

*One day when the queen asked her mirror:
Mirror, mirror, on the wall,
Who in this land is fairest of all?
It answered:
You, my queen, are fair; it's true.
But Snow-White is a thousand times fairer than you.*

Jacob and Wilhelm Grimm

Political Economics versus Public Choice

Two views of political economy in competition*

Charles B. Blankart and Gerrit B. Koester
Humboldt University Berlin
Department of Economics
Spandauer Str. 1
10178 Berlin
blankart@wiwi.hu-berlin.de
gkoester@wiwi.hu-berlin.de

JEL: P48, B50, D72, E6

Abstract:

Political economics, like public choice, is defined as the economic analysis of politics. But its exponents claim that political economics is not a complement, but the successor of public choice, a new paradigm replacing the public-choice approach. We evaluate this claim of political economics in three fields: *political business cycles, integration and secession*, and *constitutional political economy*. We find that political economics has contributed substantially to the first, but little to the second and the third, where it sticks to the world of planning and benevolent dictators. Hence the public-choice paradigm emerges strengthened from its dispute with political economics.

I	INTRODUCTION	2
II	THE PUBLIC-CHOICE PARADIGM AND ITS CHALLENGERS	2
III	COMPETING PARADIGMS – APPLICATIONS	6
IV	POLITICAL ECONOMICS VERSUS PUBLIC CHOICE	21
V	BIBLIOGRAPHY	26

**We thank Dennis Mueller and Oliver Volkart for helpful comments and benefited from discussions at the Public Choice Society 2004 Annual Meeting in Baltimore and at the European Public Choice Society 2004 Annual Meeting in Berlin.*

I INTRODUCTION

Praise and blame have been poured on public choice in the fifty years of its existence. Some have welcomed the extension of economic analysis to government in that it allows analyzing public policy and markets consistently in one framework. Others, mainly political scientists, argue that the economic approach is carried too far and that it does not contribute much to an understanding of politics, while still others criticize that public-choice researchers do not push the economic approach hard enough into politics. Among the latter are economists such as Alberto Alesina, Torsten Persson, and Guido Tabellini. In their opinion, not public choice but political economics is the right way to study politics from an economic perspective.

In this paper we want to compare political economics and public choice. In particular, we want to investigate whether the public-choice paradigm has been replaced by a political-economics paradigm, as the proponents of the latter claim. We start in section II by characterizing public choice as well as political economics, each from the point of view of its adherents. In section III we compare and evaluate contributions of both approaches to an economic analysis of politics in three particular fields common to the two – political business cycles, integration and secession, and constitutional political economy. A general comparison of public choice and political economics as competing scientific paradigms will be presented in section IV.

II THE PUBLIC-CHOICE PARADIGM AND ITS CHALLENGERS

II.1 The public-choice paradigm

The adherents of public choice trace the core of their approach back to two basic insights into the organization of the state. The first is due to Kenneth J. Arrow (1951, 1963), who showed that the state cannot be seen in analogy to a person, because the aggregation of individual preferences into a collective ordering runs into basic consistency problems. The second comes from James M. Buchanan (1949, 1954), who offered the view of the state as a market in which individuals interact through exchange. The focus on exchange and not on coercion leads Buchanan to consensus among equals as benchmark for public decision-making. As real-world institutions and decisions generally deviate largely from this ideal, it becomes an important task for economists to offer a design for better institutions.

The contributions of Duncan Black (1948) on the median-voter theorem, Gordon Tullock (1959) on logrolling, Anthony Downs (1957) on representative democracy, Ronald Coase (1960) on social costs, and Mancur Olson (1965) on interest-group activity have to be seen in conjunction with the work of Arrow and Buchanan. They all laid the foundations for a school of thought that is known as *public choice* and to

which nowadays a large family of researchers adhere.¹

The theory of science – following Thomas Kuhn (1962) – would classify the public-choice school of thought as a scientific paradigm within economics, as it contains all four decisive attributes of scientific paradigms. First, it shares *basic generalizations* (or natural laws) with economics, assuming that actors are rational and self-interested. Second, it is based on a common *ontological or heuristic model* resulting from the consistent application of the assumption of rational and self-interested actors to the realm of politics. Third, its *preferred method* is the positive analysis of political institutions, and fourth, the *common goal* of public-choice scholars is to derive normative suggestions for improvements of political and economic institutions.²

But a paradigm is never only an abstract concept. Kuhn stresses the general overlap of a paradigm and the research community that adheres to it: ‘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 (1985) demonstrates how well the public-choice paradigm, with the Public Choice Society at its core, fits this characteristic as well.

II.2 *Challenges to the public-choice paradigm*

Scientific paradigms rarely remain uncontested, and scientific progress often results from challenges to existing paradigms. Just as public choice challenged the ‘social planner approach’, it itself faces attacks from other schools of thought. Until recently there have been two main lines of criticism: one coming from political science, the other from the Chicago school of economics.

Political scientists like Green and Shapiro argue that public choice does ‘little more than restate existing knowledge in rational choice terminology’ (Green and Shapiro 1994, p. 6) and contributes little to the understanding of real politics. But the criticism by these political scientists stands on shaky ground. It is not hard to offer evidence for new and important insights that were derived by public choice. We refer here to Mueller (2003, chap. 28), who demonstrates by examples of public-choice contributions such as that by Riker on political coalitions (1962) or by Stratmann on logrolling (1992, 1995) how an abstract analysis of politics by public choice was able to improve the understanding of real political phenomena. Additionally, the fact that – far from political science driving public choice out of the analysis of politics – many political scientists have discovered the analytical power of public choice and been converted from the traditional approaches of political science to rational choice can be seen as a good indicator of the

1 See, e.g., Grofman (2004) for a discussion of the foundations of the public-choice approach.

2 See Reder (1999) for a general application of the concept of scientific paradigms in economics.

resilience of the public-choice approach against the fundamental criticism brought forward by political scientists like Green and Shapiro.

The second challenge comes from the Chicago school and is put forward most prominently by Donald Wittman's book *The Myth of Democratic Failure: Why Political Institutions Are Efficient* (Wittman 1995). Wittman – similarly to Becker (1983), Peltzman (1976), and Posner (1974) – argues that individuals reach Pareto-efficient outcomes even in the political sphere and that existing institutions are the most efficient possible, for the only reason not to adopt a superior alternative would be that the costs of change would outweigh the benefits. The Chicago critique is hard to counter. It reminds one of the famous statement of Voltaire's Master Pangloss, 'it is demonstrable [...], that things cannot be otherwise than as they are; for as all things have been created for some end, they must necessarily be created for the best end' (Voltaire 1759, chap. 1).³ Public-choice economists, however, remained skeptical of the general approach of the Chicago school and its results, and continued to follow Buchanan's criterion of consensus among equals for identifying institutional weaknesses and proposing institutional improvements.⁴

II.3 Political economics – a new challenge to public choice

Recently a new challenge to public choice has been launched by a group of researchers including Alberto Alesina, Torsten Persson, and Guido Tabellini, under the name of *political economics*. One of the first contributions to political economics was Alesina (1987) on political business cycles. An overview of the research agenda of this approach is presented in the textbook by Persson and Tabellini, *Political Economics* (Persson and Tabellini 2000) and – with respect to models in the realm of public finance – in their article *Political Economics and Public Finance* (Persson and Tabellini 2002). Earlier contributions with a focus on macroeconomic issues are Persson and Tabellini's *Macroeconomic Policy, Credibility and Politics* (Persson and Tabellini 1990) and the two volumes on *Credibility and Politics* edited by them (Persson and Tabellini 1994), which assemble seminal papers on political economics. In recent years Alesina has contributed also, especially to the literature on integration and secession of states (e.g., Alesina and Spolaore 1997, 2003; Alesina and Wacziarg 1998).

Affiliations and numerous joint authorships suggest that especially the works of Alberto Alesina, Torsten Persson, and Guido Tabellini can be seen as representative for political economics, while many others (e.g., Oliver Blanchard, Dani Rodrik, Kenneth Rogoff, Gérard Roland, and Lars Svensson) seem to be sympathetic to the approach, share the way problems are approached by political economics, and hence often agree on a critical attitude towards public choice. We shall not, however, discuss their contributions, but rather concentrate on the core group of Alesina, Persson, and Tabellini.

³ We owe this point to Gebhard Kirchgässner (1991, p. 167).

In contrast to the earlier critiques of public choice, political economics claims not to be just a challenger of public choice, but its successor:

‘Political Economics has become one of the most active research areas in the last decades. Building on earlier work of the Public Choice school, rational expectations macroeconomics, and game theory, Political Economics *has taken the next step by including rational voters, parties and politicians in the models.*’ (Persson and Tabellini 2000, p. xv; emphasis added)

Public choice is seen as only a building block for the formation of political economics. Why that view is taken becomes obvious if one takes a look at the perception of public choice from the perspective of political economics that is presented, e.g., by Persson, Roland, and Tabellini:

‘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 an alternative caricature: the malevolent Leviathan policy maker that replaces the benevolent Pigouvian planner and is solely maximizing her own rents. *The voters’ interest and the 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, pp. 686-687; emphasis added)

As public choice – in the view of political economics – is restricted to the study of the ‘Leviathan’ and includes neither voters, nor conflicts between them, nor political institutions, it becomes clear how political economics can claim the introduction of models that include rational voters, politicians, and parties to be ‘the next step’ in the economic analysis of politics.

