

Government Institutions

Political Economy

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Sources: Baron Ch. 5, Persson & Tabellini Ch. 4.4, 9.2-9.3

US Government Institutions: Checks and Balances

US government institutions are the ultimate embodiment of the [Enlightenment](#) ideals of government (Montesquieu, Locke).

They include a system of [Checks and Balances](#) among the branches of government ([Legislative](#), [Executive](#), [Judicial](#)).

Examples:

- To enact legislation, a majority of members present in each chamber of a bicameral [Congress](#) (House of Representatives & Senate) must pass the identical bill. Then, the [President](#) must sign it.
- The President may [Veto](#) the bill. However, each chamber may override the veto and enact the bill if it musters a qualified (2/3) majority.
- The statute then may have to withstand legal challenges on Constitutional and other grounds. The [Courts](#) are independent & have jurisdictions established by the Constitution, which also provides guidance together with precedents established by previous decisions.
- Once a law is enacted, it must be administered by a [regulatory/administrative agency](#). Administrative agencies operate under their own enabling legislation & the Administrative Procedure Act of 1946.

US Government Institutions: Separation of Powers

Separation of powers is an attempt to **limit the (abuse of) power of the government** “*by dividing it against itself*”.

Overlapping Jurisdictions between the different parts of government is essential (e.g. provisions to be approved by different branches of government).

Separation of powers is not mere division of authority. If each part of government has sole authority on an issue, there are few constraints on the power of each part.

It is also not a condition of independent jurisdictions over the same area. In general, that would will induce “tragedy of the commons” problems if interests are aligned.

There should be potential for **Conflicts of Interest** between the different branches. Again, if interests are always aligned, there will be no incentive for mutual checking.

“By so contriving the interior structure of the government as that its several constituent parts may, by their mutual relations, be the means of keeping each other in their proper places.”

- James Madison, The Federalist, No. 51 (from Drazen, 2000)

The Legislative Branch: Organization of Congress

- US Congress is **Bicameral: House of Representatives & Senate**
- **The House of Representatives has 435 voting members.** They serve 2-year terms, and are elected from districts of roughly the same population.
 - Notice that this implies that the 10 largest states account for half the members. (The US Bureau of Census was established with the primary objective of keeping track of this. Districts are reapportioned every decennial census.)
- **The Speaker**, selected by the majority party, is the presiding officer of the House.
- **The Senate has 100 members.** They serve 6-year terms. 2 senators elected by each of the 50 States.
 - This **overwhelmingly favors small states** (Delaware and Hawaii have the same number of senators as California and New York). Terms are staggered, so only 33 senators run for election every 2 years.
- The vice-president of the US is the presiding officer of the Senate. They have a Tie-breaking vote.

Organization of Congress (cont.)

- The US Congress internal organization is **not** dictated by the Constitution.
- The chambers have developed **their own formal and informal organization**.
 - The **formal organization** is through Committee Structure and the Legislative Process (more on this later).
 - The **informal organization** is through Party organization and discipline enforcement within chambers.

Organization of Congress by Party

- Each party elects:
 - A **leader** (majority or minority leader)
 - **Whips** (to generate discipline on issues on which the party has taken a position –e.g. the EESA of 2008)
 - A secretary of the party conference
 - Heads of policy
 - Steering committees.
- Party discipline is not the rule and members can break from their parties.

Congressional Committees

Committees are part of the formal organization of Congress.

Different **Congressional Standing (Permanent) and Working (Temporary) Committees** have jurisdiction on legislative matters.

The House has 21 committees; the Senate 20. There are 4 joint committees (for instance, the Economic committee).

Some very committees are very powerful (ex: Appropriations, Ways & Means, Budget, Rules, Energy & Commerce).

There is further subdivision into specialized **Subcommittees**.

Congressional Committees (cont.)

Each committee is **composed by members of both parties** (roughly proportional to chamber's seat allocation).

Committee assignments are **decided by party conferences** and **based on seniority**.

Chairmanship is also assigned based on seniority (with few exceptions).

The minority party indicates the **ranking member** instead.

Members of the House usually seat in two or more committees.

- Freshmen indicate their preferences (usually the committees closer to their constituent interest, or powerful committees like Ways & Means).
- Senators sit in multiple committees
- All majority senators are chair of some committee or subcommittee.

