

Electoral accountability in a country with two-tiered government

David Granlund*

Department of Economics, Umeå University, 901 87 Umeå, Sweden, and

The Swedish Retail Institute (HUI), 103 29 Stockholm, Sweden.

Tel.: +46 90 7869940; fax: +46 90 7869995

E-mail: david.granlund@econ.umu.se

Post-refereeing-version. The final publication is published in Public Choice 148, 531-546, 2011, available at Springer via <http://dx.doi.org/10.1007/s11127-010-9682-x>.

Abstract

In democracies, elections are the primary mechanism for making politicians act in voters' interests, but voters are unable to prevent that some resources are diverted to political rents. With two levels of government, the rents are reduced if voters require higher beneficial public expenditures for reelecting incumbents. Voters can also strengthen their power by holding politicians also liable for decisions made by the other level of government. When the incumbent at one level acts as a Stackelberg leader with respect to the other, there is no risk of this leading to Leviathan policies on the part of the incumbents.

Keywords: moral hazard; separation of powers; Stackelberg; transparency; voting theory

JEL classification: D72; H00; H77

*I am grateful to Thomas Aronsson, Magnus Wikström, two anonymous referees, and participants in a seminar at Umeå University for their helpful comments and suggestions, and to the Swedish Council for Working Life and Social Research for a grant that supported this research.

1 Introduction

As noted by Seabright (1996), political constitutions are incomplete contracts that leave room for abuse of power. In democracies, voters can discipline politicians by threatening to vote them out of office if they abuse their power and reward good politicians by reelecting them. The general purpose of this paper is to address voters' ability to discipline politicians when there are two levels of government and when the incumbent at one level acts as a Stackelberg leader with respect to the incumbent at the other.

In countries with multi-tiered governments, decisions made by one level of government often affect governments at other levels. Tax bases commonly overlap and responsibilities can intersect or be closely related. Examples of the latter are shared responsibilities for redistribution, infrastructure, and environmental protection between, for example, federal and state governments in the United States. In such situations, voters may be unable to accurately distinguish the consequences of the decisions made by one level of government from the consequences of decisions made by the other. In addition, when governments are affected by each others' decisions, it is often reasonable to assume that one level of government acts as a Stackelberg leader relative to the other. The relative size of the governments is one reason why a higher level of government is commonly assumed to act as a Stackelberg leader relative to lower-level governments (Keen and Kotsogiannis 2003). It is also possible that a lower-level government might become a Stackelberg leader relative to a higher-level government when the higher-level government is relatively weak (e.g., because the lower-level government already had commitments to certain policies when the higher level was formed). One example is that of the individual member states of the European Union, which often are considered to be Stackelberg leaders relative to the federal level (e.g., Caplan and Silva 1999; Aronsson, Jonsson, and Sjögren 2006). One level of government might also become a Stackelberg leader because of constitutional requirements that it decide on its budget before the other level of government does. Another example is that a government might get a Stackelberg role if it has to sign legal binding contracts on procurements and thereby commit to certain expenditures. In this paper, the higher-level government is treated as a Stackelberg leader relative to the lower-level government, but, as discussed below, the results apply equally well to situations where the roles are reversed.

In the model presented in this paper, the two levels of government each provide one good and finance their expenditures with taxes. The goods are inputs in a production function and voters observe the output, but are generally assumed not to observe the input levels. The latter assumption is made to mimic situations where voters are unable to accurately distinguish between the efforts of different governments.

The governments are assumed to be controlled by politicians motivated solely by self-interest who choose their policies to maximize the discounted value of their rents. This Leviathan view of politicians may not perfectly depict reality, but as long as politicians – like other humans – are partly driven by self-interest, this assumption allows us to study some interesting aspects of voters' electoral control. To focus on moral hazard, I neglect adverse selection issues by assuming that all politicians are identical.

The source of the rents is the fact that political constitutions are incomplete contracts, meaning that

politicians in power can choose policies with discretion.¹ To make selfish politicians restrain from Leviathan policies, voters allow them rents while in office and promise them reelection if they behave. These rents, which can be resources politicians divert to their private consumption, more broadly capture conflict of interests between voters and their representatives; for example, voters may favor a different composition of government spending than politicians.

One might ask whether politicians trying to divert rent is an important problem in reality, especially in stable democracies. Even if we observe cases where politicians clearly attempt to enrich themselves at the cost of the public – one example being the recent expense scandal in the British Parliament – the magnitudes of rents may not appear to be a major problem in democracies. One possible explanation for this is that repeated elections have a disciplining effect, in line with the analysis in this and related papers.

This paper relates to Persson, Roland, and Tabellini (1997) and even closer to Wrede (2002), who analyzed the behavior of selfish politicians in countries with two government bodies and compared the outcomes to those of unitary countries. While Persson et al. (1997) looked at the separation of powers between the executive and legislative branches of government and focused on the role of checks and balances in, for example, budget processes, Wrede, as I do, studied the separation of powers between *levels* of government and focused on the effects of different voting strategies, but assumed that the incumbents act as Nash competitors towards each other. Persson et al. (1997) and Wrede (2002) found that when two government bodies can commit resources without requiring approval from each other, the total political rent is higher than with only one government body. Another of Wrede's main findings is that voters can strengthen their power by introducing reciprocal liability, which reduces the independence of the governments, but that there is a risk of reciprocal liability leading to permanent Leviathan policy. Reciprocal liability is created by letting the incumbents' reelection probabilities also depend on the decisions of their counterparts at the other level of government.

The results of this paper indicate that the total tax rate is higher with two government bodies than with one. This is because the total political rent is higher with two government bodies – as demonstrated previously by Persson et al. (1997) and Wrede (2002) – and because voters will want to reduce public consumption by less than one unit when total rent is increased by one unit. The results also demonstrate that, with two government bodies, voters can reduce the resources diverted to political rents by increasing the beneficial public expenditures they require for reelecting incumbents. This means that, for a given level of the total political rent, voters will choose higher public expenditures and thus higher taxes, which increases the difference between the total tax rate in two- and one-government countries.