For a public-choice scholar, however, this view is astonishing. How could one possibly overlook the public-choice research on representative democracies that dates at least back to Anthony Downs (1957), Gordon Tullock (1967), Riker and Ordeshook (1968, 1973), and Ashenfelter and Kelley (1975) and covers a huge variety of models, as e.g. deterministic voting models, probabilistic voting models, and legislative bargaining models that all include rational voters, political parties, and politicians? Indeed, even Anthony Down’s ‘economic theory of democracy’ (1957) – one of the early contributions to public choice – already builds on the assumptions of rational voters, political parties, and politicians. And how could one perceive the public-choice approach as the study of the Leviathan, when the Leviathan model is, e.g., covered only in four out of close to 700 pages of Dennis Mueller’s *Public Choice III* (Mueller 2003) as the leading textbook in the field? And even more pointedly: how can one criticize public choice for disregarding

4 See Mitchell (2001, pp. 3 et sqq.) for a general comparison of the Chicago school and public choice.

political institutions when James M. Buchanan received a Nobel Prize largely for his work on the economic analysis of those very institutions?

But, notwithstanding the skewed reception of the public-choice approach – could political economics nonetheless be right? Could it be that the ambitious claim of political economics to be the successor of public choice is legitimate? Has perhaps a paradigm shift from public choice to political economics occurred?

To evaluate the possibility of a paradigm shift we rely on the concept of Thomas Kuhn (Kuhn 1962). In his view a paradigm shift occurs if a new approach emerges that is more plausible, is better able to explain empirical phenomena, and is in part or in whole incompatible with the existing paradigm (Kuhn 1962, Lakatos 1970). It is important to notice that this replacement occurs (as Lakatos pointed out) only if the alternative theory contains ‘corroborated excess empirical content’ over predecessors or rival theories – meaning that unless the new theory explains both what was explained before and new facts as well, there is no scientific reason to prefer it over the existing stock of literature (Lakatos 1970, pp. 116 et sqq.). But this concept implies as well that once a paradigm shift occurs, large parts of the preceding literature become dispensable.

In the next three sections of this paper we want to assess the question whether the claim of political economics to be the successor of the paradigm of public choice could be legitimate. Does political economics really contain ‘corroborated excess empirical content’? Is it really superior to public choice? Has a paradigm shift occurred, and is it therefore justified to neglect the public-choice tradition more or less completely?

III COMPETING PARADIGMS – APPLICATIONS

To illustrate the differences between the approaches of political economics and public choice and to assess their relative performance, we will compare their research in three fields common to both: political business cycles, integration and secession of states, and constitutional political economy. As the research in political economics and public choice overlaps in more than these three fields, the choice is not without alternative. We picked political business cycles because that was one of the first areas in which political economics contributed to the field of political economy. We picked integration and secession of states and constitutional political economy because political economics is currently most prominent in those fields. By choosing the fields that are especially important within the relatively young approach of political economics, we hope to avoid a selection of topics biased towards an advantage for public choice. We shall argue that we can distill basic characteristics of both approaches based on their research in the fields

analyzed here.

III.1 The political business cycle

Public-choice economists criticized the *social-planner approach* for its unrealistic assumptions about the purely benevolent motivation of politicians and put the study of *political failure* on the research agenda of economics. Politics should be seen ‘without romance’ (Buchanan 2003, p. 16). Politicians and bureaucrats are as self-interested as businessmen and use their positions to pursue their individual goals and plans. One early line of research emerging from the study of political failure is the theory of political business cycles.

III.1.1 Public choice on the political business cycle

Public-choice research proposed mainly two theories on political business cycles: one by William D. Nordhaus (1975), based on Bruno S. Frey and Larry Lau (1968), and one by Douglas Hibbs (1977).

According to Nordhaus, political parties behave purely ‘opportunistically’, which means that they are solely interested in obtaining a majority of votes. Assuming that voters are heavily influenced by the actual state of the economy, politicians try to create desirable economic conditions by whatever means before elections, although these means may cause costly adjustments after the elections. Especially, loose monetary policy and deficit spending are used to stimulate employment before an election, even though a recession may be necessary afterwards to bring inflation down to acceptable levels. Such political manipulations of the economy generate economic cycles, which would be absent or at least less pronounced without political manipulation. The provocative result is that democratic governments often do not moderate but aggravate business fluctuations.

Douglas Hibbs (1977) took a different approach, arguing in favor of a ‘partisan theory’. In his view, political parties do not behave purely opportunistically, but try to manipulate the economy to favor their political clientele. At the core of his model stands the trade-off between inflation and unemployment (the Phillips curve). Left-wing parties – representing the lower middle class – prefer low-unemployment–high-inflation combinations, as their clientele is worse hurt by unemployment than by inflation. The opposite holds true for right-wing parties, which represent the upper middle class. Consequently the model predicts a causal relationship between the partisanship of government and the macroeconomic variables inflation and unemployment – given that the Phillips curve works, at least in the short run.

Frey and Schneider (1978) pointed out that the two approaches are not necessarily mutually exclusive but can be combined. Parties have an ideology to which they adhere in general. Only when the popularity of the majority coalition (measured by popularity surveys) is below a critical level and elections are

approaching may the government compromise its ideological goals and launch an expansionary program in order to regain the critical votes for reelection.

III.1.2 Integrating rational expectations – the political-economics approach

One major criticism of the traditional public-choice theory of political business cycles has always been its implicit assumption that the citizens could be fooled by the government in every legislative term, over and over again. Therefore the early public-choice models of the political business cycle were said to be incompatible with rational expectations.

It is the merit of some of the first contributions of political economics to have shown that political business cycles can occur even if all actors have rational expectations. Persson and Tabellini (1990) presented an opportunistic model of the political business cycle. Alesina (1987) and Alesina and Rosenthal (1995) incorporated rational expectations in a partisan model in a two-party system. In the rational partisan theory⁵ – which we have chosen as an illustrative example here – political business cycles result from uncertainty about the election outcome and hence about whether an expansionary or a deflationary policy will take place. The policy preferences are the same as in the Hibbs model. Left-wing parties prefer a looser monetary policy, while right-wing parties care more about inflation and pursue therefore a more restrictive monetary policy. In the wage bargaining process – which takes place only at fixed dates – the economic agents calculate an expected value for the inflation rate given the election probabilities of the major parties and their respective monetary policies. After the election the inflation rate is higher than expected if the left-wing party is elected, but is lower than expected if the right-wing party is elected. In the first case there is a boom until all wage contracts are adjusted to the higher inflation rate; in the second case a contractive period follows the elections. Over the time the economy needs to adjust to the new inflation rate, a political business cycle occurs.

III.1.3 Preventing political business cycles

As political manipulation of the economy to increase reelection probabilities focuses solely on the benefits of economic booms triggered by government spending or monetary policy before elections and neglects the necessary adjustment costs after elections, it can be expected to reduce overall social welfare. Consequently economists have searched for ways to prevent the occurrence of political business cycles so as to suggest institutional improvements affecting the most important triggers of political business cycles: the extent and the timing of government spending on the one hand, and monetary policy on the other.

The timing of government spending is very hard to restrict in a democracy, as it is an elementary function of the sovereign. But budgetary rules can nonetheless help to limit the extent of government spending and

therefore the government's ability to manipulate the economy by public spending. Von Hagen (1992) – who can't be associated clearly with either of the two schools discussed in this paper – has analyzed budgetary rules and derived suggestions for institutional improvements to at least partly control government spending decisions and thereby reduce governments' ability to trigger political business cycles.⁶

With respect to monetary policy, especially political economics has suggested institutional improvements to prevent political business cycles. Examples are simple monetary rules (like fixed-exchange-rate agreements), models of central-bank independence, and work on optimal contracts for central-bank presidents (see, e.g., Persson and Tabellini 2000, pp. 435 et sqq.; Persson and Tabellini 1990, pp. 19 et sqq.).

III.1.4 Evaluation of political business cycle theories

So how to evaluate the research in political economics and public choice on political business cycles? Is one approach better than the other?

Public choice deserves the credit for the 'invention' of the approach, but political economics contributed powerfully, based on the foundation laid out by public choice, by integrating rational expectations into models with appealing elegance and by deriving the most important suggestions for institutional improvements in monetary policy. But that does not necessarily mean that political economics ultimately makes its predecessors obsolete. If one conducts simple tests of a selection of theories of business cycles in the US from 1949 to 2000, one finds that the observable business-cycle patterns are much better explained with the classical Hibbs partisan model or the opportunistic Nordhaus model than, e.g., with the Alesina–Rosenthal model.⁷ Therefore the rational-expectations models of political economics deserve praise for their contribution to the theoretical analysis – but they nonetheless remain in competition with the alternative and (at least sometimes) empirically better-performing models of public choice. Hence we see a healthy competition of both approaches to political business cycles, with some advantages for the political-economics school.

