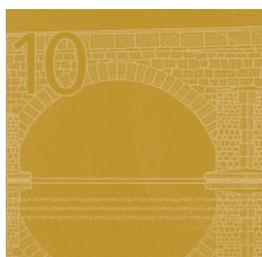




EUROPEAN CENTRAL BANK

EUROSYSTEM



In 2014 all ECB publications feature a motif taken from the €20 banknote.



## WORKING PAPER SERIES

NO 1708 / AUGUST 2014

# OPTIMAL MECHANISMS FOR THE CONTROL OF FISCAL DEFICITS

Hans Peter Grüner

---

**NOTE:** This Working Paper should not be reported as representing the views of the European Central Bank (ECB). The views expressed are those of the authors and do not necessarily reflect those of the ECB.

---

### **Acknowledgements**

I thank seminar participants at the European Central Bank, the University of Mannheim, ZEW, Mannheim, and the University of Cologne, and in particular Felix Bierbrauer, Pierre Boyer, Micael Castanheira, Antonio Ciccone and Philipp Zahn for their useful comments. This paper has been prepared by the author under the Wim Duisenberg Research Fellowship Programme sponsored by the ECB. Any views expressed are only those of the author and do not necessarily represent the views of the ECB or the Eurosystem.

### **Hans Peter Grüner**

University of Mannheim; e-mail: [gruener@hertie-school.org](mailto:gruener@hertie-school.org)

### **© European Central Bank, 2014**

<b>Address</b>	Kaiserstrasse 29, 60311 Frankfurt am Main, Germany
<b>Postal address</b>	Postfach 16 03 19, 60066 Frankfurt am Main, Germany
<b>Telephone</b>	+49 69 1344 0
<b>Internet</b>	<a href="http://www.ecb.europa.eu">http://www.ecb.europa.eu</a>

All rights reserved. Any reproduction, publication and reprint in the form of a different publication, whether printed or produced electronically, in whole or in part, is permitted only with the explicit written authorisation of the ECB or the authors. This paper can be downloaded without charge from <http://www.ecb.europa.eu> or from the Social Science Research Network electronic library at [http://ssrn.com/abstract\\_id=2464119](http://ssrn.com/abstract_id=2464119). Information on all of the papers published in the ECB Working Paper Series can be found on the ECB's website, <http://www.ecb.europa.eu/pub/scientific/wps/date/html/index.en.html>

<b>ISSN</b>	1725-2806 (online)
<b>ISBN</b>	978-92-899-1116-0 (online)
<b>EU Catalogue No</b>	QB-AR-14-082-EN-N (online)

### Abstract

This paper shows that a simple two-stage voting mechanism may implement a constrained optimal state dependent decision about a fiscal deficit. I consider a setup with strategic fiscal deficits à la Tabellini and Alesina (1990). Three groups of voters are informed about the productivity of current public spending. Voters differ in their preferences for public goods and swing voters' preferences may change over time. The current government decides on the current spending mix and it has an incentive to strategically overspend. Under certain conditions, a simple two-stage mechanism in which a deficit requires the approval by a supermajority in parliament implements a constrained optimal decision. When the current majority is small, bargaining between political parties may further increase social welfare. However, when the current majority is large, a supermajority mechanism with bargaining leads to a biased spending mix and reduces welfare whereas the laissez faire mechanism may yield the first best. An appropriately adjusted majority threshold can deal with this problem.

**Keywords:** Fiscal policy rules, constitutional choice, mechanism design.

**JEL-Classification:** D82, H62.

### **Non-technical summary**

Designers of fiscal policy institutions have to deal with a fundamental trade-off. On the one hand, elected policymakers face limited or uncertain periods in office. This can create a bias towards excessive spending. On the other hand, fiscal flexibility is desirable because new information about economic circumstances and political preferences may require a flexible policy reaction. Any suitable institutional arrangement has to address both problems at the same time. This paper studies institutional arrangements that reduce strategic fiscal deficits while still permitting some fiscal flexibility.

Tying policymaker's choices through reliable constitutional deficit rules is a simple way of addressing the problem of excessive strategic spending. In practice, such rules often permit exceptions under special circumstances in which a fiscal policy response is desirable. However, the designers of such fiscal policy institutions face the difficulty that at least some relevant information about the need for discretionary fiscal policy responses is not contractible *ex ante* or not verifiable *ex post*. It would be very costly to fully specify at the constitutional stage what kind of specific situation may make a fiscal deficit (or a surplus) desirable in the future and to specify the appropriate size of such a deficit. Even if such events could be specified in a constitution, it would often be difficult to verify *ex post* whether something exceptional has happened that justifies a specific policy response.

This paper studies how one should design a constitution that deals with decentralized non-contractible information about the desired timing and mix of public spending when elected politicians have a bias towards strategic deficits. I develop a theoretical model that studies how fiscal policy institutions aggregate information about voters' policy preferences. In my model voters differ in their preferences for two different public goods. Moreover, all voters and all policymakers are equally well informed about the productivity of current public spending. This is why, for any given spending mix, all voters agree on the optimal time path for public spending. However, the information about the productivity of current public spending is not contractible at the constitutional stage. It is the role of political institutions to base decisions regarding the spending mix and the deficit on voters' preferences and on the productivity of current public spending. By assumption, the constitution can only specify how decision rights are allocated to political parties. In such a case the government party will select its desired spending mix even if this is not maximizing social welfare. In most of the paper, this is taken to be a constraint of the mechanism designer's optimization problem.

The paper derives conditions under which a relatively simple revelation mechanism can implement an outcome in which the debt level is chosen optimally for all possible realizations of the productivity of public spending. This mechanism asks both political parties for the simultaneous announcement regarding the realized productivity parameter and implements a corresponding deficit. If the two announcements differ, a low default spending level is implemented. I show that, when voter preferences are not too distant or when the potential productivity of government spending is sufficiently large, this mecha-

nism implements a constrained optimal outcome.

The revelation mechanism requires a structured announcement procedure which may be difficult to implement in practice. A similar outcome can be implemented by a simple supermajority mechanism. This mechanism has three stages. In the first stage, the government has to propose the size of the fiscal deficit. If the deficit exceeds a prespecified value, then, in a second step, the opposition may accept or reject the proposal. In the third step the government decides on the spending mix. If the proposal is rejected the government can only spend a prespecified amount. This setup grants the opposition a veto right regarding "high" spending levels. In this sense it resembles the practice in the US where a divided government can currently only increase spending if the opposition approves this. The present paper shows that such a practice may actually be welfare increasing.

Mechanisms that grant the opposition a veto right give them considerable political power in situations in which a deficit would be in the common interest of all voters. This is why the (factual) supermajority mechanism of the United States has recently been criticized. In the paper I also study how a supermajority mechanism performs when the opposition uses its veto right in order to negotiate with the government about the spending level and the spending mix.

In this case, it depends on the features of the underlying distribution of individuals' preferences, whether a supermajority increases or reduces social welfare compared to a laissez faire constitution. The size of the current majority plays an important role. A society which is almost equally split into two political camps may benefit from a supermajority mechanism with bargaining because the bargaining process may lead to a more equal spending mix which increases social welfare. If, instead, the opposition is small the distortion of the spending mix may reduce social welfare. A properly chosen supermajority threshold can make sure that a government which is supported by a large enough majority in parliament does not need the approval of the current opposition.

# 1 Introduction

Designers of fiscal policy institutions have to deal with a fundamental trade-off. On the one hand, elected policymakers face limited or uncertain periods in office which can create a bias towards excessive spending. This bias needs to be corrected through an appropriate regulation of policymakers' activities. On the other hand, fiscal flexibility is desirable because new information about economic circumstances and political preferences may require a flexible policy reaction. Any suitable institutional arrangement has to address both problems at the same time. This paper studies institutional arrangements that reduce strategic fiscal deficits while still permitting some fiscal flexibility.

Tying policymakers' choices through strict constitutional deficit rules is a direct way of addressing the problem of strategic overspending. In order to address the problem of maintaining fiscal flexibility, constitutions often contain exemption clauses that permit exceptions under circumstances that make a fiscal policy response particularly desirable. However, formulating exception clauses can be very difficult when relevant information about the need for discretionary fiscal policy responses is not contractible *ex ante* or not verifiable *ex post*. It would be prohibitively costly to fully specify at the constitutional stage, what kind of situation makes an elevated fiscal deficit (or a surplus) acceptable in the (partly distant) future and to specify the appropriate size of the deficit. Even if some events of this kind can be listed in a constitution, it may be difficult to verify such events *ex post*. Hence, the design problem is to specify how the constitution should deal with non-contractible or non verifiable information about the state of the economy.