Congressional Committees Listed

House of Representatives Committees	Senate Committees
Agriculture	Aging (special)
Appropriations	Agriculture, Nutrition and Forestry
Armed Services	Appropriations
Budget	Armed Services
Education and the Workforce	Banking, Housing and urban Affairs
Energy and Commerce	Budget
Financial Services	Commerce, Science, and Transportation
Government Reform	Energy and Natural Resources
Homeland Security	Environment and Public Works
House Administration	Ethics (select)
International Relations	Finance
Intelligence (select)	Foreign Relations
Judiciary	Government Affairs
Resources	Health, Education, Labor and Pensions
Rules	Indian Affairs
Science	Intelligence (select)
Small Business	Judiciary
Standards Of official Conduct	Rules and Administration
Transportation and Infrastructure	Small Business and Entrepreneurship
Veteran Affairs	Veteran Affairs
Ways and Means	

Why are Committees important?

Committees are the real **Agenda Setters**.

They **draft, amend, and rewrite** (“mark up”) bills.

Committees have **gate keeping power**. They send bills to the floor or delay them (this may mean killing the bill).

However, there is a system of checks and balances here too.

- In the House, a discharge petition by a majority of members can bring a bill to floor (and out of committee).
- In the Senate, there is no germaneness rule for amendments. So, bills can be attached to other bills already on the floor.

Most importantly, Committees gather **issue-specific information**. This means that most other members will delegate them decisions.

The Legislative Process: How Does a Bill Come to Life?

- Bills are introduced by **members of Congress (sponsors)**. Usually cosponsors join in, to show the amount of support for the legislation.
- Depending on the chamber of the sponsor, the bill is referred to the **Congressional Standing Committee**, which has jurisdiction on the matter.
- The standing committee refers to the appropriate **Subcommittee**, which considers it. By majority vote, it decides to send it back to the full committee.
- Then, the full committee decides to send the bill to the floor for discussion. **The discussion includes the addition of amendments.**
 - The standing rule is that amendments have to be germane to the bill.
 - Also, Open/Restricted amendment rules can be attached to the bill.

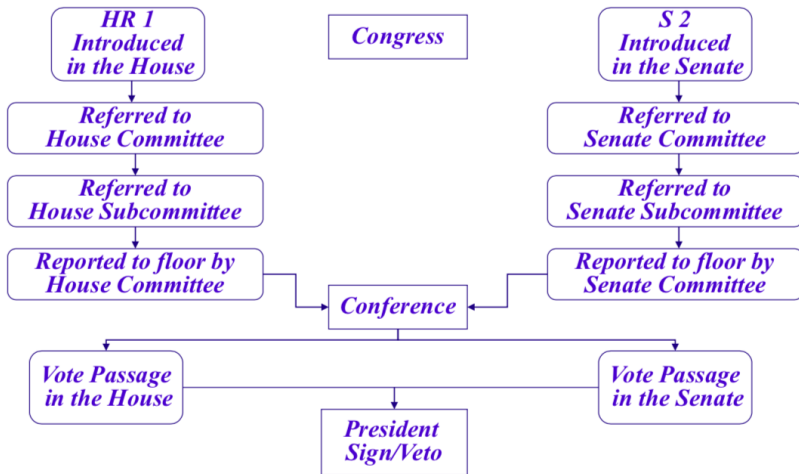
The Legislative Process (cont.)

- The same process has to be held in both Chambers. If any, **differences between the bill discussed in the House and Senate have to be reconciled in Conference.**
- Then, both chambers vote passage of the same bill.
- The bill is then **signed or vetoed by the President.**
- If a Chamber votes on the bill with a 2/3 qualified majority, the veto may be **overridden.** (290 votes in the House, 67 in the Senate).
- Any legislation pending at the end of a Congress dies! In such occasions, the legislative process is completely reset.

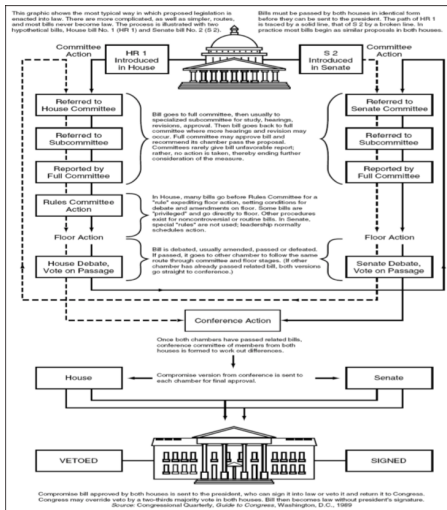
The Legislative Process (cont.)