III.2 Integration and secession – explaining the size of nations

With regard to political business cycles, political economics contributes to a well-established line of public-choice research. Within the study of integration and secession, political economics is far more ambitious

5 See for further reference especially Alesina and Rosenthal (1995, pp. 161 et sqq.) or Alesina, Roubini, and Cohen (1997, pp. 51 et sqq.).

6 See for an overview also Strauch and von Hagen (2000).

7 See, for this simple test, Mueller (2003, chap. 19).

and aims to develop a general theory of *The Size of Nations* – Alesina and Spolaore’s title, suggesting a work of similar importance to Adam Smith’s *The Wealth of Nations*. The approach consists of a normative as well as a positive analysis and is developed especially in Alesina and Spolaore (1997, 2003), Alesina and Wacziarg (1998), Alesina, Spolaore, and Wacziarg (2000, 2003, 2004), and Alesina and La Ferrara (2003).⁸ We shall use the short form ‘Alesina et al.’ when we refer to this approach. Public choice has so far not offered any theory of comparable generality. Does Alesina et al.’s theory of the size of nations therefore bespeak a paradigm shift?

III.2.1 *The optimal size of a nation: normative analysis*

Based on their ambitious goal of developing a general theory of the size of nations, Alesina et al. ask a fundamental normative question: What is the optimal size of a nation? They analyze this problem based on the trade-off between the heterogeneity of preferences (which is assumed to increase with an individual’s geographic distance from the center of a state and therefore with the size of the state) and economies of scale in public-good provision (which are assumed to increase with the size of a state) in a closed economy (Alesina and Spolaore 2003).⁹ The authors argue that a social planner could calculate the optimum country size based on this tradeoff, but that it is difficult to implement the optimal solution under real-world institutions (see chaps. 2–5 of Alesina and Spolaore 2003). Following their argument, countries would end up being too large under a dictatorial Leviathan government (because the maximization of tax revenues by a Leviathan government would lead to a tax base larger than optimal) and too small in a democracy (because regions far from the center would tend to secede). In the case of a democratic government, Coasian bargaining – with inner residents paying lump-sum transfers to the outer residents (see Alesina

⁸ There are, however, important predecessors. At the outset was David Friedman’s (1977) seminal contribution ‘A Theory of the Size and Shape of Nations’. It put integration and secession, as the processes that determine the number, size, and shape of nations, on the research agenda of economics. Friedman offered a model that explains the size and shape of nations by rulers maximizing the tax revenues from trade, land, and labor taxation net of collection costs. Ten years later Buchanan and Faith (1987) developed a theory of ‘internal exit’ by secession to accompany Tiebout’s theory of ‘external exit’ by ‘voting with the feet’. Their model builds on the theory of clubs and shows how the threat of secession can set a limit to the maximal tax rate for redistribution. In the 1990s a new line of research emerged – largely independent of public choice. Casella and Feinstein (1990) shifted attention from redistribution to the effects of integration and secession on public-good provision and the development of private markets. On the one hand, political integration – so they argue – reduces transaction costs and therefore boosts economic integration and growth. On the other hand, public-good provision is negatively affected by political integration, as public goods become farther removed from local preferences if states grow and populations become hence more heterogeneous. (Similar arguments can be made with regard to redistribution instead of public goods; see Bolton and Roland 1997.) Casella and Feinstein’s argument for a trade-off between integration and growth on the one hand and public-good provision on the other has opened the door for the large research program on the size of nations by Alesina et al.

⁹ Other influential models that are not discussed here are by Wei (1991a) and Wittman (2000). Wei proposes a model where political integration is a necessary precondition to increase openness. As in the model by Casella and Feinstein (1990), Wei assumes a negative effect of integration on preference satisfaction by public-good provision. So he derives a trade-off between trade gains and welfare losses in public-good provision instead of Casella and Feinstein’s trade-off between economic growth and welfare losses. Wittman presented the most comprehensive model so far (Wittman 2000). It builds also on the trade-off between economic gains due to larger markets and losses in satisfaction with public-good provision, but additionally expands the approach by integrating military spending and the role of coercion and by allowing for different production functions and varying effectiveness of political institutions.

and Spolaore 2003, p. 55) – offers no way out of the dilemma, as majority rule would prevent bargaining till transfers were sufficient for attaining an optimal country size.¹⁰

But what are the conclusions? What follows from the result that nations are too small under a democratic government and are too large under a Leviathan government? Should a democracy such as the United States become less democratic in order to become larger and closer to its optimal size? And what follows for Europe? Has the democratic deficit of the European Union to be praised because it might enable the EU to reach its optimal size? The authors of political-economics works avoid these questions – probably with good reason, as an in-depth discussion would reveal the nondemocratic nature of their approach and the limits of the real-world applicability of their concept of an optimal country size.

Furthermore, it is surprising that political economics borrows the trade-off between economies of scale in public-good provision and local preference satisfaction (both depending on the size of the jurisdiction) from the approach of fiscal federalism (see, e.g., Oates 1972) – which is traditionally used by public-choice theorists to study country formation – but largely disregards the possibility of a multilevel state, which might moderate or even obviate this trade-off. In reality, nearly all states of any size are organized on multiple levels. They consist of various overlapping territorial jurisdictions with different assignments of tasks and revenues. According to Tiebout (1956), individuals may choose among jurisdictions by migration. Some authors go even so far as to abandon the purely geographical definition of jurisdictions and define them as functionally overlapping, competing jurisdictions (FOCJs), following the concept of Bruno S. Frey and Reiner Eichenberger (1999). Following the concept of FOCJs, each citizen could select his or her own desired bundle of jurisdictions providing public goods. In this case the trade-off between preference adjustment and economies of scale in public-good provision would vanish completely, as would any argument for collective optimization.

Alesina et al. realized right from the start the challenge posed to their theory of the optimal size of nations by the theory of fiscal federalism,¹¹ but have only recently added a chapter on federalism in their latest book (Alesina and Spolaore, 2003). Even there, the discussion of fiscal federalism remains superficial. They write: ‘In this chapter we do not digress into the vast field of fiscal federalism, but rather cite what literature is appropriate to our perspective on political border formation’ (p. 14). Indeed, a large part of the

10 Alesina et al. prove in a lengthy discussion that a transfer scheme lacking credibility is in general not able to induce an optimal size of nations unless incentives to secede are offset by strong economies of scale (see Alesina and Spolaore 2003, pp. 53–67).

11 Alesina and Spolaore (1997) conclude: ‘In other words, an answer to the trade-off between economies of scale and heterogeneity can be found in a decentralized structure of government. This line of argument would connect us to the literature of fiscal federalism, an avenue certainly worth exploring’ (p. 1046).

literature of fiscal federalism is simply ignored.¹² And although Alesina et al. discuss the possibility of overlapping jurisdictions, they fail to acknowledge that the trade-off between preference heterogeneity and economies of scale cannot alone be the basis for the discussion of the optimal size of a country, as its federal structure has to be taken into account. But it seems that the authors in the school of political economics prefer to withdraw from this ‘intellectual minefield’ and to turn to a positive analysis of the size of nations instead.¹³

III.2.2 *The optimal size of a nation: positive analysis*

For the positive, empirical part of their analysis, Alesina et al. put the idea of an optimal country size aside and focus on the international trade regime, which they try to establish as the decisive variable to explain integration and secession. Their argument runs as follows: Under worldwide protectionism, nations will merge politically in order to achieve larger markets internally, even if they have to incur the costs resulting from centralized uniform public-good provision under increasing heterogeneity of preferences (which are assumed to increase with individuals’ geographic distance from the center of a state and therefore with the size of the state). Under a regime of international free trade, in contrast, nations will split, as they can obtain the advantages of large markets without the need of being constrained by a centralized uniform provision of public goods. The prediction therefore is: A more protectionist international trade regime will lead to fewer and larger countries, while more free trade will lead to more numerous and smaller countries.

In searching for empirical evidence for their approach, Alesina et al. describe the creation and disappearance of states over the period between 1870 and 1994 in a graphical analysis (Alesina, Spolaore, and Wacziarg 2000, p. 1292, fig. 5; Alesina and Spolaore 2003, p. 195). Five major processes can be identified: (a) the integration of 18 sovereign German states into the German Empire in 1871, (b) the creation of nine sovereign states in Europe in the aftermath of World War I, (c) the disintegration of colonies in Asia and Africa into independent states after World War II, (d) the integration of the European Union after 1958, and (e) the fall of communism and the creation of new states in Eastern and Central Europe after 1989. The empirical evidence provided by the authors, however, scarcely supports their hypotheses:

- (a) Political integration of 26 independent states into the German *Kaiserreich* in 1871 was scarcely a consequence of protectionism (as indicated by Alesina et al.), as it was preceded by a long period of over 40 years of gradually increasing free trade among these nations forming the *Zollverein* (German customs association), beginning in 1828 and continuing with

12 See e.g. Oates (1972), Wallis and Oates (1991), Nelson (1986, 1987), Pommerehne, Kirchgässner, and Feld (1996), and Oates (1985, 1989).

