

Discussing effects of direct democracy institutions on mitigation of basic political market failures with emphasis on local level

PETR CHMELÍK

Faculty of Business and Administration, Masaryk University

Lipová 41a, 602 00 Brno

Czech Republic

Email address: chmelik.petr@email.cz

Abstract

Referenda and initiatives are the means to stabilize the political business cycles and to break the politicians' coalition against the voters by destroying their monopoly on agenda setting and decision-making and by shrinking informational advantage of the „classe politique” and well-organized interest groups. Special attention is devoted to the mentioned effects on the quality of political competition on municipal level.

Key words: economic policy, direct democracy, political-business cycle, rent seeking behaviour.

1 Introduction

The aim of the paper is to show the importance of direct democracy tools¹ for the quality of political-economic processes with the emphasis on municipal level.

Assuming that the economists' normative base – methodological individualism – remains valid when leaving the marketplace and entering the political sphere, then competition must be the answer to the question of how people's wishes can best and most effectively be represented and coordinated in the public sphere [1].

Consequently, the quality of political competition is chosen as the essential criterion for the comparison of a semi-direct democracy and a representative democracy decision-making system to assess the political-business significance of direct democracy institutions.

The criterion of the competition quality in the public sphere is determined by the government's possibilities to produce political business cycles and possibilities of the well-established politicians to form a politicians' cartel, which are the main effects of the political market² failures at the supply side of politics.

The paper will demonstrate the influence of direct democracy tools on the reduction of incentives to abuse the privileged position of

- government toward opposition, which usually leads to the production of political-business cycles and
- cartels of well-established political representatives against median voter, which usually leads to rent seeking in political-business processes.

¹ The basic direct democracy tools are referenda and initiatives (possibilities of citizens to induce referendum)

² Political market is here defined as a system in which a supply of policy is represented by voting representatives (especially by political parties) and citizens represent the demand for policy.

The foundation for the analysis of local political market and possibilities of local referenda can be found in the new political economics, which has heretofore been oriented mainly on the level of national economy, because the mechanisms of political markets on both local and national levels are the same even in spite of the differences in the utility functions of political representatives at both levels as well as differences in economic policy tools.

The article proceeds as follows. After the introduction the second section is devoted to the effects of direct democracy tools on the stabilization of political-business cycles. In the third part of the paper it will be shown, how initiatives and referenda reduce incentives for rent seeking behaviour. The attention is withal transferred from national economy level, where these real political markets failures are standardly investigated, to municipal level. The final part concludes the article.

2 Body of Paper

2.1 Influence of direct democracy tools on stabilisation of political-business cycle

When solving the problems of stabilization of political-business cycles little attention was heretofore paid to institutions of direct democracy unlike the institution of central bank independence or other constitutional proposals concerning mainly voting rules.

The examination of effects of direct democracy tools in the connection with the political-business cycles depends primarily on the assumptions regarding the quality of forming of voters' expectations and length of their memory.

Discussing stabilization of traditional political-business cycles at national level

In case we proceed, in accordance with the school of rational expectations, from the assumption, that voters form their expectations in a rational way, then abuse of privilege position of government is strongly limited. Political-economic subjects adapt their behaviour to the rationally expected political-business arrangements of the government and hereby cause their neutralization, assuming of perfectly elastic prices. The economic policy has practically no effect; the economy works at potential product level³. Only informational asymmetry between the government and other political-economic subjects allows that government can in a short time horizon divert the economy from its long time equilibrium.

Referenda and initiatives raise among political-economic subjects vast discussion about political-business impacts of particular arrangements which improves knowledgeableness of voters as well as leads to mitigation of information asymmetries among political-economic subjects. This effect of referenda and initiatives helps voters and opposition to stabilize political-business cycles.

Direct democracy tools fully display its importance in case of classical models of political-business cycle (Nordhaus's opportunistic and Hibbs's ideological), that are based on limited memory of voters and adaptive way of forming of their expectation and assume higher effectiveness of the economic policy of government. The sphere of activity for abuse of privilege position of government in the relationship to opposition is getting smaller thanks to the institutions of direct democracy. The opposition can, by using direct democracy tools, take more thorough control and even initiate correction in governmental economic policy.