- In the Senate, a bill can be blocked by **Filibuster**. During the debate a Senator may discuss the bill indefinitely.
- However, a qualified ($3/5$) 60 senators vote of **Cloture** can avoid filibuster (Ex: health care reform)
- In 2013, the Senate voted (52 to 48) to require only a simple majority ($1/2$) vote to end a filibuster of all executive & judicial nominees (excluding Supreme Court nominees).
 - “**Nuclear option**” by Democrats.
 - $3/5$ majority remains for legislation and SCOTUS.
- There are **multiple veto points** in the process. Result: the majority of bills introduced are never enacted
 - In the 107th Congress only 377 out of 5,767 bills in the House and 3,190 bills in Senate were enacted.

The Legislative Process (Flowchart)



The Legislative Process (Flowchart)



Source: ch.5 Baron, 2008

Legislators and Constituents

Members of Congress base their behavior on their **legislative preferences (or ideology)** and their **reelection incentives**.

Party leaders matter as well (Canen, Kendall, Trebbi, 2019).

An electoral constituency includes voters (with specific **constituent interests**); providers of campaign resources (often **special interest groups**).

However, there is substantial evidence that for bills of lower salience than AHRFPA and EESA, politicians follow their ideology a lot (Poole and Rosenthal, 1997).

Apparently incumbent politicians are quite good at convincing voters that they should value what they do...

Legislators and Constituents (Example)

In my own research, I show the following:

- During the US mortgage default crisis of 2008, US congressmen with [high mortgage default rates in their congressional districts](#) overwhelmingly voted in favor of a Housing Rescue bill (AHRFPA of 2008).
- Moreover, when the crisis extended to Wall Street, congressmen that had received [electoral campaign contributions from Wall Street](#) overwhelmingly voted in favor of a Wall Street bailout bill (EESA of 2008).

Incumbency Advantage

The rate at which incumbent politicians who run for reelection succeed is **very high**.

In November 2008, **only 26 of 404** House members who ran for reelection were defeated.

This advantage (Lee, 2008) may come derive from various sources:

- **Name recognition** (rationally ignorant voters may find this important when they do not have incentives to investigate issues).
- **Franking privileges** (free mailings to constituents).
- **Committee seniority** (self-reinforcing given that because valuable committees are accessible to more senior members).
- **Ability to raise campaign contributions** from special interests.
- **Gerrymandering districts** (redesigning districts borders to increase electoral support).
- **Information about their ability** can be inferred from past observations. See Kendall, Nannicini, Trebbi (2014).

Parties in the US Political System

Parties are the main institution for political organization.

In the US, the Democratic Party and the Republican Party (GOP) are the largest.

- Duverger's Law
- However, locally strong exceptions are present (Green Party, Third Party, Libertarians, Socialists).

Historically, Democrats have overwhelmingly controlled both chambers. Levitt and Snyder (1997) show how this produced a very peculiar distribution of government outlays across US Congressional districts.

Parties in the US Political System (cont.)

However, starting from the 1980's a realignment of the South with the Republican party produced a substantial shift in the weight of republicans in Congress.

- In 1994 both chambers became republican. This led to radical organization of congressional organization (e.g. term limits on committee chairmanships)
- In 2006, the House & Senate went back to democrats.
- In 2010 House went to the GOP (Republicans). So did the Senate in 2014. The House back to Dems in 2018.
- There has been much more alternation in the last 20 years.
- This has led to divided government (different parties control Congress vs. Presidency). See Alesina and Rosenthal (1994)

Weak Parties in the US Political System?

In the US, parties are relatively weaker than in parliamentary systems (Canada) and in systems with a proportional representation electoral rule (Italy).

Parliamentary systems operate through coalitions and revolve around **confidence votes**.

- So, strong party discipline is necessary.
- PR rules (especially closed-rule ones) give the party the right to pick the candidates to put on the electoral lists, giving a lot of power to party leadership.

In the US, nominations for elected officials are **determined locally, not nationally**.

Electoral rule: a first-past-the-post (plurality) electoral rule assures a personal relation between a politician and her district (bypassing the party). See research by Persson and Tabellini (2000).

Campaign contributions are given directly to candidates rather than parties, so US parties do not hold up politicians.

Effects of Party Weakness in the US

The degree of independence of members of Congress from the political party line would seem high.

