

# POLITICAL ECONOMY





NEW

SZÉCHENYI PLAN

# POLITICAL ECONOMY

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# POLITICAL ECONOMY

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## Week 5

### The exit option and federalism

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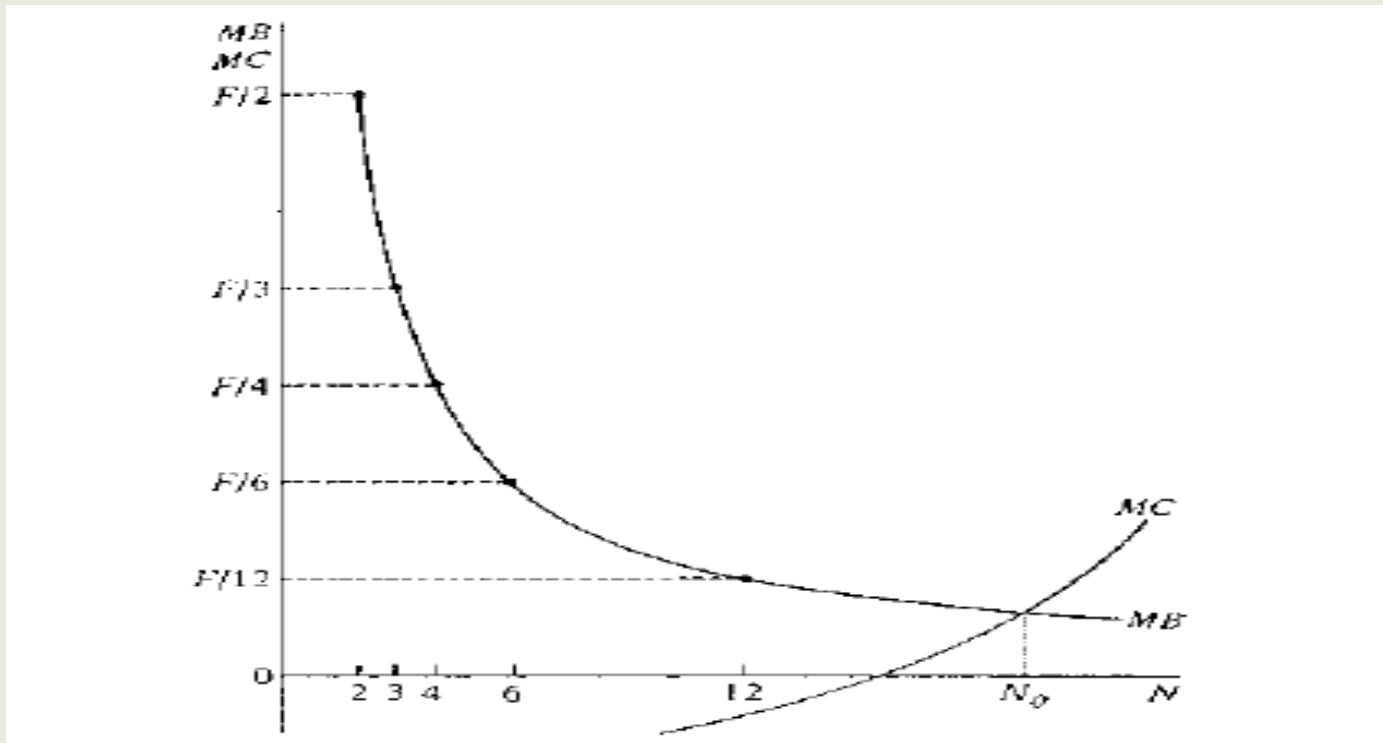
# The exit option

- Albert Hirschman made the deep point that there are three ways an individual can make her preferences known:
- "Voice": vote, complain, petition.
- "Exit": leave the community, not buy the product.
- "Be disloyal" disrupt the whole institution in question: e.g.: revolt.

# The theory of clubs

- What we have covered so far is "voice". What about exit?
- The theory of clubs (Buchanan)
- Def. a club is a voluntary association established to provide *excludable* public goods (possibly with congestion).
- Social (e.g. chess or bridge) clubs are a special case.
- Can you think of local government as a club?