Although in purely representative democracy the opposition politicians try to point out negative consequences of governmental political-business arrangements – in case of

³ Hereafter is abstracted away from supply shocks on economy.

opportunistic political-business cycles the consequences of pre-election deficits, they do not dispose of the decision power, which could avert these deficits. Moreover, given the limited voter's memory and their adaptive expectations they cannot count with positive critique of governmental economic policy during the election campaign.

In case that the parties from opposition can address the voters in the moment of decision making, initiate public discussion and contribute to it by arguments against the abuse of privilege position of government, the incentives to produce political-business cycles are strongly softened.

Discussing stabilization of classic political-business cycles at local level

In case we admit that there is not a critical difference in the content of utility function of a prime minister and a mayor, if we further incorporate different political-business armoury which is at their disposal in order to fulfil their aims and we come out from limited knowledgeable and memory of voters, then it is possible to observe political-business cycles determined by the election term on the municipal level as well. For example growing investment activity can be observed in the year of election which is connected with growing indebtedness of a municipality, due to be tackled in the forthcoming election period. The explanation of such a phenomenon can be found in the same principle of the misuse of political-business tools in order to restrict competition among political candidates. Traditional models of political-business cycles are based on this principle at national level, which work with categories such as economic growth, rate of unemployment and inflation.

Range and character of political-business cycles at municipal level as well as effects of direct democracy tools are fundamentally determined by the rate of the fiscal autonomy of the particular municipalities.

The possibility to initiate local referendum about municipal budget (primarily about running into debt), analogically to national level, improves the competition among political representatives on the local political market. Political-economic subjects, that do not dispose of the needed majority of votes in order to prevent growing expenditures in the period of election, have the possibility to use the positive effects of direct democracy tools – mainly increasing of knowledgeable of voters and decreasing of information asymmetries. This helps to create effective barrier against possible abuse of privilege position of governing coalition.

2.2 Influence of direct democracy tools on mitigation of incentives to form politicians' cartel

In case we start from well-known assumptions of new political economics that politicians advance their own interests, they are not perfectly informed about voters' preferences, they have too much space for discretionary behaviour, their pre-election promises are not binding and their voters have asymmetric information⁴, than it is possible to expect, in the conditions of purely representative democracies, even more essential aspect of policy market failure than the presence of political-business cycle – an incentive to form a cartel against the ordinary citizens and gain benefits at the median voter's expense⁵.

⁴ The asymmetric information can be seen as one of the causes for the market failure. The term informational asymmetry can be used as well for the situation, when voters in the role of principals in the political-business system dispose of limited information in the comparison with the political representatives (agents), as for the situation, when particular voters and interest groups have different information.

⁵ To rent seeking see [2].

According to Freye and Stutzer [3] politicians can use three main ways to do so:

- 1) Politicians may take decisions which they know to deviate from the voters' preferences and allow them to derive larger rents
- 2) Politicians secure themselves excessive privileges
- 3) Citizens' exploration may take the form of corruption

The above-mentioned incentives for forming a cartel influence the political-business decisions at national as well as at local level.

Referenda and initiatives represent fundamental indemnity against realization of rent by politicians' cartel especially in the connection with the first mentioned area. In this case the characteristic of direct democracy tools - they enable the political-economic subjects outside the politicians' cartel to make decisions – plays a key role. Ordinary voters, unlike various “independent” boards, are not integrated into „classe politique“ and defy the control of politicians.

By force of initiatives it is possible to affect political agenda and start to press such interests, which would never be represented by established politicians in parliament and government, because of their inconsistency with the interests of politicians' cartel. The referenda have rather a controlling function, because they enable to rectify political-business arrangements of executive or legislative.

Positive effects of the direct democracy tools on the quality of political competition on the side of the supply of policy is enhanced by the effect of direct participation right on the decrease the information asymmetries and higher information level of political-business subjects at the side of demand for policy [4]. This effect can be observed on the national as well as on local level.

Discussing mitigation of incentives to form a politicians' cartel by local direct participation rights - national dimension

The effect of direct democracy tools against the formation of politicians' cartel at national level can be demonstrated on the incentives to centralise fiscal policy. Simultaneously, national dimension of local referenda will be shown by the following case.

