

# Virginia's Public Choice versus Cambridge's Political Economics

Two views of political economy in competition

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## **Abstract:**

The Virginia School of Public Choice currently faces a “hidden challenge” by a group of researchers including Alberto Alesina, Torsten Persson and Guido Tabellini we name the “Cambridge School of Political Economics”. Although the general approach (the application of economics to politics), the topics studied and the scientific objective (positive analysis of politics as the basis for normative suggestions for institutional improvements) coincide, research in the Public Choice tradition is largely ignored by the Cambridge School and seen to be outdated. In this paper we evaluate, if there is reason to argue in favor of a “paradigm shift” (in Thomas Kuhn’s terms) from Public Choice to the younger approach of Political Economics. Based on a comparison of both approaches we argue that there has been no paradigm shift but that Public Choice and Political Economics must be seen as competing views on political economy. We speak in favor of an intensified scientific discourse that could benefit both approaches.

1	Introduction:.....	3
2	The Virginia School of Public Choice .....	4
2.1	The development of the Virginia School of Public Choice .....	4
2.2	The challenges of the Virginia School .....	5
2.3	The Virginia School of Public Choice as a scientific paradigm .....	6
3	The “hidden challenge” of the Virginia School by the Cambridge School of Political Economics.....	7
3.1	The Cambridge School of Political Economics .....	7
3.2	A hidden challenge of the Virginia School .....	7
4	Competing Paradigms – Applications.....	10
4.1	The Political Business Cycle .....	10
4.2	Confederations, Federations, Unions .....	12
4.3	Constitutional Political Economy .....	14
4.4	Summary Applications.....	21
5	Public Finance and Public Choice versus Political Economics and Public Finance .....	23
6	Modelling and Policy Advice .....	27
7	Conclusion.....	30
8	Bibliography (Preliminary) .....	31

# 1 Introduction:

The Virginia School of Public Choice currently faces a “hidden challenge” by a group of researchers including Alberto Alesina, Torsten Persson and Guido Tabellini we name the “Cambridge School of Political Economics”. Although the general approach (the application of economics to politics), the topics studied and the scientific objective (positive analysis of politics as the basis for normative suggestions for institutional improvements) coincide, research in the Public Choice tradition is largely ignored by the Cambridge School and seen to be outdated.

In this paper we evaluate, if there is reason to argue in favor of a “paradigm shift” (in Thomas Kuhn’s terms) from Public Choice to the younger approach of Political Economics.

We trace the origins of the two schools, identify them as scientific paradigms and reveal their main characteristics, methods and basic tenets. The analytic performance of both approaches is compared with respect to political business cycles, federalism and constitutional political economy as major fields of research common to both approaches. The comparisons show that Political Economics has taken the lead in the theory of political business cycles, but the Public Choice approach fulfils the stated scientific objectives better e.g. in analyzing constitutional choices. Applied to the field of Public Finance as a whole, Political Economics proves to be far from replacing Public Choice as scientific paradigm for positive analysis.

Based on the derived results, we argue that Public Choice and Political Economics must be seen as competing views on political economy. There is no reason to perceive a paradigm shift from Public Choice to Political Economics. We speak therefore in favor of an intensified scientific discourse that could benefit both approaches.

## 2 The Virginia School of Public Choice

### 2.1 *The development of the Virginia School of Public Choice*

James Buchanan and Gordon Tullock can be seen as the founding fathers of the Virginia school. The name Virginia School results from their affiliation to a number of Virginian Universities most recently George Mason University in Fairfax, Virginia, and the establishment of the Centre of Public Choice at the same university that can still be seen as its international centre of gravity. By the establishment of the Journal Public Choice in 1968 and Constitutional Political Economy in 1990 the Virginians strengthened their role in bringing the field of Public Choice forward. This prominent role of Virginia gave the whole school not only its name but has continued to have an important influence on its methodology. "The Virginia School's methodology and the "Public Choice approach" are one and the same" (Mueller 1985, p. 6). Therefore the terms "Public Choice" and the "Virginia School" will be used synonymously in the following.

The introduction of Public Choice in the 50ies and 60ies started a new line of research in two general aspects.

First Public Choice as the "application of economics to political science" (Mueller 2003, p.1), that relies on the basic economic axioms of rationality and self-interest, displaced the approach of social welfare functions. Influential theories like those of a social welfare function proposed by A. Bergson (Bergson 1938) are - based on Duncan Black's „On the Rationale of Group Decision Making“ (Black 1948) and Kenneth Arrow's "*Social Choice and Individual Values*" (Arrow 1951) - not tenable any more. Public Choice replaces social welfare functions by theories of aggregating preferences by collective voting - a way back to social welfare theorems is not possible any more. If collective decisions have to follow from individual preferences, social welfare functions lose their role. And who argues with the help of social welfare functions has to dismiss individualistic decision making procedures and democratic processes. Both approaches bar each other.

Second, Public Choice also tells us that the aggregation of preferences involves basic consistency problems as well as principal agent problems. Therefore government failure is built into Public Choice. The endeavour of welfare economists of the 50ies and 60ies to search for market failures and to demand for their correction by government was therefore challenged by Public Choice economists. Politics should be seen "without romance" (Buchanan 2003, p.16). Politicians and bureaucrats are as self-interested as businessman and use their positions to pursue their individual goals and plans. Market failure cannot always be easily offset by governmental action. Public Choice put the study of "political failure" on the research agenda of economics.

## ***2.2 The challenges of the Virginia School***

Within the nearly half a century of existence, Public Choice has faced especially two basic challenges. The first challenge attacks the basic methodological approach. Formulated especially by political scientists like Green and Shapiro this line of criticism states that Public Choice does "little more than restate existing knowledge in rational choice terminology" (Green and Shapiro 1994, p. 6) and has contributed little the understanding of politics. This critique is addressed e.g. by Mueller (Mueller 2003, chpt. 28) who defends Public Choice by demonstrating basic contributions of the Public Choice approach and its role in the positive and normative study of institutions. The second challenge comes from the Chicago School within economics and is put forward most prominently by Donald Wittman's "The myth of democratic failure: why political institutions are efficient" (Wittman 1995). Contrary to the Virginian approach, Wittman – similarly to Becker, Peltzman, Posner - argues that individuals and groups achieve pareto-efficient results even in the political sphere – a claim that was made with respect to interest groups earlier by Gary S. Becker (Becker 1983/1985). A strong belief in evolutionary institutional selection makes Wittmann et. al. conclude that the existing and prevailing democratic institutions are pareto-efficient. This contradicts the Virginian approach that sees the decisions under unanimity rule as the yardstick for efficiency and has government failure as a central topic.

