vote in the election process to a person of their choice. This person can cast as many votes in the parliament as she or he has been transferred in the election. But this is only the first round of an election. It is followed in a similar way by a second round limited to those say 200 candidates who have received most votes in the first round and for whom there is space in the parliament. In the end a parliament is elected that represents as closely as possible the preferences of the population as a whole. This system of a pure representative democracy can be ideally combined with referenda and popular initiatives of a direct democracy. In fact, it makes sense to allow voters to check from time to time in a referendum or in an initiative whether the representatives are still faithful to voters' preferences. As such, the referendum has its right place.

In a true pure two party system (PTP) party leaders propose a platform of issues which they want to tackle during the next election round. After a first round with several parties and platforms a run-off vote is held between the two platforms which obtained most votes in the first round. The platform which receives more votes will be given the government. Note that PTP differs from the Westminster system (as known in the UK) as it always encompasses a majority of votes which the Westminster system does not. In PTP the winning party is responsible for its entire platform up to the next election. Therefore it is logical not to allow direct democracy through referenda and initiatives during the election period as they would blur government's responsibility.

In conclusion: If the society decides in favour of PRD (or a similar system targeted towards truthful representation of voters as e.g. in Germany) direct democracy by referenda and popular initiative are recommended and should not be prohibited. Policy results from discussion and debate in the parliament and may be more or less close to voters' true preferences. Hence, checks by referenda and initiatives can be helpful. Moreover, in PRD it is inconsistent to say that parliament's mandate does not allow interfering referenda or initiatives given that such a mandate was not the purpose of the antecedent election. The purpose of the election was to find voters' preferences and to represent them in the parliament and not to formulate a government mandate.

If one wants to exclude direct democracy, PTP should be chosen. The function of the parliament under PTP is to guarantee a majority for the government. It is not its task to formulate a policy by discussion and debate as the policy has already been chosen in the election.

In any case, the Westminster System fares worse than either PRD or PTP if individual preferences are taken into account. It is also not recommended to mix PRD and PTP with the Westminster system of majoritarian election. The Westminster System may bring about a majority in the parliament, but not of the voters. It implies therefore more coercion of outvoted voters than is necessary under PRD or PTP.

Parliamentary Democracy and the Political Business Cycle

The temporary monopoly provided to governments in an election not only promotes a policy in favour of interest groups, it may also have a dynamic impact on promoting political business cycles.

This basic hypothesis has first been proposed by William D. Nordhaus (1975). In the elections, voters evaluate government's past ability to steer the economy between unemployment and inflation under the assumption of a Phillips curve. They weigh unemployment more negatively than inflation. The government can gain votes if it steers the economy in a way that unemployment is low at election time (even if inflation is high). If, after the election, inflation has to be reduced again and unemployment increases, the government's popularity decreases. But before the next elections, voters will have forgotten these hardships and will vote again for the government if unemployment is Iow even if inflation is high along the Phillips curve.

These considerations are diametrically opposed to the traditional economic policy paradigm: whereas in traditional public finance it is assumed that a government controls its expenditures and revenues in a way that the economic fluctuations are dampened, Nordhaus concludes from his model that the government has incentives to generate these fluctuations. In other words, if the private sector of the economy would not generate these fluctuations on its own, then the government of a representative democracy, which has to be reelected periodically, would cause them. Therefore, the attention of public choice economists should focus more on governmentally endogenous cycles than on governmentally exogenous cycles and their control.

This triggered an intense discussion about the Nordhaus model. I want to look at three important alternative approaches: The partisan theory by Douglas A. Hibbs (1977), the theory of rational expectations by Alberto Alesina (1987) and an intermediary theory by Bruno S. Frey and Friedrich Schneider (1978 a, b).