However, party loyalty is strong & in most roll calls politicians vote with their party (Canen et al, 2019; McCarty, Poole and Rosenthal, 2006).

Moreover, it does not seem that politicians elected by narrow margins are more responsive to their constituency.

- Probabilistically, they're actually more likely to break from the party line given they high number of supporters of the other faction).
- See Lee, Moretti, Butler (2004 QJE): A Democrat elected by a narrow margin votes as “liberal-ly” as a democrat elected by a hardcore liberal district.

Measuring Party Loyalty

To measure party loyalty, consider **roll-call votes** where the majority of one party voted against the majority of the other party.

- Between 40 and 50% of all roll-calls have such degree of partisanship – a lot of votes in Congress pass unanimously.
- In PoliSci, these are called **UNITY Scores**.
- In my research, I show that party loyalty can occasionally be strongly affected by constituents. However, typically UNITY hovers around **90%!**

The President of the United States

The President **presents a Budget to Congress**: the main instrument of funding for policy.

The President has a wide range of powers (wider than prime ministers in parliamentary regimes) granted by the Constitution

- Veto power over legislation
- Certain powers in foreign relations

The President also has powers delegated by Congress

- Negotiation of treaties and trade agreements.

Certain administrative areas can be influenced through the President's executive orders.

Presidential Appointments

Most importantly, the President appoints:

- Heads of cabinet departments (confirmed by the Senate)
- Members of the federal judiciary (Supreme Court)
- Members of regulatory and other commissions (e.g. the chairman of the Federal Reserve)
- Top levels of executive branch agencies

Altogether, the President's appointees implement the president's policy line.

Cabinet Departments

State	Treasury	Defence
Justice	Homeland Security	Interior
Agriculture	Housing and Urban Development	Labor
Energy	Health and Human Services	Commerce
Transportation	Veteran Affairs	Education

The President (cont.)

As in any presidential system, **the President of the United States is elected popularly**. Both direct and indirect presidential elections are common. In the US, the president is elected **indirectly, through the Electoral College**.

- Each State is allocated a number of Electoral College votes equal to the size of the state's combined delegation in the House and Senate.
- There are **538 (435+100+3)** electoral college votes (+3 because DC has representation only for presidential elections).
- Hence, the “magic” number 270 that is required for electoral victory.
- EC votes are assigned by plurality voting in most states – not all (e.g. Maine).
- In 2016 President Trump won 306 Electoral College votes, but lost the popular vote by 2M votes.

Presidential Elections are held every 4 years. There is a two-term limit (neither consecutive nor nonconsecutive – 22nd Amendment).

US State governments have a similar structure to that of the Federal government.

Major public policy areas: levy taxes and make expenditures (education, intrastate transport and infrastructure).

Their budgetary process, however, is different. See lecture on fiscal policy.

- State law governs
 - Liability standards
 - Insurance and public utility regulation
 - Some aspects of labor (e.g. minimum wage) and securities law
 - Incorporation law
 - Commercial law

Canada has a radically different political system than that of the US.

- This is mostly due to the closeness to the British government, first as a Province, then as a Dominion (Confederation in 1867), and finally as a Sovereign Nation.
- As of today, Canada and UK share the same monarch (ceremonial head of state).
- Given this Constitutional heritage, it is not surprising that the Canadian system is fundamentally Westminster.

Until 1867 (Confederation), no Canadian act could abrogate a British act.

- Only with the Statute of Westminster (1931) any British act could be abrogated, with exclusion of constitutional amendments. Requests to the British Parliament had to be made for the latter.

In 1982, the Canada Act was requested and passed by the Canadian Parliament.

- The act ended the power of the British Parliament to legislate for Canada
- The authority to amend the constitution was transferred to Canadian legislative authorities.

The Organization of Canada's Parliament

- The Parliament is Bicameral: House of Commons (Lower) and Senate (Upper House). **Only the House is elected, while the Senate is appointed** (Westminster System).
- The **House of Commons has 338 voting members** who serve until the Parliament is dissolved (at which point general elections ensue).
- The legislature would expire naturally after **5** years. However, given the opportunity of timing the general elections by dissolution, this has **never happened**. Members are elected from districts (called 'ridings') of roughly the same population by plurality rule.
- The Speaker, selected by the majority party, is the presiding officer of the House.
- The **Senate has 105 members** who serve until 75 years of age. Senators are supposed to represent each Province and are selected by the Prime Minister and appointed by the **Governor General (the ceremonial head of state)**.