Other novel results depend on the assumption of Stackelberg leadership: among other matters, these results describe differences in voters' marginal cost of expenditures by the Stackelberg leader and expenditures by the follower, and how voters are affected if the Stackelberg leader is able to give an intergovernmental

¹One reason as to why constitutions are incomplete contract is that some information needed for efficient contracts are lacking or not verifiable, implying that politicians cannot be held legally responsible for some of their actions (Seabright 1996). Persson, Roland, and Tabellini (1997) demonstrated that information asymmetries concerning the state of nature can also be a source of rents. In the model used in the present paper, however, there is no such uncertainty.

transfer to the follower. In addition, unlike the situation described by Wrede (2002), the results show that, with Stackelberg leadership, there is no risk of reciprocal liability leading to permanent Leviathan policy.

Three retrospective voting strategies are considered in the present paper. Barro (1973) and Ferejohn (1986) demonstrated theoretically that voters can prevent governments from myopically behaving as Leviathans by using retrospective voting strategies. Many scholars have also found empirical support for voters employing retrospective voting strategies and for this affecting incumbents' decisions (e.g., Besley and Case 1995; Lewis-Beck 1998).

Like Wrede, I consider one voting strategy with full reciprocal liability, meaning that voters reelect either the incumbents at both levels or none of the incumbents, and contrast this solution to that obtained when voters evaluate the performance of both incumbents entirely separately. Besides these two extreme strategies, I also consider a voting strategy with partial reciprocal liability. Here, voters are assumed to hold incumbents at both levels jointly responsible for the output produced, but not to hold the incumbent at each level responsible for the tax determined and collected by the incumbent at the other level. When voters have too little information to evaluate politicians separately, for example, because the division of responsibilities between levels of government is unclear to the voters, some degree of reciprocal liability is unavoidable. For example, in Sweden, where local governments provide basic care to the elderly while regional governments are responsible for providing more advanced medical care, voters apparently sometimes do not know which politicians to blame when healthcare to the elderly is deemed inadequate, and some voters therefore employ voting strategies with partial reciprocal liability.

In the next section, I set up the model and analyze the benchmark policy decisions of voters and the incumbent in a unitary country. Section 3 presents the solutions achieved using the different voting strategies in a two-tiered- government country. First, the voting strategy with no reciprocal liability is analyzed (subsection 3.1), then that with partial reciprocal liability (subsection 3.2), and finally that with full reciprocal liability (subsection 3.3). In section 4, I discuss how voters are affected if the Stackelberg leader is able to give an intergovernmental transfer to the incumbent at the other level. Finally, section 5 presents the paper's conclusions.

2 The model and the unitary state benchmark

An infinite series of independent periods is considered. Since the conditions in all periods are the same, no time index is used. The federation consists of two levels of government, called the federal and state levels. Following Wrede (2002), horizontal divisions of the country are neglected to focus on the common-pool problem, which arises when a government body can independently commit public expenditures without requiring approval from other government bodies.

The instantaneous utility function of the voters is written $U = u(c) + \varphi(q)$, where c is private consumption and q is the output produced by the publicly provided inputs. Preferences are identical and both sub-utility functions are increasing in their arguments and strictly concave. Assuming identical preferences allows us

to neglect that elections also serve to aggregate preferences, albeit always imperfectly.

The production function, $q = q(y, Y)$, indicates that the output is a function of the input provided by the state government, y , and of the input provided by the federal government, Y . The function is increasing in both arguments, strictly concave and symmetric with respect to y and Y in the sense that for $y = Y$, $\frac{\partial q}{\partial y} = \frac{\partial q}{\partial Y}$ and that for $y < Y$, $\frac{\partial q}{\partial y} > \frac{\partial q}{\partial Y}$ and vice versa. For example, the inputs can be basic and medical care, which produce health, or environmental legislation and environmental monitoring, which together affect environmental quality.

Input y is assumed to be provided exclusively by the state government and Y is assumed to be exclusively provided by the federal government. These assumptions are made to focus on a situation when voters have difficulties separating the actions of two levels of government. For simplicity, the units are chosen so that the unit costs of y and Y are both one.

Each level of government is assumed to finance its expenditures using a tax and to balance its budget in each period. For simplicity, I follow Persson et al. (1997) by assuming that the tax base is exogenously given and normalize it to one.² Individuals have no access to capital markets, so they consume all their income. The individuals' budget constraint can thus be written $1 - t - T = c$, where t and T are the tax rates imposed by the state and federal governments, respectively.

The politicians are assumed to be infinitely lived and to choose their policies to maximize the discounted value of their rents. Ferejohn (1986) provides one rationale for assuming infinitely lived politicians, namely, that competitors for office can be thought of as political parties that last indefinitely and manage to solve their internal incentive problems.

Voters are assumed to employ simple retrospective voting strategies based on cutoff levels for the tax rates and the output (or on y and Y) and are assumed never to reelect politicians who are voted out of office.³ Following Persson et al. (1997) and Wrede (2002), I restrict the analysis to strategies based on the outcomes in the current period and not in any previous period. The advantage of such strategies is that they are simple enough to be plausible; as noted by Persson et al. (1997), such voting strategies can be seen as a simple convention adopted by voters and suggested by social norms. In addition, in this model, where there is no uncertainty regarding the state of the economy and where all politicians are identical, voters would not benefit from basing their strategies on outcomes in previous periods.

At the start of each period, p , the voters are assumed to announce their voting rule. Next, the incumbents make their expenditure and tax decisions, knowing the voting rule. At the end of the period, the voters observe the outcome and determine whether to reelect the incumbent government according to the announced voting rule. Following Persson et al. (1997) and Wrede (2002), I assume that voters are able to commit to voting rules. This is not a strong assumption: since all politicians are identical, voters are indifferent as to whether to reelect the incumbent government or elect an opposition, meaning that there is

²The tax can resemble a head tax, or – if labor supply is inelastic – an income tax.

³Wrede (2001) demonstrated that voters' ability to control politicians is greater if politicians who are ousted from office cannot expect reelection.

no cost to the voters associated with ousting politicians who do not meet the required cutoff levels.

2.1 The solution in a unitary country

In a unitary country, both public goods are provided by a central government that finances its expenditures using a single rate, τ . The voters determine cutoff levels $\bar{\tau}_0$ and \bar{q}_0 and announce that they will reelect the incumbent if and only if $\tau \leq \bar{\tau}_0$ and $q \geq \bar{q}_0$; since $c = (1 - \tau)$, this is equivalent to determining cutoff levels for c and q .