This paper addresses the above problem from a mechanism design perspective. I assume that fiscal policy decisions should depend on two kinds of information: The desired spending mix of the majority of citizens and the productivity of public spending at different points of time. In my model voters differ in their preferences for two public goods. Moreover, all voters and all policymakers are equally well informed about the productivity of current public spending. This is why, for any given spending mix, all voters agree on the optimal time path for public spending. However, neither the spending mix nor the productivity of current public spending are fully contractible at the constitutional stage. In my model, it is the role of political institutions to base decisions regarding spending mix and deficit on voters' preferences and on the realization of the productivity of current spending. By assumption, the constitution can only specify how decision rights are allocated to political parties. This is why the government party selects its desired spending mix even if this is not maximizing social welfare. In most of the paper, this is taken to be a constraint of the mechanism designer's optimization problem.

The paper derives conditions under which a relatively simple revelation mechanism can implement a constrained optimal outcome in which the debt level is chosen optimally for all possible realizations of the productivity of public spending. The revelation mechanism asks both political parties for simultaneous announcement regarding the realized productivity parameter and implements a

corresponding deficit. If the two announcements differ, a low default spending level is implemented. I show that, when voter preferences are not too different or when the potential productivity of government spending is sufficiently large, this mechanism implements a constrained optimal state dependent collective choice.

The revelation mechanism requires a structured announcement procedure which may be difficult to implement in practice. I show that a similar state dependent outcome can be implemented by a simple three-step supermajority mechanism. In the first step, the government asks the parliament to accept a specific deficit level that may exceed a prespecified value. The approval of the deficit requires a supermajority in parliament whenever the deficit exceeds the prespecified value. In the second step, the parliament may accept or reject the proposal. If the proposal is rejected then the size of the budget may not exceed the prespecified size. In the third step the government decides on the spending mix, taking into account the parliament's decision.

In a two-party system, a supermajority mechanism grants the opposition party a veto right on any budget that exceeds a prespecified absolute or relative deficit level. In this sense it closely resembles the practice in the U.S. where the government can only increase government debt beyond a prespecified value if the house and the senate both give their approval. Over the last 30 years the composition of the two chambers and the president's party affiliation only fit together in 8 years. This effectively turned the U.S. mechanism into a supermajority rule in most of these 30 years.

The present paper shows that a mechanism which is similar to the one applied in the U.S. may in principle play a useful role.<sup>1</sup> However, a supermajority mechanism has the drawback that it grants the opposition considerable political power exactly when a deficit would be particularly useful. It is likely that the opposition uses its right to veto an increase of the size of the budget in order to negotiate the spending level and the spending mix with the government. This in turn may distort the spending mix. It depends on the features of the underlying distribution of individuals' preferences, whether a supermajority increases or reduces social welfare compared to a *laissez faire* constitution. In this context, the size of the current majority plays an important role. A society which is almost equally split into two political camps is likely to benefit from a supermajority mechanism with bargaining because the bargaining process may lead to a more moderate spending mix which increases social welfare. If, instead, the opposition is small, the distortion of the spending mix away from the majority's preferred outcome may reduce social welfare. A *laissez faire* constitution may also perform well when there is a high probability of a political change and when all members of the current majority's preferences are strongly correlated.

---

<sup>1</sup>In Italy the entire budget (i.e. spending level and composition) has to be approved by two chambers with often opposite majorities (Article 81 of the Italian constitution). This procedure is different from the supermajority mechanism that grants the government the right to choose the spending mix.

Accordingly, the constitution should ideally adjust the majority threshold to the underlying political situation. A too low majority threshold can lead to excessive spending and a too uneven spending mix. A too high threshold may lead to too little concentration of the spending mix. However, a properly chosen supermajority threshold can make sure that a government which is supported by a large enough majority in parliament does not need the approval of the current opposition.

The supermajority mechanism studied in this paper is an alternative to fiscal policy arrangements which are currently introduced in some of the countries of the Eurozone. Some of these new arrangements give the government the right to announce the existence of special economic circumstances. Exemption clauses are e.g. included in the new institutional arrangements in France and Italy. The results generated by such constitutional rules have often been rather disappointing in the past. Between 1969 and 2009, the German constitution (Article 115) ruled out that the federal government's annual fiscal deficit exceeds the annual amount of public investment. However, under exceptional economic circumstances the rule was not supposed to be binding and the government could unilaterally decide that an exception is acceptable. Moreover, the concept of investment in Article 115 has been quite vague. In 1989 the German constitutional court argued that the rule is useless because government debt continued to increase significantly while the rule was in place.

The present paper is related to a vast theoretical literature about the sources of excessive deficits and institutional measures to overcome the problem. The model is built on Tabellini and Alesina (1990) who have shown that the possibility of a change of the political majority makes policymakers overspend on their preferred projects.<sup>23</sup> The present paper extends their analysis by including time varying voter preferences and spending productivity.

Several economists have proposed that exceptionally high fiscal deficits should only be permitted if they are backed by a supermajority in parliament<sup>4</sup>. The underlying idea is that there should be more widespread support for deficits when exceptional circumstances affect many individuals in the same way<sup>5</sup>. A first formalization of this argument can be found in Becker, Gersbach, and Grimm (2010). In their model, there is a single public good and voters differ in their

---

<sup>2</sup>According to this theory, frequent changes of government should be associated with higher debt levels. Figure 1 shows that recent developments in the Eurozone are in line with this prediction.

<sup>3</sup>See also Persson and Svensson (1989), Lizzeri (1999), and Battaglini and Coate (2008).

<sup>4</sup>Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2007) and Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie (2008).

<sup>5</sup>*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2007, p.101).*

preference for private and public consumption. The parliamentary decision procedure yields an outcome that is put up for a vote against the status quo. A flexible majority threshold for this vote which increases with the proposed fiscal deficit may reduce the equilibrium deficit<sup>6</sup>. The same holds for an inflexible upper bound on the deficit. The advantage of a flexible majority rule is that it permits that the equilibrium deficit increases when all voters' present income declines. The present paper is also based on the idea that the political system should filter out the situations in which fiscal deficits do not receive widespread support. It uses a different formal framework that permits to analyze additional issues. Modelling a two-dimensional information aggregation problem permits to analyze the effect of fiscal policy institutions on the level and composition of public spending. The paper provides a welfare analysis of different alternative mechanisms. Moreover, the present paper studies the role of parliamentary negotiations that may arise when the opposition is granted a veto right regarding the deficit level.

Another model that analyzes how fiscal policy institutions should deal with new information about the desirability of deficits is Kiel (2003, chapter 3). She studies a fiscal policy mechanism design problem with cross border externalities. Several countries have idiosyncratic stochastic spending needs. A mechanism maps the vector of spending needs into a vector of fiscal deficits. Her paper studies a static case and it does not derive endogenously why the deficit bias arises.

The present paper is also related to Rogoff's (1986) seminal work on the trade off between credibility and flexibility of monetary policy. A similar trade off arises in the present model. While Rogoff studies the optimal choice of the characteristics of the policymaker, I assume that policymakers are selected by the population in an election.

## 2 The model

### 2.1 Consumers

Consider a country with a population of size 1 consisting of three homogenous groups of individuals. There are two divisible public goods,  $x$  and  $y$  and two legislative periods, 1 and 2. In both periods, the government has a given revenue of  $1/2$ . In the first period, the government can raise debt (or deposit money) at an interest rate of zero. Debt has to be fully repaid in the second period. In both periods, both public goods have the same price 1. The members of one group, called  $x$  voters, always wish to consume more of good  $x$  than of good  $y$ . The members of another group ( $y$  voters) always wants to consume more of good  $y$  than of good  $x$ . Both groups have size  $1/2 - \varepsilon$ , with  $\varepsilon > 0$ . The third

---

<sup>6</sup>The concept of a flexible majority rule has been introduced in Gersbach and Erlenmeyer (1999).

group of size  $2\varepsilon$  (swing voters) also wishes to consume more of good  $x$  in period 1. However, with a given probability  $p$ , this may change in period  $t = 2$ . All voters know, which of the three groups they belong to.<sup>7</sup>

Preferences of  $x$ -voters,  $y$ -voters and swing voters are represented by the following von Neumann Morgenstern utility functions.

$$\begin{aligned} u_x(x_1, y_1, x_2, y_2) &= \theta \cdot u(x_1, y_1) + u(x_2, y_2), \\ u_y(x_1, y_1, x_2, y_2) &= \theta \cdot v(x_1, y_1) + v(x_2, y_2), \\ u_s(x_1, y_1, x_2, y_2) &= \theta \cdot u(x_1, y_1) + \delta u(x_2, y_2) + (1 - \delta) v(x_2, y_2), \end{aligned}$$

where the indices refer to periods 1 and 2 and where  $\delta = 1$  if swing voters' preferences continue to be more in favor of consuming good  $x$  and  $\delta = 0$  otherwise. The parameter  $\theta$  measures the relative efficiency (or desirability) of public spending in period 1. It is drawn from a given distribution  $\phi(\theta)$  which is known by the designer at the constitutional stage. All voters are informed about the realization of  $\theta$  in period 1. I assume that  $x$ - and  $y$ -voters' preferences are different and symmetric in the following sense:

$$\begin{aligned} v(x, y) &\neq u(x, y) \\ v(x, y) &= u(y, x). \end{aligned}$$

The utility function  $u(x, y)$  is strictly concave and homothetic. I assume that utility values are determined by the spending level  $s_t$  and the spending share  $\chi_t := x_t / (x_t + y_t)$  as follows:

$$u(s_t \chi_t, s_t (1 - \chi_t)) = f(s_t) \cdot u(\chi_t, (1 - \chi_t))$$

with

$$f' > 0, f'' < 0, f'(0) = \infty.$$

At a relative price of 1, type  $x$  ( $y$ ) consumers want to consume a share  $\chi^* > 1/2$  of good  $x$  ( $y$ ) in each period. I define  $\bar{u} := u(\chi^*, 1 - \chi^*)$  and  $\underline{u} := (1 - \chi^*, \chi^*)$ .

