On the limits of democracy

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Abstract In this article, we extend the analysis of Gersbach (2009) and explore the limits of democratic constitutions to achieve first-best outcomes. We establish the most general possibility result and we illustrate the efficiency gains of flexible majority rules by examples. We show that no first-best constitution exists if there is uncertainty regarding the size of losses and benefits from public projects.

1 Introduction

Gersbach (2009) has introduced democratic mechanisms and has shown how increasingly sophisticated treatment, agenda and decision rules can yield first-best allocations in a variety of circumstances. However, it remains unclear when we reach situations for which it will be impossible to design first-best democratic constitutions. In this article, we extend the analysis of Gersbach (2009), to provide an answer to this question.

In particular, we explore the potential and the limitations of democratic constitutions to avoid the inefficiencies described above. A democratic constitution is a set of rules that specify (i) how the proposal maker is chosen and treated; (ii) restrictions on proposals that can be made and (iii) how the society decides on a proposal. The rules must satisfy the liberal-democracy constraint (see Gersbach (2009) and Section 2.3).

We establish the most general possibility result for achieving first-best allocations. First-best constitutions involve flexible majority rules. Under flexible majority rules, the size of the majority required for the adoption of a proposal depends on the proposal...
itself, e.g. on the share of the population who will have to pay taxes, or on the aggregate tax revenues generated by the proposal.\footnote{Some homeowner associations in Irvine, California use a flexible majority rule: the higher the proposed increase of fees, the higher the required majority to adopt it. Thus, the size of the majority is dependent on the proposal. I am grateful to Ami Glazer for this information.}

Flexible majority rules can ensure that a winning majority supports the provision of a project proposal if and only if the public project is socially valuable. If such flexible majority rules are coupled with other constitutional principles which will be developed in the article (such as taxation restricted to majority winners, maximal taxation of the agenda-setter and costly agenda-setting), first-best allocation may be achieved, as such rules jointly ensure that efficient project proposals will be proposed and adopted and neither inefficient project proposals nor pure redistribution proposals are proposed and approved.

Then, we show that knowledge about negative utility realizations is an essential constraint for this result. We demonstrate that no first-best constitution exists if there is uncertainty regarding the size of losses and benefits from public projects at the constitutional stage. The reason is that proposals leading to the adoption of a public project do not generate information about negative utilities. Without such information, constitutional rules cannot discriminate between efficient and inefficient projects.

My article is a study in constructive constitutional economics, as outlined in the classic contribution by Buchanan and Tullock (1962). Under a veil of ignorance, individuals decide which rules should govern legislative decision-making. In a long tradition dating back to Rousseau (1762), Buchanan and Tullock (1962) have examined the costs and benefits of majority rules chosen by a society operating under a veil of ignorance. Aghion and Bolton (2003) have explicitly introduced contractual incompleteness for the design of optimal majority rules. They show how the simple or qualified majority rule can help to overcome ex-post vested interests.

The twin problem of societies—the risk of tyranny by the majority and the risk of legislation-blocking by the minority, as outlined in Aghion and Bolton (2003)—has been further examined in Aghion et al. (2004), who derive optimal supermajority governing rules that balance both of these dangers. Harstad (2005) develops a theory of majority rules based on the incentives of members of a club to invest in order to benefit from anticipated projects. Optimal majority rules balance two opposing forces. Large required majorities provide little incentive to invest because of hold-up problems, while the members of small majorities invest too much to become members of a majority coalition.

Our study is complementary to the articles mentioned above. We extend the analysis of Gersbach (2009) and explore the limitations of democratic constitutions. The main differences to Gersbach (2009) are threefold: First, at the legislative stage, valuations become common knowledge in this article. Second, we allow for more uncertainty regarding project parameters at the constitutional stage. In particular, we allow that the share of project winners, the size of benefits and the size of losses from projects may be unknown. This multidimensional uncertainty yields the impossibility theorem. Third, we will introduce two novel rules: maximal taxation of the agenda setter and