13 **Other publications of Political Economics** on federalism are largely detached from the literature discussed here and do not remedy the criticized shortcomings in Alesina et al. See for example Persson and Tabellini (1996) and Persson, Roland, and Tabellini (1997). In our view fiscal federalism in this context is much more than the calculation of voter equilibria holding a union together under economies of scale and scope (as in Persson and Tabellini 2002, part 5). Federalism is – like markets – a device to stimulate the search by self-governing jurisdictions for better solutions by trial and error.

the North German Confederation in 1867 up to 1871 and beyond. The turnaround towards protectionism came no earlier than 1879–1880, much later than integration, and it lasted up to World War II.

- (b) Political disintegration following World War I led to the creation of nine new sovereign states in Europe. The era was, however, not one of free trade (in which case Alesina et al. would be right), but rather one of continuing protectionism (which is contradictory to their theory). Astonishingly, this development is left uncommented on by Alesina et al.¹⁴
- (c) After World War II the establishment of GATT in 1947 set a new turning point towards gradually expanding free trade. At the same time a large number of new nations were created. While some joined GATT, most of them abandoned free trade with their former mother country and with each other. If not tariffs, then high selective taxes, foreign exchange controls, and other nontariff barriers were frequent in these countries at least in the early decades. Therefore it remains ambiguous whether free trade was an important motive for them to become independent. In other parts of the world, however, the observations are not only ambiguous, but even contradictory to Alesina et al. Consider Canada and the US, two large countries that, according to the argument of Alesina et al., should be expected to disintegrate when international trade opened. But this was not the case. Neither has Quebec seceded from Canada, nor has any of the US states tried to become independent.
- (d) Similarly, the European Economic Community was launched in 1958 despite the evolving worldwide free trade under GATT. It started with internal free trade, but its goal was and still is political integration, ‘an ever closer Union’ as is written in the Preamble of the Treaty of Rome of 1957. Today two-thirds of national legislation within the EU is said to be a consequence of EU decisions. The EU can be characterized as a union approaching a federal state. Hence the direction of integration was from free trade to political integration and not the other way round. Alesina et al. try to adhere to their approach by arguing that EU Member States tend to disintegrate under the larger roof of the EU common market. Looking carefully, however, one sees that only a few have adopted a new constitutional statute, and among those only Belgium and Spain have transferred substantial political competences of taxation and expenditures from the national to lower government levels (Stegarescu 2004).
- (e) The disruption of the former Soviet bloc into a number of smaller countries may be seen as a move to independence under international free trade as suggested by Alesina et al. But the relationship between independence and free trade is not very strong. Up to 2004 only 14 out of 22 former communist nations have joined the WTO.

This more detailed inspection shows that four out of the five most important processes of integration and secession from 1870 to 1994 contradict the theory of Alesina et al., while one is inconclusive. Free trade is linked to political integration while secession goes hand in hand with protectionism – with case (e) left out because it is inconclusive. How can these devastating empirical results be explained? And how could the relationship of free trade to integration and secession be just the reverse of Alesina et al.’s argument? In our view political economics asks the wrong question. To explain the effects of the trade regime on the integration or secession of nations would have required solving especially two problems: First, what are the variables determining national trade policy and consequently the international trade regime? Second, what follows from a country’s trade policy and the international trade regime for political integration or secession?

To solve the first problem, Alesina et al. could have referred to the battery of investigations in the literature, such as the campaign-contributions approach by Magee, Brock, and Young (1989) and the political-contributions approach by Grossman and Helpman (1994), both with a good empirical basis.¹⁵ These approaches help to understand the determining factors for free trade and protectionism on a domestic level, based on industry interests, politicians’ interests, and political institutions. As national governments have to agree on bilateral trade liberalization as well as on multilateral free-trade agreements

14 Widespread protectionism during this period is documented in James (2002).

such as GATT and WTO, the number of free-trade-oriented national governments is decisive for the overall degree of free trade.

While our understanding of the determinants of national trade policy is comparatively well advanced, the second problem – the relationship of trade policy, free trade, and integration and secession – has so far been widely neglected. Nonetheless it is important for a convincing analysis to take the domestic determination of trade policy into account when analyzing the interplay of trade policy and integration and secession, instead of just assuming free trade to be an exogenous variable as Alesina et al. do. Once free-traders are in power domestically, it seems only logical to assume that they are not only interested in open borders, but also in making trade safer by promoting cross-border legal stability and hence advancing political integration. The more countries are promoting free trade, the more political integration we would therefore expect. If, however, protectionist interests dominate national politics, it seems rather unlikely that small nations will merge into larger ones as suggested by Alesina et al., and much more plausible that large nations will disintegrate into smaller ones; for protectionists fear large markets with competition [see case (b) above]. We would therefore expect an increasing number of secessions to be linked to rising levels of protectionism. Just by taking into account that decisions on international free trade or protectionism result from domestically made trade policy, we can therefore offer an explanation why the observable relationship between free trade and integration and secession is the opposite of the one assumed by Alesina et al.

III.2.3 Institutional improvements

That Alesina et al. are not able to explain what they intend to explain is one thing, but we see an even deeper problem in the inability of their theory to derive institutional improvements that could enhance economic welfare and individual liberty.

There is wide consensus that free trade is welfare-enhancing and therefore generally desirable. This motivates public-choice scholars to develop proposals for institutional improvements that foster liberal trade policy. Alesina et al., in contrast, do not have anything to contribute, as for them the international trade regime is exogenous.

Furthermore, political economics neglects, at least partly, the importance of individual liberty and individual preference satisfaction. The normative analysis of the optimal size of nations completely disregards individual liberty, as it rests on collective optimization. In the positive analysis Alesina et al. focus on the alleged trade-off between market expansion and local preference satisfaction by public-good provision, but do not search for ways to solve this trade-off, e.g., by fiscal federalism or migration within

15 See for a detailed discussion e.g. Hillman (1989), Rodrik (1995), Adserà and Boix (2003).

jurisdictions. They do not even ask how institutions should be changed to increase individual liberty and to improve the individual preference satisfaction, and they have therefore little to contribute to the public-choice literature on fiscal federalism, which has these questions in its core.

III.3 *Constitutional political economy*

III.3.1 *The view of political economics*

In their book *The Economic Effects of Constitutions* Persson and Tabellini (2003) write:

We would like to answer questions like the following: If the United Kingdom were to switch its electoral rule from majoritarian to proportional, how would this affect the size of its welfare state or its budget deficit? If Argentina were to abandon its presidential regime in favour of a parliamentary form of government, would this facilitate the adoption of sound policies toward economic development? (Persson and Tabellini 2003, p. 7)

Questions of comparative constitutional analysis such as these have been studied for a long time by economists of public choice, e.g., in *The Calculus of Consent* by Buchanan and Tullock (1962) or in *Constitutional Democracy* by Mueller (1996), and in the huge literature based on these contributions. But in the whole book of Persson and Tabellini there is barely a footnote referring to public choice, for Persson and Tabellini, in the tradition of political economics, reject this literature, or even deny its existence. This becomes obvious right in the beginning of their book, where they write:

Surprising as it may seem, social scientists have not, until very recently, really addressed the question of constitutional effects on economic policy and economic performance. (Persson and Tabellini 2003)¹⁶

Instead these authors prefer to cite their own work and the literature of political science, which they consult extensively. Hence they hold one eye open and the other closed, and it remains to be seen how far they are able to keep a perspective view despite their voluntary handicap of being one-eyed.

As the introductory quotation indicates, the authors want to compare the consequences of alternative constitutions in the world. Persson and Tabellini (2000, 2003) focus on two pairs of characteristics: *majoritarian* versus *proportional electoral systems*, and *presidential* versus *parliamentary forms of government*. Compared to a *social optimum* as defined by the Samuelson condition for public-good provision and zero rents to the politicians,¹⁷ they find deviations especially in three dimensions: the amount of public goods provided, redistributive transfers to politically powerful minorities, and rents to politicians. Which of the three is more pronounced depends on the particular constitutional combination.¹⁸

¹⁶ We classify economics as a social science. See e.g. Frey (1999).

¹⁷ See Persson and Tabellini (2000, p. 254).

¹⁸ Especially in *The Economic Effects of Constitutions* (Persson and Tabellini 2003), more variables (e.g., total government spending, adjustments to shocks, deficits, and structural policies) are analyzed. But for simplicity we restrict ourselves to a selection and concentrate on the main variables discussed in Persson and Tabellini (2000).

In a *parliamentary regime* the legislators of the majority coalition form the government and dictate the policy. To sustain their electoral support they promote the joint interests of their voters and therefore concentrate spending on relatively broad-based programs such as public goods and general transfers. So the level of public-good provision is relatively close to the ‘ideal level’ characterized by the Samuelson condition, although the ideal level is not actually reached, as the majority coalition focuses only on its voters and not the whole population. But the relatively satisfactory level of public goods comes at the expense of large special-interest rents and large rents to politicians, as the government is largely unconstrained in privileging special-interest groups that are part of the majority coalition supporting the government, and there are only a few checks and balances that prevent rent extraction by politicians.