## 2.2 Parties

In most of the paper (sections 2, 3, and 4) I consider a given set of two political parties ( $X$  and  $Y$ ) which represent the two groups of society with stable preferences. Parties compete for office in each of the two legislative periods 1 and 2. Their objective is to maximize the utility of their respective constituency, the  $x$ - and the  $y$ -voters. Parties cannot commit to any specific platform when they compete. In particular, they cannot commit to a platform for period 2 in period 1. An election merely determines both parties' vote shares in parliament and

---

<sup>7</sup>In Section 5, I consider the alternative case where all  $x$  voters may or may not turn into  $y$  voters with the same probability.

so allocates the right to choose policies. Swing voters have no specific political representation. Alternative assumptions regarding the structure of the party system, the motivation of party representatives and the commitment power of parties will be discussed in section 5. Throughout the paper, the political parties are treated as the informed agents in the design problem that I study.

### 2.3 Predetermined spending

In practice, some spending decisions can only be altered at a high cost. State employees often have long run contracts. These long run contracts may be a useful device when an employee is expected to make a relationship specific investment that only pays off for him if his employment lasts long enough. Similarly, procurement contracts may often only be altered at a high penalty. In times of financial difficulties it may be costly or even impossible to renege on such commitments. This is why I assume that, at the beginning of period 1, some spending decisions related to this period can only be altered at a prohibitively high cost<sup>8</sup>. I denote by  $\check{s}$  the level of predetermined spending in period 1 and by  $\check{\chi}$  the period 1 spending share of good  $x$ . Throughout the paper, I will assume that  $\check{s} < 1/2$  and that  $\check{s}$  and  $\check{\chi}$  are such that party  $X$  can still implement its preferred spending mix if there are no further restrictions, i.e. I assume that

$$\begin{aligned} \check{\chi} \cdot \check{s} &\leq \chi^* s^* \wedge (1 - \check{\chi}) \check{s} \leq (1 - \chi^*) s^* \\ \Leftrightarrow \check{s} &\leq \min \left\{ \frac{1 - \chi^*}{1 - \check{\chi}}, \frac{\chi^*}{\check{\chi}} \right\} s^*. \end{aligned}$$

### 2.4 The constitutional stage

The objective of this paper is to find appropriate constitutional arrangements that deal with a two-dimensional information aggregation problem. The problem is to find institutions that map the realization of the majority's preferences regarding the spending mix and the realization of  $\theta$  into a time path for public spending on the goods  $x$  and  $y$ .

In an unrestricted setup and with correlated (here: perfectly correlated) types, one can easily implement a social choice that maximizes expected social welfare. Just consider a direct revelation mechanism that asks both political parties to submit an announcement about the realization of  $\theta$ . If the two parties' announcements differ, the mechanism only provides the prespecified mix of public goods. Otherwise, the mechanism provides the welfare maximizing mix of public goods which lies between what  $x$ -voters and  $y$ -voters want. Clearly, this mechanism would be incentive compatible if the prespecified mix of public goods is sufficiently unattractive for both parties.

---

<sup>8</sup>In principle one could also add a similar constraint to the second period. I only consider it for the first period because it is important for parties' default options.

However, there are three practical difficulties with such an approach. The first problem is that it is difficult to fully specify in a constitution how the desired mix of public spending varies with the state of the economy. One reason is that this list of public goods and the list of states of the world would have to be quite long. Another reason is that the set of available public goods and the preferences regarding these goods may evolve over time. This is why I assume that the spending mix is not contractible at the constitutional stage. The third practical problem is that a particularly unattractive budget would not be renegotiation proof because both parties would prefer a set of alternatives.

In what follows, I assume that the constitution allocates the right to make the current spending decision. The constitution may specify default spending levels that have to respect the predetermined spending requirements. I consider the options to leave the decision about the budget to the current government or to the opposition. These decision makers also have to respect the predetermined spending requirements. In section 4 I study the case where both parties can bargain about the budget.

### 3 Results

#### 3.1 Right to manage and desired spending levels

Consider first the case where in both periods the government party unilaterally fixes the spending mix (right to manage). The following definition is useful.

**Definition 1** (i) Call  $s_W(\theta)$  the state dependent welfare maximizing spending level when, in each period, the majority has the right to manage the spending mix.

(ii) Call  $s_p(\theta)$  the desired spending level of  $p$ -voters when, in each period, the majority has the right to manage the spending mix.

The functions  $s_W(\theta)$ ,  $s_x(\theta)$ , and  $s_p(\theta)$  are depicted in figure 2. The socially optimal value of period 1 spending increases with the realization of  $\theta$ . In the case where  $\theta = 1$  a balanced budget ( $\bar{s} = 1/2$ ) would maximize social welfare because it equates marginal welfare across periods. The monotonicity and concavity of the desired spending share in  $\theta$  can be easily verified. The optimality of  $s$  requires that

$$\theta f(s)a + f(1-s)b$$

is maximized, where  $a = b = \left(\frac{1+2\varepsilon}{2}\bar{u} + \frac{1-2\varepsilon}{2}\underline{u}\right)$ . the first order condition is

$$\theta = \frac{f'(1-s)}{f'(s)}.$$

Therefore the inverse of  $s_W(\theta)$  satisfies

$$\frac{d\theta}{ds} = \frac{-f'(s)f''(1-s) - f'(1-s)f''(s)}{f'(s)^2} > 0$$

and

$$\frac{d^2\theta^*}{ds^2} = \frac{(f'(s)f''(1-s) + f'(1-s)f''(s))2(f'(s))f''(s)}{f'(s)^4} > 0.$$

### 3.2 The laissez faire constitution

Consider now a constitution that foresees an election in each period. In each period the elected government may choose both the spending mix and the spending level subject to the minimum spending constraint. In this laissez faire case, the  $t = 2$  government spends its desired share  $\chi^*$  or  $1 - \chi^*$  of the remaining budget  $1 - s$  on good  $x$ . Taking this into account, the  $t = 1$  government's payoff is concave in the spending share  $s$  with a unique maximum at a value  $s_p^*(\theta) \in [0, 1]$  satisfying

$$f'(s_p^*(\theta))\theta\bar{u} = f'(1 - s_p^*(\theta))((1 - p)\bar{u} + p\underline{u}).$$

Note that  $s_p^{*'}(\theta) > 0$ .

For all  $\varepsilon > 0$  and for all possible realizations of  $\theta$ , the laissez faire outcome does not maximize social welfare because the preferences of the current  $y$ -voters and the preferences of swing voters are not taken into account by party  $X$ . There is too much spending on good  $X$  relative to good  $Y$  in period 1 and there also is too much overall spending in period 1.

The main reasons for the welfare losses differ for different parameter constellations. When the group of swing voters is very large and when political change is likely, most voters know that their preferred spending mix will be implemented in both period. Therefore, the excessive deficit is the main problem. The deficit arises because party  $X$  overspends strategically in the interest of very few voters with stable preferences. When the group of swing voters is small and when the political majority is very stable, there is excessive spending on good  $x$ . From a welfare perspective, the government should almost spend an equal sum on goods  $x$  and  $y$ . There is no excessive deficit because party  $X$  expects that it will continue to form the government in period 2.

### 3.3 Strict budget rules

A constitution that relies on a strict spending rule fixes a maximum expenditure for period 1,  $\bar{s} \geq \check{s}$ . The spending shares  $\chi$  are the same under such a rule as in the laissez faire case. The following proposition compares a balanced budget rule ( $\bar{s} = 1/2$ ) to a laissez faire system for a simple binary distribution of types. Not surprisingly, the balanced budget rule performs better when there is little

need for fiscal discretion and when there is little political conflict. The laissez faire constitution performs better when fiscal discretion is very important.

**Proposition 1** *Let  $\theta$  be drawn from the set  $\{1, \bar{\theta}\}$  (where  $\bar{\theta} > 1$ ) according to some given distribution.*

(i) *If  $\bar{\theta}$  is small enough then a balanced budget rule yields a higher expected welfare level than a laissez faire constitution.*

(ii) *When  $\bar{\theta}$  is large enough, the laissez faire outcome yields a higher expected welfare level than the outcome under a balanced budget rule.*

*Proof* (i) Consider the case where  $\bar{\theta} = 1$  and let  $\bar{s} = 1/2$ . Swing voters know that their desired spending mix will be implemented in both periods. This is why they do not want to run a fiscal deficit. The joint welfare of the (equal sized) groups of  $x$ - and  $y$ -voters is maximized if the budget is balanced, taking into account that the current government chooses spending. The laissez faire constitution leads to a strictly lower welfare level than the balanced budget rule. The continuity of all expected payoffs in  $\bar{\theta}$  yields the result.