## 2.3 The Virginia School of Public Choice as a scientific paradigm

In the terms of Thomas S. Kuhn (Kuhn 1962), the introduction of Public Choice can clearly be seen as a scientific paradigm.<sup>1</sup> In Kuhn's view, a paradigm is a „picture“ or a „model“ of the way things are in some realm and comprises

- some basic generalizations/natural laws
- some ontological or heuristic model
- some preferred methods and goals
- and some key shared examples of problems solved.

Public Choice comprises all the four major components of a scientific paradigm. It shares its *basic generalizations* (or natural laws) with economics assuming that actors are rational and self-interested. Its *ontological or heuristic model* results from the consistent application of rational and self-interested actors to the realm of politics and the focus on preference aggregation via voting. The *preferred method* is the positive analysis of political institutions and *the goal* is to derive normative suggestions for institutional improvements that help to satisfy individual preferences better. *Key shared examples of problems solved* are e.g. the contributions of Arrow (Social Choice and Individual Values), Downs (An Economic Theory of Democracy) and Olson (The Logic of Collective Action) (see e.g. Mueller 2003, chpt. 28).

Finally we learn from Kuhn that a scientific paradigm is never abstract. „A paradigm is what the members of a scientific community share, and, conversely, a scientific community consists of men who share the same paradigm“ (Kuhn 1962, p.176). Dennis Mueller (Mueller 1985) demonstrates how well the Public Choice paradigm fits this overlap of scientific approach and research community.

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<sup>1</sup> The concept of scientific schools and their role is formally less worked out than the concept of scientific paradigms. Mueller (Mueller 1985) e.g. sees it to be central for a scientific school to have an own methodology to some extent, be coloured by a distinctive ideology and have scholars applying methodology and ideology with distinctive enthusiasm. In this view the concept of a school is less strict than the concept of a paradigm. In the following we will use the two terms synonymously.

### **3 The “hidden challenge” of the Virginia School by the Cambridge School of Political Economics**

#### ***3.1 The Cambridge School of Political Economics***

Starting in the late 80ies a new line of research emerged that labels itself “Political Economics”. Leading figures in this branch of literature are Alberto Alesina, Torsten Persson and Guido Tabellini. All major figures are related to Cambridge/Mass. either via Harvard University (as Alberto Alesina) or via the NBER where Guido Tabellini and Torsten Persson are fellows. This is why we label this approach the Cambridge School of Political Economics in distinction to the Virginia School of Public Choice. The Cambridge school entered the stage with works concerning the political business cycle (Alesina 1987). Other prominent topics on the research agenda of Cambridge school have been especially redistributive issues (single- and multidimensional) and comparative institutional analysis. Recently the integration and secession of states and the role of constitutions have become central topics.

A classic in the field is the textbook of Persson and Tabellini “Political Economics” (Persson and Tabellini 2000) and two volumes on credibility and politics (Persson and Tabellini 1994). An overview is presented in Persson and Tabellini “Political Economics and Public Finance” (Persson and Tabellini 2002b).

#### ***3.2 A hidden challenge of the Virginia School***

If seen from the outside, the similarities of the Cambridge and the Virginia School are overwhelming. Both define their general approach (the application of economics to politics – see Mueller 2003 or Persson and Tabellini 2000) in the same way. All topics studied by the Cambridge School have been on the research agenda of Public Choice and their statements of the scientific objective – the positive analysis of politics as the basis for normative suggestions for institutional improvements (see e.g. Persson and Tabellini 1990, p.2ff; Buchanan 1975, p.389 ff) – coincide.

Astonishing enough – given the large overlap of the two approaches – research in the Public Choice tradition is largely ignored by the Cambridge School of Political Economics and seen to be outdated. There is barely any discussion of the research in the Public Choice tradition and the Cambridge School acts like a paradigm on its own by separating itself completely from the Public Choice paradigm.

The Cambridge School sees itself as the successor of the Public Choice tradition and argues – implicitly and explicitly - in favor of a paradigm shift from Public Choice to Political Economics. This can be seen from statements like the one of Persson, Roland and Tabellini, who search to position the Cambridge line of research as the synthesis of traditional neoclassical theory and Public Choice: “Traditional neoclassical theory is entirely normative and assumes a benevolent planner with a well-defined social welfare function. This has been criticized as a caricature by the Public Choice school, which argues that politicians rationally follow their self-interest. Positive Public Choice theory, however, typically relies on alternative caricature: the malevolent Leviathan policy maker that replaces the benevolent Pigouvian planner and is solely maximizing her own rents. The voters’ interest and their possible conflicts among them are generally disregarded, and political institutions do not play any part in the analysis. To put it more bluntly: both traditions lack micro-political foundations. Building a bridge between these two traditions – combining their main insights – is an important task for public finance. This requires addressing the above questions regarding how well democratic institutions align the interests of voters and the incentives of self-interested politicians” (Persson, Roland and Tabellini 1998, p.686ff).

So instead of challenging Public Choice and its research directly, the Cambridge School of Political Economics tries to avoid the contest by stating a paradigm shift right from the start. Can this position be hold up? This is the basic question we want to address in this paper.

In Thomas Kuhn’s (Kuhn 1962) terms a paradigm shift occurs, when an existing paradigm encounters more and more „anomalous experiences”. A new picture emerges, incompatible in part or in whole with the old one, and the whole process

sets off again. Existing paradigms are rejected only when an alternative and more plausible theory is proposed (Kuhn 1962, Lakatos 1970). The alternative theory has to contain “corroborated excess empirical content” over predecessors or rival theories. Lakatos points out that unless the new theory explains both what was explained before and new facts as well, there is no scientific basis to prefer it over the existing stock of literature (Lakatos 1970, p. 116ff.).