The selfish incumbent's objective is to maximize the discounted value of all rents he will obtain. An incumbent who seeks reelection will choose y and Y to maximize his rents, χ , subject to $\tau \leq \bar{\tau}_0$, $q \geq \bar{q}_0$, and the budget constraint $\tau - y - Y = \chi$. The incumbent will never set τ below $\bar{\tau}_0$ and never spend more on the inputs than necessary to exactly achieve \bar{q}_0 . Thus, the incumbent's optimization problem can be simplified to

$$\text{Max}_{y, Y} \chi = \bar{\tau}_0 - y - Y$$

subject to

$$q(y, Y) = \bar{q}_0.$$

Letting λ denote the Lagrangian multiplier, the first-order conditions are written

$$y \quad : \quad -1 + \lambda \frac{\partial q}{\partial y} = 0,$$

$$Y \quad : \quad -1 + \lambda \frac{\partial q}{\partial Y} = 0.$$

This tells us that the incumbent will choose an input combination where the marginal products of y and Y are equal, meaning that the output will be produced efficiently.

An incumbent who chooses to maximize immediate payoffs instead of fulfilling the reelection criteria would set $\tau = 1$, $y = Y = 0$ and obtain a payoff of one. Since the incumbent would never be reelected by pursuing this tactic, it also follows that the discounted value of all payoffs to the incumbent would amount to one. I assume that incumbents deviate from the proposed policy only if the present value of their rents thereby becomes strictly higher. To ensure that an incumbent adheres to the proposed policy, voters therefore set $\bar{\tau}_0$ and \bar{q}_0 so that the present value of the rents that an incumbent staying in office is guaranteed also amounts to one. Since all periods are identical, this means that an incumbent in each period must be given a rent of $\chi_0 = 1 - \delta$, where δ , $0 < \delta < 1$, is the discount factor. The voters will choose cutoff levels of $\bar{\tau}_0$ and \bar{q}_0 so that the marginal utility of private consumption equals the marginal utilities of each publicly provided good (i.e., so that $u' = \varphi' \frac{\partial q}{\partial y} = \varphi' \frac{\partial q}{\partial Y}$).

3 Solutions in the case of a two-tier government

The federal incumbent is assumed to make its decisions before – and is treated as a Stackelberg leader relative to – the state incumbent. Since horizontal divisions of the country are neglected, this is the only

principal difference between the two levels of government, meaning that the model can also be used to understand situations where the state incumbent acts as a Stackelberg leader. To highlight the principal difference between the situations for the two incumbents, in the following I call the state incumbent the “follower” and the federal incumbent the “leader.”

Following Wrede (2002), I assume that incumbents at both levels do not cooperate, that they maximize the discounted value of their rents, and that they have the same discount factor as the incumbent in the unitary nation. When voters determine separate cutoff levels for the two tax rates, both are assumed to be strictly below $\frac{1}{2}$. Still, if the incumbents deviate from the proposed policies, we cannot rule out that the sum of the tax rates exceeds one. Since the sum of the governments’ tax revenues cannot exceed the tax base – which equals one – I follow Persson et al. (1997) by assuming that if the total tax rate exceeds one, the governments obtain tax revenues equal to $\frac{1}{2}$ each. That is, the maximum tax revenues to the state and federal governments are $r = \max\{1 - T, \frac{1}{2}\}$ and $R = \max\{1 - t, \frac{1}{2}\}$, respectively.

3.1 Voting strategy one, observable inputs and no reciprocal liability

When one incumbent is responsible for providing y while another is responsible for providing Y , it may matter whether the levels of y and Y are observable to the voters. To study this, the solution that would occur if voters observed y and Y and used this information to evaluate the incumbents separately is described in this subsection. In the following two subsections, solutions obtained when y and Y are unobservable to the voters are compared with this solution.

Under strategy one, voters announce that they will reelect the follower if and only if $t \leq \bar{t}_1$ and $y \geq \bar{y}_1$ and the leader if and only if $T \leq \bar{T}_1$ and $Y \geq \bar{Y}_1$. The follower will either deviate from the proposed policy by choosing $t = r$ and $y = 0$ or seek reelection by choosing $t = \bar{t}_1$ and $y = \bar{y}_1$.⁴ If the follower would deviate, his payoff would equal $r = \max\{1 - T, \frac{1}{2}\}$. Therefore, the follower will seek reelection if and only if the discounted value of the rents he is allowed per period in office, x_1 , is at least as large as r ; that is, if

$$x_1 \equiv \bar{t}_1 - \bar{y}_1 \geq r(1 - \delta). \quad (1)$$

Condition (1) indicates that the follower will be more likely to seek reelection the lower is \bar{y}_1 , the higher is \bar{t}_1 and – for values of T below $\frac{1}{2}$ – the higher is T .

The situation of the leader is essentially the same as that of the follower. The leader can deviate from the proposed policy by choosing $T = R$ and $Y = 0$ and would then obtain a payoff of $R = \max\{1 - t, \frac{1}{2}\}$. Therefore, the leader will seek reelection if and only if

$$X_1 \equiv \bar{T}_1 - \bar{Y}_1 \geq R(1 - \delta). \quad (2)$$

Condition (2) indicates that the leader will be more likely to seek reelection the lower is \bar{Y}_1 , the higher is \bar{T}_1 and – for values of t below $\frac{1}{2}$ – the higher is t .

⁴To be exact, if the follower deviates when $T \geq 1/2$, it does not matter what tax rate the follower chooses as long as it is at least $1/2$.

In the equilibrium, the voters will determine the rents so that none of the incumbents prefers to deviate, which means that $y = \bar{y}_1$, $Y = \bar{Y}_1$, $t = \bar{t}_1 = \bar{y}_1 + x_1$, and $T = \bar{T}_1 = \bar{Y}_1 + X_1$. The rents can therefore be written as

$$x_1 = (1 - \bar{Y}_1 - X_1)(1 - \delta), \quad (3)$$

$$X_1 = (1 - \bar{y}_1 - x_1)(1 - \delta). \quad (4)$$

Solving for x_1 and X_1 gives

$$x_1 = \frac{[1 - \bar{Y}_1 - (1 - \bar{y}_1)(1 - \delta)](1 - \delta)}{2\delta - \delta^2}, \quad (5)$$

$$X_1 = \frac{[1 - \bar{y}_1 - (1 - \bar{Y}_1)(1 - \delta)](1 - \delta)}{2\delta - \delta^2}, \quad (6)$$

and

$$X_1^{Tot} = \frac{[2 - \bar{y}_1 - \bar{Y}_1]}{2 - \delta}(1 - \delta). \quad (7)$$

Under this strategy, the follower will not react to the leader's decisions. For $Y = \bar{Y}_1$ and $T = \bar{T}_1$, the follower will obtain the same discounted rents by fulfilling the reelection criteria as by deviating from them, and will then, by assumption, fulfill the reelection criteria. If the leader, for some unfathomable reason, would deviate, the payoff the follower could obtain by deviating would be reduced, meaning that he would strongly prefer to seek reelection. That the follower does not react to the leader's decisions under this strategy means that the game effectively becomes a Nash game, even though the leader makes decisions first, and the equilibrium can be described as a stable and unique Nash equilibrium.