(ii) The balanced budget mechanism yields a higher welfare level than the laissez faire outcome if  $\theta = 1$ . For  $\theta = \bar{\theta}$ , all voters' desired spending level for period 1 converges to 1 as  $\bar{\theta}$  goes to infinity. The laissez faire mechanism yields a strictly higher welfare level than a balanced budget rule. The welfare difference is increasing and unbounded. The continuity of all expected payoffs in  $\bar{\theta}$  yields the result. *Q.E.D.*

### 3.4 A welfare maximizing mechanism

I now turn to more general mechanisms which determine the fiscal deficit and allocate the right to choose the spending mix. A direct revelation mechanism simultaneously asks both political parties for announcements regarding the realization of the information parameter  $\theta$ . The spending level of period 1,  $s$ , is then directly made a function of the two announcements. Note that in theory such a mechanism can in principle force the government to implement some spending level for sure, i.e. can force the government to spend more money than what it actually wants. Since transfers to taxpayers can hardly be excluded in practice, it may be more appropriate to assume that the mechanism can only determine a maximum spending level. In both cases, I assume that both the mechanism and the government must respect the predetermined expenditures.

The following definition helps to determine expenditure decisions that are incentive compatible.

**Definition 2** *Consider a given default period 1 spending level  $\bar{s}$  and a default spending mix  $\bar{\chi}$ . Define  $\tilde{s}_y(\theta, \bar{s}, \bar{\chi})$  and  $\tilde{s}_x(\theta, \bar{s}, \bar{\chi})$  as the unique solution to*

$$\begin{aligned} & \theta f(\tilde{s}_y(\theta, \bar{s}, \bar{\chi})) \underline{u} + f(1 - \tilde{s}_y(\theta, \bar{s}, \bar{\chi})) ((1-p) \underline{u} + p\bar{u}) \\ = & \theta f(\bar{s}) u((1 - \bar{\chi}, \bar{\chi})) + f(1 - \bar{s}) ((1-p) \underline{u} + p\bar{u}), \end{aligned} \quad (1)$$

and

$$\begin{aligned} & \theta f(\tilde{s}_x(\theta, \bar{s}, \bar{\chi})) \bar{u} + f(1 - \tilde{s}_x(\theta, \bar{s}, \bar{\chi})) ((1-p) \bar{u} + p\underline{u}) \\ = & \theta f(\bar{s}) u((\bar{\chi}, 1 - \bar{\chi})) + f(1 - \bar{s}) ((1-p) \bar{u} + p\underline{u}). \end{aligned} \quad (2)$$

According to this definition, party  $P \in \{X, Y\}$  is indifferent between the default spending level  $\bar{s}$  with spending mix  $\bar{\chi}$  and the spending level  $\tilde{s}_P(\theta, \bar{s}, \bar{\chi})$  when party  $X$  has the right to manage public spending in period 1.

**Definition 3 (Revelation mechanism 1)** *Revelation mechanism 1 specifies a default maximum spending level  $\bar{s} \in \{\check{s}, 1/2\}$  for period 1. The mechanism asks both political parties for announcements  $\hat{\theta}_X$  and  $\hat{\theta}_Y$  and enforces a maximum spending level*

$$s^{\max}(\hat{\theta}_X, \hat{\theta}_Y) = \begin{cases} \max\left\{\bar{s}, \min\left\{s_W(\hat{\theta}_Y), \tilde{s}_y(\hat{\theta}_Y, \bar{s}, \chi^*)\right\}\right\} & \text{if } \hat{\theta}_X = \hat{\theta}_Y \\ \bar{s} & \text{otherwise} \end{cases}. \quad (3)$$

*The party that wins the majority in period 1(2) decides on the spending mix in period 1(2).*

In the following propositions I stick to the simple binary case where  $\theta$  is drawn from the set  $\{1, \bar{\theta}\}$ .

**Proposition 2** *Let  $\theta$  be drawn from the set  $\{1, \bar{\theta}\}$  with a given probability distribution  $(q, 1 - q)$ .*

(i) *Revelation mechanism 1 has a truthtelling equilibrium.*

(ii) *For any given value  $\bar{s}$  there is a value  $\theta^+$ , so that for  $\bar{\theta} > \theta^+$  revelation mechanism 1 yields a constrained optimal spending level.*

(iii) *Let  $\tilde{\chi} = \chi^*$ . The welfare maximizing value of  $\bar{s}$  is  $\check{s}$ , i.e. it is as small as possible.*

*Proof* Part (i) The incentive compatibility constraints of party  $X$  and the incentive compatibility constraint of party  $Y$  obviously hold for  $\theta = 1$ . It remains to consider the incentive compatibility constraint of the  $y$ -voters when  $\theta = \bar{\theta}$ . It follows directly from definition 1 that this constraint holds with equality when  $\tilde{s}_y(\hat{\theta}_Y, \bar{s}, \bar{\chi}) \leq s_W(\hat{\theta}_Y)$ . Otherwise it holds with inequality. The incentive

compatibility constraint of the  $x$ -voters is implied by the one of the  $y$ -voters because  $\tilde{s}_x(\theta, \bar{s}, \chi^*) > \tilde{s}_y(\theta, \bar{s}, \chi^*)$  for all  $\theta > 0$ .

(ii) The incentive compatibility constraint of  $y$ -voters is

$$\bar{\theta} f(s) \underline{u} + f(1-s)((1-p)\underline{u} + p\bar{u}) \quad (4)$$

$$\geq \bar{\theta} f(\bar{s}) \underline{u} + f(1-\bar{s})((1-p)\underline{u} + p\bar{u}) \Leftrightarrow \quad (5)$$

$$\bar{\theta} \geq \frac{f(1-\bar{s}) - f(1-s)}{f(s) - f(\bar{s})} \cdot \frac{(1-p)\underline{u} + p\bar{u}}{\underline{u}}. \quad (6)$$

As  $\theta$  goes to infinity,  $s = \min\{s_W(\theta), \tilde{s}_y(\theta, \bar{s})\}$  goes to 1 which is why the right hand side of (6) converges to

$$\frac{f(1-\bar{s})}{f(1) - f(\bar{s})} \cdot \frac{(1-p)\underline{u} + p\bar{u}}{\underline{u}}$$

while the left hand side is unbounded. This proves part (ii).

(iii) This follows from the strict monotonicity of  $\tilde{s}_y(\theta, \bar{s}, \chi^*)$  in  $\bar{s}$ . *Q.E.D.*

The following result is a comparison of the revelation mechanism and a strict rule. It is a direct consequence of (3).

**Proposition 3** *Let  $\theta$  be drawn from the set  $\{1, \bar{\theta}\}$  with a given probability distribution  $(q, 1-q)$ . Revelation mechanism 1 with maximum period 1 spending level  $\bar{s}$  weakly (strictly) dominates the strict rule with spending level  $\bar{s}$  for all (some) values of  $\bar{\theta} > 1$ . The revelation mechanism is strictly better than the strict rule if  $\bar{\theta}$  is large enough.*

Note that in principle, the default spending share  $\bar{s}$  could be specified in the constitution, e.g. through a requirement to always balance the budget. Alternatively, it could be set equal to the share of predetermined spending  $\bar{s}$ , e.g. by permitting the government to only spend money on a subset of predetermined spending items.

The following proposition formulates another condition under which revelation mechanism 1 with a balanced budget as a default solution achieves a constrained welfare maximum. This is the case when the preferences of voters do not differ too much.