Applying the basic concept of a paradigm shift to the competition of the Virginia and the Cambridge School we ask, if the Cambridge School can really be seen as superior to the Virginia School. Does it really contain excess empirical content? Is it better? And even more: does it justify neglecting the Public Choice tradition completely? To address these questions we first compare the contributions of both schools to three basic fields: the political business cycle, confederations, federations and unions and constitutional political economy. Then we draw the larger picture and evaluate the role of the two approaches for public finance.

## **4 Competing Paradigms – Applications**

From the shared general approach and the shared objective of both schools results a large overlap in the fields studied. The younger Cambridge School has conducted research in fields that have a long tradition within the Public Choice School. We compare the research of both schools in three fields: political business cycles, federations, confederations and unions and constitutional political economy. We argue that the Cambridge School has successfully contributed to the theory of political business cycles while the results in the other fields studied are less convincing.

### **4.1 *The Political Business Cycle***

The academic dispute about political business cycles started with the work of Bruno Frey and Larry Lau (Frey and Lau 1968) and became popular by W.D. Nordhaus' contribution "The Political Business Cycle" (PBC) in 1975. According to Nordhaus' view, political parties behave purely "opportunistic" e.g. they are attempting to maximize the probability for their re-election. Assuming that voters are heavily influenced by the state of the economy when voting, politicians try to create desirable economic conditions before elections although costly adjustments might be necessary after elections. Especially loose monetary policy is used to stimulate employment, although a recession is needed afterwards to bring inflation down to acceptable levels. This political manipulation of the economy results in economic cycles – the Keynesian model of a government that is moderating business fluctuations is reversed.

Douglas Hibbs (1977) took a different approach arguing in favour of a "partisan theory". In his view, political parties are not purely opportunistic but are driven by different preferences over the trade-off between inflation and unemployment (the Phillips-Curve) as these have important redistributive consequences. Left-wing parties – representing the lower-middle class – prefer low unemployment/high inflation combinations while the opposite holds true for right-wing parties who are

representing the upper middle class. The model predicts a causal relationship in between macroeconomic variables and the partisanship of government.

As Frey and Schneider (1978) pointed out both approaches are not necessarily mutually exclusive.

In the mid-70ies especially the “rational expectations revolution” questioned the reliability of the assumption of myopic voters that is the basis for the Phillips-Curve. If voters cannot be fooled by the government, a manipulation of macroeconomic outcomes is not possible any more.

The Cambridge School of Political Economics contributed to the Political Business Cycle debate by successfully integrating rational expectations. Persson and Tabellini (Persson and Tabellini 1990) presented an opportunistic model of the political business cycle while Alesina (Alesina 1987) incorporated rational expectations in a partisan model in a two party system. In Alesina’s model – on which we focus here exclusively – Political Business Cycles results from the uncertainty about the election outcome. Especially in the wage bargaining process - that takes place only at fixed dates – the economic agents calculate an expected value for the economic policy to come after the next elections based on the different party platforms and their preferences especially with respect to monetary policy. If the left-wing party comes into power, monetary policy will be looser than the expected value – resulting in an expansion of the economy. The right-wing party will pursue a tighter monetary policy than the expected value leading to an economic contraction. Therefore a Political Business Cycle results (see for a detailed discussion Alesina, Roubini and Cohen 1997).

The integration of rational expectations into the concept of the political business cycle is one of the major merits of the Cambridge School of Political Economics within the field. In 1977 Buchanan and Tullock had already expressed their critical evaluation of the assumption of myopic voters as basis for the analysis: “As expectations came to be adjusted to inflation, unemployment would rise to roughly the level determined by these structural features [of the economy]. The price level would, of course, be higher because of the expected monetary spending, but there would be no permanent

increase in employment. A permanent increase in prices would be the cost of, at best, a temporary and short-lived reduction in unemployment.” (Buchanan und Wagner, 1977, p. 167).

A theory that does not have to rely on the myopic voters hypothesis has therefore a clear advantage from the perspective of both schools of thought. Measured by the common goals of Public Choice and Political Economics, Political Economics has brought forward the positive analysis of democratic institutions and contributed to normative suggestions for improving institutions (for suggestions see: Alesina 1989, p. 82ff.).

Although there has been clear progress in the Political Business Cycle theory by the contributions of the Cambridge School, research is still ongoing. If judged by the quality of their empirical predictions alone the rational expectations models are not necessarily more powerful than the traditional models with an exploitable Phillips Curve. In Dennis Mueller’s actual comparison for the U.S. from 1949 to 2000, the empirical performance of the traditional Hibbs model was much better than e.g. a rational expectations model of Alesina and Rosenthal (Mueller 2003, p. 452).

## ***4.2 Confederations, Federations, Unions***

Within the last years the Cambridge School has pushed the analysis of separation and integration of states - based on the work of Alesina, Spolaore and Wacziarg (2000, 2003), Alesina and Wacziarg (1998), Bolton, Roland and Spolaore (1996), Bolton and Roland (1997), Alesina and Spolaore (1997), Alesina, Angeloni and Etro (2001). The authors motivate the importance of their research by the empirical observation of separationist tendencies in middle- and east Europe on the one hand and the integration of states e.g. under the umbrella of the European Union on the other hand.

Most of the works cited focus on the pros and cons of a politically integrated national state compared to a diversity of states. Based on their analysis they derive some key trade-offs:

1. A politically integrated nation state guarantees free trade within its borders. If free trade is warranted outside of the nation state by economic integration, the political integration becomes less important. Division of labour can be achieved internationally. Therefore large nation states tend to disintegrate.
2. Developed states rely more heavily on a differentiated division of labour. Therefore political and economic integration is more important for developed than for developing states.
3. The central provision of public goods is more likely to be accepted the more political integration is needed because of lacking international free trade. If international free trade is possible, a secession can take place and the new state orientates the provision of public goods at his own median voter.

