Abstract. A major role of (repeated) elections is to create incentives for politicians to act in the interests of voters. This paper considers the disciplining role of elections in countries with either one or two levels of government. Simple retrospective voting strategies which are based on cut-off levels with respect to expenditure and tax rates are considered. It is shown that the power of voters is weakened if a second independent level of government is added. However, voters can partially reinforce their power by making politicians not only liable for their own policy, but also for the policy carried out at each other level of government.

Key words: voting theory, separation of powers, vertical fiscal externalities

JEL classification: D7, H0, H7

1. Introduction

A huge part of voting theory is devoted to the agency problem, which is caused by the conflicting interests of politicians and voters. Since electoral commitments cannot be enforced and since politicians in power always have the opportunity to choose the policy with discretion, voters have to offer rewards for a policy in their interest and have to threaten to punish politicians for bad policies. Since monetary incentives are almost completely unavailable, voters are constrained to rewarding through re-election and to punishing by voting out. The major role of repeated elections is to create incentives for politicians to act in the
interests of voters rather than to select the most preferred policy proposal. Taking into account the inability of politicians to commit to verifiable state contingent electoral promises, Barro (1973) and Ferejohn (1986) have analyzed performance-oriented voting strategies, which promise re-election if a certain cut-off level of public expenditure is provided or if the utility received is high enough. Although voters have to give up some rents, politicians are prevented from myopically behaving as a Leviathan through retrospective voting strategies.

Besides elections, the separation of powers, i.e., the assignment of specific rights to different political institutions, is a means of disciplining the politicians. However, separation of powers is not beneficial in itself since it might induce a common-pool problem among institutions. This will certainly be the case if both institutions unilaterally determine policies without any veto rights. The common-pool problem was not only discussed by Persson et al. (1997) who employed a modern public choice approach, but was also analyzed in the public finance literature on vertical fiscal externalities [see, e.g., Flowers (1988), Dahlby (1996), Keen (1995, 1997), and Wrede (1996, 1999)].

A common result of Persson et al. (1997) and of the public finance literature is that the common-pool problem among tax setting institutions put the tax payers at a disadvantage. However, in contrast to Persson et al. (1997), who discovered that selfish politicians benefit from the common-pool situation, the public finance literature on vertical tax externalities stated that revenue maximizing politicians suffer as well when they levy taxes independently because they end up at the downward sloping part of the Laffer curve. This paper will discuss the difference in method and result. The paper will analyze taxation when politicians appropriate some resources because holding power between elections is a source of rent. Simple retrospective voting strategies which are aimed at taming rent maximizing politicians will be considered. The paper highlights the conflicting interests among voters and politicians by considering a coordinated voting strategy. Unitary countries and two-tier government countries in which the common-pool problem arises will be compared. Furthermore, it will be discussed whether voters ought to make politicians only liable for themselves or also for their counterparts at the other level of government. In fact, this paper will discuss in detail a voting strategy that reduces the independence of governments by introducing reciprocal liability. The strategy under consideration is not meant as an optimum strategy but as a simple alternative to a more complex system of public function assignment with a two-tier government. It will be shown that introducing reciprocal liability has its merits although the risk of Leviathan policies increases. This paper is closely related to Persson et al. (1997), but there are some differences. On the one hand, the approach employed here is much simpler than theirs since full information is assumed in the entire paper. On the other hand, the economic part of the model of this paper is richer than theirs because neither the tax base nor total tax revenue is assumed to be constant and distorting taxes are included. The optimum level of beneficial public expenditure also depends on the political system. This paper, as well as the paper by Persson et al. (1997), focuses on the common-pool problem but does not discuss checks