**Proposition 4** *Let  $\theta$  be drawn from the set  $\{1, \bar{\theta}\}$  with a given probability distribution  $(q, 1-q)$ . Revelation mechanism 1 with default spending level  $\bar{s} = 1/2$  always implements the constrained optimal spending level when, for a given value  $\bar{\theta}$  the ratio  $\bar{u}/\underline{u}$  is small enough.*

*Proof* A welfare maximum is reached if the following expression is maximized:

$$\theta f(s) ((1-p)\underline{u} + p\bar{u}) + f(1-s) ((1-p)\underline{u} + p\bar{u}),$$

or if

$$\theta = \frac{f'(1-s)}{f'(s)}.$$

It follows from the concavity of  $f(s)$  that for all  $s > 1/2$

$$\frac{f'(1-s)}{f'(s)} > \frac{f(\frac{1}{2}) - f(1-s)}{f(s) - f(\frac{1}{2})}.$$

By assumption  $s_W(\theta) > 1/2 > s_W(\theta) - 1$ . Hence,

$$\frac{f'(1-s_W(\theta))}{f'(s_W(\theta))} = \theta > \frac{f(\frac{1}{2}) - f(1-s_W(\theta))}{f(s_W(\theta)) - f(\frac{1}{2})}.$$

At  $s = s_W$  the incentive compatibility constraint can be written

$$\theta \geq \frac{f(\frac{1}{2}) - f(1-s_W(\theta))}{f(s_W(\theta)) - f(\frac{1}{2})} \cdot \frac{(1-p)\underline{u} + p\bar{u}}{\underline{u}}. \quad (7)$$

Hence, the incentive compatibility constraint of party  $Y$  for  $\theta = \bar{\theta}$  holds at  $\min\{s_W(\theta), \bar{s}_y(\theta, \bar{s})\}$  if, for a given  $\theta$  the ratio  $\bar{u}/\underline{u}$  is small enough. *Q.E.D.*

### 3.5 A simple three-stage mechanism

A direct revelation mechanism requires that both parties have to simultaneously and independently announce a  $\theta$  value or, equivalently, the corresponding spending level. It may be somewhat complicated to organize this in practice because members and leaders of political parties tend to communicate a lot outside any such structured mechanism. It is therefore worthwhile to study alternative mechanisms that produce similar results. In this section, I study a simple supermajority mechanism.

**Definition 4 (*Supermajority mechanism*)** *In period 1, after observing  $\theta$ , the government proposes a spending level  $s$ , where  $s$  may not exceed  $s_W(\bar{\theta})$ . The opposition can accept or reject this proposal. If the proposal is rejected, the government can not spend more than a predetermined spending level  $\bar{s} \geq \check{s}$ . If the proposal is accepted then the government may raise debt accordingly. The government chooses the spending mix.*

**Proposition 5** *The supermajority mechanism with default spending level  $\bar{s}$  implements the same social choice function as revelation mechanism 1 with default spending level  $\bar{s}$ .*

*Proof* This mechanism has an equilibrium in which the period 1 government asks for a deficit  $s = \min \{s_X^*(\theta), \tilde{s}_y(\theta, \bar{s})\}$ . Party Y does not veto this proposal unless  $\theta = 1$ . *Q.E.D.*

### 3.6 Continuous types

Consider now a distribution  $\phi(\theta)$  on  $[a, b]$  with  $0 < s_Y^{-1}(\check{s}) < a < 1 < b$ . The support of the distribution is such that a welfare maximizing policy sometimes includes a fiscal deficit and sometimes a surplus. Moreover, it is such that for the lowest possible realization of  $\theta$ , spending wishes of both parties do not fall below the level of predetermined spending,  $\check{s}$ . Based on the previous results, one can state the following proposition.

**Proposition 6** *Consider the case where the government can be forced to spend any amount  $\bar{s} > \check{s}$ . The following social choice is truthfully implementable as a Bayesian Nash equilibrium:*

$$s_R(\theta) = \begin{cases} \max \{s^*(\theta), \tilde{s}_x(\theta, \bar{s}, \chi^*)\} & \tilde{s}_x(\theta, \bar{s}, \chi^*) \leq \bar{s} \\ \bar{s} & \tilde{s}_y(\theta, \bar{s}, \chi^*) < \bar{s} < \tilde{s}_x(\theta, \bar{s}, \chi^*) \\ \min \{s^*(\theta), \tilde{s}_y(\theta, \bar{s}, \chi^*)\} & \tilde{s}_y(\theta, \bar{s}, \chi^*) \geq \bar{s} \end{cases} .$$

(ii) *Consider the case where the government can not be forced to spend any amount  $\bar{s} > \check{s}$ . The following social choice is truthfully implementable through a Bayesian Nash equilibrium:*

$$s_R(\theta) = \begin{cases} s_X(\theta) & s_X(\theta) \leq \bar{s} \\ \bar{s} & \tilde{s}_y(\theta, \bar{s}, \chi^*) < \bar{s} < s_X(\theta) \\ \min \{s^*(\theta), \tilde{s}_y(\theta, \bar{s}, \chi^*)\} & \tilde{s}_y(\theta, \bar{s}, \chi^*) \geq \bar{s} \end{cases} .$$

*Proof* (i) Consider the following direct revelation mechanism asking for announcements  $\hat{\theta}_X$  and  $\hat{\theta}_Y$ :

$$s(\hat{\theta}_X, \hat{\theta}_Y) = \begin{cases} \max \{s^*(\theta), \tilde{s}_x(\theta, \bar{s}, \chi^*)\} & \text{if } \hat{\theta}_X = \hat{\theta}_Y \leq \tilde{s}_x^{-1}(\bar{s}, \bar{s}, \chi^*) \\ \min \{s^*(\theta), \tilde{s}_y(\theta, \bar{s}, \chi^*)\} & \text{if } \hat{\theta}_X = \hat{\theta}_Y \geq \tilde{s}_y^{-1}(\bar{s}, \bar{s}, \chi^*) \\ \bar{s} & \text{otherwise} \end{cases} .$$

It follows from definition 1 that truthtelling is a Bayesian Nash equilibrium.

(ii) Consider the following direct revelation mechanism asking for announcements  $\hat{\theta}_X$  and  $\hat{\theta}_Y$ :

$$s^{\max}(\hat{\theta}_X, \hat{\theta}_Y) = \begin{cases} \min \{s^*(\theta), \tilde{s}_y(\theta, \bar{s}, \chi^*)\} & \text{if } \hat{\theta}_X = \hat{\theta}_Y \geq \tilde{s}_y^{-1}(\bar{s}, \bar{s}, \chi^*) \\ \bar{s} & \text{otherwise} \end{cases} .$$

It follows from definition 1 that truthtelling is a Bayesian Nash equilibrium. *Q.E.D.*

Figures 3 and 4 show that the spending function related to parts (i) and (ii) of the proposition approximates the welfare maximal one  $s_W(\theta)$ . Different default spending levels lead to different approximations of this function. The supermajority mechanism in turn delivers a result which, for low enough  $\theta$  values, replicates the social choice depicted in figure 4.

**Proposition 7** *The following social choice is implementable as a subgame perfect Nash equilibrium of the supermajority mechanism with default spending level  $\bar{s}$ .*

$$s = \begin{cases} \min \{ \bar{s}, s_X^*(\theta) \} & \tilde{s}_y(\theta, \bar{s}, \chi^*) \leq \bar{s} \\ \max \{ \bar{s}, \tilde{s}_y(\theta, \bar{s}, \chi^*) \} & \text{otherwise} \end{cases}$$

*Proof* It is optimal for party  $Y$  to accept everything that is at least as good as  $\tilde{s}_y(\theta, \bar{s})$ . *Q.E.D.*

The outcome of the supermajority mechanism is weakly monotonous in the realization of the information parameter  $\theta$ . The outcome of this sequential mechanism yields a lower expected social welfare than the one of the simultaneous move game if the support of the distribution of  $\theta$  is large enough.

## 4 Bargaining about the spending level and spending mix

### 4.1 Welfare enhancing bargaining when the majority is sufficiently small

The supermajority mechanism that we have studied so far enables the opposition party to veto any "non-standard" deficit requested by the current government. This makes the opposition more powerful than it would be in a purely majoritarian system. In practice one would expect that the opposition party makes use of its power to veto a spending level that has been requested by the government. It may so be able to informally and jointly negotiate the period 1 spending level and spending mix with party  $X$ . I now assume that the spending mix can be the issue of such a negotiation among the two political parties. The Nash bargaining solution shall describe the outcome of the bargaining process.<sup>9</sup> I begin the analysis considering a given commonly known realization of the productivity parameter  $\theta$ . The following two lemmata establish useful invariance and monotonicity properties of the bargaining outcome.

---

<sup>9</sup>I derive conditions for the Nash bargaining solution in the appendix.

**Lemma 1** (i) *The laissez-faire policy outcome is independent of the size of the group of swing voters.*

(ii) *The bargaining outcome is independent of the size of the group of swing voters.*

*Proof* (i) Under a laissez faire constitution, party  $X$  selects its preferred spending mix in the first period. In the second period the majority picks its preferred spending mix. The spending level of the first period is determined by party  $X$  not taking into account that swing voters and  $y$ -voters prefer a lower spending level. (ii) Bargaining takes place between party  $X$  and party  $Y$ . The size of the group of swing voters is irrelevant for both groups' payoffs. This is why the Nash bargaining solution (see the appendix for details) is independent of the size of the group of swing voters. *Q.E.D.*

**Lemma 2** (i) *Social welfare under a laissez-faire constitution is linear and strictly increasing in the size of the group of swing voters.*

(ii) *Social welfare under a supermajority rule with bargaining is linear in the size of the group of swing voters.*

*Proof* (i) We know from lemma 1 that the laissez-faire outcome is independent of the size of the group of swing voters. Social welfare is a weighted average of the three groups' utilities. It is given by  $2((1 + \varepsilon)\bar{u} + (1 - \varepsilon)\underline{u})$ . This establishes linearity in  $\varepsilon$ . When the size of the group of swing voters increases, the unequal spending mix that obtains in both periods is optimal for a larger part of the population. (ii) Decisions do not depend on the size of the three groups. Social welfare is a weighted average of the three groups' utilities where the weights are  $\varepsilon$ ,  $1 - 2\varepsilon$ , and  $\varepsilon$ . *Q.E.D.*

Based on the previous results, one can now compare a supermajority rule with bargaining with a laissez faire constitution.