Canada's Form of Government

The key difference between Canada's political system and the US system is the form of government: **Canada is a Parliamentary regime.**

As all parliamentary regimes, the key peculiarity is that the **Prime minister (head of the Executive branch)** is selected by - and thus needs to hold the Confidence of - **the Legislative branch.**

- Although, this is not necessarily by a predefined majority -minority governments are also possible, mustering confidence through ad-hoc support.

The prerogative of parliamentary systems is the **motion of confidence.** The prime minister can (and sometimes must, as for the budget law) ask the parliament for a confidence vote. In Canada, only the Lower House votes the confidence.

Given the high stakes of a confidence motion (if it fails to muster 50% support, the executive cannot rule), **party discipline is more critical in a parliamentary system.**

Canada's Form of Government (cont.)

Failure to pass a motion of confidence or the passage of a motion of no confidence by a majority of the Lower House induces **the resignation of the prime minister**.

If no alternative government coalition can be formed, the Governor General proceeds to the **dissolution of Parliament and general elections are called**.

This guarantees an almost perfect correlation between the strength of the executive and legislative branches. A solid majority in the Lower House is the key for a strong and effective executive.

Discussion: *The Prime Minister is much less insulated from the legislative branch than the President from Congress. So the US President must be more insulated and free to rule. True or false?*

The Canadian Legislative Process

- 1 The majority of bills are **not** submitted by general members of the legislative assembly (e.g. US Congressmen), but by **Ministers of the Crown**.
- 2 After a first (purely formal) and second (general) reading, the bill is sent to committee for report. It is at the third reading back on the floor that specific discussion takes place.
- 3 After the three readings, the bill is sent to the other chamber for the same procedure. **Amendments are only allowed in the Senate**. The House has to approve any amendment produced in the Senate.
- 4 Once the final bill passes both chambers in the same form, it is sent to the Governor General for a Royal Assent.
- 5 Note: there is **no Presidential Veto in Canada**. No checks and balances in this dimension. **The Governor General always “grants” Royal Assent to the bill.**

SOME THEORETICAL FORMALIZATION

Now we will try to formalize some of the concepts we just considered.

Let us start with a model of political accountability. Based on Persson and Tabellini (2000, ch. 4.4, 9.2, 9.3) and Persson, Roland and Tabellini (QJE 1997).

We will show what role elections play in disciplining a politician.

We will then investigate how separation of powers will help us disciplining the politician.

Note: This is going to be a standard format for our classes: Get to know the institutional details/facts and then provide intuition through formalization.

Mandate vs. Accountability View

“The aim of every political constitution is, or ought to be, first to obtain for rulers men who possess most wisdom to discern, and most virtue to pursue, the common good of the society;

and in the next place, to take the most effectual precautions for keeping them virtuous whilst they continue to hold their public trust.”

James Madison in Federalist Papers, no. 57

(cited at p. 46 Democracy, Accountability and Representation by Przeworski, Stokes, and Manin, 1999).

A Model of Electoral Accountability: Setup

Consider a political system with one incumbent politician and N voters.

Voters get utility from consumption c and a general public good g

$$U = c + H(g)$$

where H has standard properties. Let us assume that voters consume all disposable income so:

$$U = y - \tau + H(g) \quad (1)$$

Where y is income and τ indicates taxes.

The Politician: Public Goods and Rents

The politician (i.e. the government) employs tax revenues to produce the public good, but can also appropriate part of the revenues as private rents r .

The production of public good g entails a cost of transforming private goods into public goods of θ .

θ is a random variable whose realization is common knowledge (later on we will consider the case of asymmetric information and voters not observing θ).

Then, the government budget constraint is:

$$\theta g = N\tau - r \quad (2)$$

The Politician: Public Goods and Rents (cont.)

The politician enjoys also (exogenous) rents from being in office R . You can think of them as the expected present value of future rents from being in office.

However the politician can obtain R only if elected, which happens with reelection probability p .

Preferences of politicians are then given by:

$$\gamma r + pR \quad (3)$$

where $\gamma < 1$ reflects the fact that politicians face some transaction cost in extracting private rents.

Electoral Accountability

Voters are assumed to be **retrospective**. They judge the politician by her actions (not by her future policy) and decide upon a voting rule to which they commit.