In *presidential systems*, in contrast, there is no firm parliamentary majority. Therefore powerful officeholders such as the heads of the US congressional committees dictate the agenda and try to play off one minority against another. Because of politicians promoting minority interests and the absence of a parliamentary majority, there are fewer incentives than in a parliamentary system to provide public goods, and a severe underprovision of public goods results. But on the other hand the presidential veto power allows for better prevention of rent seeking by special-interest groups and rent extraction by politicians than in a parliamentary system.

With respect to electoral rules the authors derive similar effects. A *majoritarian* electoral system leads – compared to a proportional electoral system – to increased competition between the political parties and helps therefore to restrict rent-seeking activities aiming at transfers to politically powerful minorities. But on the other hand more severe underprovision of public goods occurs, as spending is targeted only at the marginal districts (especially if the districts are small) while the safe districts are neglected. In *proportional* systems, on the other hand, more – and in particular more broad-based – spending can be expected (especially if districts are large), as all votes are equally important in the election. But competition and accountability are weaker, because representatives’ efforts are internalized to a lesser extent and so rents to politicians tend to be larger.

Taking the effects together, a trade-off in between limiting rents to politicians and providing sufficient amounts of public goods results for the choice of the electoral rule as well as for the choice of the form of government.

The Economic Effects of Constitutions (Persson and Tabellini)

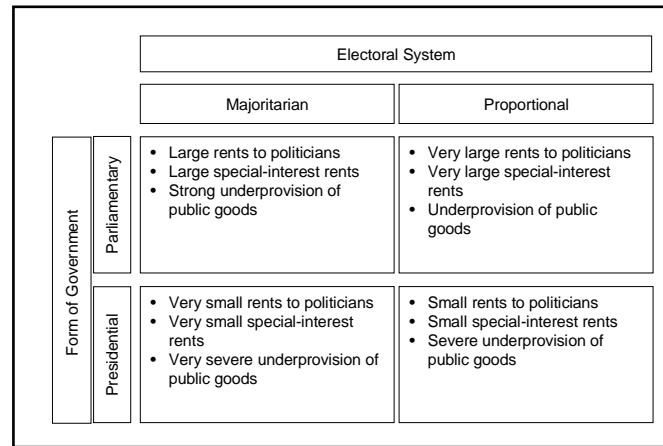


Diagram based on: Persson, Torsten and Guido Tabellini (2003): *The Economic Effects of Constitutions*. Cambridge (Mass.). MIT Press. ; Persson, Torsten and Guido Tabellini (2000): *Political Economics*. Cambridge (Mass.). MIT Press.

Combining different electoral rules and forms of government leads to four main regimes, which are summarized in a simplified form in figure 1.

In an extensive cross-sectional empirical analysis, Persson and Tabellini find their derived trade-offs at least partly supported (see, for a summary, Persson and Tabellini 2003, pp. 269 et sqq.). The influence of electoral rules on public-good provision, rents to politicians, and rents to interest groups comes out fairly clearly. Concerning the form of government, they state that their empirical results are largely inconclusive.

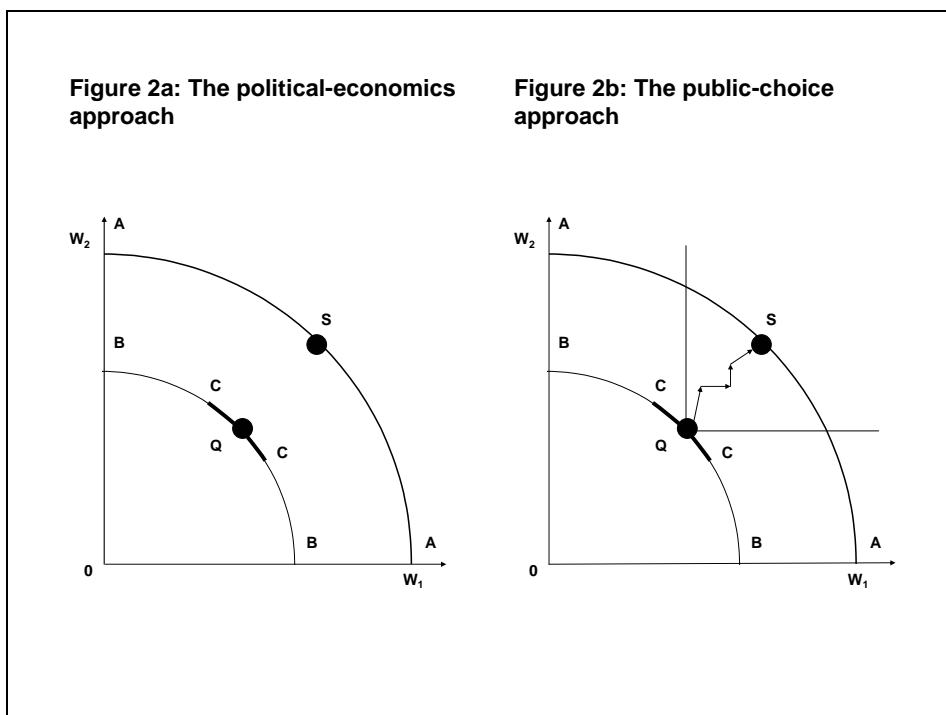
III.3.2 A public-choice perspective on constitutional political economy

Compared to their work on integration and secession, the discussed political-economics contributions to constitutional political economy are far more convincing. Some of their empirical results are very interesting and enrich the existing literature with new findings.

So might political economics – based on its advances in the current literature – be able to replace public choice in constitutional political economy? To discuss this question we do not want to evaluate the described theory in detail, focus on uncovering possible weaknesses in the argument, or go into the details of the empirical analysis. Instead we find it – in this case – far more interesting to compare the proclaimed ends of the research with its results. Let us return to the introductory quotation of this section. Suppose that the British or Argentinean voters are confronted with the trade-offs identified by Persson and Tabellini and summarized in figure 1. What should they do? What is the assistance given to them by political economics?

Persson and Tabellini might say: ‘Look, you are in a situation of second best. Switching from parliamentary to presidential democracy or from a majoritarian to a proportional system may not improve your situation. You may discover that you got out of the frying pan but straight into the fire and will never reach the social optimum as defined by the Samuelson condition and zero rents to the politicians, as you cannot avoid the principal–agent problem. Your political agent works under an incomplete contract, and there is nothing you can do about that. In a graphical exposition, you remain on an inner utility possibility frontier such as BB connecting the welfare of voters V_1 and V_2 depicted on the axes of figure 2a, and the only choice I can offer you is a bundle of alternative political systems CC . But consider that when departing from the status quo Q , you will always be confronted with a trade-off between e.g. securing public-good provision and limiting rents to politicians.’

From a public-choice view this approach of political economics looks completely static. All it says remains within given institutions. Nothing is said about institutional innovations. This is surprising, as especially constitutional analysis calls for a creative approach. The men and women who developed the Constitution in the French Revolution and the founding fathers of the American Constitution were characterized by this creativity. They could not have won their cause, had they merely concluded that the world is second best and cannot be improved.



So why is the approach of political economics so conservative? We find the reason for this conservatism in its predominant reference to the political-science literature while the public-choice literature is largely neglected. Political science, according to the political scientist Hans J. Morgenthau (1948), can be defined as follows:

Political science deals with the nature, the accumulation, the distribution, the exercise, and the control of power on all levels of social interaction, with special emphasis upon the power of the state.

According to this definition, political scientists ask: What are the institutions and constraints that allow the accumulation, distribution, exercise, and control of power here and now – and not under some alternative, not yet existing framework? And they focus on the coercive nature of the state. Political economics fits into this approach, as political scientists analyze how politicians decide when confronted with a set of well-known alternative institutions. Choice is limited by the trade-off in the status quo.

Public-choice scholars, in contrast – working on the foundations laid especially by Buchanan – do not regard these trade-offs as inevitable constraints, but rather as challenges. If there is a social optimum beyond the constraint CC as claimed by Persson and Tabellini, there must also be an institutional arrangement to approach and eventually achieve it (see figure 2b). Public-choice scholars typically ask the question: What can be done to go step by step from Q towards S ? How can we improve institutions so that we come closer to the point S ? For public choice the relevant question in constitutional analysis is not limited to what effects existing institutions have. They rather want to know: *Which system has the effect that the government spends more when the citizens want higher spending and that it spends less when the citizens want lower spending?*

Hence public choice focuses on suggestions for institutional improvements based on constitutional analysis. And luckily the improvements derived by public-choice theory could dissolve large parts of the basic trade-offs discussed so intensively by Persson and Tabellini, as the following examples may illustrate.