Charles B. Blankart [5] introduced on the example of Federal Republic of Germany “cartel hypothesis”. According to the hypothesis, the process of centralisation of decisions about revenues and expenditures is a result of cartel, which is formed by particular federative lands in order to avoid the tax competition. To simultaneously eliminate the inherent instability of cartel, it was necessary to transfer the tax authority to central government. The state is able to guarantee (and sanction) obligatory rules, for which it is “rewarded” with further authorities to make expenditures and hereby to maximise votes and to realise rent of politicians at national level. The centralisation at the side of incomes is thus very closely associated with the centralisation of expenditures. The explanation of centralisation process by using cartel hypothesis is in the contrast with traditional normative perception, which is based on the principle of subsidiarity, economy of scale or interregional spill over effects. Consequently, it can be assumed, that process of centralisation initiated by politicians' cartel does not correspond with median voter's preferences.

Nevertheless Blankart's cartel hypothesis, as Blankart himself stresses, is not valid in general. The impulsions to centralise fiscal policy are endogenous part only of those systems, where it is possible to transfer the authorities of fiscal legislative to central level. This central organ then plays role of a guarantor of the local representatives' cartel, which is able to sanction abundance by the obligatory rules.

Blankart uses the competence of the central authorities to decide about the fiscal legislation as the explanation of the diametrical difference of development of centralisation of

fiscal decision-making in Switzerland and the Federal Republic of Germany⁶ after the Second World War. In Germany, the authority to make decisions about fiscal legislative was transferred to the central level, which results in substantial centralisation of decisions about public incomes and expenditures. In Switzerland, where the transfer of fiscal authority is controlled by referenda, totally opposite development was observed. Swiss voters in referenda refused lot of suggestions of fiscal policy centralisation. Concurrently important tax authorities were transferred only for limited period of time. Thus direct democracy institutions have successfully proven the ability to destabilize the base for politicians' cartel.

The citizens can soften the effort of established politicians to confine political competition via the institutions of direct democracy (in this example in the field of fiscal policy) as well as they can create prerequisites for increasing the incentives of politicians at national as well as at local level to follow preferences of median voter. This viewpoint offers to transfer research attention over to international level, where potential effects of direct participation rights can be considered for example in the context of European integration.

Discussing mitigation of incentives to form a politicians' cartel by local direct participation rights - local dimension

Analogically to analysis of political business cycles at local level the effects of direct democracy institutions on fighting the politicians' cartel are fundamentally determined by the rate of fiscal autonomy of particular municipalities.

Effects of direct democracy tools against systematic deviation of economic policy from voters' preferences at the local political market can be demonstrated on an example of restriction of indebtedness of public budgets.

The influence of direct democracy institutions on the mitigation of running into debt was shown on the stabilisation of political-business cycles in the previous chapter. In the case of political-business cycles, the abuse of the government monopolistic position in the relationship to the opposition is concerned. However, the effect of direct participant rights on the mitigation of a more serious failure of political market competition, where agreement between governmental politicians and established oppositional politicians is assumed, can be demonstrated on the case of public budgets deficits.

In this connection we can imagine various "development investments", which usually do not have immediate connection to the short-term voting cycle and primarily serve to saturate the preferences of well-organized interest groups. The relationship between these subjects of demand side of political market and the political representatives (governmental and oppositional as well) is characterised by the fact, that it is cultivated independently of the voting of these well organized groups in the election. This determines the cardinal difference from the incentives of governmental and oppositional representatives, which create political-economic cycle by the expenditures, realized in the term of election in order to buy votes.

In the case of stabilisation of political-business cycles the main role of referenda and initiatives can be seen in the boosting of the position of main oppositional forces. On the other hand, in the case of mitigation of impulses to rent seeking the main up rating mechanism can be seen in the weakening of entrance barriers for new subjects.

Fiscal restriction limits opportunities to rent seeking in political-economic processes. In the purely representative democracy local governments thus typically avoid saving arrangements, even if they are contained in pre-election promises. The attitude of particular

⁶ The degree of centralisation by tax was in 1950 in both countries approximately the same – The part of national tax was about 60% of total tax yield. In 1995 this part has arisen to 93% in the case of Germany, whereas in the case of Switzerland it has dropped to 47% [5]. In the harmony with the cartel hypothesis the correlation between the centralisation of tax yields and state budget deficit can be observed.

opposition parties⁷ will be most probably depended on their opportunities in the participation on rent, which could be by fiscal restriction endangered.