We assume that a **challenger**, in all respects equivalent to the current incumbent, runs. Hence, voters do not use elections to select better quality candidates, but **only as disciplining device based on past history**.

Assume all voters can coordinate on the same retrospective voting strategy (the choice of an electoral probability function):

$$p = 1 \text{ if } U(g(\theta), r(\theta)) > k(\theta) \\ = 0 \text{ otherwise}$$

Where $k(\theta)$ indicates the voter's reservation utility.

Timing of the Game

Sequential structure:

- 1 State of θ is realized.
- 2 Voters pick a retrospective voting rule p
- 3 Incumbent chooses the policy vector $[g, r, \tau]$
- 4 Elections are held.

Trade-off for the Politician

This simple electoral accountability model is one in which a politician (the agent) can **trade off** her electoral rents (R) for short-term private gains (r).

Voters (the principal) employ elections as the disciplining device.

The politician has two strategies at stage (3).

- a) **Steal everything** setting $g^* = 0$, $\tau^* = y$ and rents $r^* = Ny$.
Politician's utility in this case will be γNy
- b) **Please the voters and earn reelection**. The incumbent does so at the minimum cost, so it provides them with their reservation utility $k(\theta)$ to obtain $p = 1$. However, she cannot exploit her discretion fully.

Equilibrium Rents (cont.)

The politician will be pleasing the voters if her utility (3) is higher doing so

$$\gamma r + R \geq \gamma N y$$

To minimize rents paid to the incumbent, for any θ the voters will require the above condition to hold with equality, so:

$$r^* = \text{Max}[0, N y - R/\gamma]$$

Equilibrium Public Goods

The optimal level of g^* is pinned down by the Samuelson criterion $NH'(g) = \theta$

- [For a pure public good the sum of the marginal utilities of agents should be equal to the marginal cost of g . If it is more intuitive, you can divide both sides by N and check that private marginal benefit equals private marginal cost in the form of higher taxes (θ/N).]

For this to be an equilibrium we need an additional small assumption. We need to assume that foregoing r^* leaves enough revenue for optimal public good level $g(\theta)$ in every state θ , that is

$$\theta g^*(\theta) \leq R/\gamma$$

This condition derives from the necessity of

$$Ny - N\tau \geq 0$$

Where $N\tau^* = \theta g^*(\theta) + r^* = \theta g^*(\theta) + Ny - R/\gamma$ by equation (2).

Equilibrium Voting Rule

Last piece: The optimal voting rule.

Voters should optimally set their reservation utility to

$$k^*(\theta) = y - (\theta g^*(\theta) + r^*)/N + H(g^*(\theta))$$

Where we use definition (1) of utility and $\tau^* = (\theta g^*(\theta) + r^*)/N$

This pins down the optimal voting rule p^* .

Notice that the politician has an **incumbency advantage** that allows her to extract rents.

The larger y is, the larger the threat. So, the politician can **extract more rents when the tax base is larger**.

Also, private rents go down if it is very valuable to stay in office (R high) or if it is very expensive to extract rents (γ low).

Introducing Separation of Powers

The Constitution splits decision making power between the holders of two different offices: one has power of initiative (L) and the other has a veto right (X).

- This creates checks and balances.
- This may represent the Executive and Legislative Branches; Two legislative chambers, etc.

In presence of conflict of interests, we show

- That accountability to voters increases.
- That wasteful spending diminishes (rents to politicians go down).
- We **can** show that the transmission of information from government officials to voters increases.

Voters are unanimous as before, but now choose retrospective voting strategies for X and L separately. The two office holders split total rents from office $r^L + r^X = r$

For $i = X, L$ preferences are given by:

$$\gamma r^i + p r^i R^i \quad (4)$$

Note: *We will assume sequential decision making and two separate proposal powers for the two politicians.*

Timing of the Game

Sequential structure:

- 1 State of θ is realized.
- 2 Voters pick retrospective voting rules p^i for both incumbents.
- 3 Incumbent X proposes a tax rate τ
- 4 If incumbent L approves then τ is implemented; otherwise default rate $\tau^0 \geq 0$ is implemented.
- 5 Incumbent L chooses the public goods spending and rent allocation $[g, r^L, r^X]$.
- 6 If incumbent X approves, then $[g, r^L, r^X]$ is implemented; otherwise a default allocation $[g^0, r^{L0}, r^{X0}]$ with $g^0 > 0$ is implemented.
- 7 Voters observe the policy vector $[g, r^L, r^X, \tau]$
- 8 Elections for both incumbents (each facing an identical opponent) are held.