One example is the promotion of the concept of *direct democracy* by public choice: Complementing representative democracy with a referendum will have the effect that the government spends less (imposes lower taxes) when the citizens want lower spending. Likewise, a popular initiative will cause it to spend more if the voters want to have higher expenditures. Public-choice scholars have shown in empirical studies for different countries how referenda and initiatives have decisive effects on spending, taxation, and government debt as government discretion decreases and accountability is strengthened (see, for a survey, Kirchgässner, Feld, and Savioz (1999) and Matsusaka (2005), who summarize some recent studies of the effects of direct democracy).¹⁹ A second public-choice concept is *decentralization of government*. If labor and capital can migrate at low cost to other jurisdictions in a decentralized state, citizens have a larger say under decentralized than under centralized government. Public output becomes more adjusted to local preferences. And recent studies (Kirchgässner 2002) show that at least on the local level, on average no cost increases occur in smaller as compared to larger jurisdictions, and scale effects are therefore often negligible. Both concepts can hence be seen as important steps towards the social optimum identified by

Persson and Tabellini (see above), as their application helps to increase the supply of public goods to the level demanded by the citizens and to restrict the rents of politicians by giving a larger say to the voters.

But public choice has not only derived complementary improvements for existing political systems, but has fundamentally challenged the view that constitutional choice is limited to majoritarian versus proportional electoral rules and presidential versus parliamentary forms of government. Gordon Tullock has offered one basic alternative by a simple vote-transfer mechanism (1967): Every adult person is a member of the parliament (as in a popular assembly). But citizens can transfer their vote to a person whom they expect to have nearly the same preferences and to vote as she would vote herself. Those who go to parliament will vote with as many votes as they have received. In this case the advantages of personality vote (in the approach of political economics restricted to a majoritarian system) can be combined with those of proportional representation. Accountability increases in that candidates' shirking can be observed. As representatives are linked more closely to their voters, the transmission of preferences into politics will be less distorted. Under such a regime, representatives would not necessarily join a fixed coalition, but rather aim at increasing their reelection probability by voting issue by issue as closely as possible to their voters' preferences. And the government would no longer be either parliamentary or presidential (in the American sense). The parliament may rather appoint an executive board (like the Federal Council in Switzerland), or the citizens elect a president whose function is to arrange compromises and majorities in the parliament. To prevent free-riding, exploitation of minorities, and cycling, the parliament could decide by qualified majority rule or by one of the simple voting procedures such as voting by veto (Mueller 1978, 1984) or Hylland-Zeckhauser's point voting procedure (Hylland-Zeckhauser 1979), so that the decisions come closer to those under unanimity rule without causing high transactions costs. Taken together, the vote-transfer mechanism, an executive board in the parliament, and a voting procedure such as voting by veto would lead to political outcomes continuously closer to the social optimum than in any of the political systems discussed by Persson and Tabellini (for further details see Blankart and Mueller 2002, 2004).

Hence we conclude that the contribution of political economics to the study of constitutional political economy is strictly limited to research on the status quo and therefore far from displacing public choice. In particular, the voluntary monophthalmia of political economics in disregarding public choice almost completely has prevented it from facing the central and most important question in constitutional political economy: how to design a constitution that assures the best possible alignment of public policy with

19 Indeed, the political-economics community seems to be not totally unaware of this. In a footnote, Persson and Tabellini (2003, p. 5) quote one older study by Pommerehne and Frey (1978), but come to the surprising statement that only very limited research has been conducted along these lines.

individual preferences. This calls for criticism especially in that innovation in governments is clearly required.²⁰

IV POLITICAL ECONOMICS VERSUS PUBLIC CHOICE

IV.1 Political economics versus public choice – a paradigm shift?

So what are the results of our preceding analysis of political economics and public choice with respect to the paradigmatic competition of the two approaches? Is political economics going to replace public choice? Is a paradigm shift observable?

Based on our analysis in section III of this paper, we can summarize:

1. Political economics deserves praise for the integration of rational expectations into political business-cycle models, although the empirical record of these models is not necessarily more convincing than that of public-choice models.
2. The political-economics literature on the size of nations, however, has turned out to be far less persuasive. On normative grounds the idea of an optimal size of nations seems to be misplaced. It rests on a collective optimization of country size and is therefore undemocratic. As states are considered to be organic entities, options offered by fiscal federalism are forsaken. On positive grounds, the assumption of exogeneity of the trade regime leads to inconsistent predictions inferior to even the simplest hypotheses of public choice. And suggestions for institutional improvements enhancing welfare can hardly be derived, as the central policy variable – trade – is exogenous.
3. In constitutional political economy the achievements of political economics are also not outstanding. They focus almost exclusively on trade-offs within existing representative democracies and miss the central question of constitutional analysis: how to secure the alignment of public policy with individual preferences. Therefore political economics is not able to replace public choice in this field either.

Altogether, there is no indication of a paradigm shift: Political economics cannot explain what was explained before by public choice and new facts as well. Quite the contrary seems to be true: Public-choice explanations continue to be more convincing in central fields of analysis common to both approaches. This is especially true of the newer contributions of political economics, which ignore public-choice research almost completely.

²⁰ Much more creative than the works by Persson and Tabellini is the book by Andrei Shleifer and Robert Vishny (1999), *The Grabbing Hand*, in which the authors are searching for superior institutional designs for privatization, for prevention of corruption, and to support market-oriented politicians in foreign-aid policy. This would be a way to go.

Instead of a paradigm shift, a different picture emerges. It is hard to argue that political economics is a paradigm on its own. In all four important categories (basic generalizations, ontological or heuristic model, preferred method, and scientific goal [see section II.1]), political economics is equivalent to the long-existing paradigm of public choice. Both define themselves as the economic analysis of politics that is based on rational and self-interested actors and seeks – based on positive analysis – to derive normative suggestions for improvements of political and economic institutions.²¹

This striking similarity might have motivated Heinrich Ursprung's statement that the authors of political economics are new in the field and that the field may be new for them, but that this does not necessarily mean that the field itself is new (Ursprung 2003).²² From a paradigmatic perspective, political economics therefore *is* public choice.²³

But even given that political economics does not qualify as a paradigm on its own, it still separates itself from public choice, and the two approaches remain in competition. So what is the current score of the two approaches in this competition if we compare them more generally?

IV.2 Political economics versus public choice – general comparison

The comparison of the research in political economics and public choice reveals especially three basic differences that distinguish the two approaches, leading to different questions, different research designs, and consequently different analytical results: their point of reference, the importance they assign to individual liberty, and their attitude to modeling techniques.

First, choice versus conflict: Political economics and public choice have different points of reference, which strongly affect their basic approaches. Political economics starts its analysis within the framework of existing representative democracy (see e.g. Persson and Tabellini 2000, pp. 251 et sqq.) and focuses on the coercive character of the state. Within this framework political decisions are legitimate if they are supported by a majority of votes. As majority decisions allow for the exploitation of minorities, the main topics within political economics are redistributive conflicts. This is e.g. reflected in the overview article 'Political Economics and Public Finance' (Persson and Tabellini 2002), where the existing literature is classified along the dimensions of one-dimensional redistributive conflict, multidimensional redistributive conflict, and analysis of the effects of different constitutional arrangements on redistribution. The

21 See e.g. Persson and Tabellini (1990, p. 2 et sqq.; 2000, p. 1 ff).

22 Exact quotation: 'The 'new' political economist would benefit from a little bit of academic restraint and integrity by admitting that the term 'new' refers to their being relatively new in the field because it took them some time to realize and to admit that, to paraphrase Nietzsche, the benevolent dictator is dead (Ursprung 2003, p. 225).

23 Compare Ursprung (2003, p. 225).

analytical results of political economics are therefore mostly trade-offs between different second-best solutions for redistributive conflicts within the political systems of representative democracies.

Public choice on the other hand starts strictly at the individual level. Individuals form a state and choose institutional arrangements for this state. The yardstick for the general legitimacy of the state and its decisions is therefore the individual willingness of all citizens to join a state and accept its decisions. This is why public choice puts voluntary exchange at its core (Buchanan 1954). Institutionally the point of reference of public-choice scholars lies in the model of Wicksell (1896), in which a commonly elected parliament (which represents the preferences of all citizens) decides **unanimously**, i.e., it bargains till unanimity is (nearly) reached. This process secures that all preferences – and not just the preferences of a majority – are accounted for in the final decision. Deviations from unanimity are only acceptable if bargaining costs would otherwise be prohibitively high. New research in public choice is intended to reduce these costs by new voting procedures such as those mentioned above (see section III.3.2).

Based on this approach, scholars of public choice see their main task in developing arrangements that facilitate voluntary exchange. This distinguishes them sharply from the scholars of political economics.

Second, liberty versus efficiency: Based on the different points of reference, the two approaches derive different criteria to evaluate political decisions and political institutions. Political economics assigns central importance to efficiency considerations of political decisions within representative democracy (see e.g. Ursprung 2003, pp. 224 et sqq.). Typical questions asked by political economics are: presidential or parliamentary, and majoritarian or proportional, democracy? The criteria to evaluate these institutional arrangements are comparisons of efficiency in categories like underprovision of public goods versus rents to politicians.