Equations (3) and (4) tell us that the total political rent is larger under strategy one than in the unitary country. Since $\bar{t}_1 = \bar{y}_1 + x_1 < \frac{1}{2}$ and $\bar{T}_1 = \bar{Y}_1 + X_1 < \frac{1}{2}$, by assumption, equations (3) and (4) indicate that both x_1 and X_1 are strictly greater than $\chi_0/2$, which means that $X_1^{Tot} \equiv x_1 + X_1 > \chi_0 = (1 - \delta)$.⁵ Persson et al. (1997) and Wrede (2002) derived corresponding results. While the model here differs quite significantly from theirs, a feature common to all three is that the government bodies can commit resources without requiring approval from each other.⁶ This is known as a common-pool problem. That the total political rent is larger in such settings is because the incumbents are able to deviate independently and could therefore secure an immediate payoff larger than half the tax base. To avoid a Leviathan policy, voters have to guarantee political rents based on these "fallback payoffs," meaning that the total rent in the two-tier-government country must be allowed to be larger than in the unitary country.⁷ That the total political rent is larger under strategy one means that voters are more strongly restricted than voters in the

⁵An alternative proof is that equation (7) indicates that $X_1^{Tot} > \chi_0$, if and only if $\bar{y}_1 + \bar{Y}_1 < \delta$. Note that $\bar{t}_1 + \bar{T}_1 < 1$ implies that $\bar{y}_1 + \bar{Y}_1 < \delta$, since $\bar{t}_1 + \bar{T}_1 = X_1^{Tot} + \bar{y}_1 + \bar{Y}_1 = 1 + \frac{\bar{y}_1 + \bar{Y}_1 - \delta}{2 - \delta}$ can only be below one if $\bar{y}_1 + \bar{Y}_1 < \delta$.

⁶Persson et al. (1997) also demonstrated that separation of powers between government bodies can be beneficial to voters if both bodies are required to agree on public policy.

⁷The discussion here draws on Persson et al. (1997) and Wrede (2002).

unitary country, since the total political rent is larger under strategy one. This makes the voters worse off; that is, their utility is reduced.

Proposition 1 contains results describing the voters' incentives regarding their public expenditure choices. Before turning to the proposition, let us define *voters' marginal cost of public expenditures* as the reduction in private consumption that voters have to accept in order to increase public expenditures by one unit.

Proposition 1 *Under strategy one, (a) voters' marginal cost of public expenditures is below unity, and (b) the output is produced efficiently.*

To prove Proposition 1, let us analyze the voters' choice of cutoff levels. Using that $1 - \bar{y}_1 - \bar{Y}_1 - X_1^{Tot} = c$, the voters' optimization problem can be written

$$\text{Max}_{\bar{y}_1, \bar{Y}_1} V = u(1 - \bar{y}_1 - \bar{Y}_1 - X_1^{Tot}) + \varphi(q(\bar{y}_1, \bar{Y}_1)),$$

where X_1^{Tot} is defined as in equation (7). The first-order conditions then become

$$\bar{y}_1 : -u' \left[1 - \frac{1 - \delta}{2 - \delta} \right] + \varphi' \frac{\partial q}{\partial \bar{y}_1} = 0, \quad (8)$$

$$\bar{Y}_1 : -u' \left[1 - \frac{1 - \delta}{2 - \delta} \right] + \varphi' \frac{\partial q}{\partial \bar{Y}_1} = 0. \quad (9)$$

The expressions in square brackets describe how much voters have to reduce their private consumption to increase beneficial public expenditures by one unit. In other words, $1 - \frac{1 - \delta}{2 - \delta}$ is the voters' marginal cost of public expenditures and, since $\delta < 1$, it is below unity, which proves (a). This result is explained by the fact that the incumbents' payoffs from deviating unilaterally, and thus their rents, depend on each others' tax rate. When beneficial public expenditures are increased, the tax rates must be increased as well. This reduces the payoffs of deviating unilaterally, so the rents can also be reduced. That voters' marginal cost of public expenditures is below unity in this case, while it was unity in the unitary country, works for higher public expenditures here than in the unitary country.

Result (b) is proved by combining the voters' first-order conditions (8) and (9) to get $1 = \frac{\partial q / \partial \bar{y}_1}{\partial q / \partial \bar{Y}_1}$, which demonstrates that the voters choose an efficient input combination with $\bar{y}_1 = \bar{Y}_1$. Result (b) is a consequence of the total rent being reduced equally if voters increase \bar{y}_1 or \bar{Y}_1 , implying that the marginal cost of both inputs to the voters are the same. Equations (5) and (6) indicate that when $\bar{y}_1 = \bar{Y}_1$, $x_1 = X_1$, which in turns means that $\bar{t}_1 = \bar{T}_1$; that is, the equilibrium under strategy one is symmetric.

3.2 Voting strategy two, partial reciprocal liability

Here, I return to the assumption that y and Y are unobservable to the voters and therefore let the voters determine one cutoff level for q , instead of separate cutoff levels for Y and y . Thus, under strategy two, the voters will reelect the follower if and only if $t \leq \bar{t}_2$ and $q \geq \bar{q}_2$, and the leader if and only if $T \leq \bar{T}_2$ and $q \geq \bar{q}_2$. The rents under this strategy are denoted x_2 and X_2 .