# Determination of optimal club size



You can think of private goods as a special case!



# The algebra of clubs

- Let a representative individual's utility be defined over private good  $X$ , public good  $G$ , and club size  $N$ ,  $U = U(X, G, N)$ .
- Let the cost of providing the public good to the club include a fixed cost,  $F$ , and a unit cost (price) of  $P_g$ .
- Assume that each individual has not only the same utility function  $U$ , but the same income  $Y$ , and that each pays the same fee,  $t$ , for membership in the club.

# The algebra of clubs

$$L = U(X, G, N) + \lambda(Y - P_x X - t)$$

$t$  must satisfy

$t N = F + P_g G$ . Plugging that in, we obtain:

$$L = U(X, G, N) + \lambda(Y - P_x X - F/N - P_g G/N).$$

Hence:

$$[N(\partial U/\partial G)/(\partial U/\partial X)] = P_g/P_x$$

And

$$N = -[(\partial U/\partial G)/(\partial U/\partial N)] [(F + P_g G)/P_g].$$

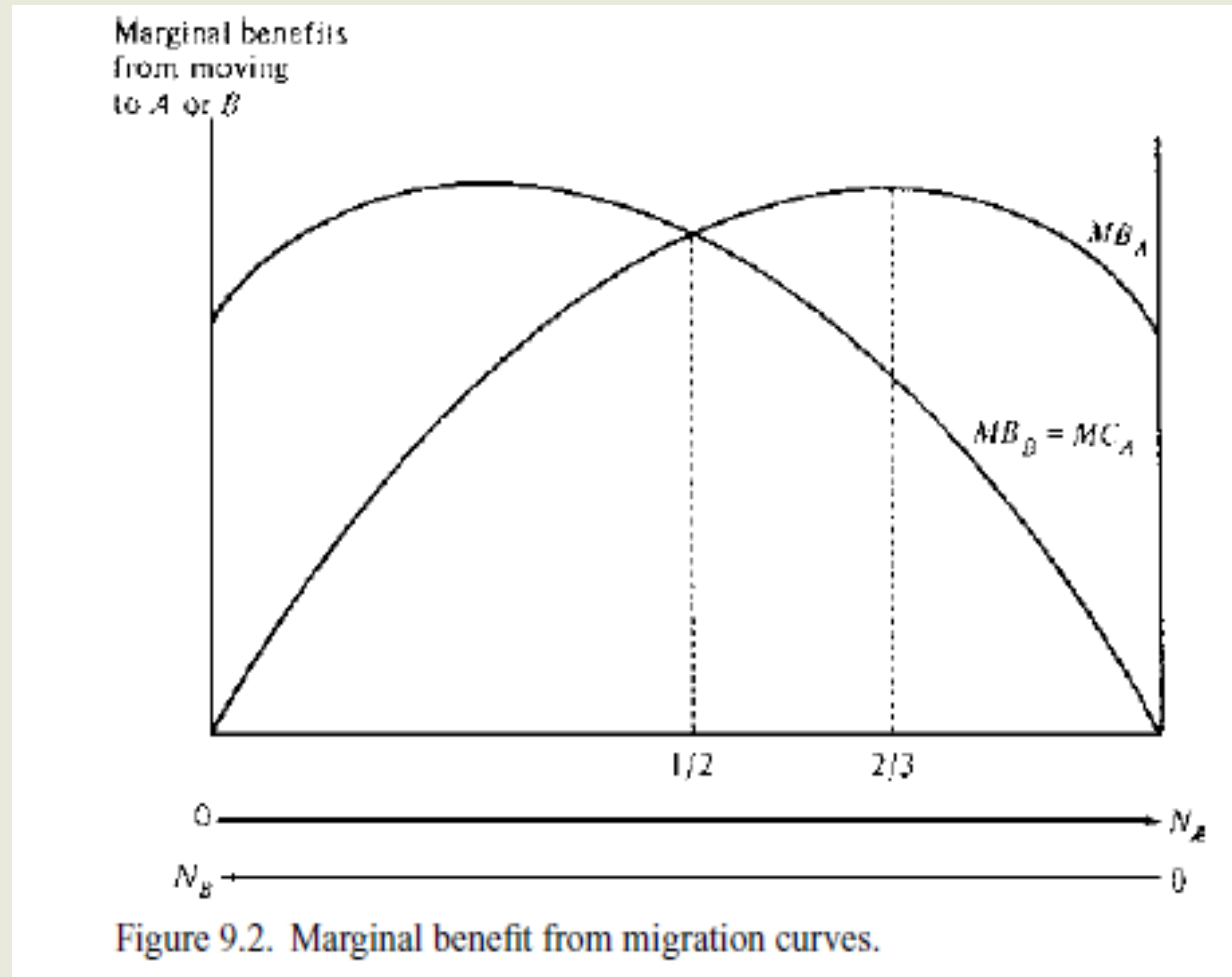
# What if there are more than one clubs?

