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Politicians as experts, electoral control, and fiscal restraints☆

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ABSTRACT

We propose an argument for fiscal restraints that is based on the premise that the services of politicians are credence goods. Politicians are experts who specialize in observing the true state of the economy. Budget maximizing politicians are better informed than the electorate about the level of public spending necessary to manage public affairs. Voters, who are able to observe the size of the budget but not the necessary level of spending, affect the government's spending behavior via electoral control. A fiscal restraint limits the maximum spending a government can choose. We identify conditions under which such a fiscal restraint improves voter welfare and discuss the role of the political opposition as a second expert in situations in which the state of the economy requires a level of spending which exceeds the fiscal restraint.

1. Introduction

Fiscal restraints have become an integral part of public finance in various countries. While in 1990 only five countries (United States, Germany, Japan, Indonesia and Luxembourg) had an explicit fiscal restraint, this number increased to 76 two decades later.[1] Though more prevalent than before, however, fiscal restraints have proven to be controversial. Supporters emphasize negative externalities imposed on future generations as well as on other countries to be curtailed by fiscal restraints, while opponents argue that such rules hinder the ability of governments to intervene in the economy in times when major interventions are needed.[2] In light of this debate we provide an analysis of the welfare costs and benefits of such restraints, which is based on the assumption that politicians serve as experts in the sense that they are better informed than voters about the level of public spending necessary to manage public affairs.

Our treatment of politicians as experts mandated by voters to manage public affairs is novel in that we view politicians as serving a similar role as doctors, lawyers or other experts.[3] If a person feels sick, he or she consults a doctor to identify the cause as well as potential therapies. In most cases the patient him- or herself is not able to verify either the diagnosis or the choice of the therapy. The doctor, owing to her education and experience, has the expertise to make these determinations. The relationship between voters and politicians can be viewed in a similar way. The politician specializes in understanding public affairs and, additionally, has governmental resources at her disposal to identify the need for necessary policy interventions. Similar to the example of

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[1] See Schaechter et al. (2012). In Germany, fiscal restraints have a particularly long history. German constitutions have restricted public debt since the foundation of the German Empire in 1871. For further details see Burret and Feld (2013).

[2] For a general discussion of the pros and cons of fiscal restraints see, e.g., Schick (2010). Hallerberg et al. (2009) discuss fiscal restraints in the European Union between 1984 and 2004. Wyplosz (2012) provides evidence that the fiscal performance of countries having a fiscal restraint is mixed and emphasizes the role of political governance for a fiscal restraint to become effective.

[3] Of course, the agency perspective on the political process as such is not new. See Besley (2006), who discusses political economy applications of moral hazard, adverse selection and career concerns. Also related to our approach is the literature on strategic information transmission such as Crawford and Sobel (1982), Gilligan and Krehbiel (1987, 1988) and Krishna and Morgan (2001).

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the doctor, voters often lack the information and experience that would enable them to assess the decisions of politicians.[4] For instance, most voters are not able to determine the size and the scope of the macroeconomic policy interventions required to deal with an economic or financial crisis. While no one may have the perfect answer, politicians do have access to substantial analysis and data to make an informed decision. Similarly, in the case of foreign and defense policy, many voters are not able to determine the severity of external threats to the country and the necessary level of defense spending. Politicians, on the other hand, have access to highly classified intelligence information, which enables them to evaluate the level of threat to national security and to determine the amount of resources required to manage that threat level.

The theoretical literature on industrial economics has extensively studied the role of and the incentives for experts (see Darby and Karni (1973), for the classic reference, Dulleck and Kerschbamer (2006), for a survey of the theoretical literature and Dulleck et al. (2011), for experimental evidence). The goods and services provided by experts are referred to as “credence goods”, since the customer must trust the expertise of the provider in choosing the appropriate course of action. To view the services of politicians as credence goods has not been considered in the literature. The present article attempts to fill this gap by assuming that politicians function as experts mandated by voters. We consider the implications of this approach for the analysis of fiscal policy and, in particular, the role of fiscal restraints.

The informational asymmetry between voters and politicians would be of no concern if the interests of both parties were perfectly aligned. We do not make this assumption; rather, we assume that politicians are self-interested, rational agents, in line with the public choice tradition following Buchanan (1967). Specifically, we assume that politicians are interested in maximizing public spending (Niskanen, 1971). In our model, politicians systematically exploit their expertise in pursuing this goal.