Free trade lies at the centre of all three trade-offs. Empirical observations raise doubts almost immediately. It is especially hard to find a clear correlation of size and stage in the economic development, as the trade-offs would predict.

Although free trade might be one important variable in determining the size of states, the concept is surprisingly sparse related to the existing literature. Especially the work of Oates (Oates 1972) addresses a similar problem that includes not only the determination of the size of states but as well the federalist structure. He identifies the three key variables preferences, scale and spill-overs which basically determine the optimal size of a state as a whole as well as the allocation of competencies to the different levels of government (federalism).<sup>2</sup> Especially federalism and vertical task sharing would have enriched the analysis not at least because they often allow for solutions that avoid fundamental conflict leading to secessions.

An extension of the Oates approach by the inclusion of free trade as an additional variable would have contributed more from our point of view than the pure application of free trade.

Additionally to the learnings from Oates the Cambridge School could have benefited from the contributions of Public Choice. From Tiebout's (Tiebout 1956) work they

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<sup>2</sup> Persson and Tabellini (1994) rediscovered the same trias of variables to be decisive for the level in charge of public good provision. However there is no reference to the ealier work of Oates.

should have integrated migration as an important mechanism for preference revelation and allocation.

If the Cambridge School had incorporated these additional explanatory variables they would have discovered a vast empirical literature with important aspects for the topic. To name a few we would refer to Wallis and Oates (1991) Nelson (1986, 1987), Pommerehne, Kirchgässner, Feld (1996), Oates (1985, 1989), Zodrow and Mieszkowski (1986), Zax (1989).

But the writings of the Cambridge School concerning integration and separation of states do not link themselves to the Public Choice literature although a research that would have been set-up on the basis of the existing literature would probably have been more fruitful. So the Cambridge School contributes to the discussion by stressing the importance of international free trade for the integration and separation of states. But apart from that, the contribution is very limited and the results are barely surprising for Public Choice scholars.

### **4.3 Constitutional Political Economy**

Another field of research common to both schools can be labelled constitutional political economy.

Cambridge economists turned their interest only very recently to analyzing the effects of alternative constitutional regimes (Persson and Tabellini 2000 ch. 10 and Persson and Tabellini 2003). In the introduction to their recent book Persson and Tabellini (Persson and Tabellini 2003, p. 2-5) emphasize the relevance of the study of constitutions as social scientist have for a long time neglected the issue or did not ask the relevant questions. Persson and Tabellini “forget”, however, to mention that constitutions always have been an intensive field of study of the Virginia School of Public Choice.<sup>3</sup> In a footnote they concede: “But this literature [of the Public Choice school] is mostly normative and has not led to a careful empirical analysis, with the main exception of a few interesting papers on referenda (e.g. Pommerehne and Frey

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<sup>3</sup> Even figure 1 on p. 3 can be found in nearly identical way in Bruno S. Frey (1977).

1978).” But if the papers are “interesting” to the topic of constitutions why do the authors not consider them in their research? Isn’t it much more productive to cooperate in research and to build on other researchers’ achievements to promote our general knowledge even if it is revealed that one was not the first and unique in detecting the problems of constitutions (see Pommerehne 1974/1978, Feld and Savioz 1997, Feld and Kirchgässner 2001, Feld and Matsusaka 2003, and for an overview: Kirchgässner, Feld, Savioz 1999)?

Let us consider the Virginian approach to constitutional political economy first and compare it to the Cambridge approach.

From Virginians’ point of view, the quality of a constitution has to be judged by how accurately individual preferences are aggregated into collective choices, or vice versa, how truthfully collective choices represent individual preferences. One way to attain this goal is to let citizens vote in a direct democracy on collective issues concerning their local community. Direct democracy has the following characteristics:

1. Issues are generated from the floor by discussion and debate.
2. Decisions are reached directly by those who are affected.
3. Voting takes place according to a pre-designed voting rule (which is not necessarily the simple majority rule, but rather a more encompassing rule such as voting by veto [see: Mueller 2003, ch. 7]).

Direct democracy is, however, feasible only in very small communities. In larger communities, states and nations, bargaining costs are much too high, and a constitution has to be found through which some of the decision making power is delegated to elected agents. Virginians have studied empirically in particular two alternative forms of delegation: representative democracy without referenda (RD) and representative democracy with referenda (RDR), both based on simple majority rule.<sup>4</sup>

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<sup>4</sup> We leave aside the question of how the representatives are elected.

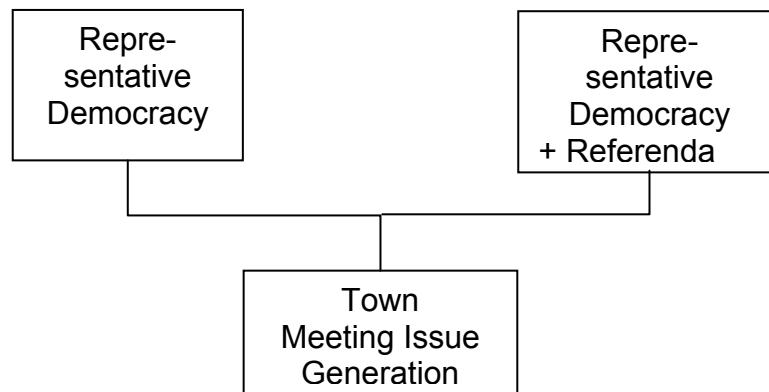


Figure 1: Simple Constitutional Democracies

Under these rules it should be expected that the median voter casts the decisive vote and determines the volume of public expenditures and taxation in the community. It turned out, however, that the variable representing the median voter (mostly the median income recipient), was only significant in representative democracies with referenda and not in representative democracies without referenda (Pommerehne 1974, 1978). Moreover it was revealed that public expenditures, taxes and public debt per capita are lower in representative democracies with referenda than in those without referenda.<sup>5</sup> Apparently, the power of the median voter to enforce her preferences in a vote is blurred in representative democracies if citizens cannot (occasionally) check the collective decisions made by their agents. What one can learn from these empirical analyses is that the principal agent problem should be a core criterion when evaluating constitutions.