a) Hibbs develops a partisan theory. His parties have partisans and the party will support their causes if they come to power. Hibbs, therefore, does not follow the previously discussed Downsian hypothesis, which states that parties make their programs not in accordance with their ideology, but rather according to vote maximization. In Hibbs' model partiestry to win on power in the political science tradition with the ideology of their partisans. According to the Phillips curve, left-wing parties pursue, in Hibbs' work, an expansive and inflationary labour market policy for their clientele, i.e. the poorer classes downwards from the lower middle class. They accept inflation and focus on lower unemployment. Right-wing parties pursue the opposite policy for their clientele, the group upwards of the upper middle class. As a consequence, Hibbs predicts a political business cycle with the change in the governing party under the requirement that the Phillips curve is stable, at least in the short run.

b) Alesina (1987) and other proponents of the Political Economics School are critical on the theory of the political business cycle of Nordhaus whom they include in the Public Choice School. Their approach is "contra-public choice" (Blankart and Koester 2006). They argue that the Nordhaus and Public Choice theoriescontradict the theory of rational expectations. A government acting, as in the Nordhaus model, deceives systematically and permanently the voters. If e.g. the government pursues an inflationary policy to lower unemployment, it is assumed that workers do not realize that this policy is accompanied by a decrease in the real wage. Only with this illusion, will they be willing to work more, and only in this case, is a drift along the Phillips curve possible for the government. However, if rational expectations are assumed, individuals do not evaluate the government on the performance in the expired legislative period, but rather on the impact that governmental actions will have in the future. The individuals see through the intentions of the government, do their appropriate disposals and attempt toblock their impacts: e.g. unions will anticipate the inflation effects of an expansive tax and spending policy; they will not accept the decrease in real wages and therefore will demand higher wages, and similar, with the consequence that a positive employment effect will not be initiated and there will be no political business cycle.

Indeed there is no sense why a government should try to create political business cycles with their budgetary policy. A political influence on the economic cycle – if suspected – has to be justified in another way. Alesina (1987) takes Hibbs' partisan theory as a starting point and introduces the assumption of an uncertain election outcome. Before the vote, voters do not exactly know if a left-wing party with a preference for an expansive national budget or a right-wing party favouring a contractionary budget, will come to power. Therefore the citizens will behave carefully in their function as workers and union agents. They will assume an average budgetary policy for their wage claim if the labour agreement will hold beyond the election date. If one party comes to power there will be surprises and real (expansive or contractionary) impacts effects. From this perspective, politics will keep its influence on the economy. However, it remains an open question why workers with rational expectations do not adjust their labour agreements to the election dates so they could partly avoid surprises of the election outcome. Then there would be no political business cycles. Potentially there are no complete rational expectations.

Dennis C. Mueller (2003, chapter 19) puts the different models to the test and analyzed which one explains the U.S. business cycles between 1949 and 2000 better. The partisan theory from Hibbs performs best. If the president is a democrat, unemployment decreases whereas it increases if the president is a republican. The theories of political business cycles of Nordhaus perform slightly worse and the theoretically ambitious models of Alesina (in Alesina and Rosenthal 1995) perform even worse.

While Hibbs' partisan theory seemed to work well for the United States it was less successful for other countries. For Germany, Gerrit B. Koester (2009) shows that, contrary to the partisan theory, SPD-led governments between 1994 and 2004 lowered the progressive income tax and increased the more regressive value added tax, while CDU-CSU dominated governments behaved conversely.

c) An intermediate approach between Nordhaus and Alesina has been developed by Frey and Schneider (1978a, b). In their theory, incentives of the government to become budgetary-political active depend on the electoral-political need. This is given if elections are about to happen and the economic situation is bad. With a bad economic situation, e.g high unemployment or high inflation, the regularly measured popularity of the government is low. With upcoming elections the government sees itself forced to take immediate budgetary counteractions. In case of high unemployment it will raise the expenditures (especially transfers) and lower taxes. In case of high inflation it will lower the expenditures for goods and services and possibly raise taxes. In doing so, it hopes to win back lost popularity and to avoid an election loss. This case is illustrated in the upper left field in figure 2. In all other cases where either the economic situation is good and the popularity is high or no elections are upcoming, the government does not need to become politically active. The government can plan its incomes and expenditures in the long run dependent on their ideology and does not have to directly consider the interests of the voters[1]. The approach of Frey and Schneider was successfully tested for different countries (1978 a, b).