**Lemma 3** (i) *Consider any given productivity  $\theta$  and any given probability  $p \in [0, 1]$ . There is a cutoff value  $\varepsilon^* \in [0, 1]$  below (above) which a supermajority rule with bargaining yields a weakly higher (lower) welfare level than a laissez faire constitution.* (ii) *For any given default spending level  $\bar{s} < 1$ , there are values  $\theta$  and  $p \in [0, 1]$  for which the cutoff value  $\varepsilon^*$  lies in the interior of  $[0, 1]$  and the above ranking is strict for all  $\varepsilon \neq \varepsilon^*$ .*

*Proof* (i) First consider the case where  $\varepsilon = 0$ . Conditions for a welfare maximum are derived in the appendix. The welfare maximizing spending mix for  $\varepsilon = 0$  is symmetric. The laissez faire constitution leads to the suboptimal spending mix  $\chi^* \neq 1/2$  in period 1 and  $\chi^*$  or  $1 - \chi^*$  in period 2. The laissez faire constitution also leads to an excessive deficit. Party  $Y$  prefers both a lower

deficit and a more moderate spending mix (i.e. a lower value of  $\chi$ ) in period 1. The bargaining outcome is a constrained Pareto-optimum that makes party  $X$  ( $Y$ ) weakly worse (better) off than the laissez faire solution. The constraint is that the majority party in the second period picks its desired spending mix. Constrained Pareto-optimality requires that the first period spending level does not exceed the one of the laissez faire outcome. Otherwise, a reduction of spending would benefit both parties. Constrained Pareto-optimality also requires that the first period spending share of good  $x$  does not exceed  $\chi^*$ . Therefore, at  $\varepsilon = 0$ , welfare under a supermajority rule with bargaining is weakly higher than under a laissez faire constitution. Linearity of social welfare under both mechanisms in  $\varepsilon$  (lemma 2) yields the result. (ii) Consider  $p = 0$ . Under a laissez faire constitution, the spending level in period 1 is chosen optimally. In both periods, the spending share of good  $x$  is  $\chi^*$ . When  $\varepsilon = 0$  and when  $\theta$  is large enough, a supermajority rule with bargaining yields a higher welfare level than a laissez faire constitution. Both parties agree on the spending level. Bargaining can only concern the spending mix. When  $\theta$  is large enough, the bargaining outcome must be associated with a lower spending mix than  $\chi^*$  which increases social welfare (because the welfare maximizing spending mix is  $\chi = 1/2$ ).

When  $\varepsilon = 1$  a laissez faire constitution yields the first best while a supermajority rule with bargaining does not if  $\theta$  is large enough. Hence, when  $\theta$  is large enough, a supermajority rule with bargaining yields a strictly higher (lower) welfare level than a laissez faire constitution for  $\varepsilon = 0$  (1). This and the linearity results from lemma 2 yields the result. *Q.E.D.*

## 4.2 The choice of the majority threshold

At the constitutional stage, the value of  $\theta$  is not known. In the following proposition I permit that  $p$  is also stochastic at the constitutional stage.<sup>10</sup> The choice of the constitution (laissez faire vs. supermajority with bargaining) then depends on the size of the group of swing voters.

**Proposition 8** *Consider any given joint and independent distribution of  $p$  and  $\theta$ ,  $\gamma(p, \theta)$ . There is a cutoff value  $\varepsilon^* \in [0, 1]$  below (above) which a supermajority rule with bargaining yields a weakly higher (lower) welfare level than a laissez faire constitution.*

*Proof* We have already established that the difference of welfare under the two mechanisms is a linear function of  $\varepsilon$ . Call this function  $D(\varepsilon, p, \theta) = \hat{D}(p, \theta) \cdot$

---

<sup>10</sup> At the constitutional stage, there may be some information available about the stability of voters' political preferences.

$\varepsilon$ . The expected welfare difference of the two mechanisms is

$$\tilde{D}(\varepsilon) := \frac{\int_0^1 \int_0^1 D(\varepsilon, p, \theta) \cdot \gamma(p, \theta) \cdot dp \cdot d\theta \int_0^1 \int_0^1 \hat{D}(p, \theta) \cdot \gamma(p, \theta) \cdot dp \cdot d\theta}{\int_0^1 \int_0^1 \gamma(p, \theta) \cdot dp \cdot d\theta \int_0^1 \int_0^1 \gamma(p, \theta) \cdot dp \cdot d\theta} \cdot \varepsilon.$$

This function is linear in  $\varepsilon$  and non-negative for  $\varepsilon = 0$ . *Q.E.D.*

To summarize, the option to negotiate the spending mix and the spending level may increase social welfare. However, when there are many swing voters, a small opposition party may be able to substantially change the political outcome which reduces social welfare. Therefore, for any given joint distribution of  $p$  and  $\theta$  it would be important to know the size of the group of potential swing voters.

At first glance, the previous result implies that constitutions should be tailored to the value of  $\varepsilon$ . Tailoring mechanisms would be difficult in practice because the political environment may change over time<sup>11</sup>. However, in the context of the present model, a properly chosen supermajority threshold can make sure that a large enough current majority does not need the approval of the current opposition.

To see why, consider joint and independent distribution of  $\varepsilon, p$  and  $\theta$ . From proposition 8 we know that there is a threshold  $2\varepsilon^*$  for the size of the group of swing voters below (above) which a supermajority mechanism with bargaining is better than (not as good as) a *laissez faire* constitution. An automatic adjustment an ex-ante unknown size of the group of swing voters can be achieved by a majority threshold for a deficit of size  $1 + \varepsilon^*$ . If the current majority exceeds this threshold, then party  $X$  does not require the support of a supermajority for a deficit. Therefore the mechanism turns effectively into a *laissez faire* one.

## 5 Robustness and extensions

So far, I have assumed that swing voters have no direct political representation, in the sense that there is no party that shares swing voters' interest in good  $x$  and in a moderate expenditure policy. On the one hand this may seem to be a reasonable assumption because voters with unstable preferences may find it more difficult to establish a party with a recognizable party identity. However, on the other hand, swing voters have a clear interest in a more moderate deficit than "full" supporters of the current majority and they have voting rights. In this section, I discuss how the policy outcome is affected if swing voters have more political influence than in the baseline model.

<sup>11</sup>See Engelmann and Grüner (2013) for a discussion of this problem.

## 5.1 All $x$ -voters are potential swing voters

A straightforward way to model a political representation of swing voters is to assume that all  $x$ -voters are potential swing voters. More specifically, assume that with probability  $p$  a fraction of the group of  $x$ -voters of size  $2\varepsilon$  turns  $y$ -voters. In case of such a preferences switch, the corresponding voters are drawn randomly from the set of  $x$ -voters. Hence, each individual  $x$ -voter's preferences shift with probability  $2\varepsilon p / (1 - 2\varepsilon)$ . Moreover,  $x$ -voters know that if their own preference shifts, they become part of a new majority of  $y$ -voters. If some  $x$ -voters' preferences shift then  $x$ -voters whose preferences do not shift become a minority in period 2.

In this setting, party  $X$  represents the interest of a homogenous group of voters. It is easy to verify that when  $p < 1$  and when  $2\varepsilon < 1$ , for all realizations of  $\theta$  the deficit under a laissez faire constitution exceeds the one in a constrained welfare maximum.

It is also straightforward to verify that the supermajority mechanism performs similarly to the case in which swing voters can be distinguished from  $x$ -voters. What changes is that party  $X$  suggest a lower deficit than before because it now represents potential swing voters. This mechanism still outperforms a strict rule with the same benchmark spending level.

Concerning the negotiation of the spending level and the spending mix, one obtains a stronger result regarding the role of large preference shifts. When  $2\varepsilon = 1$ ,  $x$ -voters know that their desired spending mix will always be implemented. This is why the probability  $p$  leaves the desired spending level of  $x$ -voters unaffected. They always pick the welfare maximizing spending level. Therefore, a laissez faire constitution always realizes the first best when  $2\varepsilon = 1$ . A supermajority mechanism with bargaining may still yields a higher social welfare than a laissez faire mechanism when  $\varepsilon$  is small.

## 5.2 Two parties with credible platforms

Another way of modelling a stronger political influence of swing voters is to assume that two competing parties can commit to political platforms. This makes parties compete for the swing voters and so it makes this group politically more influential. Consider first the case where two parties can commit to a spending level for period 1 but not to the spending mix. Assume that indifferent voters choose party  $X$ .