This message in mind, we shall now proceed to the design of constitutions of national governments. Starting from direct democracy our goal must be to reduce bargaining costs while keeping in mind the principal agent problem. Mueller (Mueller 1996) has shown that there are mainly two ways to proceed. Following the characteristics 1 and 2 above, we can economize on either the number of issues decided upon by the voter or we can reduce the number of discussing agents (Blankart, Mueller 2002, 2004).

In the former case, parties present platforms, and the one that obtains a majority of votes in the election (or in a subsequent run off vote if necessary) forms the

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<sup>5</sup> See quotations above.

government. This procedure guarantees that the government is always supported by a majority of votes in the population. We call this system the pure two party democracy PTPD (not to be confused with the Westminster system in which the parliamentary majority party usually obtains only a minority of votes of the citizens). In the latter case of a pure representative democracy PRD a parliament has to be elected that replicates the preferences of the voters on the floor as accurately as possible so that issues can come up by decision and debate. Tullock (Tullock 1967) has suggested that each citizen transfers her vote to a fellow citizen she trusts and who will vote with as many votes in the parliament as he has received in the election.<sup>6</sup> The result will be a truly representative parliament.

Under PTPD parties will present platforms according to the model of probabilistic voting in a two party competition (see Mueller 2003, ch. 12). PRD will generate decisions preferably by the application of the new voting rules following 3. Moreover the citizen may always check parliamentary decisions by referenda.<sup>7</sup> These two alternatives are depicted in figure 2 by the quadrangles i. and iii. respectively.

The Pure Representative Democracy (PRD) can be transformed into a presidential system, if chairmanship of parliament is assigned by the citizens (not by the parliament) to a president. In this case we talk about a Pure Representative Presidential Democracy (PRPD, nr. iv. in figure 2). The task of the president is solely to act as an intermediary to shape proposals in such a way that they can reach the necessary majorities in the decisions in parliament. The president has no right to veto and a legislative deadlock in between president and parliament cannot occur. Therefore we expect results comparable to those of iii.

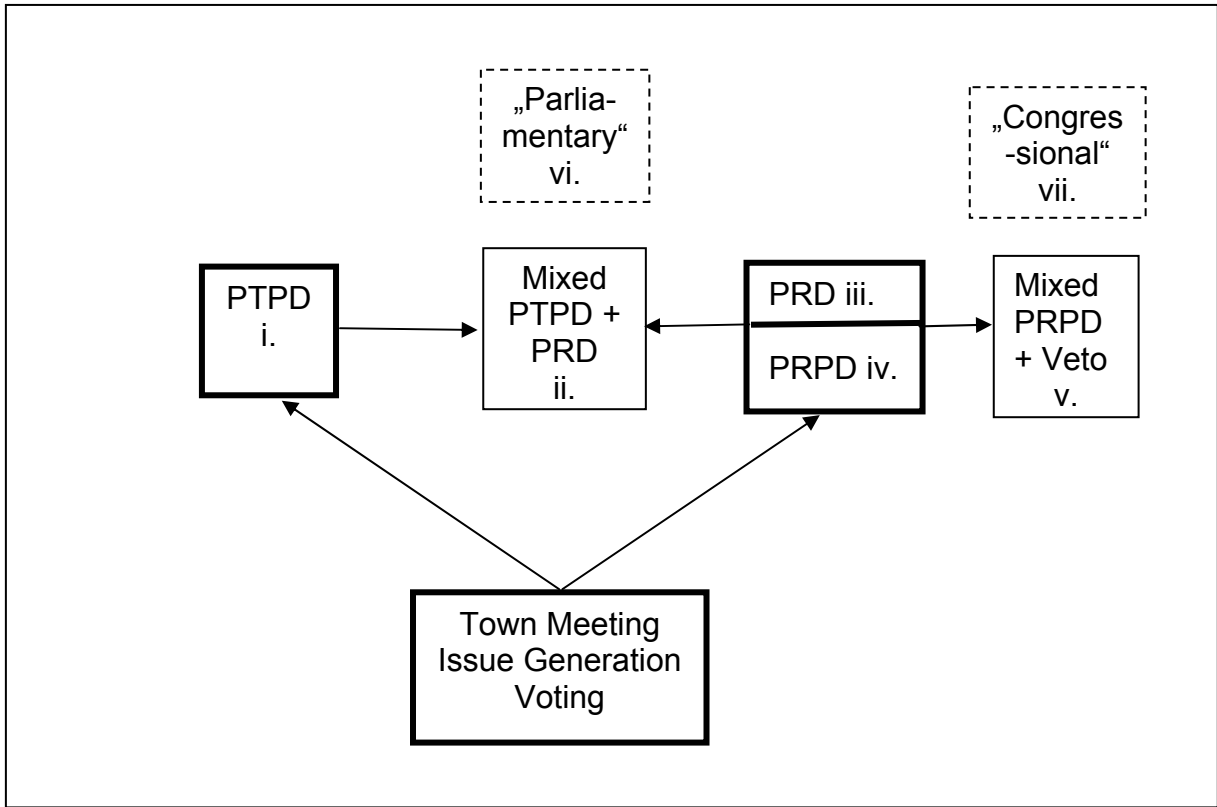
Differing from the discussed pure forms of parliamentary democracy are “mixed systems”. A first mixed system is a PRPD amended by extensive veto rights by the President as in the US. The outcome of discussion and debate in the Congress reflecting citizens’ preferences may now be vetoed by the President wherefrom often a stalemate with non-decision making may result (PRPD plus veto, nr. iv. in figure 2). A second mixed system is observable especially in continental Europe. Here voters

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<sup>6</sup> For details see Blankart and Mueller (2002, 2004).

<sup>7</sup> In the former case the voters have voted for a program for which the government is responsible up to the next elections. Therefore interfering referenda may not always be indicated.

elect Members of Parliament on a more or less representative base and within the parliament a majority coalition elects the government (nr. ii. in figure 2). We suppose that neither of the two mixed systems carefully reflects the principal agent problem. The outcome of the political process may considerably deviate from voters' preferences. Under the American style PRPD, President and Congress stalemate through their mutual veto positions, while under the mixed system of PRD and PTPD citizens do not know whether their vote will contribute to the majority coalition or not (as it cannot be known with certainty in advance which parties will form the ruling coalition). Hence it is difficult if not impossible for the citizens to make a rational choice. Due to these built-in distortions and the ensuing principal agent problem we conclude that voters are less able to enforce their preferences in a mixed system such as ii. and v. than in pure systems such as i., iii., and iv.