Discussion

In this setting, X has proposal rights over taxes but is not a residual claimant on tax revenues.

Instead, L is the residual claimant on tax revenues and captures all additional rents produced by higher taxes.

We are depriving L , who allocates the rents, of the proposal power over the size of the budget (taxes).

Since X is not a residual claimant on tax revenues, we have removed the conflict of interest between the voters and X . X is reelected if she set taxes at the level desired by voters.

With a single office holder the politician is always full residual claimant of tax revenues and can always threaten to steal everything ($r = Ny$). Hence voters need to leave her some rents to avoid this.

You also need checks and balances.

- X has only veto power on the allocation decision.
- X cannot do better than taking the default level utility because he faces a take-it-or-leave-it offer by L , who has all the bargaining power at stage (6).

This creates a **strong conflict of interest**, that benefits voters.

Giving amendment rights to X at this point would make X share in part of the rents, eliminating the benefits of separation of powers.

Also a more realistic setting of repeated interaction may allow L to credibly commit to rent sharing, hence realigning the interests of the politicians against the voters. Basically you revert to facing a single politician. Common pool problems may even become likely.

It should be evident that institutional design matters substantially!!

Elimination of Rents Under Separation of Powers

We now show that we can eliminate wasteful spending (rents) completely in this setting (if reelection incentives are strong enough).

Equilibrium rents will drop from r^* to 0

To see this consider that voters can coordinate on the same retrospective voting strategy (the choice of an electoral probability function) for $i = X, L$:

$$\begin{aligned} p^i &= 1 \text{ if } U(\theta) \geq k^*(\theta) \\ &= 0 \text{ otherwise} \end{aligned}$$

where $k^*(\theta)$ indicates the voter's reservation utility at the socially optimal solution with:

$$\begin{aligned} N_y - N\tau &\geq 0, \\ g &= g^*(\theta), \\ \text{and } \tau^* &= \theta g^*(\theta)/N \end{aligned}$$

Expenditure Decision Stages (5)-(6)

The only hope for reelection is if taxes have been set at the correct level $\tau^* = \theta g^*(\theta)/N$ at stages (3)-(4).

If this is the case, L has a decision to make:

- Decision 1: Stealing everything

- Setting $g^* = 0$
- Setting rents $r^* = N\tau^* = \theta g^*(\theta)$.
- L has to convince X not to veto.
- Since both politicians will not be reelected, the minimum level of rents to allocate to X has to be r^{X0} .
- Rents for L are $r^L = \theta g^*(\theta) - r^{X0}$

Expenditure Decision Stages (5)-(6) (cont.)

The only hope for reelection is if taxes have been set at the correct level $\tau^* = \theta g^*(\theta)/N$ at stages (3)-(4).

If this is the case, L has a decision to make:

- Decision 2: Pleasing the voters, earning reelection.
 - Set $r^L = r^X = r^* = 0$
 - Set $g = g^*(\theta)$.
 - The utilities of the two politicians are then R^L, R^X

L will be pleasing the voters if L 's utility is higher doing so

$$R^L \geq \gamma(\theta g^*(\theta) - r^{X0}) \quad (5)$$

Taxation Decision Stages (3)-(4)

Are taxes going to be set at the correct level $\tau^* = \theta g^*(\theta)/N$ at stages (3)-(4)?

If this is the case, X has a decision to make:

- Set any tax rate $\neq \tau^*$. This will induce L to steal and X will get the minimum level of rents r^{X0} . She will get the bare minimum not to veto, so rents for X have to be $r^X = r^{X0}$

Or

- Please the voters and earn reelection: If (5) holds, set $\tau^* = \theta g^*(\theta)/N$. The utility of the two politicians are then R^L, R^X

X will be pleasing the voters if X 's utility is higher doing so

$$R^X \geq \gamma r^{X0} \quad (6)$$

Note: L will not veto this proposal unless default taxes are unreasonably high, $\tau^0 > \tau^*$ so that she actually prefers to take the money and run.

Equilibrium Results When Separating Proposal Power

If conditions (5) and (6) hold and default taxes are not too high, the socially optimal equilibrium can be achieved under separation of powers.

Equilibrium rents fall to zero.