The follower will seek reelection if and only if

$$x_2 \equiv \bar{t}_2 - y_2^i(\bar{q}_2, Y_2^i) \geq r(1 - \delta), \quad (10)$$

where y_2^i denotes the minimum value of y required to achieve \bar{q}_2 for $Y = Y_2^i$. Condition (10) indicates that the follower will be more likely to seek reelection the lower is \bar{q}_2 , the higher are Y_2^i and \bar{t}_2 and – for values of T below $\frac{1}{2}$ – the higher is T . Thus, for the follower, the decision context itself is unaffected by the changed strategy. He still observes the leader’s decisions before making his own and will still require a rent of $r(1 - \delta)$ to seek reelection. The value of this required rent, however, is affected by a changed decision context for the leader; unlike x_1 , x_2 is directly affected by the leader’s decisions, since y_2^i is a function of Y_2^i .

The leader chooses T_2 and Y_2 to maximize

$$\text{Max}_{T_2, Y_2} U_L = \sum_{p=0}^{\infty} \delta^p X_2$$

subject to the budget constraint ($T_2 - Y_2 = X_2$), the voting rule (\bar{T}_2, \bar{q}_2), and the follower’s reactions.

If the leader seeks reelection, he prefers that the follower also seek reelection, since the value of Y required to achieve \bar{q}_2 is decreasing in y . The leader would therefore set $T = \bar{T}_2$ and $Y = Y_2^I$, where Y_2^I is the minimum value of Y for which the follower also seeks reelection: so that $\bar{t}_2 - y_2^I(\bar{q}_2, Y_2^I) = (1 - T)(1 - \delta)$.⁸ Note that $Y_2^I(\bar{q}_2, \bar{t}_2, T)$ is increasing in \bar{q}_2 , but decreasing in \bar{t}_2 and T since the follower is prepared to increase y when tax rates are increased. This is because a higher \bar{t}_2 increases the follower’s rent for a given y_2^I , and because a higher T reduces the follower’s payoff from deviating.

If the leader does not seek reelection, for reasonable values of δ and \bar{q}_2 he would still prefer that the follower seeks reelection: if both deviate from the voting rule, both obtain a payoff equal to $\frac{1}{2}$, but if only the leader deviates, he could obtain a payoff exceeding $\frac{1}{2}$. To induce the follower to seek reelection, the leader will set Y such that the maximum amount the follower is prepared to spend on his input is just enough to achieve \bar{q}_2 . Let us call these values of Y and y for Y_2^{II} and y_2^{II} . The rent the follower requires not to deviate is only $(1 - \delta)/2$ when the leader deviates (since $T > \frac{1}{2}$ for payoffs to the leader of above $\frac{1}{2}$), meaning that $y_2^{II} = \bar{t}_2 - (1 - \delta)/2$. Thus, if the leader chooses $Y = Y_2^{II}$ and $T = 1 - \bar{t}_2$, his payoff becomes $1 - Y_2^{II} - y_2^{II} - (1 - \delta)/2$. This is above $\frac{1}{2}$ given that $Y_2^{II} + y_2^{II} < \delta/2$, which is assumed, and means that the leader will seek reelection if and only if

$$X_2 \equiv \bar{T}_2 - Y_2^I(\bar{q}_2, \bar{t}_2, \bar{T}_2) \geq [1 - Y_2^{II}(\bar{q}_2, \bar{t}_2) - y_2^{II}(\bar{t}_2) - (1 - \delta)/2](1 - \delta). \quad (11)$$

As discussed in section 4, the leader’s choice would be altered if he could secure a payoff exceeding $\frac{1}{2}$ if both incumbents deviate simultaneously. Note that $Y_2^{II}(\bar{q}_2, \bar{t}_2)$ is unaffected by marginal changes in T , since $T > \frac{1}{2}$ when the leader deviates. Since the payoff that the follower could obtain by deviating is smaller when the leader also deviates, we know that $Y_2^{II} < Y_2^I$ and $y_2^I < y_2^{II}$. As demonstrated in Appendix B of a working paper version of this paper (Granlund 2010), a sufficient condition for $Y_2^{II} > 0$ is that less than 2/3 of the follower’s tax revenues go to rents when he seeks reelection, which is assumed.

⁸Since $\bar{T}_2 < 1/2$, $r = 1 - T$ when the leader seeks reappointment.

Rational voters will set \bar{t}_2 , \bar{T}_2 , and \bar{q}_2 so that both incumbents seek reelection. Using that r in (10) then equals $1 - Y_2^I - X_2$ and substituting for X_2 , the rents can be written

$$x_2 = [1 - Y_2^I(\bar{q}_2, \bar{t}_2, \bar{T}_2) - [1 - Y_2^{II}(\bar{q}_2, \bar{t}_2) - y_2^{II}(\bar{t}_2) - (1 - \delta)/2](1 - \delta)](1 - \delta), \quad (12)$$

$$X_2 = [1 - Y_2^{II}(\bar{q}_2, \bar{t}_2) - y_2^{II}(\bar{t}_2) - (1 - \delta)/2](1 - \delta) \quad (13)$$

and

$$X_2^{Tot} = x_2 + X_2 = \left[\begin{array}{c} 1 - Y_2^I(\bar{q}_2, \bar{t}_2, \bar{T}_2) \\ + \delta [1 - Y_2^{II}(\bar{q}_2, \bar{t}_2) - y_2^{II}(\bar{t}_2) - (1 - \delta)/2] \end{array} \right] (1 - \delta). \quad (14)$$

Note the asymmetry between (12) and (13): the leader's rent is affected by the total expenditures required to achieve \bar{q}_2 if he deviates, while the follower's rent is affected, besides the rent to the leader, by only Y_2^I .

Proposition 2 describes the equilibrium under strategy two and compares it with the equilibrium under strategy one.

Proposition 2 *Under strategy two, (a) voters' marginal cost of public expenditures is below unity, (b) the output is produced inefficiently, and (c) voters are better off than under strategy one.*

The proof to (a) and (b) is given in Appendix C of Granlund (2010). The intuition for (a) is the same as under strategy one: when voters increase the beneficial public expenditures by increasing the cutoff levels, the payoff from deviating unilaterally, and thus the required rents, is reduced. This means that the voters' marginal costs of y_2^I and Y_2^I ($1 + \frac{\partial X_2^{Tot}}{\partial y_2^I}$ and $1 + \frac{\partial X_2^{Tot}}{\partial Y_2^I}$, respectively) are below unity.