PTPD = Pure Two Party Democracy      PRD = Pure Representative Democracy

Figure 2: Pure and Mixed Parliamentary/Congressional Democracies

Within these variants of democracies worked out from the perspective of the Virginia School, the Cambridge School (see Persson and Tabellini 2000, 2003) focuses exclusively on two constitutions: The so-called “parliamentary system” of nr. vi. which is similar to the PTPD plus PRD system of nr. iii. and the “congressional system”, i.e. an American type presidential democracy of nr. vi. which is similar is to nr. v. above.

Studying these two forms of democracy Persson and Tabellini (Persson and Tabellini 2003) derive trade-offs depending on the form of government (parliamentary versus presidential) and the election rules (majoritarian versus proportional). Compared with the social optimum they find deviations in three dimensions: the amount of public goods provided, redistributive transfers to politically powerful minorities and rents to politicians. The extent of the deviations from the social optimum depends on the institutional setting.

In their model they derive a trade-off in between the parliamentary and the congressional/presidential system. Especially the veto-right of the president in a congressional/presidential system limits the chances for rents to politicians and the success of rent-seeking activities. But on the other hand public goods tend to be severely underprovided in presidential systems due to strong agenda setting power of a minority. In parliamentary systems on the other hand the amount of public goods provided is higher than in the presidential system (also still under the optimal level) but rent seeking is more successful and rents to politicians are higher as well.

With respect to electoral rules the authors derive a similar trade off. A majoritarian electoral system compared to a proportional electoral system increases competition in between the parties and helps therefore to restrict the success of rent-seeking activities aiming at transfers to politically powerfull minorities. But on the other hand especially the increased competition under a majoritarian electoral system leads to an increasing underprovision of public goods. A trade-off in between limiting rents to politicians and providing sufficient amounts of public goods results.

Combining different electoral rules and forms of government leads to four different regimes (see figure 3).

## The Economic Effects of Constitutions/ Persson and Tabellini

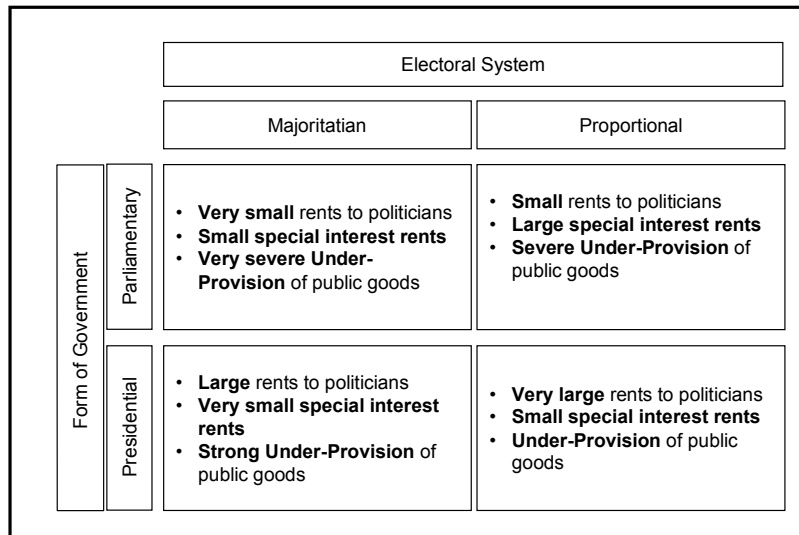


Diagram based on: Persson and Tabellini: The Economic Effects of constitutions. Cambridge/Mass. 2003.

Figure 3: The Economic Effects of Constitutions

In their 2003 book Persson and Tabellini test the predicted trade-offs empirically with a large data set and find strong empirical support for most of their hypotheses.

But given the derived and tested trade-offs the Cambridge School is unable to evaluate the different regime types any further. It misses its own objective of deriving normative suggestions for institutional improvements. “From a normative point of view, the analysis in this chapter suggests a trade-off in institution design. In both political regimes, equilibrium policy differs from the social optimum: the institutional features generating legislative cohesion also increase the rents to politicians, whereas separation of proposal powers induces legislative competition, and this, in turn, leads to more severe underprovision of public goods. Which distortion is worse depends on circumstances.” (Persson and Tabellini 2000, p. 267) (see also Persson and Tabellini 1999, p. 113)

So what have we learned from this approach? “Cui bono?” one could ask when considering these alternative constitutions. What will voters answer when they are confronted with the alternatives to have either a system that generates a severe underprovision of public goods or to have an alternative system providing more public goods but also more rents to the politicians and special interests? Are these the relevant alternatives? Can economists not do better than to propose citizens a choice between two evils found in the status quo? Should we wonder that voters, in a constitutional referendum, will be frustrated, reject both and stay with the status quo?

Concerning these questions the Virginian approach is clearly superior to the Cambridge School of Political Economics. As Public Choice does not start its analysis within existing regimes but asks how the accurate aggregation of individual preferences into Public Choice can be achieved, it is better prepared for normative suggestions for constitutional arrangements. From the Virginian perspective the regimes studied by the Cambridge School of Political Economics are all mixed systems and have therefore built-in distortions. Their research helps to clarify in more detail the consequences of the different distortions. But normative suggestions follow only directly from the Virginian approach: mixed systems can always be expected to perform inferior to pure systems of democracy like the described Pure Representative Democracy or Pure Two Party Democracy. And: referenda play an important role in ensuring the desired outcomes of different political regimes by limiting the principal-agent problems in between voters and politicians.

In sum the almost complete negation of the extensive research of the Virginia School of Public Choice by the Cambridge School of Political Economics had important drawbacks. It would have benefited the analysis of the Cambridge economists if they had integrated more carefully the individualistic point of view of the Virginians instead of comparing only existing constitutions on the macro level.