According to Eichenberger [6] rational voters in standard representative democracies adapt their expectation as reaction to the above-mentioned tendency. This leads to the decrease of trustworthiness of the pre-election promises, which are not in accordance with the preferences of cartel of established politicians. Low level of trustworthiness of the pre-election promises strengthens the privilege position of politicians' cartel, because it builds effective barrier for entry of new subjects at the supply side of political market.

In this respect Eichenberger puts emphasis on totally different conditions of oppositional non-established political parties to enforce political-business aims in semi-direct democracy. Oppositional, non established (newly founded respectively) political party can by itself initiate decision of citizens about decreasing of indebtedness of public budgets or about rejecting the planned "public" investments enforced by well organized interest groups. The newly founded party has as well the opportunity to establish itself by proposals of public budgets consolidation. The rate of trustworthiness of such political-business conceptions, which are not in accordance with interests of politicians' cartel, is growing thanks to direct democracy tools. Assuming an approval of proposed issue in a referendum the decision will directly come into operation.

The mentioned difference in the conditions for indebtedness control at local level is in accordance with the results of empirical research using modern econometrical methods (for overview of studies based on experience from Switzerland and USA see [7]). The municipalities with more direct democracy show *ceteris paribus* less indebtedness.

3. Conclusion

With respect to the presented effects of direct democracy tools on the quality of political competition, higher incentives of political representatives to follow interests of their voters can be expected in semi direct democracy in comparison with purely representative democracy.

The paper shows, in the framework of the analysis of direct democracy tools' abilities to restrict the basic expressions of political market failures, how referenda and initiatives can help to stabilise political-business cycles and to soften the impulses of established politicians to constitute cartel to realize rent from consumer surplus of median voter.

Withal the focus was taken from level of national states onto level of local municipalities. The effects of direct democracy tools on the quality of political markets were thus shown on the local level as well. Further research area of the effect of direct democracy institutions can be seen in the transnational dimension of the problems, which are connected with the presented forms of imperfect political competition.

Implementation of direct democracy tools into the purely representative democracy systems thus promises positive effects on the enhancement of political competition. Higher quality of competition on the political market then creates better conditions for the enforcing of median voter preferences in common economic policy.

⁷ It is possible to assume the support of governmental intent to circumvent election promise of fiscal restriction especially by the minority government, because this is forced to enable participation of other parliamentary parties on the rents realisation.

References

- [1] FREY, B. S. – BOHNET, I. (2001): Democracy by Competition: Referenda and Federalism in Switzerland. In: Elazar, D. J. (ed.): Commonwealth: The Other Road to Democracy. The Swiss Model of Democratic Self-Government, Lexington Books, str. 153–156, 2001.
- [2] FREY, B. S. – STUTZER, A. (2003): Direct Democracy: Designing a Living Constitution. Institute for Empirical Research in Economics, University of Zurich, Working Paper No. 167, str. 1- 48, 2003.
- [3] TOLLISON, R. D. (1982): „Rent – Seeking: A Survey“. Kyklos 35, str. 575– 602, 1982.
- [4] BENZ, M., STUTZER, A. (2004): Are Voters Better Informed When They have a Larger Say in Politics? Evidence for the European Union and Switzerland. Public Choice 119(1-2), str. 31-59, 2004.
- [5] BLANKART, CH. B. (1999): Die schleichende Zentralisierung der Staatstätigkeit: Eine Fallstudie. ZWS, 119, str. 331 –350, 1999.
- [6] EICHENBERGER, R. (1999): Mit direkter Demokratie zu besserer Wirtschafts- und Finanzpolitik: Theorie und Empirie. In: Hans Herbert von Arnim (eds.): Adäquate Institutionen: Voraussetzung für „gute“ und bürgernahe Politik? Berlin, Duncker&Humboldt, str. 259- 288, 1999.
- [7] KIRCHGÄSSNER, G. – FELD, L. – SAVIOZ, M. R. (1999): Die direkte Demokratie: Modern, erfolgreich, entwicklungs- und exportfähig. Helbing und Lichtenhahn/ Vahlen, 1999.

This paper has arisen in the framework of the grant project: GAČR no. 402/07/P260 “The Effect of the Institution of Local Referendum on the Quality of Political-economic Processes in the Czech Republic”