Public-choice scholars on the other hand argue that efficiency considerations are not sufficient. They assign the greatest importance to the value of individual liberty and its promotion as a criterion to evaluate political decisions and institutions. The extent of liberty as being free from willed constraints and the ability of individuals to avoid being forced are the criteria, which follow directly from the focus on voluntary exchange. A typical question asked by public choice is therefore how we can improve the institutions of representative democracy to increase individual liberty and limit exploitation of minorities by majorities (see, e.g., Buchanan and Congleton 1998). In political economics, in contrast, the link between economic analysis and liberty is missing. Therefore its conclusions for public policy are, despite the integration of political processes, often not much different from those of a benevolent dictator. Public choice, however, integrates a calculus of individual liberties and comes therefore to largely different questions, results, and advice.

Third, methodological determination versus methodological openness: Finally political economics is built at least partly on methodological characteristics. For Persson and Tabellini the approach of political economics is to study ‘some of the classic problems in public choice’, adopting a general-equilibrium approach with explicit micropolitical foundations – meaning that economic behavior and political behavior are derived from the same individual preferences (see Persson and Tabellini 2000, pp. 3 et sqq.). In contrast with political economics, researchers in public choice have always rejected the idea that the discipline is defined by the analytical tools or techniques they use and focused instead on the questions they wanted to answer. The dedication of political economics to technical concerns makes it especially vulnerable to favoring analytical refinements over practical applicability. Modeling becomes an end in itself, and the application of political economics to politics moves as far from reality as that of classical mainstream economics, which has always been criticized by public-choice scholars for its lack of practical applicability.

IV.3 A head start for public choice

We have argued that political economics can hardly be seen as a paradigm on its own. But nonetheless it separates itself and competes with public choice. So how can we evaluate the ‘current score’ of the competition between these two approaches? We propose to compare the results of the two approaches with respect to their common scientific goal (see section IV.1): to derive normative implications for institutional improvements.²⁴ Are the two approaches on a par with respect to this goal, or does one have an advantage?

In analyzing political business cycles, political economics has – based on the research of public choice – contributed very successfully and derived important new suggestions for institutional improvements. The success of political economics with respect to political business cycles, however, may have nourished the fallacious opinion that all that is necessary to take over the role of public choice is technical problem solving. A few more ‘formal game-theoretic tools’ combined with ‘the equilibrium approach of macroeconomic theory’ is enough to replace the public-choice tradition, and the foundations of the public-choice approach such as the importance of liberty and choice are only of minor relevance. Unfortunately, this belief has blurred the perspective of the political-economics research and led to unconvincing results. As we have demonstrated above, the newer contributions of political economics on integration and secession (section III.2) and constitutional political economy (section III.3) have been unable to provide any meaningful advice for institutional innovations – their explicitly declared scientific goal.

²⁴ See, e.g., Persson and Tabellini (1990, pp. 2 et sqq.); Buchanan (1975, pp. 389 et sqq.).

The causal factors for this decline of political-economics research were identified above in its inability to define a relevant point of reference outside of the given institutional setting (e.g., outside the existing western representative democracies), its concentration on the coercive character of the state, and its preference for efficiency considerations over concerns for individual liberty. Public-choice scholars, on the other hand – with Wicksell as their point of reference and individual choice and liberty as their main criteria – were much better able to derive advice for institutional improvements, e.g., in constitutional political economy (section III.3).

Hence, measured by their common scientific goal to derive normative implications for institutional improvements, we still see an edge for public choice in the economic analysis of politics.

Nonetheless, there is an ongoing competition that can only benefit both approaches of political economy. Solely looking in the queen's mirror will bring neither public choice nor political economics forward.

V BIBLIOGRAPHY

- Adserà, Alicia and Charles Boix (2003). The Political Economy of Trade and Economic Integration: A Review Essay, in: Devlin, Robert and Antoni Esteveadoral (eds.), *Bridges for Development*. Washington, DC: Inter-American Development Bank: 75-92.
- Alesina, Alberto (1987). Macroeconomic Policy in a Two-Party System as a repeated game, *Quarterly Journal of Economics*. 102: 651–678.
- Alesina, Alberto and Eliana La Ferrara (2003). Ethnic Diversity and Economic Performance. Source: <http://post.economics.harvard.edu/faculty/alesina/papers.html>.
- Alesina, Alberto and Enrico Spolaore (1997). On the Number and Size of Nations, *Quarterly Journal of Economics*. 112: 1027–1056.
- Alesina, Alberto and Enrico Spolaore (2003). *The Size of Nations*. Cambridge, MA: MIT Press.
- Alesina, Alberto and Howard Rosenthal (1995). *Partisan Politics, Divided Government, and the Economy*. Cambridge: Cambridge University Press.
- Alesina, Alberto and R. Wacziarg (1998). Openness, Country size and Government, in: *Journal of Public Economics*. 69: 305–321.
- Alesina, Alberto, Enrico Spolaore, and Romain Wacziarg (2004). *Trade, Growth and the Size of Countries*. Harvard University: mimeo.
- Alesina, Alberto, Nouriel Roubini, and Gerald D. Cohen (1997). *Political Cycles and the Macroeconomy*. Cambridge, MA: MIT Press.
- Alesina, Alberto, Enrico Spolaore, and Romain Wacziarg (2000). Economic Integration and Political Disintegration, *American Economic Review*. 90: 1276–1296.
- Alesina, Alberto; Spolaore, Enrico, and Romain Wacziarg (2003). *Trade, Growth and the Size of Countries*. Source: <http://post.economics.harvard.edu/faculty/alesina/papers.html>.
- Arrow, Kenneth (1951). *Social Choice and Individual Values*. New York: John Wiley and Sons.
- Ashenfelter, Orley C. and Stanley Kelley Jr. (1975). Determinants of Participation in Presidential Elections, *Journal of Law and Economics*. 18: 695–733.
- Becker, Gary S. (1983). A Theory of Competition among Pressure Groups for Political Influence, *Quarterly Journal of Economics*. 98: 371–400.
- Black, Duncan (1948). On the Rationale of Group Decision Making, *Journal of Political Economy*. 56: 23–34.
- Blankart, Charles B. and Dennis C. Mueller (2002). Alternativen der Parlamentarischen Demokratie, *Perspektiven der Wirtschaftspolitik*. 3: 1–21.
- Blankart, Charles B. and Dennis C. Mueller (2004). The advantages of pure forms of parliamentary democracy over mixed forms, *Public Choice*. 122: 431–453.
- Bolton, Patrick and Gerard Roland (1997). The Break-Up of Nations: A Political Economy Analysis, *Quarterly Journal of Economics*. 112: 1057–1090.
- Buchanan, James M. and Gordon Tullock (1962). *The Calculus of Consent*. Ann Arbor: University of Michigan Press.
- Buchanan, James M. (1949). The Pure Theory of Public Finance: A suggested approach, *Journal of Political Economy*. 57: 496–505.
- Buchanan, James M. (1954). Individual choice in voting and the market, *Journal of Political Economy*. 62: 334–343.

- Buchanan, James M. (1975). Public Finance and Public Choice, *National Tax Journal*. 28: 383–394.
- Buchanan, James M. (2003). Public Choice - Politics Without Romance, *Policy*. 19: 13-18.
- Buchanan, James M. and Roger L. Faith (1987). Secession and the Limits of Taxation: Toward a Theory of Internal Exit, *American Economic Review*. 77: 1023–31.
- Buchanan, James M. and Roger D. Congleton (1998). *Politics by Principle, Not Interest : Towards Nondiscriminatory Democracy*. Cambridge: Cambridge University Press.
- Casella, Alessandra and Jonathan S. Feinstein (1990). Public Goods in Trade: On the Formation of Markets and Political Jurisdictions. *NBER Working Paper 3554*.
- Coase, Ronald H. (1960). The Problem of Social Cost, *Journal of Law and Economics*. 3: 1–44.
- Downs, Anthony (1957). *An Economic Theory of Democracy*. Boston, MA: Addison Wesley.
- Kirchgässner, Gebhard, Feld, Lars P., and Marcel R. Savioz (1999). *Die direkte Demokratie: Modern, erfolgreich, entwicklungs- und exportfähig*. Basel, München: Helbing und Lichtenhahn/Vahlen.
- Frey, Bruno S. (1985). The Political Economy of Protectionism, in: David Greenaway (ed.), *Current Issues in International Trade*. London: Macmillan: 139–157.
- Frey, Bruno S. (1999). *Economics as a Science of Human Behaviour. Towards a New Social Science Paradigm*. Boston, Dordrecht, London: Kluwer Academic Publishers.
- Frey, Bruno S. and Reiner Eichenberger (1999). *The New Democratic Federalism for Europe*. London: Edward Elgar.
- Frey, Bruno S. and Friedrich Schneider (1978). An Empirical Study of a Politico-Economic Interaction in the U.S, *Review of Economics and Statistics*. 60: 174–183.
- Frey, Bruno S. and Larry Lau (1968). Towards a mathematical model of government behaviour, *Zeitschrift für Nationalökonomie*. 28: 355–380.
- Friedman, David (1977). A Theory of the Size and Shape of Nations, *Journal of Political Economy*. 85: 59–77.
- Green Donald P. and Ian Shapiro (1994). *Pathologies of rational choice theory*. New Haven: Yale University Press.
- Grofman, Bernard (2004). Reflections on Public Choice, *Public Choice*. 118: 31–51.
- Grossmann Gene M. and Elhanan Helpman (1994). Protection for Sale, *American Economic Review*. 84: 833–850.
- Hagen, Jürgen von (1992). *Budgeting Procedures and Fiscal Performance in the European Communities*. Brussels: EEC.
- Hibbs, Douglas A. Jr. (1977). Political Parties and Macroeconomic Policy, *American Political Science Review*. 71: 1467–1487.
- Hillman, Arye L. (1989). *Political Economy of Protection*. Reading: Harwood Academic Publishers.
- Hylland, Aanund and Richard Zeckhauser (1979). A mechanism for selecting public goods when preferences must be elicited, *KSG Discussion Paper 70D*. Cambridge (Mass.): Harvard University.
- James, Harold, ed. (2002). *The Interwar Depression in an International Context. Schriften des Historischen Kollegs. Kolloquien 51*. München: Oldenbourg.
- Kirchgässner, Gebhard (1991). *Homo Oeconomicus. Das ökonomische Modell individuellen Verhaltens und seine Anwendung in den Wirtschafts- und Sozialwissenschaften*. Tübingen: Mohr.
- Kirchgässner, Gebhard (2002). Föderalismus und Staatsquote, in: Wagschal Uwe and Hans Rentsch (eds.), *Der Preis des Föderalismus*. Zürich: Orell Füssli: 70–91.
- Kuhn, Thomas S. (1962). *The Structure of Scientific Revolutions*. Chicago: University of Chicago Press.