Revelation of Information

The role of separation of powers is important also in case of asymmetric information. Laffont and Martimort (1999 RAND); Laffont and Meleu (2001 JDE); Persson, Roland and Tabellini (1997 QJE)

We show how separation of power can discipline politicians in truth telling as well.

Assume θ is not observed by the voters, but only by the two politicians L and X .

Let's abstract from separation of proposal power and go back to the case where a politician (L) has full proposal power over budget and allocation.

- *In this setting, we will be interested in truth telling on the part of politicians as well as obtaining minimal rents.*

Voters can extract information from the branch/politician that has the lowest stakes in informational rents and this helps in disciplining the other branch/politician.

Timing of the Game

Sequential structure:

- 1 State of θ is realized. L and X observe it, but not the voters
- 2 Voters pick retrospective voting rules p^i for both incumbents.
- 3 Incumbent X is required to announce a state of the world θ^X
- 4 Incumbent L chooses the policy and allocation vector $[\tau, g, r^L, r^X]$.
- 5 If incumbent X approves then $[\tau, g, r^L, r^X]$ is implemented; otherwise default allocation $[\tau^0, g^0, r^{L0}, r^{X0}]$ with $\tau^0 > 0$, $g^0 > 0$ is implemented.
- 6 Voters observe the policy vector $[\theta^X, g, r^L, r^X, \tau]$
- 7 Elections for both incumbents (each facing an identical opponent) are held.

Assume that voters can coordinate on the same retrospective voting strategy (the choice of an electoral probability function) for $i = X, L$:

$$p^i = 1 \text{ if } U(\theta^X) \geq k^*(\theta^X) \\ = 0 \text{ otherwise}$$

Where $k^*(\theta^X)$ indicates the voter's reservation utility at the minimal non-state dependent rents level (note we have a politician L setting the budget that is full residual claimant on taxes, so we will have some rents in equilibrium).

Note: the policy is evaluated at the announced state θ^X and not the true state θ .

L's decision

Suppose X announces θ^X .

If this is the case, L has a decision to make:

- Steal everything

- Setting $g^* = 0$ and
- Setting rents $r^* = Ny$.
- L has to convince X not to veto.
- Since both politicians will not be reelected, the minimum level of rents to allocate to X has to be r^{X0} .
- Rents for L are $r^L = Ny - r^{X0}$

- Please the voters and earn reelection

- If L is aiming at reelection first need to check if X is interested in not putting a veto $R^X \geq \gamma r^{X0}$ (Again, assume reelection incentives are strong enough. so this holds).
- L sets $r^L = r^*$, $r^X = 0$ and $g = g^*(\theta^X)$.
- The utility of the two politicians are then $\gamma r^* + R^L, R^X$.

The Voters' Decision Rule

L will be pleasing the voters if L 's utility is higher doing so

$$\gamma r^* + R^L \geq \gamma(Ny - r^{X0}) \quad (7)$$

Since voters want to minimize wasteful rents, (7) will have to hold with equality. The equilibrium level of rents will be $r^* = Ny - r^{X0} - R^L/\gamma$

Taking this into account, voters should optimally set their reservation utility in p^j to:

$$\begin{aligned} k^*(\theta^X) &= y - \tau^* + H(g^*(\theta^X)) \\ &= y - (\theta^X g^*(\theta^X) + r^*)/N + H(g^*(\theta^X)) \\ &= (r^{X0} - R^L/\gamma - \theta^X g^*(\theta^X))/N + H(g^*(\theta^X)) \end{aligned}$$

Will X tell the truth?

By over-reporting $\theta^X > \theta$, X could create informational rents for L . [i.e. Voters would think it is expensive to provide g , so they'd tolerate higher taxes ending up in L 's pocket]

However, X does not appropriate any of those informational rents under the (strong) assumption of take-it-or-leave-it offer by L (i.e. maximal bargaining power of L).

Key point: X 's payoff does not depend on the report and L cannot commit otherwise. So X is actually indifferent in telling the truth or not.

Now, if X has an epsilon chance of being discovered lying and being kicked out of office, then you may have that truth-telling equilibria are possible.

As before, collusion cannot be ruled out in repeated settings.

Taking the US and Canadian political systems as examples, we have explored some common features of the different branches of government.

We also developed a simple agency model of political accountability of incumbent politicians.

We have shown how certain institutional features may interact with each other and provide socially desirable outcomes.

- The case of checks and balances and separation of powers is an example.

NEXT: we will now take a broader perspective in the next set of slides.