By studying (14) we directly see the main reason for (b): Y_2^I , but not y_2^I , has a direct negative effect on the total political rent, indicating that the voters' marginal cost of Y becomes lower than that for y . A counteracting effect occurs if $Y_2^{II} < y_2^{II}$ (and thus $\frac{\partial q}{\partial y_2^{II}} < \frac{\partial q}{\partial Y_2^{II}}$). Then, if the voters reduce y_2^I/Y_2^I for a given \bar{q}_2 – which they can do by reducing \bar{t}_2/\bar{T}_2 – a deviating leader will not have to increase Y_2^{II} as much as y_2^{II} is reduced. This increases the leader's rent and generates higher total political rent. This latter effect is dominated by the former in the optimal solution, meaning that the voters' marginal cost of Y is lower than that for y . Voters will therefore choose their cutoff levels so that $\frac{\partial q}{\partial Y_2^I} < \frac{\partial q}{\partial y_2^I}$ and the output will be produced inefficiently with $y_2^I < Y_2^I$.

Voters have enough instruments to choose efficient input mixes: they can, for example, reduce Y and increase y by reducing \bar{T} and increasing \bar{t} . Despite this, voters will choose an inefficient input combination to reduce the total political rent. This result stems from two characteristics of the model: (i) that one incumbent acts as a Stackelberg leader relative to the other and (ii) that the Stackelberg leader's decisions will affect whether the follower is reelected.

To prove (c), it is helpful to use that $y_2^{II} + (1 - \delta)/2 = y_2^I + x_2 = \bar{t}_2$, which allows the rents to be written as

$$x_2 = \frac{[1 - Y_2^I - (1 - Y_2^{II} - y_2^I)(1 - \delta)](1 - \delta)}{2\delta - \delta^2}, \quad (15)$$

$$X_2 = \frac{[1 - Y_2^{II} - y_2^I - (1 - Y_2^I)(1 - \delta)](1 - \delta)}{2\delta - \delta^2} \quad (16)$$

and

$$X_2^{Tot} = x_2 + X_2 = \frac{2 - y_2^I - Y_2^I - Y_2^{II}}{2 - \delta} (1 - \delta). \quad (17)$$

Comparing (17) with (7), we see that for given levels of y and Y , the total political rent under strategy two is less than under strategy one, since $Y_2^{II} > 0$. This means that voters are less restricted under strategy two and thus obtain a higher utility.

That voters are worse off under strategy one than under strategy two might seem surprising, since they had more information under strategy one. The explanation, of course, is not the difference in information itself, but that voters were assumed to use their additional information under strategy one to evaluate the incumbents separately. As Wrede (2002) demonstrated, it may be in the voters' interests to enforce reciprocal liability, which is created when the reelection probabilities of both incumbents also depend on each others' policies. Basing the reelection decision on q , instead of on y and Y , in fact induces reciprocal liability, even though stronger forms of reciprocal liability are possible. The reason why voters are better off if they enforce reciprocal liability is that this reduces the leader's possibility to deviate unilaterally and thus the payoff he would obtain by deviating. This, in turn, means that the rent that voters must guarantee the leader can be reduced. For given levels of y and Y , the follower's rent must be increased by $(1 - \delta)$ times the reduction in the leader's rent, meaning that the total political rent is reduced by δ times the reduction in the leader's rent. Thus, voters benefit from enforcing reciprocal liability.

3.3 Voting strategy three, full reciprocal liability

Let us now consider full reciprocal liability, meaning that voters follow strategy three and reelect both incumbents if $t_3 + T_3 \leq \bar{\tau}_3$ and $q_3 \geq \bar{q}_3$, and reelect none if either of these conditions is not fulfilled. Thus, under this strategy the incumbents are liable for each others' expenditure decisions, as under strategy two, and also for each others' tax decisions. The rents under this strategy are denoted x_3 and X_3 , and t_3 , T_3 , y_3 , and Y_3 denote the levels of taxes and expenditures determined by the incumbents.

The follower will seek reelection if and only if

$$x_3 \equiv \bar{\tau}_3 - T_3^i - y_3(\bar{q}_3, Y_3^i) \geq r(1 - \delta), \quad (18)$$

where $y_3^i(\bar{q}_3, Y_3^i)$ denotes the minimum value of y required to achieve \bar{q}_3 for $Y = Y_3^i$.

Leaders seeking reelection have no choice under strategy one, but under strategy two they choose Y_2^I to maximize their rents. Under strategy three, a leader seeking reelection chooses T_3 and Y_3 to maximize his rents, $X_3 \equiv T_3 - Y_3$, subject to the follower's selection constraint, $\bar{\tau}_3 - T_3 - y_3(\bar{q}_3, Y_3) - (1 - T_3)(1 - \delta) \geq 0$ and the voting rule. The first-order conditions become

$$T_3 : 1 - \lambda_3 [1 - (1 - \delta)] = 0, \quad (19)$$

$$Y_3 : -1 - \lambda_3 \frac{\partial y_{3v}}{\partial Y_{3v}} = 0, \quad (20)$$

where λ_3 denotes the Lagrangian multiplier for the follower's selection constraint and where $\frac{\partial y_3}{\partial Y_3} \equiv -\frac{\partial q / \partial Y_3}{\partial q / \partial y_3}$.

Full reciprocal liability eliminates the leader's possibility to deviate independently: if the leader chooses a higher tax or lower expenditures than is in accordance with the follower's selection constraint, it is in the follower's interests to maximize his immediate payoff. Both incumbents will then obtain a payoff of $\frac{1}{2}$. Thus, the rents can be written

$$x_3 = [1 - Y_3 - (1 - \delta)/2] (1 - \delta), \quad (21)$$

$$X_3 = (1 - \delta)/2 \quad (22)$$

and

$$X_3^{Tot} = x_3 + X_3 = [1 - Y_3 + \delta/2] (1 - \delta). \quad (23)$$

When writing the leader's optimization problem and the expression for x_3 above, I used that T_3 must be strictly below $\frac{1}{2}$ since $\bar{\tau}_3 < 1$. To understand why, note that in a situation where the leader chooses $T_3 > \frac{1}{2}$, x_3 would equal $(1 - \delta)/2$ and thus be unaffected by marginal changes in T_3 . The first-order condition for T_3 would then become $1 - \lambda_3 = 0$, which, combined with equation (20), would give $\frac{\partial y_{3v}}{\partial Y_{3v}} = 1$ and $y_3 = Y_3$. With $x_3 = X_3 = (1 - \delta)/2$, this means that $t_3 = T_3$, but this is impossible when $T_3 \geq \frac{1}{2}$, given that $\bar{\tau}_3 < 1$, which proves that $T_3 < \frac{1}{2}$.