#### ***4.4 Summary Applications***

From the comparison of the work of the two schools in three central fields we learned, that the Cambridge School of Political Economics brought Public Choice

forward in some fields (like Political Business Cycles), while there was little new in others (like federalism). Public Choice on the other hand continues to have the lead in approaches like the study of constitutional political economy.

These results demonstrate, that it is hard to argue in favor of a paradigm shift in Thomas Kuhn's terms (Kuhn 1962). If existing paradigms are rejected only when an alternative and more plausible theory is proposed (Kuhn 1962, Lakatos 1970) and the alternative theory has to contain "corroborated excess empirical content" over predecessors or rival theories, then the paradigm of Public Choice is as valid as before the attack of the Cambridge School. In our opinion, we see two views to be in scientific competition.

Three other findings are worth noting.

- In Political Business Cycles the Cambridge School referred explicitly to the Public Choice tradition and tried to contribute to the discussions started there. The articles and books of the Cambridge School show by far more references to Public Choice scholars than in later years. In our view this partly explains the success of the Cambridge School in this field and the observed weaknesses in the areas where there is no connection of the two literatures.
- The contribution to political business cycles was at least partly technical (solving the problem how to integrate rational expectations in the existing theory). That might have created the impression that all that is needed to take over the field of Public Choice is just a bit more technical analysis. In our view this is a superficial approach with limited benefits for the discipline.
- If the scientific objective of deriving normative implications for institutional improvements based on positive analysis is taken seriously, demonstrating trade-offs alone is not sufficient and the Cambridge School can profit heavily from basic Public Choice tenets like its Wickselian foundations.

## 5 Public Finance and Public Choice versus Political Economics and Public Finance

Public Choice as well as Political Economics - as the application of economics to politics - cover a wide range of topics from the realm of all social sciences. Within economics the core lies in the economic analysis of the state – traditionally studied in Public Finance. Political Economics as well as Public Choice claim to establish a new approach of Public Finance.

To evaluate the contribution of the two schools to economics a broader assessment of their contribution to Public Finance is called for. In the following the approaches of the two schools are illustrated and compared.

Traditional Public Finance applied welfare economics to derive normative yardsticks for optimal policies and assumed the implementation of these policies by a benevolent social planner. Public Choice challenged the assumption of a benevolent social planner. From a Public Choice perspective it has to be replaced by an analysis of decision-making processes taking the self-interest of politicians and bureaucrats into account. This leads to a perspective on public finance, which has the individual at its core and not the fictive, higher level of the state as an “acting subject” as it had been the case in public finance so far. Resulting is a new approach to Public Finance. Political Economics shares this basic view of Public Choice and starts its analyses on an individual level with self-interested voters and politicians as well.

Public Choice took the challenge of building up a new approach to Public Finance seriously. James Buchanan laid out the research program for this new approach to Public Finance almost 30 years ago in his programmatic essay *„Public Finance and Public Choice“* (1975). Within the following years Public Choice scholars worked out the research program and by now Public Choice covers all important parts of public finance. Within the new approach the most important theories are the following:

- a theory of the emergence and the break-down of states based on Thomas Hobbes

- a theory of public goods derived from the paradigm of economic exchange (Wicksell, Samuelson, Black, Buchanan und Tullock)
- a theory of taxation
  - o under a government without effective competition (Buchanan's Leviathan theory, Brennan und Buchanan 1980)
  - o in a competitive two-party system (Hettich und Winer, 1997)
- a theory of public deficits (Buchanan, 1958, based on Ricardo 1817, Buchanan/Wagner 1977)
- a theory of federalism (Oates, Pommerehne, Feld, Kirchgässner et al.)
- a theory of the growth of government expenditure (Borcherding)
- a theory of justice (Brennan und Buchanan, 1983)
- a theory of interest groups and rent seeking (Olson Tullock).

The Cambridge School of Political Economics formulated its perspective on the whole field of Public Finance only very recently. In an overview article, Persson and Tabellini discuss the concept of „*Political Economics and Public Finance*“ (Persson and Tabellini 2002b). From their perspective the contribution of Political Economics to public finance can be classified within the three categories single-dimensional redistributive conflicts, multi-dimensional redistributive conflicts and comparative politics. Within the category of single-dimensional conflicts fall the redistributive conflicts in between rich and poor, young and old, employed and unemployed and so on. Multidimensional conflicts cover interest-group models and comparative politics focuses on the effects of different government forms and election rules on economic policy.

Compared to Public Choice Political Economics is theoretically by far not as rich. On the background of the classical topics in public finance, Political Economics addresses only an evanescent small number of questions. This is partly due to the limited time of the existence of Political Economics.

Far more important that the difference in the scope of the analysis is that Political Economics grounds in a different understanding of economics applied to decision making processes. This different understanding is crucial for structural differences in the research programs of both schools and their basic tenets.

In its approach to Public Finance, Public Choice starts strictly at the individual, pre-constitutional level. Individuals form a state and all institutional arrangements of the state are judged based on their consequences for the satisfaction of the preferences of all citizens. Within this context, Public Choice puts voluntary economic exchange and not redistributive conflict at its core (Buchanan 1957). Therefore scholars of the Public Choice school see their main task in developing arrangements that facilitate economic exchange. Their methodological point of reference lies in the model of Wicksell (Wicksell 1896), in which a commonly elected parliament that should represent the preferences of all citizens decides unanimously, i.e. it is bargained till unanimity is (nearly) reached. The process secures that all preferences are accounted for in the final decision. Deviations from unanimity are only acceptable if transaction costs would otherwise be prohibitively high. The Endeavour of Public Choice is to approximate its normative suggestions for institutional improvements towards the Wicksellian ideal taking the restrictions of existing transaction costs into account.<sup>8</sup>

The Cambridge School - as reflected in the overview article of Persson and Tabellini – takes a different view. They do not question the existing systems of representative democracy. The decisions about the political institutions are already made in their models and therefore not discussed. Individual entry and exit are not considered and even if fundamental changes like secessions are discussed, this takes place within the setting of representative democracy. This narrow focus explains the concentration of the Cambridge School on redistributive issues and therefore conflicts in between different social groups like the rich and the poor, the old and the young, the employed and the unemployed, capital and labour and different regions within states (see Persson and Tabellini 2002a, Part I). And it helps us understand why the Cambridge School is at best able to derive trade-offs but often lacks a yardstick for the normative suggestions for institutional improvements: The Wicksellian ideal is neglected and an equivalent point of reference is not developed.