Party  $X$  can only attract a majority if it makes swing voters strictly better off than party  $Y$ . Party  $X$ 's best reply to a given spending level offered by party  $Y$  is to make swing voters indifferent or - if this yields a majority of votes - to pick its preferred deficit.

Party  $Y$  can only attract a majority if it makes swing voters strictly better off than party  $X$ . If this makes party  $Y$  worse off than party  $X$ 's offer, then party  $Y$  should pick a platform that makes it lose the election.

Party  $X$  has an advantage. If, in period 1, both parties propose the same spending level, swing voters and  $x$ -voters are both attracted by party  $X$ . Ob-

viously, in equilibrium party  $Y$  cannot win the election. There are equilibria in which party  $Y$  loses the election. The constraint on these equilibria is that party  $X$  chooses a spending level so that party  $Y$  cannot make swing voters better off without making itself worse off. In some of these equilibria party  $X$  overspends relative to the welfare maximum. The deficit is undesired from the perspective of the swing voters whose desired deficit level maximizes social welfare. A supermajority mechanism can improve the outcome.<sup>12</sup>

### 5.3 Three parties and proportional representation

Consider next an electoral system with proportional representation in which swing voters are represented by a third political party. The preferred policy of this party is to choose the majority's desired spending mix but not to run a deficit when  $\theta = 1$ . The median voter in parliament along both policy dimensions would be a member of this party. Accordingly, a system of proportional representation should display low deficits even if there is no supermajority mechanism in place.

### 5.4 The political economy of supermajority rules

Our analysis shows that there are situations in which the introduction of supermajority mechanisms increases welfare compared to a *laissez faire* situation or a strict fiscal rule. Such supermajority mechanisms (or rules that work similarly most of the time) exist in some countries but they are not widespread. In the present model, the acceptance of supermajority mechanism by the political actors depends on the institutional status quo. If the status quo constitution is a *laissez faire* one, an elected government opposes the introduction of a supermajority mechanism and the current opposition favors it. The outcome is generally suboptimal.

There is no scope for a deal between both parties because - in the present setup with only two periods - the opposition has nothing to offer. This may be different when there are many periods because in this case, future election results are not perfectly known.

For the same reason, a reform is feasible if one considers a *laissez faire* constitution before the period 1 election result is known. In this case both political parties are in favor of a supermajority mechanism and the outcome of constitutional bargaining is constrained optimal.

It is well known that the participation in a mechanism depends can be facilitated by properly choosing the status (see e.g. Cramton, Gibbons, and Klemperer, 1987). In the present context, the introduction of a supermajority mechanism is possible when the status quo is a constitution with a strict rule.

---

<sup>12</sup>It is more complicated to study the case in which both spending level and spending mix are part of a policy platform. In this case the three groups of voters all have distinct ideal points  $(\chi_1, s)$ . In this case there often is no Nash equilibrium in political platforms.

In this case, even if the election results of the first period are known, there may be scope for constitutional negotiations between both parties when the productivity of public spending is high.

## 6 Conclusion

This paper addresses the trade off between fiscal policy discipline and fiscal policy flexibility. It studies this trade-off in a setup with non-contractible and partly private information about voters' desired spending mixes and their desired spending levels. The paper has two main findings. The first main finding is that, under certain conditions, a simple revelation mechanism yields a constrained welfare maximizing state dependent budget decision. The result of the revelation mechanism can be approximated by a simple supermajority mechanism. However, the supermajority mechanism gives the opposition a veto right that it may use to influence the spending mix. The second main finding concerns the conditions under which a supermajority mechanism outperforms a *laissez faire* constitution when bargaining cannot be ruled out. If the opposition is small in size, the introduction of a supermajority mechanism may actually lower expected social welfare. When the two political camps have similar size, supermajority mechanisms may instead perform very well. A properly chosen supermajority threshold can make sure that a large enough current majority does not need the approval of the current opposition.

Several extensions of the present basic framework can be considered in further research. This paper studies a dynamic fiscal mechanism design problem with two periods and two public goods. It is important to understand how robust the present results are in a setup with more periods. When there are more periods, the size of the debt level might play a role as a state variable. The Eurozone states now put more emphasis on the current debt level (the 1/20th rule). This is why a particular focus of further research should be on how the permitted deficit or incentive payments should be adjusted to the participating countries' debt levels. In a dynamic context one can also consider the predetermined government expenses as a state variable that can be chosen strategically.

Another topic for further research is the role and the emergence of the party structure. It would be worthwhile to endogenize this structure in a setup where individual preferences cannot be categorized into two or three groups. Such an analysis can also consider cases where there are more than two public goods. Moreover, the analysis could be extended for different preferences regarding the source and size of public revenues.

The present paper has focused on the strategic deficit explanation for excessive deficits. It is important to study the performance of a supermajority if other factors such as political polarization and resulting indivisibilities (Alesina and Drazen, 1989) are the key drivers of deficits (see also Grüner, 2013).

Another research topic concerns the optimal size of the required supermajor-

ity. In the present model, a supermajority rule with a large majority threshold implies that all (i.e. both) parties must accept the deficit. When there is considerable voter - and party - heterogeneity, one may expect that a unanimity requirement leads to a lack of flexibility or significant distortions of public spending. In a model with multiple public goods and more voter diversity, one could attempt to determine the optimal size of the required majority for a deficit of a given size.<sup>13</sup> It would also be important to find out how one can empirically adjust the size of the majority to the size of the deficit that has been requested.

The focus of this paper is on purely national solutions for the problem of strategic deficits. When part of the relevant information is internationally observable, one might consider a solution where international decision makers are also involved in the decision procedure. In this context, it would be desirable to study the case in which excessive debt generates externalities across countries. Such an extension should address the efficiency, individual rationality and renegotiation proofness of hybrid (national and international) mechanisms for the control of fiscal deficits.

## 7 Appendix

### 7.1 The Nash bargaining solution

Consider a given realization of  $\theta$  and a given value  $p$ . Define  $\tilde{u}(p) := pu + (1-p)\bar{u}$ . Hence,  $f(1-s)\tilde{u}(p)$  is the expected overall utility of  $x$  voters in the second period when the transition probability is  $p$  and the first period spending share is  $s$ . Moreover, define  $u_P$  ( $u_{0P}$ ) as the (disagreement) utility of party  $P$ . The Nash product is:

$$\begin{aligned}
N(s, \chi_1) &= (u_X - u_{0X}) \cdot (u_Y - u_{0Y}) \\
&= (\theta f(s) u(\chi_1) + f(1-s)\tilde{u}(p) - u_{0X}) \\
&\quad \cdot (\theta f(s) u(1-\chi_1) + f(1-s)\tilde{u}(1-p) - u_{0Y}) \\
&= \theta^2 f(s)^2 u(\chi_1) \cdot u(1-\chi_1) \\
&\quad + \theta f(s) f(1-s) (\tilde{u}(1-p) u(\chi_1) + \tilde{u}(p) u(1-\chi_1)) \\
&\quad + f(1-s)^2 ((\tilde{u}(p)) \tilde{u}(1-p)) \\
&\quad - u_{0X} \cdot (\theta f(s) u(1-\chi_1) + f(1-s)\tilde{u}(1-p) - u_{0Y}) \\
&\quad - u_{0Y} \cdot (\theta f(s) u(\chi_1) + f(1-s)\tilde{u}(p) - u_{0X}).
\end{aligned}$$

The first-order conditions are

---

<sup>13</sup>See Becker, Gersbach, and Grimm (2010) for an analysis of a flexible majority rule in the case where the government provides a single public good.

$$\begin{aligned}
N'_{\chi_1} &= \theta^2 f(s)^2 (-u(\chi_1) \cdot u'(1 - \chi_1) + u'(\chi_1) \cdot u(1 - \chi_1)) \\
&\quad + \theta f(s) f(1 - s) (\tilde{u}(1 - p) u'(\chi_1) - \tilde{u}(p) u'(1 - \chi_1)) \\
&\quad + u_{0X} \cdot \theta f(s) u'(1 - \chi_1) \\
&\quad - u_{0Y} \cdot \theta f(s) u'(\chi_1) \\
&= 0.
\end{aligned}$$

and

$$\begin{aligned}
N'_s &= \theta^2 2f(s) f'(s) u(\chi_1) \cdot u(1 - \chi_1) \\
&\quad + \theta (-f(s) f'(1 - s) + f'(s) f(1 - s)) (\tilde{u}(1 - p) u(\chi_1) + \tilde{u}(p) u(1 - \chi_1)) \\
&\quad - 2f(1 - s) f'(1 - s) ((\tilde{u}(p)) \tilde{u}(1 - p)) \\
&\quad - u_{0X} \cdot (\theta f'(s) u(1 - \chi_1) - f'(1 - s) \tilde{u}(1 - p)) \\
&\quad - u_{0Y} \cdot (\theta f'(s) u(\chi_1) - f'(1 - s) \tilde{u}(p)) \\
&= 0.
\end{aligned}$$