Looking at (22) and (21), we see that $x_3 > X_3$, since $T_3 = Y_3 + (1 - \delta)/2 < \frac{1}{2}$. Actually, X_3 is less than the rent the leader would obtain if the two incumbents acted as Nash competitors towards each other: then the leader would obtain a rent equal to what he obtained under strategy one, $X_1 = (1 - \bar{y}_1 - x_1)(1 - \delta)$, which is above $\frac{1}{2}$ since $\bar{t}_1 = \bar{y}_1 + x_1 < \frac{1}{2}$. Thus, under full reciprocal liability an incumbent is clearly hurt by having to make its decisions before the other incumbent.⁹ Consider Proposition 3.

Proposition 3 *Under strategy three, (a) voters' marginal cost of public expenditures of the leader is below unity, while their cost for public expenditures of the follower is unity, (b) the output is produced inefficiently, and (c) the voters are better off than under strategies one or two.*

To prove (a), note that voters' marginal cost of public expenditures are one, plus the effect that a marginal increase in the expenditures has on the total political rent, described in (23). Therefore, we see that the voters' marginal cost is δ for Y , but that it is unity for y , since the leader's payoff from deviating is fixed at $(1 - \delta)/2$ and hence unaffected by the follower's tax and expenditure decisions.

Result (b) is proved by combining the leader's first-order conditions, (19) and (20). This gives $\delta = \frac{\partial q / \partial Y_3}{\partial q / \partial y_3}$, which demonstrates that the leader chooses T_3 and Y_3 so that $y_3 > Y_3$. By choosing this inefficient input combination, the leader reduces the payoff that the follower could obtain by deviating, and thus the rents he must be given. Note that while the inefficient input combination was chosen by the voters under strategy two, it is chosen by the leader under strategy three. This difference is because two policy variables are generally insufficient to enable voters to choose the input combination they prefer. However, that voters' marginal cost of public expenditures are δ for Y and unity for y implies that they, like the leader, prefer an input combination described by $\delta = \frac{\partial q / \partial Y_3}{\partial q / \partial y_3}$. That the leader's and the voters' interests coincide in this

⁹Under partial reciprocal liability it is inconclusive whether the leader gets lower rent than the follower (Granlund 2010).

matter is because y and Y do not affect the leader's payoff from deviating, and it implies that the voters are not restricted by being unable to choose the ratio y/Y , by choosing separate cutoff levels for t and T (or for y and Y).

To prove (c), first note that the leader is worse off under strategy three than under strategies one or two, since both X_1 and X_2 are above $(1-\delta)/2$ (as discussed in previous subsections), while $X_3 = (1-\delta)/2$. In addition, note that under all three voting strategies, the follower's rent and the total political rent can be written $x = [1 - Y - X](1 - \delta)$ and $X^{Tot} = X + [1 - Y - X](1 - \delta) = \delta X + [1 - Y](1 - \delta)$. Therefore, if X is reduced by one unit and Y is left unchanged, the total political rent is reduced by δ even though the follower's rent is increased by $(1 - \delta)$. This tells us that, for a fixed level of Y , the total political rent is lower under strategy three than under strategies one or two. Since under all strategies voters can obtain the level of Y that they prefer, voters are less strongly restricted and better off under strategy three than under the other two strategies.

Propositions 2 and 3 demonstrate that voters in an economic federation can strengthen their ability to discipline the incumbents by introducing partial reciprocal liability, and even more so by introducing full reciprocal liability. Still, total rents are higher than in the unitary country even under strategies two and three. This is proved by the fact that the t_2 , T_2 , and T_3 are all below $\frac{1}{2}$, which gives $x_2 > (1 - \delta)/2$, $X_2 > (1 - \delta)/2$ and thus $X_2^{Tot} > \chi_0$, and $x_3 > (1 - \delta)/2$ and thus $X_3^{Tot} > \chi_0$. Since the total political rent is larger than in the unitary country, voters are more strongly restricted and therefore worse off than voters in the unitary country. Corollary 1 describes what implications this has for the total tax rates.

Corollary 1 *Under strategies one, two, and three, the total tax rates are higher than in the unitary country.*

Corollary 1 is proved by that the total rents under all strategies are higher than in the unitary country and that public expenditures are reduced by less than one unit when the total political rent is increased by one unit.

4 Intergovernmental transfers

In this section, I briefly describe how voters are affected if the leader is able to give an intergovernmental transfer, s , to the follower. With the intergovernmental transfer, under all strategies, the leader will choose s , T , and Y to maximize

$$\text{Max}_{T,Y,s} U_L = \sum_{p=0}^{\infty} \delta^p X$$

subject the budget constraint ($T - s - Y = X$), the voting rule, and the follower's reactions. Voters will take into account possible effects that the leader's new instrument has on the leader's and follower's decisions, when determining the cutoff values.

Proposition 4 describes how voters are affected if the leader is allowed to decide on an intergovernmental transfer that is allowed to be negative, meaning that the leader could demand a transfer from the follower.

Proposition 4 *Under all strategies, voters are hurt if the leader is able to decide on a transfer that is allowed to be negative.*

Proposition 4 is explained by that if the leader can demand a transfer from the follower, the leader is able to circumvent that he will access only half of the tax base directly if the total tax rate exceeds one. If the leader can secure the transfer if he deviates, the leader could, under all strategies, guarantee himself a payoff of unity by setting $T \geq \frac{1}{2}$, $s = -\frac{1}{2}$, and $Y = 0$ and would therefore require a rent of $1 - \delta$ not to do so. The increases in the leader's rent also imply increases in the total political rents under all strategies, which in turn means that voters become more restricted and hence worse off.¹⁰

Proposition 5 describes how voters are affected if the leader is allowed to decide on an intergovernmental transfer that is restricted to be nonnegative.

Proposition 5 *(a) Under strategies one and three, voters are not affected by whether the leader is able to decide on a positive transfer to the follower, but (b) under strategy two, the outcome is affected negatively from the voters' perspective if $y_2^{II} < Y_2^{II}$ when $s = 0$.*

To see (a), first note that under strategy one, the leader has no incentive to transfer resources to the follower, since the incumbents are evaluated separately by the voters. Thus, the leader's opportunity to decide on a positive transfer does not change the outcome under this strategy.