- Lakatos, Imre (1970). *The methodology of scientific research programs: philosophical papers. Volume I*. New York: Cambridge University Press.
- Magee, Stephen P., William Brock and Leslie Young (1989). *Black Hole Tariffs and Endogenous Policy Theory*. Cambridge and New York: Cambridge University Press.
- Matsusaka, John G. (2005). Direct Democracy Works, *Journal of Economic Perspectives*. 19 (2): 185-206.
- Mitchell, William C. (2001). The old and new public choice: Chicago versus Virginia, in: William F. Shughart and Laura Razzolini (eds.), *The Elgar companion to public choice*. Cheltenham: Edward Elgar.
- Morgenthau, Hans J. (1948). *Politics Among Nations: The Struggle for Power and Peace*. New York: Knopf.
- Mueller, Dennis C. (1978). Voting by veto, *Journal of Public Economics*. 10: 57–75.
- Mueller, Dennis C. (1984). Voting by veto and majority rule, in: Hanusch, Horst, *Public finance and the quest for efficiency*. Detroit : Wayne State University Press: 69–86.
- Mueller, Dennis C. (1985). *The Virginia School of Public Choice*. mimeo.
- Mueller, Dennis C. (1996). *Constitutional Democracy*. New York: Oxford University Press.
- Mueller, Dennis C. (2003). *Public Choice III*. Cambridge and New York: Cambridge University Press.
- Nelson, Michael A. (1986). An Empirical Analysis of State and Local Government Tax Structures in the Context of the Leviathan Model of Government, *Public Choice*. 49: 283–294.
- Nelson, Michael A. (1987). Searching for Leviathan: Comment and Extension, *American Economic Review*. 77: 198–204.
- Nordhaus, William D. (1975). The Political Business Cycle, *Review of Economic Studies*. 42: 169–190.
- Oates, Wallace E. (1972). *Fiscal Federalism*. London: Harcourt Brace.
- Oates, Wallace E. (1985). Searching for Leviathan: an empirical study, *American Economic Review*. 75: 748–757.
- Oates, Wallace E. (1989). Searching for Leviathan: A Reply and Some Further Reflections, *American Economic Review*. 79: 578–583.
- Olson, Mancur (1965). *The Logic of Collective Action*. Cambridge, MA: Harvard University Press.
- Peltzman, Sam (1976). Toward a More General Theory of Regulation, *Journal of Law and Economics*. 19: 211–240.
- Persson, Torsten and Guido Tabellini (1990). *Macroeconomic Policy, Credibility and Politics*. Amsterdam: Harwood.
- Persson, Torsten and Guido Tabellini (1994). *Monetary and Fiscal Policy*. Volumes I and II. Cambridge, MA: MIT Press.
- Persson, Torsten and Guido Tabellini (1996). Federal fiscal constitutions: Risk sharing and moral hazard, *Econometrica*. 64: 623–646.
- Persson, Torsten and Guido Tabellini (2000). *Political Economics*. Cambridge: MIT Press.
- Persson, Torsten and Guido Tabellini (2002). Political Economics and Public Finance, in: Auerbach, Alan J. and Martin Feldstein (eds.), *Handbook of Public Economics*. Volume 3. Amsterdam: North Holland.
- Persson, Torsten and Guido Tabellini (2003). *The economic effects of constitutions*. Cambridge, MA: MIT Press.
- Persson, Torsten; Gerard Roland, and Guido Tabellini (1997). The theory of fiscal federalism: What does it mean for Europe?, in: Siebert, Horst (eds.), *Quo Vadis Europe?* Tübingen: Mohr: 23-41.
- Persson, Torsten; Gerard Roland, and Guido Tabellini (1998). Towards micropolitical foundations of Public Finance, *European Economic Review*. 42: 685–694.

- Pommerehne, Werner W. and Bruno S. Frey (1978). Bureaucratic Behavior in Democracy: A Case Stud., *Public Finance/Finances Publiques*. 33: 98-112.
- Pommerehne, Werner, Gebhard Kirchgässner, and Lars P. Feld (1996). Tax Harmonization and Tax Competition at state–local levels: Lessons from Switzerland, in: Pola, Giancarlo, Rosella Lebaggi and George France (eds.), *Developments in Local Government Finance. Theory and Policy*. Cheltenham: Edward Elgar: 292–330.
- Posner, Richard A. (1974). Theories of Economic Regulation, *Bell Journal of Economics and Management Science*. 5: 355–358.
- Reder, Melvin W. (1999). *Economics. The Culture of a Controversial Science*. Chicago and London: The University of Chicago Press.
- Riker, William H. (1962). *The Theory of Political Coalitions*. New Haven: Yale University Press.
- Riker, William H. and Peter C. Ordeshook (1968). A theory of the calculus of voting, *American Political Science Review*. 62: 25–42.
- Riker, William H., and Peter C. Ordeshook (1973). *An Introduction to Positive Political Theory*, Englewood Cliffs: Prentice-Hall.
- Rodrik, Dani (1995). Political Economy of Trade Policy, in: Grossman, Gene M. and Kenneth Rogoff (eds.), *Handbook of International Economics*. vol. III. North-Holland. Amsterdam. Chap. 28.
- Shleifer, Andrei and Robert W. Vishny (1999). *The Grabbing Hand: Government Pathologies and Their Cures*. Cambridge: Harvard University Press.
- Stegarescu, D. (2004), Public Sector Decentralization: Measurement Concepts and Recent International Trends, Working Paper, Centre for European Economic Research, Mannheim.
- Stratmann, Thomas (1992). The Effects of Logrolling on Congressional Voting, *American Economic Review*. 82: 1162–1176.
- Stratmann, Thomas (1995). Logrolling in the U.S. Congress, *Economic Inquiry*. 33: 441–456.
- Strauch, Rolf R. and Jürgen von Hagen (2000). *Institutions, Politics and Fiscal Policy*. Dordrecht: Kluwer.
- Tiebout, Charles M. (1956). A pure theory of local expenditures, *Journal of Political Economics*. 64: 416–424.
- Tullock, Gordon (1959). Some Problems of Majority Voting, *Journal of Political Economy*. 67: 571–79.
- Tullock, Gordon (1967). *Toward a Mathematics of Politics*. Ann Arbor: University of Michigan Press.
- Ursprung, Heinrich W. (2003). Where do we go from here?, in: Winer, Stanley L. and Hirofumi Shibata (eds.), *Political Economy and Public Finance*. Edward Elgar. Cheltenham, U.K., Northampton, (Mass.): 234–231.
- Voltaire (Arouet, François-Marie) 1759: *Candide, ou l'Optimisme*.
- Wallis, John J. and Wallace E. Oates (1991). Decentralization in the Public Sector: An Empirical Study of the State and Local Government, in: Wallace E. Oates (eds.), *Studies in Fiscal Federalism*. Aldershot: Edward Elgar: 107–130.
- Wei, Shang-Jin (1991). To Divide or to Unite: A Theory of Secessions. Unpublished Manuscript. University of California at Berkeley.
- Wicksell, Knut (1896). A new principle of just taxation, in: Richard A. Musgrave und Alan T. Peacock (1967), *Classics in the Theory of Public Finance*. New York: St. Marin's Press: 72-119.
- Wittman, Donald A. (1995). *The myth of democratic failure: why political institutions are efficient*. Chicago: University of Chicago Press.
- Wittman, Donald (2000). The Wealth and Size of Nations, *Journal of Conflict Resolution*. 44: 868–884.