## 7.2 The welfare maximum

Consider first the welfare maximizing size of the first period budget and spending mix when the ruling party in period 2 determines the spending mix in that period. Welfare is given by

$$\begin{aligned}
W(s, \chi_1) &= \left(\frac{1}{2} - \varepsilon\right) (u_X + u_Y) + 2\varepsilon u_S \\
&= \left(\frac{1}{2} - \varepsilon\right) \cdot \\
&\quad (\theta f(s) u(\chi_1) + f(1 - s) \tilde{u}(p)) \\
&\quad + \theta f(s) u(1 - \chi_1) + f(1 - s) \tilde{u}(1 - p)) \\
&\quad + 2\varepsilon (\theta f(s) u(\chi_1) + f(1 - s) u(\chi_2)),
\end{aligned}$$

where  $\chi_2$  denotes the second period spending mix. The first-order conditions are

$$\begin{aligned}
W'_s &= \left(\frac{1}{2} - \varepsilon\right) (\theta f'(s) (u(\chi_1) + u(1 - \chi_1)) - f'(1 - s) (\tilde{u}(p) + \tilde{u}(1 - p))) \\
&\quad + 2\varepsilon (\theta f'(s) u(\chi_1) - f'(1 - s) u(\chi_2)).
\end{aligned}$$

and

$$W'_{\chi_1} = \left(\frac{1}{2} - \varepsilon\right) (\theta f(s) u'(\chi_1) - \theta f(s) u'(1 - \chi_1)) + 2\varepsilon (\theta f(s)) u'(\chi_1).$$

The optimal spending level is characterized by

$$\frac{f'(s)}{f'(1-s)} = \frac{1}{\theta} \frac{(\frac{1}{2} - \varepsilon) (\tilde{u}(p) + \tilde{u}(1-p)) + 2\varepsilon u(\chi)}{(\frac{1}{2} - \varepsilon) (u(\chi) + u(1-\chi)) + 2\varepsilon u(\chi)},$$

and the optimal spending mix by

$$\frac{u'(\chi)}{u'(1-\chi)} = \frac{\frac{1}{2} - \varepsilon}{\frac{1}{2} + \varepsilon}.$$

## References

- [1] Alesina, Alberto and Allan Drazen (1989) "Why are Stabilizations Delayed?", *American Economic Review*, 79, 1170-1189.
- [2] Battaglini, Marco and Stephen Coate (2008): "A Dynamic Theory of Public Spending, Taxation, and Debt", *American Economic Review*, 98, 201-236.
- [3] Becker, Johannes Gerd, Gersbach, Hans, and Grimm, Oliver (2010) "Debt Sensitive Majority Rules", CEPR Discussion Paper 7860.
- [4] Cramton, Peter, Gibbons, Robert and Paul Klemperer (1987) "Dissolving a Partnership Efficiently" *Econometrica*, 55, 615-32.
- [5] Engelmann, Dirk and Hans Peter Grüner (2013) "Tailored Bayesian Mechanisms: Experimental Evidence from Two-Stage Voting Games", with Dirk Engelmann, CEPR Discussion Paper No. 9544.
- [6] Gersbach, Hans and Ulrich Erlenmaier (1999) "Flexible Majority Rules", Discussion Paper Series, Universität Heidelberg, Wirtschaftswissenschaftliche Fakultät, No. 305.
- [7] Grossman, Sanford and Oliver Hart (1986): *The Costs and Benefits of Ownership. A Theory of Vertical and Lateral Integration.* *Journal of Political Economy*, 94, 691-719.
- [8] Grüner, Hans Peter (2013) „The Political Economy of Structural Reform and Fiscal Consolidation Revisited”, *European Economy, Economic Papers*, May 2013.
- [9] Kiel, Alexandra (2004) "Decision Making in the European Union: Externalities and Incomplete information", Ph.D. dissertation, Universität Mannheim.
- [10] Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2007) "Staatsverschuldung wirksam begrenzen, Expertise im Auftrag des Bundesministeriums für Wirtschaft und Technologie", Nomos-Verlag, Baden-Baden.

- [11] Lizzeri, Alessandro (1999) "Budget Deficits and Redistributive Politics," *Review of Economic Studies*, 66, 909-928.
- [12] Persson, Torsten, and Lars E. O. Svensson (1989) "Why a Stubborn Conservative Would Run a Deficit: Policy with Time-Inconsistent Preferences", *Quarterly Journal of Economics*, 104, 325-45.
- [13] Tabellini, Guido and Alberto Alesina (1990) "Voting on the Budget Deficit," *American Economic Review*, 80, 37-49.
- [14] Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie (2008) "Zur Begrenzung der Staatsverschuldung nach Art. 115 GG und zur Aufgabe des Stabilitäts- und Wachstumsgesetzes".

Figure 1

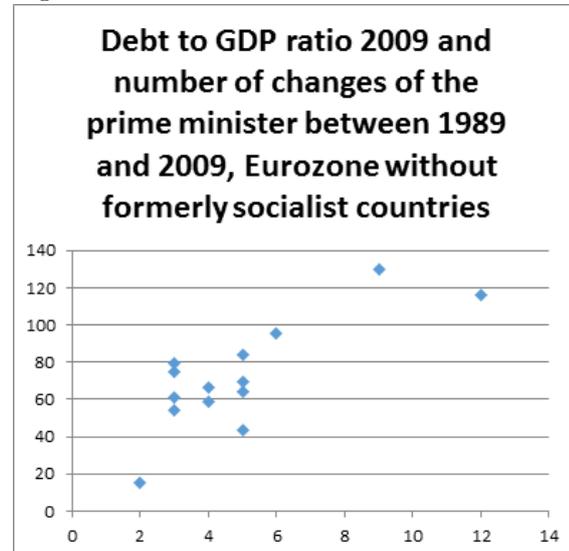
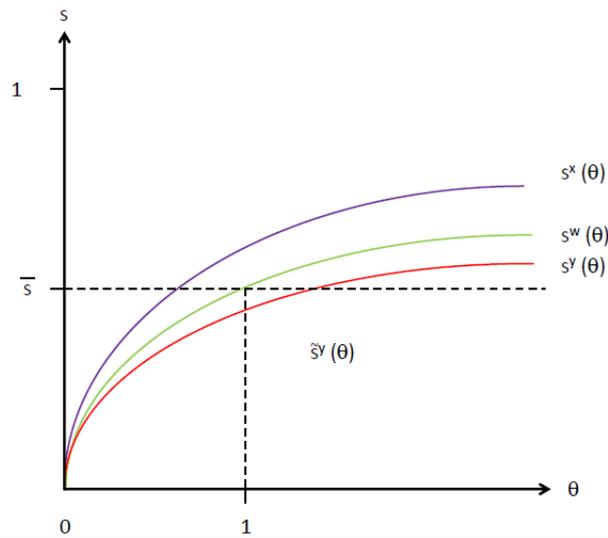
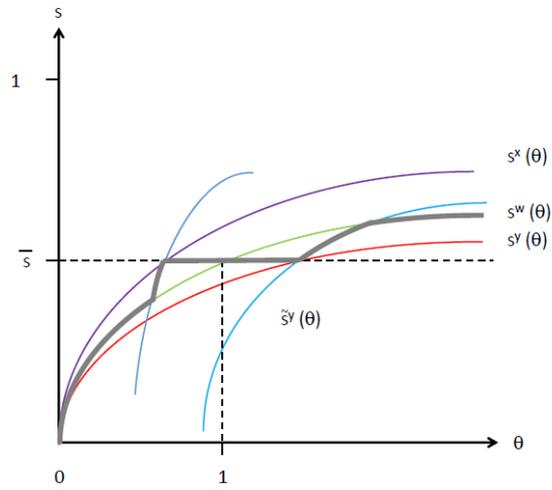


Figure 2



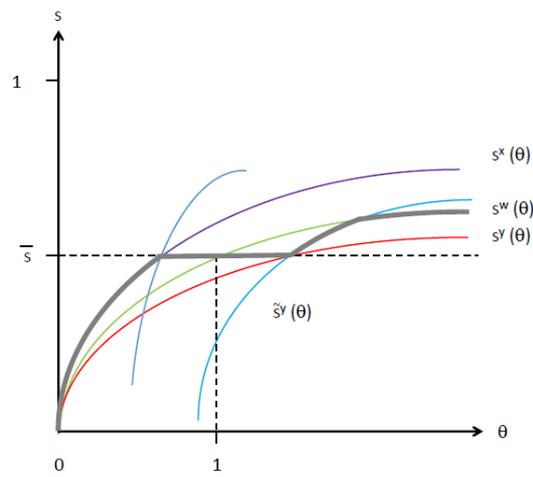
Desired spending levels of both parties and welfare maximizing spending level. It is assumed that party  $X$  determines the spending mix in period 1.

Figure 3



The implemented spending level under a revelation mechanism.

Figure 4



The implemented spending level under a sequential mechanism. For low values of  $\theta$ , party  $X$  proposes its preferred deficit level. This is accepted by party  $Y$ .