Under strategy three, the leader is able to distribute the total tax revenues $\bar{\tau}_3$ equally freely with and without s . What matters to the leader is $T - s$, not the individual level of T or s . Thus, under strategy three, s is a superfluous instrument for the leader. This means that the levels of y , Y , x , and X will not be affected by the leader's ability to transfer resources either under strategy three, which proves (a).

To see (b), note that if the cutoff levels are such that $y_2^{II} < Y_2^{II}$ when $s = 0$, a deviating leader would reduce Y_2^{II} and increase y_2^{II} by increasing s until $y_2^{II} = Y_2^{II}$. This would reduce the total expenditures required to fulfill \bar{q}_2 , because of the concavity of the production function, without increasing the rent the follower requires, since the follower's payoff from deviating simultaneously with the leader is fixed at $\frac{1}{2}$. This would increase the payoff the leader could obtain by deviating and thus the rent he requires not to deviate.

The reason why voters can be hurt by allowing the leader to transfer resources to the follower under strategy two, but not under strategies one or three, is that it is only under strategy two that both the leader and the voters can affect the leader's rent by altering the input combination: this can be done by the leader if s is allowed and $y_2^{II} < Y_2^{II}$ when $s = 0$, and otherwise by the voters.

¹⁰The leader could get a rent of $1 - \delta$ even without a negative transfer if the rules were changed so that he would get the entire tax base if the total tax rate exceeds 1. Note that such a change would not imply that follower's rent would vanish, since the follower's rent is based on the payoff he can get by deviating, given that the leader has not deviated.

5 Discussion

This paper addresses voters' ability to discipline selfish politicians. The focus is on a country with two levels of government, where the incumbent at one level acts as a Stackelberg leader relative to the incumbent at the other and where voters are unable to evaluate the performance of the incumbents separately. Simple retrospective voting strategies are considered.

As demonstrated previously by Persson et al. (1997) and Wrede (2002), I found that, compared with a situation with only one government body, more resources are diverted to political rents and voters are worse off when two government bodies can commit resources independently. Since public expenditures are reduced by less than one unit when the total political rent is increased by one unit, the higher political rent also means that the total tax rate is higher in two-tier-government countries than in unitary countries. The results of this paper also demonstrate that voters in two-tier-government countries have incentives to increase the beneficial public expenditures they require for reelecting incumbents, since this reduces the resources diverted to political rents. This incentive increases the differences between the total tax rates in two-tier-government countries and the tax rate in a unitary country.

As in Wrede (2002), the present results demonstrate that voters can strengthen their power by introducing reciprocal liability; that is, also holding politicians accountable for the decisions of politicians at the other level of government. In fact, the present results provide stronger arguments for reciprocal liability than do those of Wrede. Unlike the situation described by Wrede, where incumbents act as Nash competitors towards each other, when one incumbent acts as a Stackelberg leader, permanent Leviathan policy is not a potential equilibrium even under full reciprocal liability. This difference between a Nash and a Stackelberg game is easily understood: given that cutoff levels are set appropriately, the Stackelberg leader can induce the other incumbent not to deviate from the proposed policy and, knowing this, will have an incentive not to deviate himself.

The results demonstrate that, with reciprocal liability, the voters' marginal cost of beneficial expenditures of the Stackelberg leader is lower than their marginal cost of beneficial expenditures of the follower. The reason is that when more resources are "tied up" by the Stackelberg leader, the follower requires lower rent not to deviate and take all the remaining resources. In addition, the results show that it is never in voters' interests to allow the Stackelberg leader to transfer resources to the follower. In the special cases where voters enforce no or full reciprocal liability, the outcome will not be affected by the transfer as long as it is restricted to be weakly positive, but in the intermediate case with partial reciprocal liability, the outcome may be affected, making the voters worse off.

A policy implication of the results presented in this paper is that voters should strive for a situation where one level of government acts as a Stackelberg leader relative to another. Emerging democracies, or others forming new constitutions, can perhaps do this by requiring government bodies to decide on their budgets at different times. The results also imply that voters rather should expand the obligations for governments that act as Stackelberg leaders, than for governments acting as followers.

When voters are unable to evaluate the performance of the incumbents separately, some degree of reciprocal liability is unavoidable. One might argue that this can be seen as a positive effect of lack of transparency, since some voters likely do not realize the benefits of reciprocal liability. However, reciprocal liability and lack of transparency have serious downsides not captured by this model. Topics for further research therefore include analyzing these issues when voters and politicians have heterogeneous preferences and when politicians differ in competence. Another topic is to analyze how incumbents can increase reelection probabilities by targeting expenses towards voters in key electoral constituencies.

References

- Aronsson, T., Jonsson, T., and Sjögren, T. (2006). Environmental policy and optimal taxation in a decentralized economic federation. *FinanzArchiv* 62, 437–454.
- Barro, R. (1973). The control of politicians: an economic model. *Public Choice* 14, 19–42.
- Besley, T. and Case, A. (1995). Incumbent behavior: vote-seeking, tax-setting and yardstick competition. *American Economic Review* 85, 25–45.
- Caplan, A. and Silva, E. (1999). Federal acid rain games. *Journal of Urban Economics* 46, 25–52.
- Ferejohn, J. (1986). Incumbent performance and electoral control. *Public Choice* 50, 5–26.
- Granlund, D. (2010) Electoral accountability in a country with two-tiered government. Umeå Economic Studies 786, www.econ.umu.se/ues/ues786/, Umeå University.
- Lewis-Beck, M.(1998). *Economics and elections: The major Western democracies*. University of Michigan Press, Ann Arbor.
- Keen, M. and Kotsogiannis, C. (2003). Leviathan and capital tax competition in federations. *Journal of Public Economic Theory* 5, 177–199.
- Persson, T., Roland, G. and Tabellini, G. (1997). Separation of powers and political accountability. *The Quarterly Journal of Economics* 112, 1163–1202.
- Seabright, P. (1996). Accountability and decentralisation in government: an incomplete contracts model. *European Economic Review* 40, 61–89.
- Wrede, M. (2001). Yardstick competition to tame the leviathan. *European Journal of Political Economy* 17, 705–721.
- Wrede, M. (2002). Vertical externalities and control of politicians. *Economics of Governance* 3, 135–151.