Generally, the spending behavior of politicians can be disciplined by two mechanisms. On the one hand, voters can exert electoral control by voting a politician out of office if her expenditure appears to be too excessive. Voters thus provide incentives for politicians to act in their interest. This argument has been put forward by Barro (1973) and Ferejohn (1986). On the other hand, the spending behavior of politicians can be constrained by fiscal restraints. The role of such restraints on fiscal policy has been emphasized in particular by Brennan and Buchanan (1980). Such a restraint reduces the maximum spending. However, it also implies that in some cases politicians are not able to manage public affairs adequately. Therefore, most existing fiscal restraints specify exemptions that allow politicians to exceed the fiscal limit under certain circumstances.[5] Obviously, if only the politician in power—because of her expertise—is able to determine whether these circumstances apply, the fiscal restraint is essentially ineffective. In order to make the restraint effective, a second expert is needed who is able to verify whether the circumstances that allow for an exemption apply. Referring to our earlier analogy of the doctor–patient-relationship, the patient may mitigate the asymmetric information problem by seeking a second expert opinion. In the fiscal context, the political opposition may assume the role of a second opinion provider for voters. We specify a game where both the government and the opposition have access to information about public affairs and the required level of spending. We demonstrate that a fiscal restraint that requires support by the opposition if the government wants to exceed the fiscal restraint always improves voter welfare.

The remainder of the paper is organized as follows. Section 2 discusses the related literature and further elaborates on the key idea of this paper. Section 3 introduces the basic model. Section 4 establishes the properties of a voting equilibrium in the basic model. Section 5 introduces a fiscal restraint on the public budget and identifies the conditions under which such a restraint improves voter welfare. Section 6 extends the model by considering the role of the political opposition as a second expert in applying a fiscal restraint. Section 7 concludes.

2. Related literature

Fiscal restraints are a common theme in the public choice literature (Brennan and Buchanan, 1980, and Wilson, 1989). Most of this literature focuses on the problem of externalities of excessive public spending. These externalities may either be imposed on future generations (Buchanan and Tullock, 1962), on countries with close ties to the economy in question (von Hagen and Eichengreen, 1996), or they may arise because an incumbent government overspends strategically to limit the maneuverability of a future government (Persson and Svensson, 1989; Tabellini and Alesina, 1990).

Our model is based on the assumption of an infinitely lived electorate in a closed economy. We explicitly abstract from intergenerational as well as international externality issues. We address the function of fiscal restraints in a political accountability framework inspired by Barro (1973) and Ferejohn (1986). Barro (1973) has shown that if the preferences of the government and its electorate are not perfectly aligned then the electorate has to offer the incumbent some rent of holding office to militate against the government's pursuit of its own goals. Where Barro assumes perfect information, Ferejohn (1986) adds asymmetric information. In Ferejohn's model, the electorate cannot observe the activities of the government but is only able to assess the government's performance. The electorate thus needs to motivate politicians with a reelection rule that provides incentives to act in the interest of the public.

Persson et al. (1997) elaborate on Ferejohn's approach by analyzing how the separation of powers can help to elicit information on government activities and curtail the rent seeking behavior of politicians. Another paper on political accountability is Yared (2010). This author assumes that politicians are able to extract rents because of temporary economic shocks. These shocks generate changes in tax revenue and in the need for expenditure, thus allowing the government to exploit the tax base for rent appropriation. In this model, the voters' reelection decision puts restrictions on taxes levied as well as on minimum levels of public spending. While a benevolent government would impose constant tax rates to limit the excess burden of taxation, taxes with rent seeking politicians will be volatile, as citizens face a trade-off between the benefit of constant tax rates and the cost of potential rent appropriation by the government.

We differ from this literature by setting up the information problem as a credence good problem. Voters can observe the budget chosen by the government and they can observe its effect on their own wellbeing. However, voters cannot fully assess whether the extent of the budget was necessary to achieve this outcome. Only politicians can observe the true state of the world and this state determines the minimum necessary public budget. Within this framework we present a rationale for a fiscal restraint that functions as an instrument to limit the rents associated with the incumbent politician's expertise.

The only article, to our knowledge, discussing fiscal restraints from an agency perspective on government is Besley and Smart (2007). These authors study the role of fiscal restraints in the presence of moral hazard and adverse selection where politicians can be either good, i.e., always work in the interest of the electorate, or bad, i.e., pursuing self-serving concerns. In their model a fiscal restraint is used to select the right politicians as well as to limit rents extracted by bad incumbents. The authors

[4] Clearly, the analogy to a doctor is imperfect. What we want to emphasize is that the informational asymmetry and the incentives involved are similar.

[5] The German constitution, for example, specifies in Article 115 (2) a balanced budget rule and then states “… In cases of natural catastrophes or unusual emergency situations beyond governmental control and substantially harmful to the state's financial capacity, these credit limits may be exceeded on the basis of a decision by a majority of the Bundestag's Members.” Similar amendments to the constitutions have been made in other European countries, e.g., Switzerland and Spain. Also, most US states have some form of a balanced budget or spending rule that allows for exemptions.