In sum, Political Economics and Public Choice share the critique of traditional Public Finance for not taking decision-making procedures into account. But the overlap of

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<sup>8</sup> Therefore Virginians put much energy into the development of new voting procedures such as voting by veto (Mueller 2003) which aim to approximate unanimity rule as closely as possible.

the works of the Public Choice approach and of the Political Economics approach is limited not only because of the recency of Political Economics but as well because of its methodological restriction to the study of political institutions in existing representative democracies. Within this limited focus it is called for an intensified academic discussion in between the two approaches. But all in all Political Economics is far from challenging the much more comprehensive approach of Public Choice to Public Finance.

## 6 Modelling and Policy Advice

In their book *Political Economics* Persson und Tabellini complain: “The gap between theory and evidence is a final weakness of the existing literature.” (Persson and Tabellini 2000, p. 481). They think the existing empirical literature is unsatisfying.

- (1.) “[T]he indicators and tests in this empirical work are not tied well to the extensive form games or theoretical predictions in theoretical works.” (Persson and Tabellini 2000, p. 481).
- (2.) “Convincing empirical work requires a combined analysis of time-series and cross-section data. Although economists and political scientists have done plenty of such work, they have not yet taken advantage of modern estimation techniques for data in the form of dynamic heterogeneous panels. Nor has the search for ‘natural experiments,’ which has become common practice in one branch of modern labour economics, taken root in Political Economics.” (Persson and Tabellini 2000, p. 481).

The first request is taken back by the authors later in their own work They write „the possible assignments of control rights are infinite, and you can prove anything with extensive form game theory“. And they continue : “Although this may be a valid criticism of certain theories of industrial organization, we do not find it too damaging here, because constitutional rules are very well established, both legally and historically” (Persson and Tabellini 2000, p. 267). As there is always some scope for discretion, which rules should be integrated into the models and how they should be interpreted, the allegation cannot be easily rejected.

The second request is not up to date any more (end of 2003). By now there exist important works which include dynamic heterogeneous panels or natural experiments (see e.g. Matsusaka und Feld 1999)

It is true that economic advice relevant for policy making is favourable if it is based on economic models. But models alone cannot secure relevant advice. If the policy-making question does not match the model exactly, there is often no input from the

model for the actual policy-making process. But how should questions in public finance be evaluated? If economic reasoning without explicit modelling is rejected, only textbook-economics remains. Polit-economic questions are not taken into account and the scientific funding of a statement is minor than in classical Public Choice approach.

One example to demonstrate this point is the distribution of competencies within the European Union. Guido Tabellini – one of the prominent scholars of the Cambridge School - gave the following statement on a conference on the reform of EU institutions:

”From the perspective of cost and benefit analysis, it seems obvious that there would be large payoffs to more central provision of public goods in the areas of defence foreign policy, and of aspects of internal security, border patrols, immigration policy. The abolition of borders between EU countries carries with it the need to centralise aspects of law enforcement against organised crime. Moreover the recent terrorist attacks have made it absolutely clear that the challenges in these areas are global and require a co-ordinated European response. The positive spill-over effects and the economies of scale for foreign and defence policy, international security, border patrols and immigration policy are very large. ... Currently the EU budget is mainly devoted to finance the re-distributive programs of the EU. ... Now the whole discussion on the EU budget only concerns who gains and who loses, and in particular which countries are net beneficiaries or net payers, and by how much. No attention is paid as to whether the money is well spent for the average European tax payer, or whether reallocations across alternative programs are desirable. Enlargements, with the large disparities between rich and poor countries, will make the political debate on the EU budget a nightmare.” (Tabellini, 2002, pp. 17-19)

Public goods properties and the functioning of international policy coordination are not examined carefully just assumed straight away. The principal-agent problem – central especially in the Public Choice analysis of European Institutions (see e.g. Vaubel 2001) are completely blocked out. A shift from distributive to allocative spending is advocated without a discussion of the current status quo and the chances to change it under the given institutional framework. If this is the policy

advice derived from explicit modelling the modelling does not seem to have helped much.<sup>9</sup>

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<sup>9</sup> Compare for a different approach Blankart and Kirchner 2003.

## 7 Conclusion

The Cambridge School of Political Economics started a full-fledged attack on the Virginia Public School of Public Choice although it is not carried out openly but by far-reaching negation and ignorance of the writings of Public Choice. The Cambridge School does not only claim to be the “synthesis of Normative Welfare Economics and Public Choice” with respect to the economic analysis of politics but also to establish a new approach to public finance.

An analysis of the contribution of both schools in central fields of the analysis shows that the track record of the Cambridge School does not speak in favour of a paradigm shift from Public Choice to Political Economics. Although the Cambridge School pushed some important advantages in Political Business Cycles Theory, Public Choice is still leading e.g. in the analysis of constitutional political economy.

With respect to the field of Public Finance, Political Economics is by far not as rich as the established approach of Public Choice. But more important than the richness is the different understanding of economics applied to the decision making process. As the Cambridge School uses to start their analysis in a setting of representative democracy they are restricted to a discussion of societal conflict while Public Choice, starting its analysis with the individual, is much broader and far more successful in deriving normative suggestions for institutional improvements. Within the field of Public Finance Political Economics is far from challenging the comprehensive approach of Public Choice.

Compared to their abilities in giving policy advice, Political Economics has sometimes troubles to live up to its own expectations. At least the economics-textbook-like-advice of some proponents of the school points in that direction.

As demonstrated in the field of Political Business Cycles, the Cambridge School contributed most when it referred heavily to the work of Public Choice. As we would hope for and expect other contributions that are as fruitful, we advocate an intensified discourse within the two approaches that would benefit both.

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