It depends. If the optimal  $N$ s are small compared to the size of the citizenry  $\rightarrow$  the Tiebout story, coming up soon.

If  $N$  is  $2/3$ s of the citizenry, we might have a problem (next slide): the equilibrium might not be the social optimum.

In general, there need not be an equilibrium, endless cycles of migration are possible.

# Two, optimally big clubs



# The Tiebout model

The following conditions ensure the global optimality of excludable public goods:

1. Full mobility of all citizens
2. Full knowledge of the characteristics of all clubs
3. Availability of a range of community club options spanning the full range of public good possibilities desired by citizens
4. Absence of scale economies in producing the public good and/or smallness of the optimum scale of production relative to the population size
5. Absence of spillovers across communities (clubs)
6. Absence of geographical constraints on individuals with respect to their earnings

# Are the Tiebout conditions plausible?

Well, not quite.

Also potential issues and contradictions:

- What is the true optimal scale?
- Who provides the services?
- What is the community size? (1 vs. 5)
- Single or multiple public good provision?  
(3)

# Testing Tiebout

What of it is testable at all?

1. Individuals do move in response to local government expenditure–tax offerings.
2. This migration process sorts people into groups of homogeneous tastes consuming the bundles of public goods of their choice, and therefore
3. individuals are more satisfied with their local public goods–tax packages where Tiebout sorting takes place.

# Equity in Tiebout and clubs

Sorting for tastes – what if tastes are related to income?

Is exclusion acceptable? That depends on what you consider the polity – issues of citizenship (e.g. European Union vs. USA) and what you think about freedom to associate vs. e.g. discrimination.

Equity might require transfers across "clubs".



# Federalism

# Federalist state

- Separate and overlapping levels of government exist (need not be, but usually we have *partitions* at different levels) and
- different responsibilities are attached to the different levels of government.

# Federalism – ”Too large government”?

- Logrolling
- Universalism
- Reasons for intergovernmental transfers
  - external effects across local governments
  - equity
- Local politicians might want to push locally important projects up to the federal level.

# Intergovernmental transfers

Types:

- Matching
- Unconditional
- Earmarked

The flypaper effect: earmarked intergovernmental transfers from the central government "stick where they land".

# Explanations for the flypaper effect

- Fiscal illusion
- Budget-maximizing bureaucracy
- Earmarked = implicit matching grant

# Centralization under federalism

- "Popitz's Law": revenues and expenditures tend to become more centralized in time in federal states.
- Reasons
  - local governments cartelize against tax- and Tiebout competition
  - Nationwide equity
- Cases
  - Germany: 1950: 40%, 1995: 7% of all tax revenue regional or local
  - Canada: ditto
  - But: Switzerland
- What can resist Popitz's Law?
  - Direct democracy?
  - Hard to change constitutional distribution of powers

# Decentralization – Arguments for

- Sensitivity to local preferences
- Household mobility as a preference revelation mechanism: Tiebout and voting with your feet; even capitalized into housing and land prices
- Restraining the Leviathan by tax competition (more about this later in the course)
- Public sector innovation

# Decentralization – Arguments against

- Inefficient interregional resource allocation
- Destructive tax competition for mobile factors.  
E.g. fiscal and pecuniary externalities of capital taxation
- Spillover problems
- Suboptimal income distribution within regions
- Suboptimal income distribution across regions
- Suboptimal stabilization