Table 2: Government budgetary policy dependent on election dates and economic situation

	Upcoming elections	No upcoming eletion
Economic situation bad, popularity low	Active anticyclical budgetary policy	Ideological budgetary policy
Economic Situation good, popularity high	Ideological budgetary policy	Ideological budgetary policy

[1] In Nordhaus, there is always assumed a vote maximizing policy. That is why an active business cycle policy is executed even if the current popularity would be enough for a re-election.

Source: Frey and Schneider (1978a, b)

Public Choice and the Euro Crisis

The euro should establish a unitary currency in Europe. Why was the experience with the euro so poor?

Traditionally economists say that markets fail when the law of substitution does not work and individual decision making has to be replaced by public choice. But why should the law of substitution fail? The euro belongs to financial markets which are known as the markets that react most flexibly to changes of demand and supply. Therefore market failure is rather more of a puzzle than what one would expect. Market failure may, however, creep in when it is considered that financial markets do not exist as such, but that they are built on the very long run fiscal infrastructure of the state. We can observe that these fiscal infrastructures were of no harm as long as the European countries had their own currencies. It is only with the common currency that the crisis came. It came as soon as the national currencies were tied to one common denominator, the euro. When, for example, the Banque de France formerly printed money in order to balance the national budget, Germany was unaffected because the relative price changes were compensated by corresponding foreign exchange rate changes. But as soon as the European Central Bank starts to print common euros to buy national government bonds, the burden of money creation is carried by all euro states, and in particular by Germany as the largest euro state. Similarly shifting national public expenditures on the European level is of no harm as long as each member state pays its costs. It becomes, however, a problem when the bill is shared by the participants. At that point, the so called “restaurant effect” takes place in which the costs generated by one government are socialized on the community as a whole.

According to the Maastricht Treaty every national government should carry its own costs. Neither ECB bond purchases nor Eurobonds are allowed and similar instruments are disallowed as well. The “restaurant effect” should not be practiced either. So far everything looks simple. But a member state’s costs to adjust from the national status quo to Maastricht are unequal for countries as Germany and France. Germany has a government sector which is constitutionally disaggregated in federal, state and local budgets. Each government has its endowment, its title in the total government funds for which it is responsible. Already under the national rule each authority has been constrained to break even (with current revenues and debt from the capital market). Money from the Bundesbank was not available. Therefore Germany’s adjustment costs to Maastricht were not a problem. France, however, had a national budget since the French revolution of 1789 in which all tax and other revenues stand for all expenditures. Allocation and distribution of resources should be decided uno actu which is, however, impossible as has been shown already by Arrow fifty years ago (Arrow 1951). What results is that the needs chronically exceed the means, and burden shifting as well as access to the money printing press have been common practice. Maastricht, however, has blocked these escapes. Given the antecedent budgetary tradition France had to make much greater efforts to adjust its budget process to Maastricht than Germany where the decisions on the distribution of endowments have always been separated from the decisions on the use of endowments and where therefore Coasian bargains are feasible (Coase 1960). As these costs are regarded to be excessivefor France it revealed rational to externalize them by shifting them to the European level via the ECB purchases of government bonds or via the restaurant effect (Blankart 2012).

In terms of game theory Germany and France can play “cooperatively” if they both comply with Maastricht. By doing so, they maximize the joint payoff from the monetary union. But France, for the reasons given, occasionally plays “defect” by increasing its own payoff at the costs of Germany’s and of other member states’ payoff. Germany, in contrast, cannot retaliate by playing “defect” too as its jurisdictions are tied to break even (with own revenues and own debt) under the eternity clause of Germany’s federal constitution. Therefore the euro is a destructive game which cannot work satisfactorily.

Some economists plead for a reform restoring Maastricht. This would require several years of a consistent policy. But the probability that a government behaves time consistently over several years is very unlikely. Therefore it is rather likely that the euro crisis will continue. Ending the destructive game of the euro would rather require that a sovereign assumes power, declares the state of emergency and dissolves the euro (Schmitt 1922). This is, however, risky. Therefore it remains the task of public choice to bring about constructive reform proposals.

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